REPORT OF THE HEARING OFFICER

to the

MULTISTATE TAX COMMISSION
EXECUTIVE COMMITTEE

on the

PROPOSED MODEL UNIFORM STATUTE FOR REPORTING ADJUSTMENTS TO FEDERAL TAXABLE INCOME AND FEDERAL PARTNERSHIP AUDIT ADJUSTMENTS

from the

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TABLE OF CONTENTS

1
Introduction and Executive Summary 4
General Background 5
Terminology Used in this Report 5
Note on Federal Statutory and Regulatory Changes 6
Need for the Model - Generally 6
Summary of the Process Creating the Proposed Model 7
Federal Partnership Audit Changes 8
The Basics of Partnership Taxation Under Subchapter K 8
Potential Audit Issues 9
Need for Partnership Audits 10
Audit Difficulties 10
Summary of the Federal Centralized Partnership Audit Regime 11
The audit is conducted at the entity level through a partnership representative 11
The Adjustments are determined and tax is calculated at the entity level 11
Modifications to the audit adjustments and imputed underpayment 12
Final partnership adjustments and partnership payment or push-out election 13
Key Provisions of the Proposed Model – Generally 14
Alternative Forms for Reporting 14

Final Determination Date 14
General Filing Deadline 14
De Minimis Amount 14
Estimated Payments 14
Key Partnership-Related Provisions - Summary 15
State Partnership Representative 15
Adjustments Taken Into Account During Modification Period – Amended Return 15
Partnership-Pays Election – State Issues 16
Partnership-Pays Election – Approach Taken by the Proposed Model 17
Optional Election 20
Hearing Officer Comments and Recommendations 21

INTRODUCTION AND EXECUTIVE SUMMARY

On September 12, 2018, the Multistate Tax Commission's Executive Committee voted to have a public hearing on the proposed Model Uniform Statute for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments ("the proposed model"). The Commission's Executive Director appointed me to conduct that hearing, which was held October 15, 2018.[1] The proposed model is set out in Appendix A to this report.[2]

The model, if adopted, would replace the 2003 Model Uniform Statute for Reporting Federal Tax Adjustments. That model is included in Appendix B to this report.

The Commission received written comments endorsing the model from the following groups: the ABA Tax Section, the Master Limited Partnership Association, the Tax Executives Institute, Inc., the AICPA, and the Council on State Taxation. The Commission also received comments from the Commissioner of Revenue of the Minnesota Department of Revenue recommending drafter's notes. No other comments were received at the public hearing. Copies of the written comments are included in Appendix C to this report.

The Hearing Officer recommends that the model be adopted with drafter's notes as an introduction. Those drafter's notes are included in this report as part of the Hearing Officer's recommendations at pages 21-25.

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[1] I was also the chief staff person on this project.

[2] Note that the information related to the drafting of the model, including previous versions of the model, issue lists, staff analysis, presentations and articles, federal statutory information, proposed IRS regulations, and more is on the Commission's website, on the partnership project page, here: www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project.

GENERAL BACKGROUND

TERMINOLOGY USED IN THIS REPORT

The proposed model defines certain operative terms. But when used in this report, generally, the terms below have the following meaning:

- Partnership – a business subject to IRC Subchapter K (e.g. limited partnerships, limited liability partnerships, limited liability companies, certain publicly traded partnerships, etc., but not S corporations).
- Partnership tax item – an item determined under federal tax rules that goes into calculation of income, gain, or loss on a partnership return.
- Allocate (or allocation of) a share of partnership item(s) – refers to the determination of a partner's distributive share of partnership tax items.
- Taxpaying partners – partners (or owners) who, themselves, are subject to tax (e.g. individuals, corporations, taxable trusts, etc.).
- Residency – the tax status of an individual in a particular state whether based on domicile or as determined under statutory residency rules.
- Tiered partners or partnership structures – any partnership structure in which a partnership has partners that are also partnerships.
- Allocation or apportionment – generally, the rules used by a particular state to source business income – also "sourcing."
- Nexus – the authority to impose tax or tax-reporting requirements on the partners or the partnership.
- Partnership return – either the federal form 1065 (for reporting partnership income, expense, gains, losses, etc.) or its state equivalent.
- Schedule K-1 – either the federal form for allocating a share of partnership items to the partners for tax purposes, of its state equivalent.
- Withholding – the requirement for partnerships to withhold the taxes owed by nonresident taxpaying partners.
- Composite return – a return filed by the partnership reporting the income taxes owed by nonresident taxpaying partners, the payment of which relieves those partners from separate filing requirements.

NOTE ON FEDERAL STATUTORY AND REGULATORY CHANGES

At the end of 2015, Congress passed the Bipartisan Budget Act which provided for the new centralized partnership audit regime. In 2016, Congress made technical corrections to provisions of the 2015 act. The IRS has issued a series of proposed regulations to implement the provisions of these acts. The IRS has not yet addressed all issues and the proposed regulations may change. (As noted in the introduction, copies of the federal statutes and proposed IRS regulations are available on the project page on the Commission's website.)

NEED FOR THE MODEL - GENERALLY

States that conform, in whole or in part, to federal tax law in computing the items that go into the calculation of taxable income must anticipate that adjustments to those items may result from audits or taxpayer amendments. States, therefore, generally provide a process for taxpayers to report and pay state taxes (or claim refunds) when such federal adjustments occur.

For multistate taxpayers, this process can be complicated because state rules and timelines vary considerably. The Commission adopted a Model Uniform Statute for Reporting Federal Tax Adjustments in 2003 ("the 2003 model"), but no states have fully conformed to that model. The Uniformity Committee agreed that the 2003 model should be updated. Accordingly, the proposed model modifies the general provisions of the 2003 model.

The main focus of the proposed model, however, is Section C, which addresses adjustments resulting from the new federal centralized partnership audit regime. States ordinarily impose filing and payment requirements on taxpayers when they have either filed an amended return or received an assessment of tax (or notice of adjustment) from the IRS. But federal tax on partnership audit adjustments may be assessed and paid without the taxpaying partners filing amended returns or receiving assessments (as will be discussed further in the report). Therefore, states will need additional authority, as well as a process, for assessing state taxes on federal partnership audit adjustments.

