

2018 FTA Annual Meeting

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PARTNERSHIP AUDIT REGULATIONS The Great Unknown

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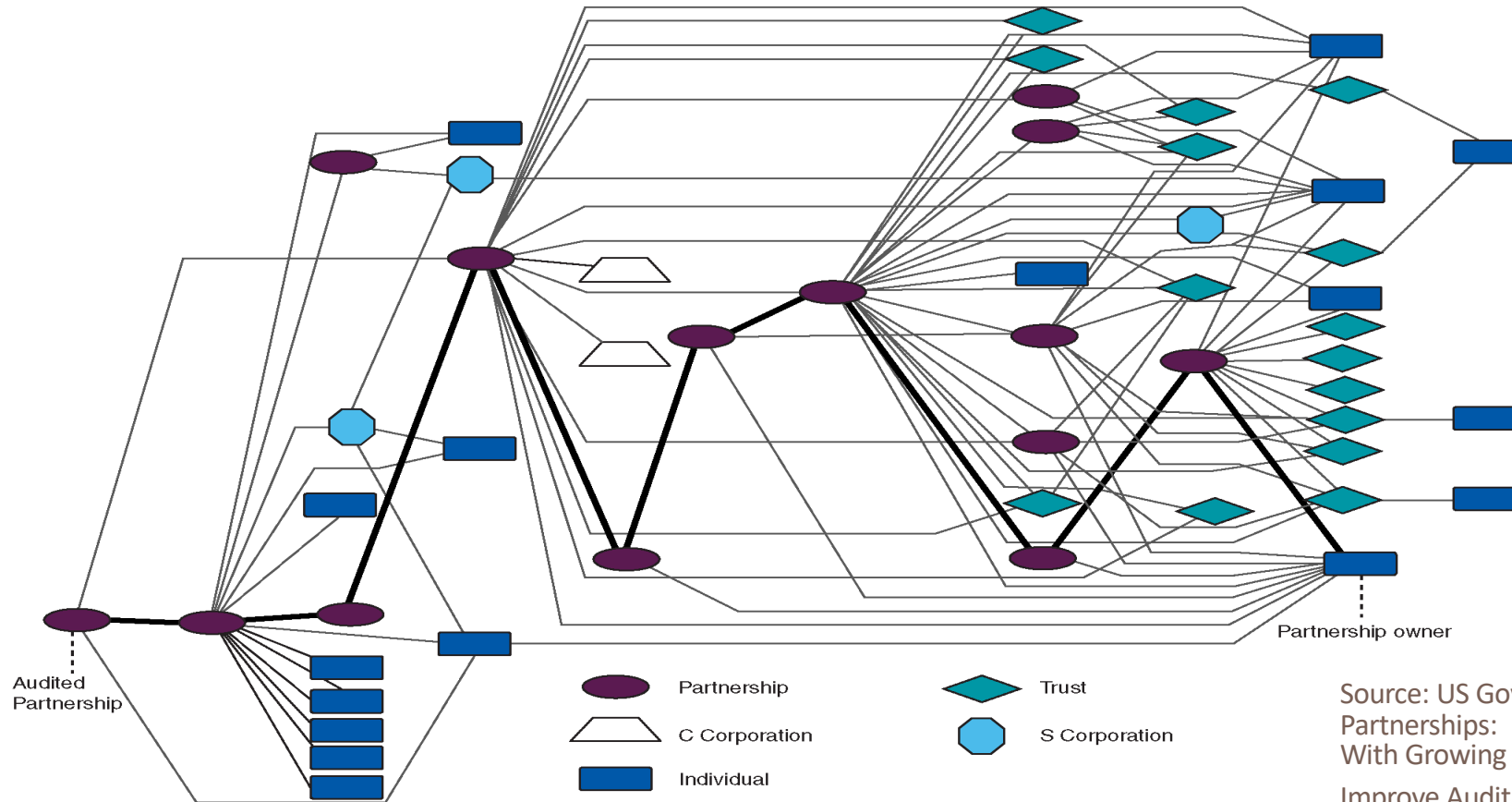
Partnership Audit Rules Background

- The Bipartisan Budget Act of 2015 adopted new IRS audit procedures for partnerships and LLCs
 - HR 1314 (P.L. 114-74) enacted in 2015, separate from 2017 tax reform legislation
- New audit rules apply to taxable years beginning after December 31, 2017
 - Option to elect into the new rules for earlier years
- Expected to raise additional tax revenue by enabling the IRS to more efficiently audit partnership 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.
- “Technical Corrections” adopted as part of the Consolidated Appropriations Act, 2018 (P.L. 115-141)

New Federal Partnership Audit Rules

Complex 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))

Centralized Audit Regime Overview

- Centralized Audit Regime Applies To All Partnerships and LLCs
 - All partnership and operating agreements for entities taxed as a partnership 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 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 partnership in IRS audit proceedings.
 - Important decisions: 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 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 and must be made when return is filed
 - Limitations on eligible partners for valid opt-out election to apply
 - **Voluntary Reporting During 270-Day Period: Section 6225 Reporting**
 - Partners affected by a reallocation must agree to file individual amended returns or similar reports; 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 with a lower maximum tax rate than the highest marginal rate (37% in 2018)
 - **The Pull-In Procedure:** Reviewed year partners can choose to pay the tax, make binding changes to their tax attributes for later years, and provide the IRS with the information necessary to substantiate that the tax was correctly computed and paid
 - **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
 - Tax on the adjustment is reported on the current year return

Centralized Audit Regime Timeline

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

1. IRS sends a Notice of Administrative Proceeding
2. After conducting audit, IRS sends 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 (voluntary reporting under Section 6225)

Centralized Audit Regime Timeline (cont.)