SUMMARY OF THE PROCESS CREATING THE PROPOSED MODEL

In early 2016, the Uniformity Committee under the direction of the then Chair, Wood Miller of Missouri, convened an informational project to help members understand the new federal centralized partnership audit regime. The committee heard a U.S. Treasury Department researcher who explained the need for better audit tools to address large, complex partnerships, and predicted that that the new process would produce significant federal adjustments.

In July 2016, the Uniformity Committee voted to form a work group to draft a model provisions requiring reporting and payment of state tax on federal partnership audit adjustments. The committee received a proposal from the "interested parties" to incorporate the provisions necessary for this purpose into a modified version of the 2003 model. (The interested parties include: the Council on State Taxation (COST), the Tax Executives Institute (TEI), the ABA SALT section (ABA), and the AICPA SALT committee (AICPA), the Professionals in Taxation (IPT), and others.) Sheldon Laskin, counsel to the Commission, analyzed the proposed modifications to the 2003 model and gave a report at the March 2017 committee meeting that was generally favorable. The committee also received a suggestion that it consider the issues involved in imposing tax on partnerships at the entity level, as opposed to the partner-level. The committee voted to have the work group consider both proposals.

In July 2017, the interested parties presented the Uniformity Committee with a draft model statute and the committee, under the current Chair, Holly Coon of Alabama, voted to consider that draft and make any changes the work group might deem necessary. The partnership work group held periodic calls, under the leadership of Tracee Abel of Montana and Katie Lolley of Oregon to discuss issues affecting state assessment of tax. Substantial changes were made to the draft model statute and a final version was presented to the Uniformity Committee at its July 2018 in-person meeting. That version of the model was approved for referral to the Executive Committee.

FEDERAL PARTNERSHIP AUDIT CHANGES

This section provides background on the new federal centralized partnership audit process and how it is expected to work.

THE BASICS OF PARTNERSHIP TAXATION UNDER SUBCHAPTER K

To understand the new federal centralized partnership audit process, it is necessary to understand the basics of partnerships and partnership taxation. The partners relationship to the partnership and to each other is governed by their agreement and by state law. Under state law, a partnership may be both an entity and an aggregate of individual partners. Partnership taxation is generally governed by IRC Subchapter K.

Subchapter K respects the hybrid legal status of partnerships. The character of tax items is determined at the entity level each year (e.g. whether income is recognized or deferred, whether it is ordinary or capital gains, whether expenses are deductible or must be capitalized and depreciated, etc.). Tax items retain their character as they flow through from the partnership to the taxpaying partners. The partnership allocates the partnership tax items to the taxpaying partners according to their agreement. The partners may agree to allocate different partnership items differently, and need not allocate them according to the value of partnership interests, provided the allocations conform to various rules designed to make sure they have economic effect.

Only one level of tax is imposed on partnership income. Therefore, contributions to and distributions from the partnership are generally not taxable—provided that one level of tax has been previously been paid. For this reason, the partnership must track the tax basis in partners' partnership interests and partnership assets. Each year, the determination of partnership tax items and the allocation of a share of those items to the partners will, in turn, have an effect on these basis calculations. (For example, the allocation of income to partner increases their basis in their partnership interests.) The annual tax calculations can also affect other tax attributes at the partnership level.

POTENTIAL AUDIT ISSUES

In a post entitled: Abusive Tax Shelters Again on the IRS "Dirty Dozen" List of Tax Scams for the 2016 Filing Season," the IRS notes:

> Multiple flow-through entities are commonly used as part of a taxpayer's scheme to evade taxes. These schemes may use Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), International Business Companies (IBCs), foreign financial accounts, offshore credit/debit cards and other similar instruments. They are designed to conceal the true nature and ownership of the taxable income and/or assets.[3]

Even where tax shelters or other questionable tax schemes are not an issue, the application of Subchapter K can give rise to a number of partnership audit issues. Those issues fall into three basic categories:

- The partnership may incorrectly characterize or calculate partnership tax items (e.g. classifying the sale of an asset as capital gain when, instead, it should be treated as ordinary income, etc.).
- The partnership may improperly allocate the partnership's tax items (e.g. where the partnership allocates a greater share of income to a partner with a lower effective tax rate but only because it will later allocated a greater share of losses to off-set the economic effect of the income allocations).
- Transactions between the partners or between a partner and the partnership may not be properly characterized (e.g. two partners may use a partnership to engage in a "disguised sale," where one partner makes a nontaxable contribution of property and the other a non-taxable contribution of cash, followed by a distribution of the property to the second partner and the cash to the first).

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[3] Available at: https://www.irs.gov/newsroom/abusive-tax-shelters-again-on-the-irs-dirty-dozen-list-of-tax-scams-for-the-2016-filing-season.

NEED FOR PARTNERSHIP AUDITS

In 2014, the Government Accountability Office published a report. It noted:

> The number of large partnerships has more than tripled to 10,099 from tax year 2002 to 2011. Almost two-thirds of large partnerships had more than 1,000 direct and indirect partners, had six or more tiers and/or self reported being in the finance and insurance sector, with many being investment funds.[4]

According to the report, "there has been a dramatic shift in the way American businesses organize and pay taxes." That shift has been away from C corporations that are subject to the corporate income tax and toward entities, like partnerships, that are not.[5] In 2011, nearly two-thirds of large partnerships had 1,000 or more direct and indirect partners. Hundreds of large partnerships had more than 100,000 partners.[6] Furthermore, the report found that more than two-thirds of large partnerships were situated within tiered structures involving 100 or more pass-through entities and 36 percent had at least 1,000 or more pass-through entities as direct and indirect partners.[7] Most of these large, complex partnerships operate in the financial and real estate sectors.[8]

AUDIT DIFFICULTIES

In the past, if the IRS wished to audit partnership items, it generally had to trace any potential adjustments from the partnership through to one or more individual taxpaying partners as part of the audit of those partners, resolving any issues at the partner level. This made audits of the biggest and most complex partnerships impossible.

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[4] Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency, Sept. 2014, Summary, available here: http://www.gao.gov/products/GAO-14-732.
[5] Id. p. 1.
[6] Id. p. 15.
[7] Id. p. 16.
[8] Id. p. 18.

SUMMARY OF THE FEDERAL CENTRALIZED PARTNERSHIP AUDIT REGIME

The new federal partnership audit rules effectively shift the administrative burden of an audit from the IRS to the partnership. The partnership itself will have to pay tax on any adjustments unless it shows that tax has been properly paid by the partners, or arranges for them to pay the tax. If the partnership pays the tax, the amount will generally be greater because of the way in which it is computed. (This partnership tax expense would then be taken into account by the partners through their agreement.) Small partnerships may elect out of the centralized partnership audit regime. Partnerships that cannot elect out are those with more than 100 partners or multiple pass-through tiers.

The following is a summary of important elements of the new process.

THE AUDIT IS CONDUCTED AT THE ENTITY LEVEL THROUGH A PARTNERSHIP REPRESENTATIVE

The centralized audit will be conducted entirely at the partnership level through a partnership representative, designated by the partnership, who will make all audit-related decisions. While the partners may direct the partnership representative, the IRS will deal solely with that person and has no obligation to notify or confer with the partners themselves. It is up to the partnership representative to see that the administrative work required by the audit is done.

THE ADJUSTMENTS ARE DETERMINED AND TAX IS CALCULATED AT THE ENTITY LEVEL

The scope of the centralized audit is broad and may determine adjustments to partnership items, allocations of partnership items, or transactions between the partners or between a partner and the partnership. The audit will compute an entity-level tax amount called an "imputed underpayment." The imputed underpayment is determined following specific rules for that purpose. The IRS may net some types of positive and negative adjustments. But reallocation adjustments, where the shares of tax items are redistributed among the partners, will not be netted. Instead, the portion of reallocation adjustment that represents under-allocated taxable income—so that it would increase the tax owed by one or more partners—will be included in the partnership's imputed underpayment, while the portion representing over-allocated taxable income—so

that it would decrease the taxes owed by one or more partners—will flow through and be reported on tax returns in the "adjustment year" (the year the adjustments are final under IRC §6225(d)(2)).

For states that conform to federal partnership tax rules, the portion of a reallocation adjustment that flows through and is reported in adjustment year federal tax returns will also reduce state taxes for the affected partners in that same year. This treatment is also given to other adjustments that do not result in additional tax—that is, they are reported on the tax returns for the partnership and the partners in the adjustment year. (See IRC §6225(a)(2).)

As for the tax rate to be applied in computing the federal imputed underpayment, the IRS will use the highest marginal rate. It may also split adjustments into multiple imputed underpayments in order to facilitate their resolution.

MODIFICATIONS TO THE AUDIT ADJUSTMENTS AND IMPUTED UNDERPAYMENT

At the end of the normal audit process, the IRS must issue something called a notice of proposed partnership adjustment—setting out the specific audit adjustments as well as the proposed imputed underpayment (partnership-level tax). Then, the IRS must allow a 270-day period in which certain specific modifications to the proposed imputed underpayment may be made. The IRS has proposed regulations listing those modifications. For example, the IRS will make modifications to the tax rate to be applied in computing the imputed underpayment if the partnership representative shows that some portion of the adjustments would ultimately flow to non-taxable partners.

The most important modification for state purposes is the one that is provided for partners who file amended returns reporting their share of audit adjustments and paying taxes due. Alternatively, the partnership may follow a new procedure to collectively report tax on adjustments on a partner-by-partner basis, paying the taxes due by those partners. (This is called the "pull-in" process.) When either of these modifications occurs, the final audit adjustments and the imputed underpayment will be reduced accordingly.

The IRS has recently indicated that it expects that the partnership representative may be able to provide information during the modification period to show that certain adjustments (e.g. reallocation adjustments) would not result in additional tax due, or perhaps, that special allocations (where items are allocated other than in accordance with the value of partnership interests) had substantial economic effect and should therefore be respected.

FINAL PARTNERSHIP ADJUSTMENTS AND PARTNERSHIP PAYMENT OR PUSH-OUT ELECTION

At the end of the 270-day modification period, assuming there is still some portion of the audit adjustments on which tax must be assessed, the IRS will issue a notice of final partnership adjustment. The partnership must then either pay the entity-level tax represented by the modified imputed underpayment or, alternatively, it can elect to "push-out" the audit adjustments to its partners. If the audited partnership, or one of its partnership partners, makes the push-out election, the tax due from the partners will not be reported on amended returns for the audit year, nor will it be assessed to the partners by the IRS. Instead, the partnership will provide an information report, similar to a Schedule K-1, to the partners setting out their share of specific adjustments and giving them information necessary to compute the tax owed. That tax will be computed and reported by each partner as an "other tax" item on the partner's return in that adjustment year.

In summary, the federal tax on partnership audit adjustments may be assessed and paid in essentially three ways:

- Some or all of the adjustments may be reported by one or more partners during the 270-day period (with or without amending federal returns);
- The final imputed underpayment may be paid by the partnership; or
- The adjustments may be pushed out to partners who will report the related tax on adjustment-year returns as a separate "other tax" item.

Finally, if the partnership representative successfully contests adjustments through appeals or the courts, taxes paid may be refunded.

KEY PROVISIONS OF THE PROPOSED MODEL – GENERALLY

ALTERNATIVE FORMS FOR REPORTING

The proposed model provides for a "federal adjustments report," Section A(7), which might include, in addition to amended state tax returns, various other methods or forms for reporting federal adjustments to the state.

FINAL DETERMINATION DATE

The proposed model uses the "final determination date" as the date from which any deadline for filing and paying state taxes begins to run. See Section A(9). If the adjustment arises from an IRS action or audit, then the final determination date is the date on which all adjustments have been resolved, through agreement or, if contested, by a final decision with respect to which all rights of appeal have been waived or exhausted. If an audit adjustment relates to a combined or consolidated group, the final determination date is occurs when all adjustments for all group members have been resolved. For adjustments arising from a taxpayer's filing of an amended federal return (including any similar filing during a partnership audit), or a federal refund claim, or an Administrative Adjustment Request, the final determination date is the date of that filing.

GENERAL FILING DEADLINE

Except for partnership audit adjustments, taxpayers have 180 days from the final determination date to report and pay state taxes. Section B.

DE MINIMIS AMOUNT

The state agency is given the authority to promulgate regulations to establish a de minimis amount under which no state filing is required. Section D.