4. After 270 days, IRS sends its Final Proposed Adjustment (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 partnership representative's authority to make push-out election
 - Push-out election increases interest rate by 2 percent on imputed underpayment
6. OR, within 90 days of receiving the FPA, the partnership may file a petition for readjustment with the U.S. Tax Court, U.S. district courts, or the Court of Federal Claims








Statute of Limitations

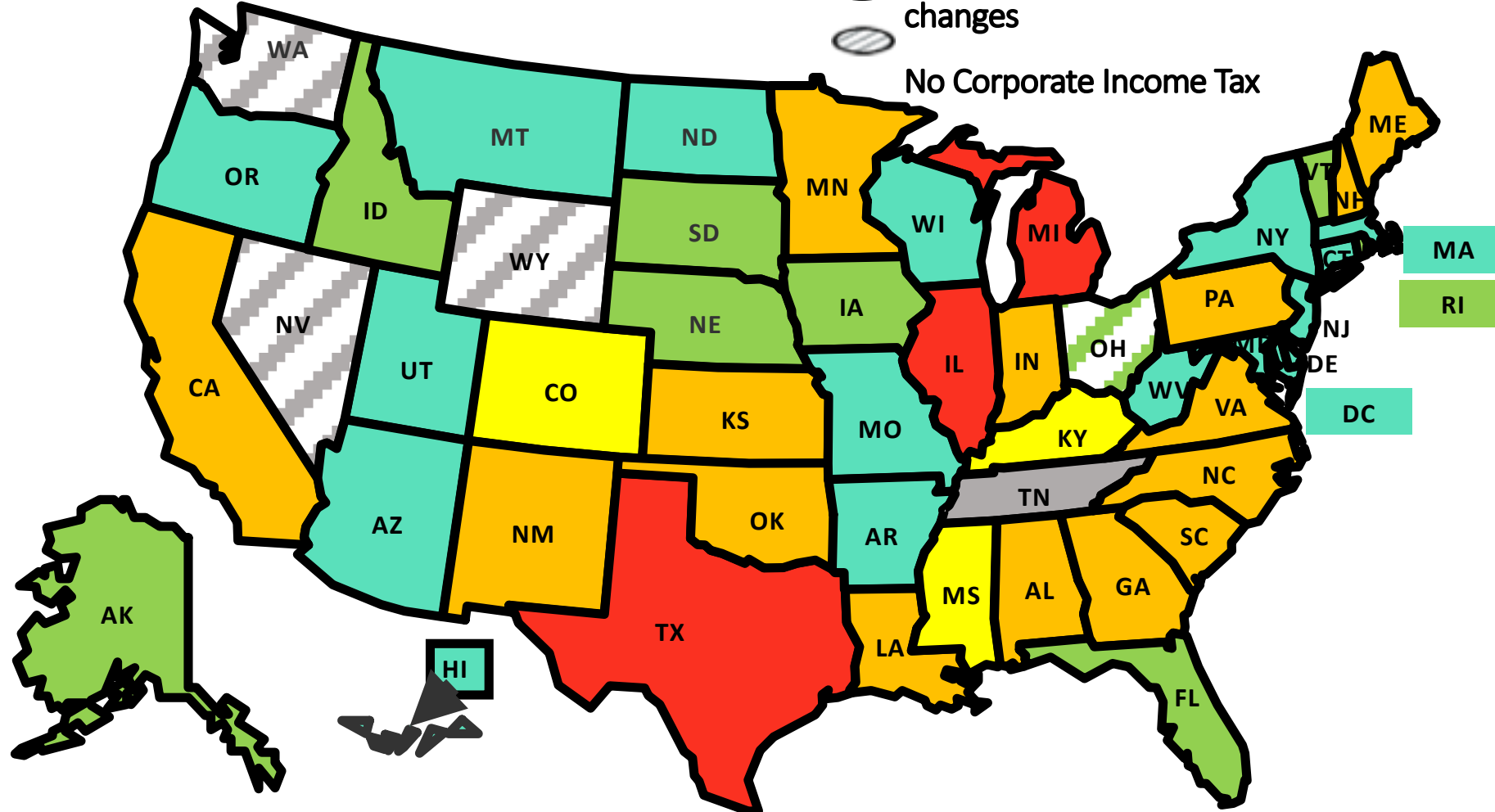
- The statute of limitations structure for auditing partnerships also significantly changed in light of the new centralized audit regime.
- Code Section 6235 provides a single partnership statute of limitations of 3 years after the later of:
 - (i) the date of filing the partnership return (IRS Form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

New Federal Partnership Audit Rules – State Impact

When Do Taxpayers Have to

File

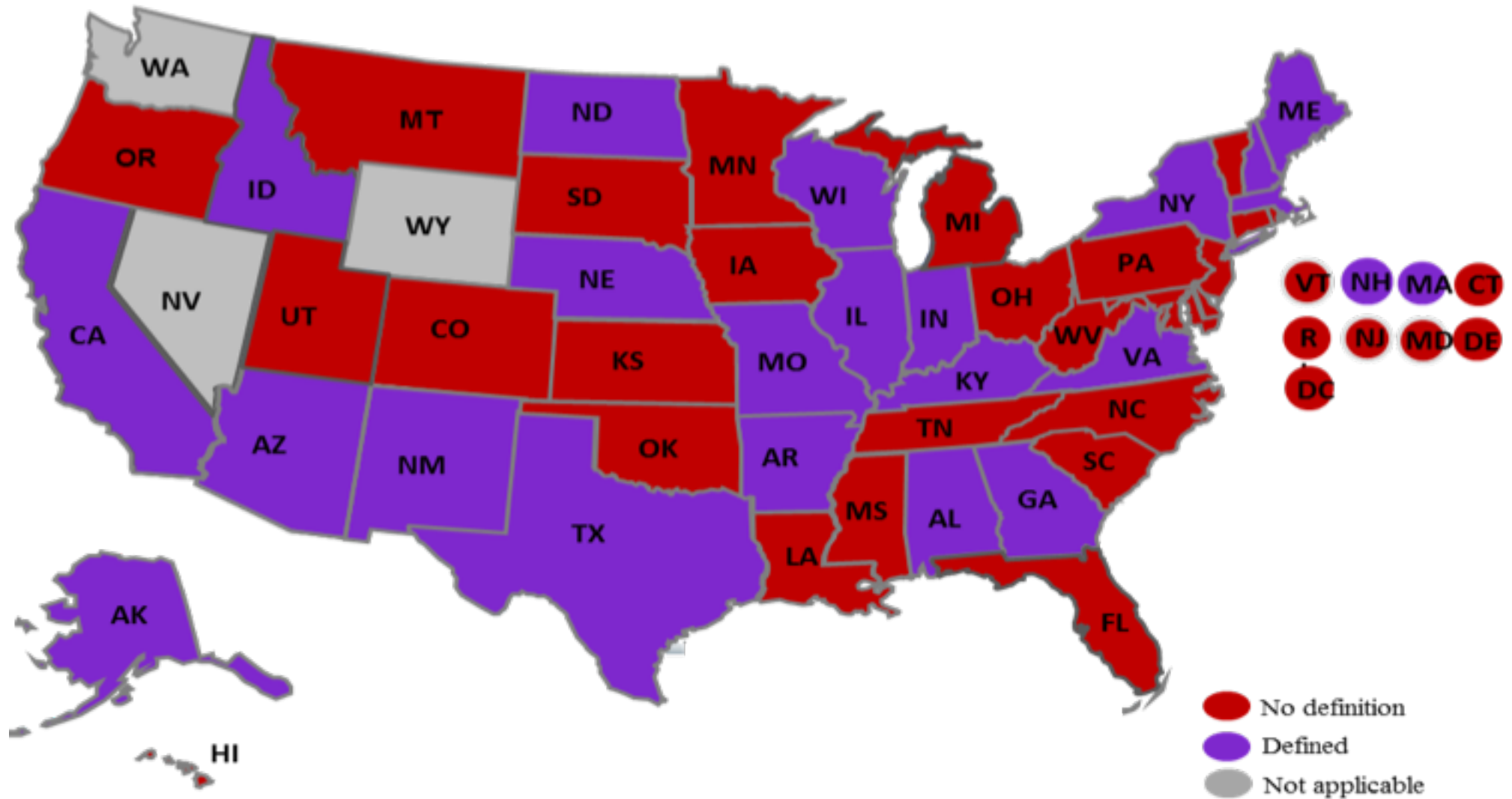
-  Report Changes within 30 days
-  Report Changes within 60 days
-  Report Changes within 90 days
-  Report Changes within 120 days
-  Report Changes within 180 days or longer
-  No statutory time limit to report federal changes
-  No Corporate Income Tax



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 with Definition of a “Final Determination”



Source: COST Administrative Scorecard, December 2016

Issues for States to Consider

- Conformity is not automatic
 - Most states conform to the IRC ***but only*** for the determination of taxable income, not for its administrative procedures – states usually have their own administrative procedures
- State statutes don't treat partnership as "taxpayer" (except for nonresident partner composite returns and withholding)
- Few states have their own partnership audit procedures
- Information sharing between IRS and states is unclear

More Issues...

- Will states accept the federal partnership representative?
- How will the partnership report federal changes to the states?
- Should partnerships and states be bound by federal elections?
- Unique state partnership issues:
 - Multistate income apportionment factor - Reviewed vs. Adjustment year
 - Unitary partnership – apportion/allocate at the partner level or partnership level
 - Partners that move between reviewed years and adjustment year
 - Credit for taxes paid to other states

And Still More Issues...

- Statutes of limitation and notices to partners
 - Relationship to existing state RAR statutes
- Adjustments that affect one partner vs. multiple partners
- Adjustments that affect other years
- Adjustments resulting in refunds
- Penalties and interest, collection of liabilities, due process?

State Issues In Depth – Procedural Considerations

- Issues the states need to address:
 - State procedural rules need to be amended to address the new federal 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
 - 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 Issues In Depth– Apportionment/Nexus Considerations

- At the federal level, the IRS can impose tax on 100% of any adjustment.
- For state purposes, that adjustment needs to be apportioned and/or allocated if the partnership is operating or doing business in multiple states
- Residents of a state typically pay tax on 100% of their income with a credit for taxes paid to other states.
- Many states use different apportionment rules for partnerships that are part of a unitary business with corporations
- If the partnership pays, the payment is being made on behalf of its partners.
 - Can the partnership's apportionment factor be used?
 - How do resident individual partners calculate their credits for taxes paid to other states?
 - Does the credit apply if the partnership paid the tax in another state?
- At the federal level, IRS has jurisdiction to collect tax from all partnerships and partners. States, however, may only impose and collect tax on taxpayers with nexus (pesky constitution!).

New Federal Partnership Audit Rules: State Responses

- MTC has an ongoing “Partnership Project” to study -
 - Do the states need to amend their tax laws to address new partnership audit procedures?
 - If so, how should those laws be revised?
 - How should the states deal with multiple-tiered entities?
 - Website: <http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project>
- Arizona enacted legislation in 2016
 - Arizona’s legislation does not comprehensively address federal changes (*e.g.*, fails to address tiered partnerships)
 - Will likely be amended at some point
- Five states proposed but did not pass legislation in 2017

New Federal Partnership Audit Rules: State Responses (cont.)