ESTIMATED PAYMENTS

When there is a pending IRS audit, taxpayers are given the right to make estimated payments of the state taxes that are expected to result from any audit adjustments, tolling interest accrual. Section F.

KEY PARTNERSHIP-RELATED PROVISIONS - SUMMARY

This section of the report summarizes the provisions of the proposed model that govern reporting federal partnership audit adjustments.

STATE PARTNERSHIP REPRESENTATIVE

A partnership is allowed to appoint a state partnership representative. If it does not, then the federal partnership representative serve in that role. The state partnership representative is required to handle matters involving state reporting of federal centralized partnership audit adjustments. Section C(1).

ADJUSTMENTS TAKEN INTO ACCOUNT DURING MODIFICATION PERIOD – AMENDED RETURN

Under the proposed model, a state filing requirement is triggered if one or more partners reports audit adjustments and pays tax on adjustments during the 270-day period, either by filing amended returns or through the pull-in process that the IRS sets up. In that case, partners are required to report and pay taxes, penalties and interest no later than 180 days after the final determination date – which in this case is the date the partner filed the amended federal return or the partnership filed a pull-in report including that partner. Section B and Section A(9)(c).

ADJUSTMENTS REMAINING AFTER MODIFICATION PERIOD – DEFAULT RULE

Under the proposed model, if any adjustments remain after the 270-day period, there is a default rule for reporting state taxes owed, regardless of whether the partnership paid the federal tax or elected to push out the adjustments at the federal level. The default rule requires the audited partnership and its direct and indirect partners, including any partners that are partnerships, to file amended state returns, report their share of adjustments, and pay any taxes, penalty and interest, following the general state rules. This must be done by a deadline starting at the date when all federal adjustments are final. At that point, the audited partnership has 90 days to file a report notifying the state of the federal adjustments. The partnership and the partners then have 180 days to file amended returns. If the state imposes a withholding reports or composite

return requirements, then the partnership would also have to file amended reports or returns and pay the associated tax. Section C(2).

PARTNERSHIP-PAYS ELECTION – STATE ISSUES

The proposed model also provides for a partnership-pays election at the state level. Section C(3). The reason this was deemed necessary is because there will be cases in which it is administratively burdensome, relative to the amounts owed, for individual partners to file separate amended returns in each state where they might owe taxes. For example, an audited partnership is likely to have at least 1,000 partners. So, an adjustment that changes taxable partnership income by $10 million might translate to approximately $500,000 in total state taxes owed by the partners. Divided by 1,000 partners, this is an average multistate liability of $500 per partner. But assuming the partnership does business in 10 states, the average liability per partner in a *single* state would be $50. Moreover, a large partnership may be composed of multiple tiers, necessitating amended returns by multiple entities.

But the partnership-pays approach is also more difficult to implement at the state level. States must address three additional issues that the federal government need not address:

- NEXUS - A state may lack nexus over a partnership even where a direct or indirect partner resides in that state. A state may also lack nexus over a nonresident partner even where the partnership does business in the state.
- APPORTIONMENT GENERALLY – A state will typically apportion multistate business income earned by partnerships and may apply apportionment rules differently if the income is part of the unitary business of a corporate partner.
- TREATMENT OF RESIDENT/NONRESIDENT PARTNERS. A state typically taxes nonresident partners on a source basis, using the state's allocation and apportionment rules, while taxing residents on 100% of their

partnership income, with a credit s for source-based taxes paid to other states. States may also source certain types of partnership income (generally passive investment income) to the state of a partner's residency.

PARTNERSHIP-PAYS ELECTION – APPROACH TAKEN BY THE PROPOSED MODEL

The partnership-pays election must address the issues of nexus, apportionment, and the treatment of adjustments allocated to resident and nonresident partners (as discussed above). In addition, an electing partnership that has tiered partners may have no information about so-called "indirect" taxpaying partners (that is, the partners of those tiered partners). So the electing partnership may not have the information necessary for sourcing the share of federal adjustments that would be allocated to those tiered partners. Below is a summary of the ways in which the proposed model addresses these state tax issues:

- NEXUS - The potential lack of nexus over nonresident partners of a partnership doing business in the state does not affect the amount of tax owed by the partnership under the election. (This is consistent with the application of partnership withholding and composite return rules that many states have). The potential lack of nexus over the partnership itself is addressed by giving states an option to exclude such partnerships from the partnership-pays election. Section C(3)(d).

- APPORTIONMENT GENERALLY – To compute the state-level partnership-pays amount of tax for federal audit adjustments reported by multistate partnership, a share of the adjustments must be sourced to the state in which the election is made. Under the model, a state is free to apply its own sourcing (allocation and apportionment) rules, applicable to the reviewed year (audit year). These sourcing rules will generally be applied at the level of the electing partnership. Section C(3)(b). But the portion of any audit adjustment that would be unitary business income of a direct or indirect corporate partner is simply excluded from the partnership pays calculation (and must, instead, be reported separately by the corporate partner). Section C(3)(c)(i).

- TREATMENT OF RESIDENT/NONRESIDENT PARTNERS – The following is a summary of how audit adjustments that would be allocated to different types of partners would be sourced to the state in which the election is made:
    - Direct resident individual (and trust) partners – their shares would be sourced 100% to the state. Section C(3)(b)(vi). (Direct resident partners may also receive credit for tax paid to other states on a source basis by the partnership. Section C(6)(b).)
    - Direct nonresident individual (and trust) partners – a portion of their shares would be sourced to the state based on the state's general allocation and apportionment rules applied to the adjustment at the partnership level. Section C(3)(b)(iii). (See also discussion in the prior section.)
    - Direct corporate partners - a portion of their shares would be sourced to the state based on the state's general allocation and apportionment rules applied to the adjustment at the partnership level. (Note: This assumes that the portion that would be allocated to the corporate partners would not be excluded and reported by that partner. Section C(3)(b)(ii). (See discussion in the prior section.)
    - Direct nontaxable partners – their shares of audit adjustments would be excluded. Section C(3)(b)(i).
    - Tiered partners - Recognizing that the electing partnership may not know the residency status a tiered partner's partners (indirect partners), the model uses different rules to source the share of audit adjustments that would be allocated to those tiered partners. In that case, the model looks to the type of income to which the adjustment relates. Section C(3)(b)(iv).

- Adjustments related to income that the state would tax to nonresidents on a source basis – these adjustments are allocated or apportioned to the state at the partnership level in the same way as if the tiered partner was a nonresident individual. Section C(3)(b)(iv)(A). (NOTE: If the tiered partner has resident partners, those partners would normally pay tax on 100% of their share of adjustments and receive a credit for taxes paid to other states on a source basis. Under the partnership pays election, the electing partnership, instead, would pay tax on the share of adjustments that would flow to these resident partners on a source basis but there would also be no credit for taxes paid to other states.)

- Adjustments related to income the state taxes based on residency – these adjustments are presumed to be sourced 100% to the state (as though all the taxpaying partners of the tiered partner were residents). The electing partnership may be able to overcome this presumption by providing information showing the share of the adjustment allocated to the tiered partner that would be allocated to nonresident indirect partners of that tiered partner. If the electing partnership does so, then that portion of the adjustment would be allocated and apportioned as if the tiered partner were a nonresident partner. Sections C(3)(b)(iv)(B)-(C).

Adjustments that do not result in additional tax (including the offsetting side of reallocation adjustments) are not included in the partnership-pays tax calculation. Section C (referencing IRC §6225(a)(2). As discussed earlier in this report, those adjustments will flow through to the affected partners as part of the federal tax returns for the year the adjustments are final (as defined under IRC §6225(d)(2)), and will therefore be included in income for that year for states that conform to federal treatment generally.

The amount of the adjustments sourced to and included in the calculation of the partnership pays amount is multiplied by the highest marginal tax rate for the partners (individuals or corporations). See Sections C(3)(b)(ii)-(iii).

The partnership pays election may be made by the audited partnership. If it does so, the election will take care of the tax owed by all of its direct and indirect partners in that state. If that partnership does not make the election (and instead files amended returns), any of its direct or indirect tiered partners may make the election. Section C(4). If made by the audited partnership, the election must be made within 90 days of the final determination date – along with the filing by the partnership of the information to the state on the federal adjustments. The audited partnership then has 180 days to file and pay the tax due, along with penalty and interest. Section C(3). If made by a direct or indirect partnership partner of the audited partnership, the election must be made and required returns filed by a single deadline tied to federal rules (under IRC §6226) but the state may also, by regulation, set interim deadlines. Section C(4). Very large partnerships are granted an extension of this time and other partnerships may request an extension. Section H(2).

OPTIONAL ELECTION

In addition to the partnership-pays election, the model also provides for an election, at the discretion of the administrative agency, to use another method that would allow the tax due to be reported and paid. Section C(5).

HEARING OFFICER COMMENTS AND RECOMMENDATIONS

The hearing officer makes the following general comments:

1. When the drafting process began, there was some skepticism about whether states might be willing to adopt more uniform rules for reporting federal adjustments, generally. As this report has noted, to our knowledge, no state has conformed to the 2003 model (although some states may have adopted provisions that are similar to some of the model's provisions). The Uniformity Committee was told that one of the barriers for the states in adopting other more uniform provisions was the need for systems changes. Sensitive to these and other concerns, the model attempts to address only the essential procedural aspects of reporting federal adjustments and leaves as many related policies to the states, individually, to set.

2. Throughout the process, members of the work group and the Uniformity Committee were cognizant that the model was more likely to be adopted to the extent that it has only minimal impacts on the state tax revenues. The one provision of the model that has, at least, the potential to change the tax that would otherwise be paid is the partnership-pays election. The tax owed under that election would often be greater than would otherwise be due, in part because the highest tax rates are used. In other cases, the election might result in offsetting differences, the effect of which is de minimis.

   However, concerns have been raised throughout the process that, unless there are sufficient safeguards, the partnership-pays election might possibly be used to avoid state taxes due on federal audit adjustments—especially through the use of tiered structures to obscure the residency of indirect partners. The hearing officer believes these concerns have been substantially addressed in three ways. First, through the requirement for computing the partnership pays amount when adjustments are allocated

to indirect partners through tiered partners. (See discussion in the prior section.) Second, through the ability of states to retain control over their sourcing (allocation and apportionment) rules—including equitable apportionment authority granted to state agencies. Third, through the ability of states to exercise general authority to challenge structures that lack economic substance.

The Minnesota revenue department, however, points out that some states may lack sufficient authority under their law to impose equitable apportionment or challenge structures that lack economic substance. Therefore, the hearing officer believes the recommendation of the department to add a drafter's note on this subject is well taken, including a note to consider any potential revenue impacts. (See below.)

3. The model calls for regulations to be issued to implement certain provisions. The hearing officer believes that states are likely to need regulations to implement other aspects of the model as well and that uniformity, at least in certain regulations, might be useful.

The hearing officer recommends that drafter's notes be added to the model as introductory material and suggests the following language be used for that purpose:

> Certain provisions of this model, particularly Section C, were drafted by the Commission's Uniformity Committee in anticipation of federal audits that will be done through the new centralized partnership audit regime beginning for 2018 tax years. These provisions are necessary because states otherwise lack the means to require reporting of, or to assess taxes related to, partnership audit adjustments where the federal tax is assessed to and paid by the partnership or is "pushed-out" to the partners in adjustment year returns. This model also updates provisions of the Commission's 2003 Model Uniform Statute for Reporting Federal Tax Adjustments.

The drafters concluded that states could not effectively implement a "push-out" approach similar to the federal approach, for various reasons. But Section C does include a partnership-pays election for paying state taxes owed on federal partnership audit adjustments. In drafting the provisions of this election, it was recognized that, with respect to "tiered partners," the electing partnership may not have sufficient information to source the adjustments allocated to those partners—particularly information on the residency status of the tiered partner's individual partners ("indirect partners"). Therefore, if a federal audit adjustment relates to a type of income that is sourced 100% by the state based on residency (rather than apportioned), the calculation of the partnership-pays amount effectively assumes that indirect partners are residents so that 100% of the adjustment would be sourced to the state for those tiered partners. See Section C(3)(b)(iv)(B). Nor would the tiered partner's indirect partners be allowed a credit for taxes paid to another state. If the partnership wishes, instead, to apportion any part of these types of adjustments when allocated to tiered partners, it will have to provide information on the residency of the tiered partner's taxpaying partners. See Section C(3)(b)(iv)(C).