- State activities during 2018 legislative sessions*
 - Georgia – enacted HB 849
 - California – introduced SB 274 on April 9th – awaiting hearing/possible amendments
 - Minnesota – introduced HF 3411 on March 8th – Passed the House and Senate, governor vetoed legislation
 - Missouri – introduced SB 897 on January 8th – no action taken or expected this year
- No urgency - most other states have deferred action until 2019 legislative session
 - First returns subject to federal regime not filed until March 2019 (if extended, September 2019)
 - First IRS audits likely to begin in 2020, earliest completion date expected to be in 2021 or even 2022

*as of May 3, 2018

Interested Parties

- The Interested Parties include:
 - 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) to draft a model statute
- Note: The Draft Model Statute has not yet been formally endorsed by the Interested Parties or the MTC - it is a draft *for discussion purposes only*

Overview of Draft Model*

- 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

*as of May 3, 2018

Overview of Draft Model, cont.*

- 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

*as of May 3, 2018

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, the date on which the requests were filed

*as of May 3, 2018

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

*as of May 3, 2018

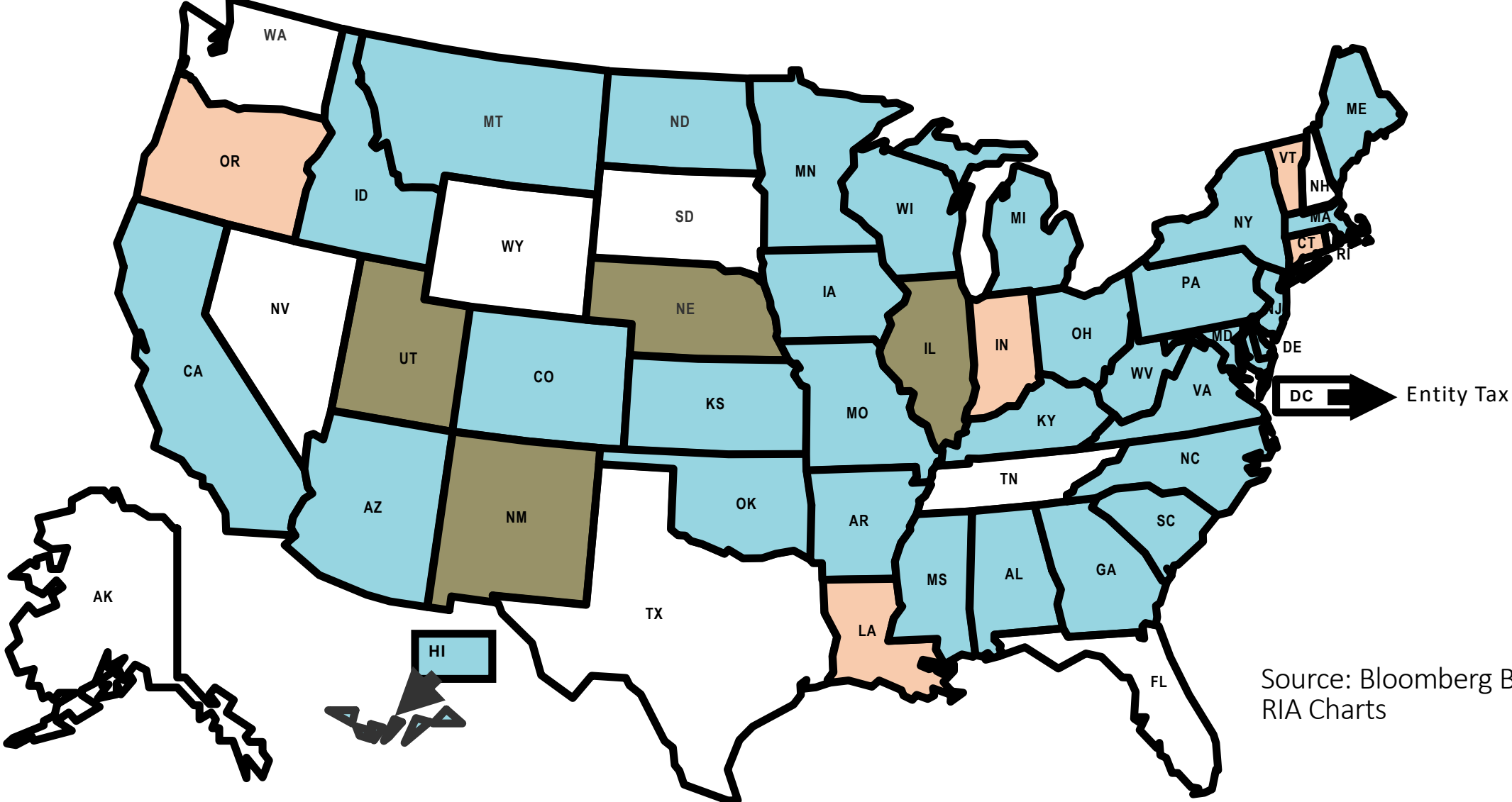
Key Partnership Definitions (cont.)*

- 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 shares of partnership-related items allocated to partners.
 - Partnership-related items are defined as any item or amount with respect to the partnership that is relevant in determining the income tax liability of any person and any partner's distributive share
 - Positive reallocation adjustments increase income owed by Partner
 - Negative reallocation adjustments decrease income owed by Partner

*as of May 3, 2018

Composite Returns for Individuals

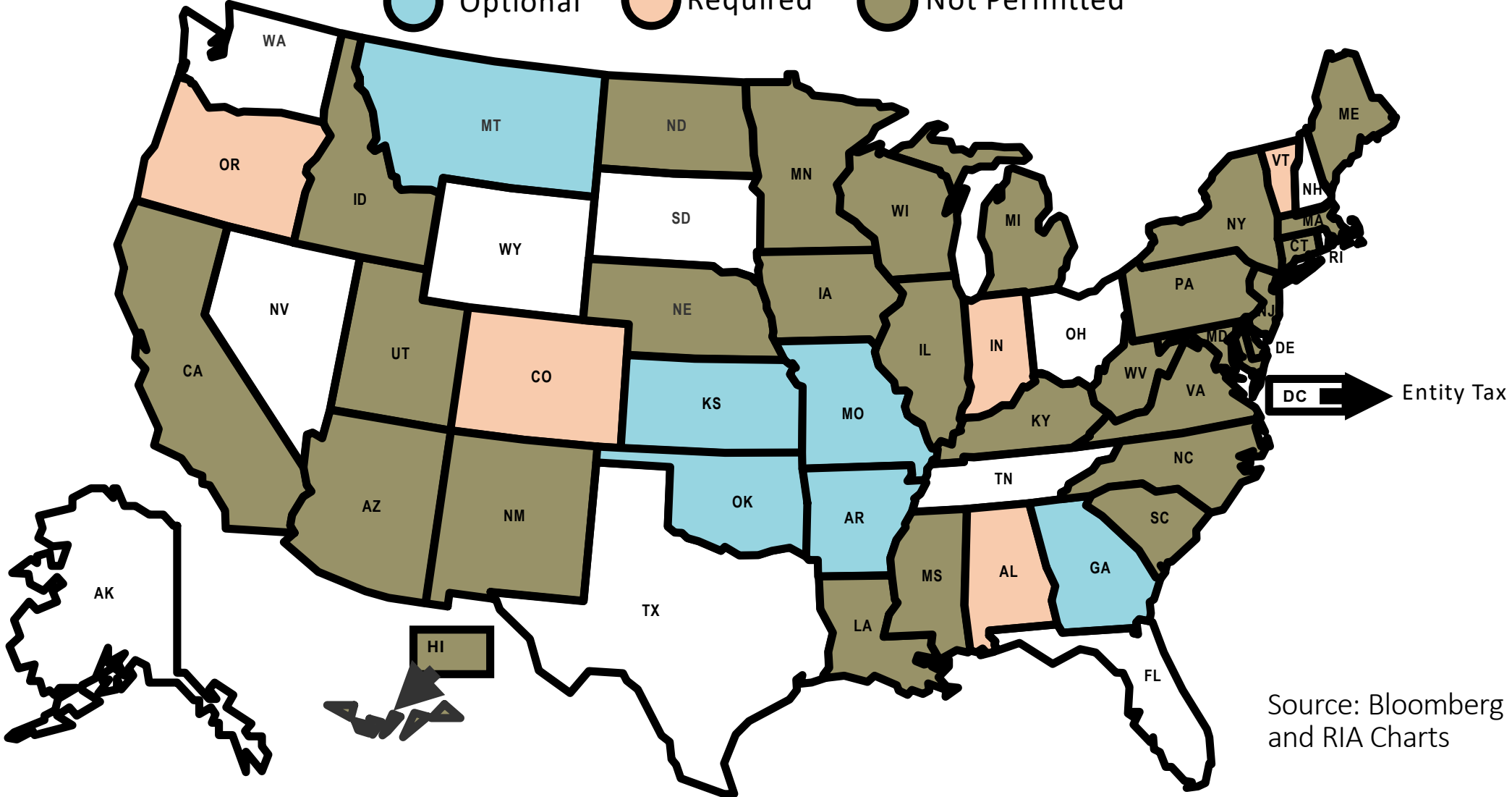
Optional Required Under Certain Circumstances Not Permitted