Throughout the model, references to existing state laws of the adopting state must be included. Particularly in the partnership pays election, there are references to state law governing the sourcing of multistate income (allocation and apportionment rules). The model does not constrain the states in applying particular sourcing rules nor does it require the states to apply uniform rules. Those rules can also change over time. And, to the extent that there are specific rules for apportioning partnership income or certain types of income, those rules would apply in the partnership-pays election context. Such rules might also include equitable apportionment provisions. The only requirement is that the rules generally applicable in the reviewed year (audit year) be applied to adjustments for that year.

Note that certain provisions of the model specify that regulations should be promulgated to implement those provisions. Other regulations, or agency instructions, may be necessary, as well, to fully implement the model. The model was drafted in this manner, in part, to retain some flexibility, recognizing that the provisions related to partnership audit adjustments are new and untested. In addition to the provisions that specifically call for regulations, states may wish to consider regulations or instruction to:

- Define the precise information required to be provided in a federal adjustments report, generally, and specifically in the case of federal partnership adjustments that must be reported by the partnership under Section C(2).
- Specify the manner in which federal adjustments, and especially federal partnership adjustments, might need to be modified in order to conform to state tax laws (e.g. where an add-back statute might apply to an adjusted item or where that item has no impact at the state level) including how those modifications would be reported by the partnership.
- Specify the information that would be required for a partnership electing the partnership-pays approach to overcome the presumption that, in some cases, the indirect partners are residents, and the manner of requesting other adjustments in the partnership-pays approach. Section C(3)(b)(iv)(C) and Section C(5).
- Define how adjustments determined to be unitary business income of a corporate partner should be reported and treated by that partner where the partnership makes the partnership-pays election. Section C(3)(c).
- Determine the manner of allowing credits for taxes paid to other states by the partnership for its direct resident partners. Section C(6)(b).

- Specify the manner for making estimated payments as provided for in Section F during the course of a federal audit.

Finally, the partnership-pays election may potentially have revenue impacts. In many cases, the tax paid under that election to the state would be greater (primarily because of the use of the highest marginal rate to compute the tax), or differences may be largely offsetting. During the drafting process, however, concerns were raised as to whether the partnership-pays election might be used to shift income or avoid state taxes. In particular, the concerns focused on federal partnership adjustments that would be allocated by the electing partnership to "tiered partners." In those cases, the status and other information about indirect taxpaying partners might not be known, which might mean that adjustments could not be properly sourced. The model addresses these concerns through the provisions in Section C(3)(b)(iv). In addition, the model also allows states to apply state-specific sourcing rules, including equitable apportionment authority, and would not interfere with the use of state authority to challenge a particular structure or transaction as lacking economic substance. If a state lacked these other types of authority, however, it might consider adopting such authority for this purpose. This, in turn, might influence the estimate of any revenue impacts.

APPENDIX A TO THE HEARING OFFICER'S REPORT

Draft as of October 22, 2018
Edits Discussed as of July 24, 2018 Accepted
All Other Edits in Redline

(WITHOUT SUGGESTED REGULATIONS)

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

SECTION A. Definitions

The following definitions apply for the purposes of [this subdivision of the State Code]:

(1) "**Administrative Adjustment Request**" means an administrative adjustment request filed by a Partnership under IRC section 6227.

(2) "Audited Partnership" means a Partnership subject to a Partnership Level Audit resulting in a Federal Adjustment.

(3) "**Corporate Partner**" means a Partner that is subject to tax under [reference to State law].

(4) "Direct Partner" means a Partner that holds an interest directly in a Partnership or Pass-Through Entity.

(5) "Exempt Partner" means a Partner that is exempt from taxation under [reference to State law] [except on Unrelated Business Taxable Income[1]].

(6) "**Federal Adjustment**" means a change to an item or amount determined under the Internal Revenue Code that is used by a Taxpayer to compute [State tax] owed whether that change results from action by the IRS, including a Partnership Level Audit, or the filing of an amended federal return, federal refund claim, or an Administrative Adjustment Request by the Taxpayer. A Federal Adjustment is positive to the extent that it increases state taxable income as determined under [reference to State laws] and is negative to the extent that it decreases state taxable income as determined under [reference to State laws].

(7) "**Federal Adjustments Report**" includes methods or forms required by [State Tax Agency] for use by a Taxpayer to report Final Federal Adjustments, including an amended [State] tax return, information return, or a uniform multistate report.

(8) "**Federal Partnership Representative**" means the person the Partnership designates

[1] Drafting note: This portion of definition should only be used by the [State] if it taxes unrelated business income.

for the taxable year as the Partnership's representative, or the person the IRS has appointed to act as the Federal Partnership Representative, pursuant to IRC section 6223(a).

(9) "Final Determination Date" means the following**:**

(a) Except as provided in Section A(9)(b) and (c), if the Federal Adjustment arises from an IRS audit or other action by the IRS, the Final Determination Date is the first day on which no Federal Adjustments arising from that audit or other action remain to be finally determined, whether by IRS decision with respect to which all rights of appeal have been waived or exhausted, by agreement, or, if appealed or contested, by a final decision with respect to which all rights of appeal have been waived or exhausted. For agreements required to be signed by the IRS and the Taxpayer, the Final Determination Date is the date on which the last party signed the agreement.

(b) For Federal Adjustments arising from an IRS audit or other action by the IRS, if the Taxpayer filed as a member of a [combined/consolidated return/report under State law], the Final Determination Date means the first day on which no related Federal Adjustments arising from that audit remain to be finally determined, as described in Section A(9)(a), for the entire group.

(c) If the Federal Adjustment results from filing an amended federal return, a federal refund claim, or an Administrative Adjustment Request, or if it is a Federal Adjustment reported on an amended federal return or other similar report filed pursuant to IRC section 6225 (c), the Final Determination Date means the day on which the amended return, refund claim, Administrative Adjustment Request, or other similar report was filed.

(10) "**Final Federal Adjustment"** means a Federal Adjustment after the Final Determination Date for that Federal Adjustment has passed.

(11) "Indirect Partner" means a Partner in a Partnership or Pass-Through Entity that itself holds an interest directly, or through another Indirect Partner, in a Partnership or Pass-Through Entity.