Source: Bloomberg BNA and RIA Charts

Composite Returns for Corporations

Optional Required* Not Permitted

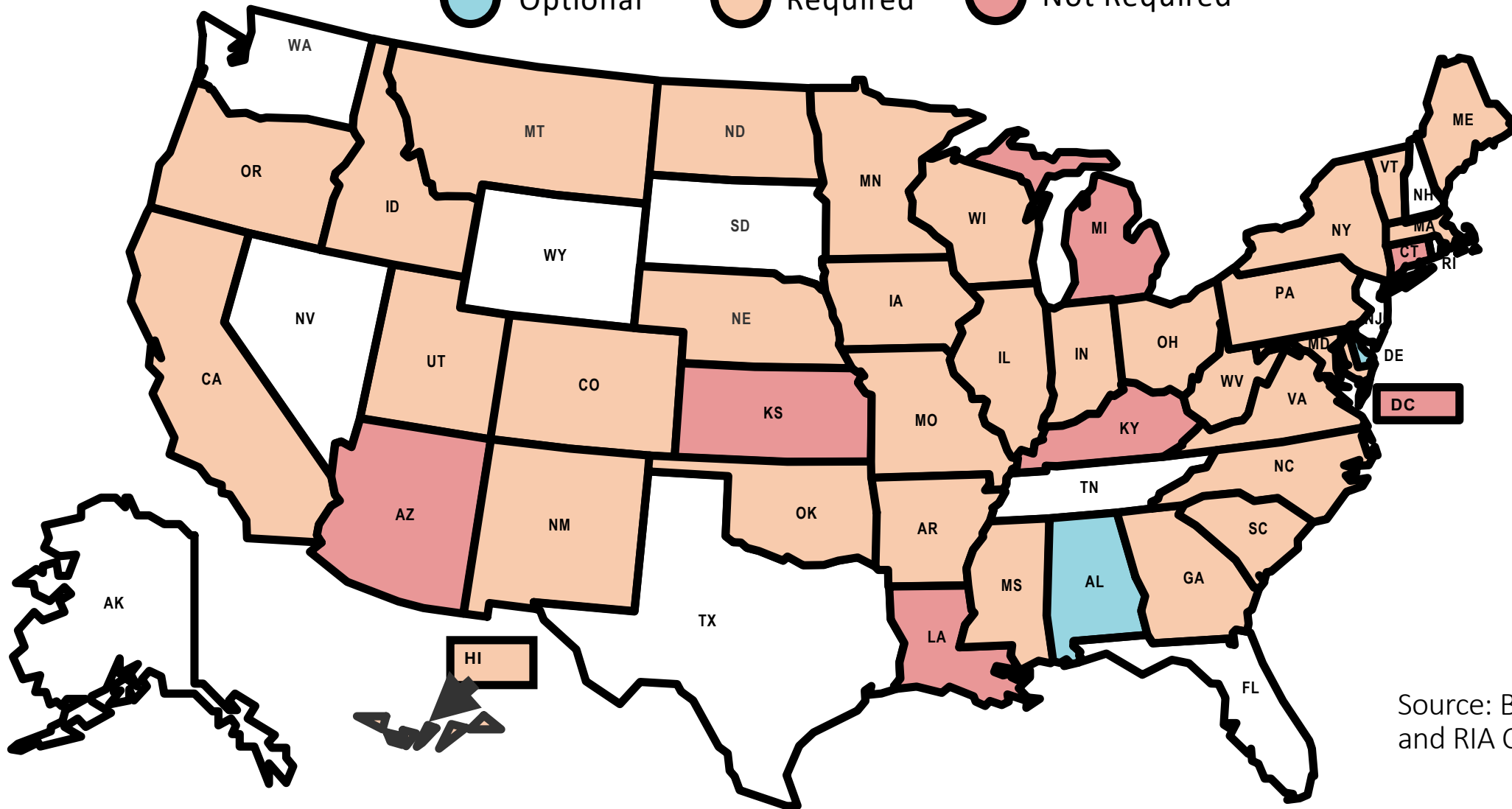


Source: Bloomberg BNA and RIA Charts

*Required returns may be limited to certain circumstances

Withholding for Individuals

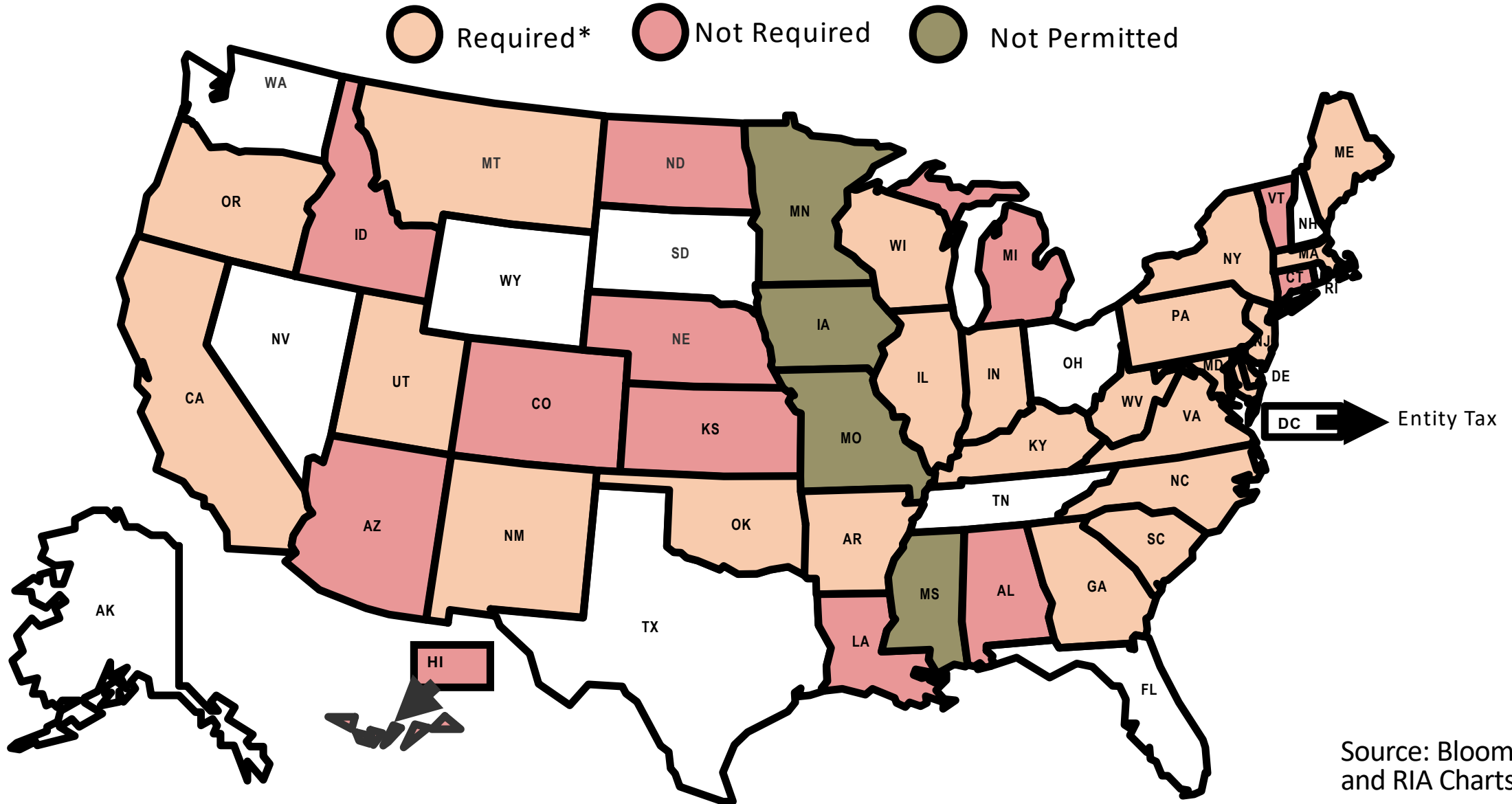
Optional Required* Not Required



Source: Bloomberg BNA and RIA Charts

*Required withholding may be limited to certain circumstances

Withholding for Corporations



*Required withholding may be limited to certain circumstances

Source: Bloomberg BNA and RIA Charts

State Default Rule*

- For reviewed years:
 - Within 90 days of the Final Determination Date, audited partnership shall:
 - File a Federal Adjustments Report with the state;
 - 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 shall:
 - File a Federal Adjustments Report with the state; and
 - Pay the additional tax, including penalty and interest, to the state (less any applicable credits)

*as of May 3, 2018

State Default Rule (cont.)*

- For Tiered Partners (and their Direct Partners)
 - Within 90 days after the date of federal deadline for tiered partners, the tiered partners and their direct partners shall:
 - Complete all the above reporting requirements; and
 - Make all payments
- Large Partnerships
 - Upon request, audited partnership or tiered partner with over 10,000 direct partners can request an additional 60-day extension
- State Partnership Representative
 - By default, the state partnership representative is the federal representative, but following state revenue agency procedures, a different representative can be used for a state(s)

*as of May 3, 2018

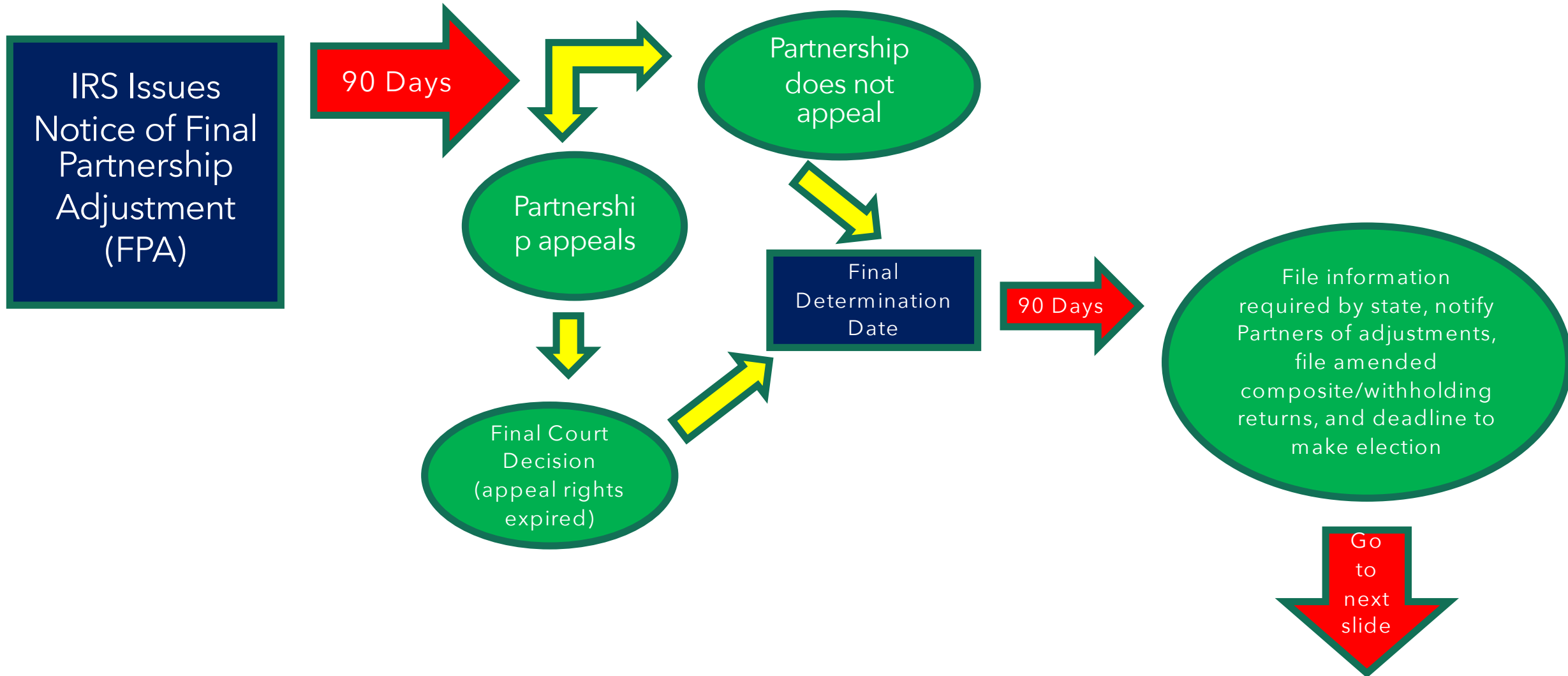
State Partnership Pays Election*

- Alternatively, audited partnership can make an election to pay the tax for reviewed year
 - 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 for its direct partners (and certain indirect resident partners) based on calculation prescribed in Draft Model Statute
- Tiered partners (and their direct partners) – eligible to make the election but are not subject to the interim time restrictions – they must finalize all elections, reporting, and payment of the tax within 90 days after the date of federal deadline
- This applies to all tiered partners (including their partners)
- Does not apply to partners that are members of a unitary group
- Federal deadline is extended due date of the audited partnership's return for the adjustment year