(12) "**IRC**" means the Internal Revenue Code of 1986, as codified at 26 United States Code (U.S.C.) Section 1, et seq., [insert State's current practice to incorporate IRC] and applicable regulations as promulgated by the U.S. Department of the Treasury.[2]

(13) "**IRS**" means the Internal Revenue Service of the U.S. Department of the Treasury.

(14) "**Non-Resident Partner**" means an individual, trust, or estate Partner that is not a

[2] Drafting note: A State may need to address undefined terms. Suggested language – "To the extent terms used in this [article] are not defined in this Section or elsewhere in [citation to chapter in which this article is contained], it is the intent of the Legislature to conform as closely as possible to the terminology used in the amendments to the IRC pertaining to the comprehensive partnership audit regime as contained in the Bipartisan Budget Act of 2015, Public Law 114-74, as amended, and this [article] shall be so interpreted."

Resident Partner.

(15) "Partner" means a person that holds an interest directly or indirectly in a Partnership or other Pass-Through Entity.

(16) "Partnership" means an entity subject to taxation under Subchapter K of the IRC.

(17) "**Partnership Level Audit**" means an examination by the IRS at the partnership level pursuant to Subchapter C of Title 26, Subtitle F, Chapter 63 of the IRC, as enacted by the Bipartisan Budget Act of 2015, Public Law 114-74, which results in Federal Adjustments.

(18) "Pass-Through Entity" means an entity, other than a Partnership, that is not subject to tax under [reference to State law imposing tax on C corporations or other taxable entities].

(19) "**Reallocation Adjustment"** means a Federal Adjustment resulting from a Partnership Level Audit or an Administrative Adjustment Request that changes the shares of one or more items of partnership income, gain, loss, expense, or credit allocated to Direct Partners. A positive Reallocation Adjustment means the portion of a Reallocation Adjustment that would increase federal income for one or more Direct Partners, and a negative Reallocation Adjustment means the portion of a Reallocation Adjustment that would decrease federal income for one or more Direct Partners [pursuant to Regulations under IRC section 6225].

(20) "**Resident Partner**" means an individual, trust, or estate Partner that is a resident in [State] under [reference to state laws] for the relevant tax period.

(21) "**Reviewed Year**" means the taxable year of a Partnership that is subject to a Partnership Level Audit from which Federal Adjustments arise.

(22) "**Taxpayer**" means [insert reference to State definition] and, unless the context clearly indicates otherwise, includes a Partnership subject to a Partnership Level Audit or a Partnership that has made an Administrative Adjustment Request, as well as a Tiered Partner of that Partnership.

(23) "**Tiered Partner**" means any Partner that is a Partnership or Pass-Through Entity.

(24) "**Unrelated Business Taxable Income**" has the same meaning as defined in IRC section 512.[3]

SECTION B. Reporting Adjustments to Federal Taxable Income – General Rule

Except in the case of Final Federal Adjustments that are required to be reported by a Partnership and its Partners using the procedures in Section C, and Final Federal Adjustments required to be reported for federal purposes under IRC section 6225(a)(2), a Taxpayer shall report and pay any [State] tax due with respect to Final Federal Adjustments arising from an audit or other action by the IRS or reported by the Taxpayer on a timely filed amended federal income tax return,

[3] Drafting note: This term should only be used by the [State] if it taxes unrelated business income.

including a return or other similar report filed pursuant to IRC section 6225(c)(2), or federal claim for refund by filing a Federal Adjustments Report with the [State Tax Agency] for the Reviewed Year and, if applicable, paying the additional [State] tax owed by the Taxpayer no later than 180 days after the Final Determination Date.

Section C. Reporting Federal Adjustments – Partnership Level Audit and Administrative Adjustment Request

Except for adjustments required to reported for federal purposes pursuant to IRC section 6225(a)(2), and the distributive share of adjustments that have been reported as required under Section B, Partnerships and Partners shall report Final Federal Adjustments arising from a Partnership Level Audit or an Administrative Adjustment Request and make payments as required under this Section C.

(1) **State Partnership Representative.**

(a) With respect to an action required or permitted to be taken by a Partnership under this Section C and a proceeding under [reference to provisions for State administrative appeal or judicial review] with respect to that action, the State Partnership Representative for the Reviewed Year shall have the sole authority to act on behalf of the Partnership, and the Partnership's Direct Partners and Indirect Partners shall be bound by those actions.

(b) The State Partnership Representative for the Reviewed Year is the Partnership's Federal Partnership Representative unless the Partnership designates in writing another person as its State Partnership Representative.

(c) The [State Tax Agency] may establish reasonable qualifications for and procedures for designating a person, other than the Federal Partnership Representative, to be the State Partnership Representative.

(2) **Reporting and Payment Requirements for Partnerships Subject to a Final Federal Adjustment and their Direct Partners.** Final Federal Adjustments subject to the requirements of this Section C, except for those subject to a properly made election under Section C(3), shall be reported as follows:

(a) No later than 90 days after the Final Determination Date, the Partnership shall:

(i) File a completed Federal Adjustments Report, including information as required by [State Tax Agency regulation], with [State Tax Agency]; and

(ii) Notify each of its Direct Partners of their distributive share of the Final Federal Adjustments including information as required by the [State Tax Agency regulation]; and

(iii) File an amended composite return for Direct Partners as required under [reference to State law] and/or an amended withholding return for Direct Partners as required under [reference to State law] and pay the additional amount under [reference

to State law(s)] that would have been due had the Final Federal Adjustments been reported properly as required.

(b) [Except as provided under State law for minimal tax liabilities][4], no later than 180 days after the Final Determination Date, each Direct Partner that is taxed under [reference to State law imposing tax on individuals, trusts, estates, C corporations, etc.] shall:

(i) File a Federal Adjustments Report reporting their distributive share of the adjustments reported to them under Section C(2)(a)(ii) as required under [reference to State laws]; and

(ii) Pay any additional amount of tax due as if Final Federal Adjustments had been properly reported, plus any penalty and interest due under [reference to State law] and less any credit for related amounts paid or withheld and remitted on behalf of the Direct Partner under Section C(2)(a)(iii).