*as of May 3, 2018

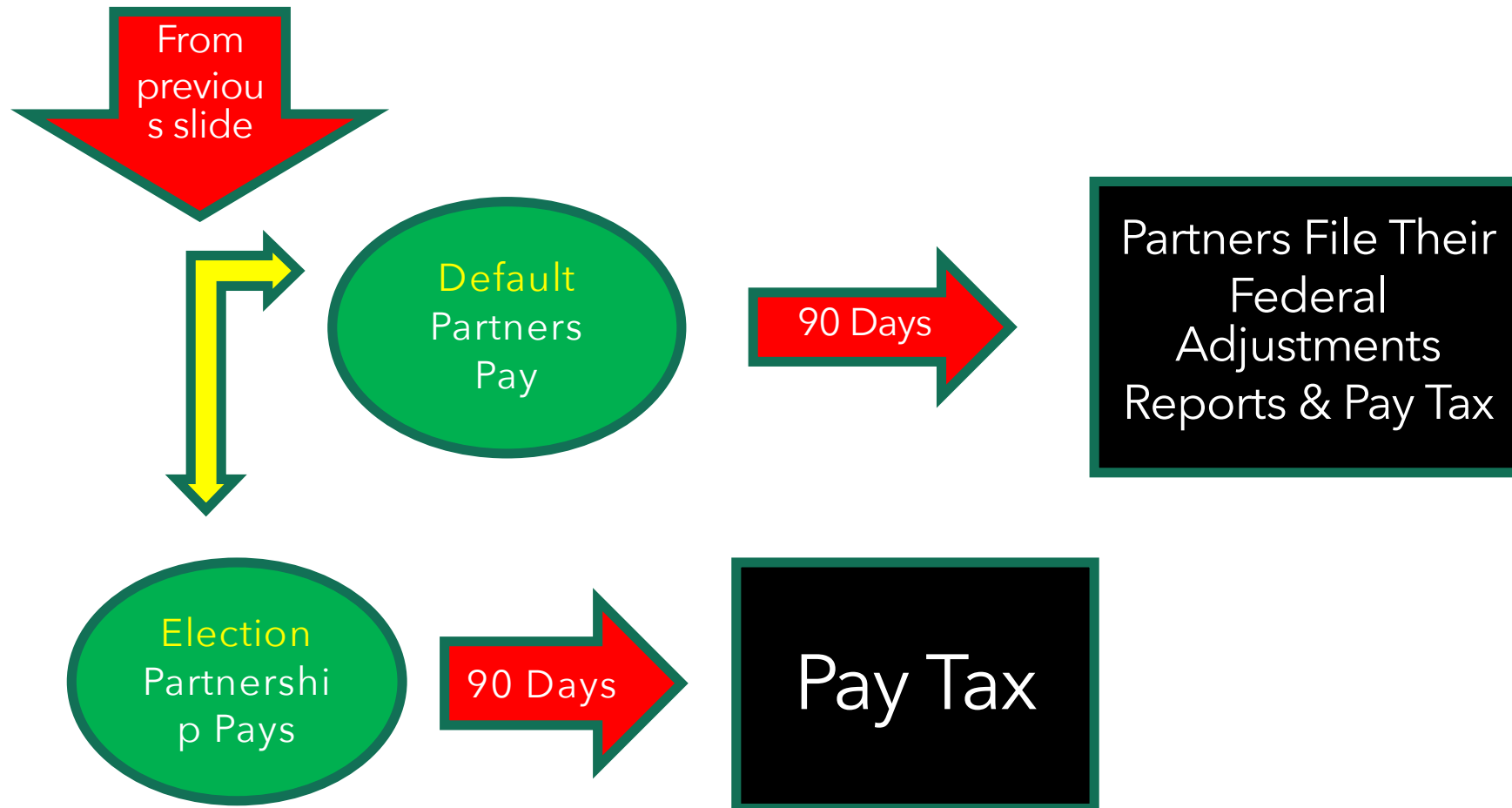
Flow Chart Following Federal Partnership Audit Adjustment

Slide 1 (Reflects timing for Audited Partnership only)



Flow Chart Following Federal Partnership Audit Adjustment

Slide 2 (Reflects timing for Audited Partnership only)



Alternative Election by Mutual Agreement*

- To address unique situations, the Draft Model Statute allows the audited partnership or tiered partners to enter into a mutual agreement with the state revenue agency
 - Can agree to use:
 - A different reporting method
 - A different payment method
 - Audited partnership & tiered partners must demonstrate requested method is reasonable

*as of May 3, 2018

Open Issues and Next Steps*

- In April 2018, the MTC's Uniformity Committee voted to have the Partnership Project continue studying and refining the state partnership pays election with respect to adjustments attributable to indirect partners.
 - Options include limiting the use of this election, for example, by eliminating the state partnership pays election for partnerships with passive investment income
- The MTC and Interested Parties hope to have the Partnership Project finalize a model statute in 2018, at which point it will be referred for a public hearing.
- State legislatures will likely consider enacting state partnership audit statutes during their 2019 and 2020 legislative sessions

Federal Audit Reporting Process	Draft Interested Parties/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 similar report to remit tax	Partnership can remit tax using specified apportionment/allocation rules with tax calculated at highest individual/corporate income tax rates
Has option for partnership to “push-out” tax to review year partners to remit the tax when they file their amended 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?