(3) **Election – Partnership Pays.** Subject to the limitations in Section C(3)(c), an Audited Partnership making an election under this Subsection (3) shall:

(a) No later than 90 days after the Final Determination Date, file a completed Federal Adjustments Report, including information as required by the [State Tax Agency rule or instruction], and notify the [State Tax Agency] that it is making the election under this Subsection (3);

(b) No later than 180 days after the Final Determination Date, pay an amount, determined as follows, in lieu of taxes owed by its Direct and Indirect Partners:

(i) Exclude from Final Federal Adjustments the distributive share of these adjustments reported to a Direct Exempt Partner not subject to tax under [reference state law taxing certain income to tax-exempt entities].

(ii) For the total distributive shares of the remaining Final Federal Adjustments reported to Direct Corporate Partners subject to tax under [reference to State law] and to Direct Exempt Partners subject to tax under [reference state law taxing certain income to tax-exempt entities], apportion and allocate such adjustments as provided under [reference to existing multi-state business activity allocation/apportion law or regulation] and multiply the resulting amount by the highest tax rate under [reference to State law(s)];

(iii) For the total distributive shares of the remaining Final Federal Adjustments reported to Non-Resident Direct Partners subject to tax under [reference to State law applying to individuals and /or trusts], determine the amount of such adjustments

[4] DRAFTER'S NOTE: If the state adopts a de minimis rule as further set out in this model, then this section would need to be conditioned on a reference to that rule.

which is [State]-source income under [reference to existing non-resident partner sourcing law or regulation], and multiply the resulting amount by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(iv) For the total distributive shares of the remaining Final Federal Adjustments reported to Tiered Partners:

(A) Determine the amount of such adjustments which is of a type that it would be subject to sourcing to the [State] under [reference to existing State rules for allocating/apportioning income of non-resident partners]; and then determine the portion of this amount that would be sourced to the state applying [these rules];

(B) Determine the amount of such adjustments which is of a type that it would not be subject to sourcing to the [State] by a Nonresident Partner under [reference to existing State rules for income fully sourced based on a taxpayer's residency];

(C) Determine the portion of the amount determined in Section C(3)(b)(iv)(B) that can be established, under regulation issued by [State Agency], to be properly allocable to Nonresident Indirect Partners or other Partners not subject to tax on the adjustments; or that can be excluded under procedures for Modified Reporting and Payment Method allowed under Paragraph (5).

(v) Multiply the total of the amounts determined in Section C(3)(b)(iv)(A) and (B) reduced by the amount determined in Section C(3)(b)(iv)(C) by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(vi) For the total distributive shares of the remaining Final Federal Adjustments reported to Resident Direct Partners subject to tax under [reference to State law applying to individuals and /or trusts], multiply that amount by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(vii) Add the amounts determined in Section C(3)(b)(ii), (iii), (v), and (vi), along with penalty and interest as provided in [reference to State law.

(c) Final Federal Adjustments subject to this election exclude:

DRAFTER'S NOTE: THE EXCLUSION IN (i) IS INTENDED TO ADDRESS THE PARTICULAR STATE'S LAW WITH RESPECT TO ADJUSTMENTS THAT WOULD FLOW THROUGH TO CORPORATE PARTNERS AND MIGHT BE TREATED AS PART OF THE UNITARY BUSINESS OF THE CORPORATION.

(i) The distributive share of Final Audit Adjustments that under [reference to State law] must be included in the unitary business income of any Direct or Indirect Corporate Partner, provided that the Audited Partnership can reasonably determine this; and

(ii) Any Final Federal Adjustments resulting from an Administrative Adjustment Request.

(d) {OPTIONAL PROVISIONS}

Option A - An Audited Partnership not otherwise subject to any reporting or payment obligation to [State] that makes an election under this Subsection (3) consents to be subject to [State] laws related to reporting, assessment, payment, and collection of [State] tax calculated under the election.

Option B - An Audited Partnership not otherwise subject to any reporting or payment obligation to [State] may not make an election under this Subsection (3).

(4) **Tiered Partners.** The Direct and Indirect Partners of an Audited Partnership that are Tiered Partners, and all of the Partners of those Tiered Partners that are subject to tax under [reference to State laws imposing tax on individuals, trusts, corporations, etc.] are subject to the reporting and payment requirements of Section C(2) and the Tiered Partners are entitled to make the elections provided in Section C(3) and (5). The Tiered Partners or their Partners shall make required reports and payments no later than 90 days after the time for filing and furnishing statements to Tiered Partners and their Partners as established under IRC section 6226 and the regulations thereunder. The [State Agency] may promulgate regulations to establish procedures and interim time periods for the reports and payments required by Tiered Partners and their Partners and for making the elections under this Section C.

(5) **Modified Reporting and Payment Method.** Under procedures adopted by and subject to the approval of the [State Agency], an Audited Partnership or Tiered Partner may enter into an agreement with the [State Agency] to utilize an alternative reporting and payment method, including applicable time requirements or any other provision of this Section C, if the Audited Partnership or Tiered Partner demonstrates that the requested method will reasonably provide for the reporting and payment of taxes, penalties, and interest due under the provisions of this Section C. Application for approval of an alternative reporting and payment method must be made by the Audited Partnership or Tiered Partner within the time for election as provided in Section C(3) or (4), as appropriate.

(6) **Effect of Election by Audited Partnership or Tiered Partner and Payment of Amount Due.**

(a) The election made pursuant to Section C(3) or (5) is irrevocable, unless [State Agency], in its discretion, determines otherwise.

(b) If properly reported and paid by the Audited Partnership or Tiered Partner, the amount determined in Section C(3)(b), or similarly under an optional election under Section C(5), will be treated as paid in lieu of taxes owed by its Direct and Indirect Partners, to the extent applicable, on the same Final Federal Adjustments. The Direct Partners or Indirect Partners may not take any deduction or credit for this amount or claim a refund of the amount in this State. Nothing in this Subsection(C)(6) shall preclude a Direct Resident

Partner from claiming a credit against taxes paid to this State pursuant to [reference to State law], any amounts paid by the Audited Partnership or Tiered Partner on the Resident Partner's behalf to another state or local tax jurisdiction in accordance with the provisions of [State law or regulation allowing credit for taxes paid to another state or locality].

(7) **Failure of Audited Partnership or Tiered Partner to Report or Pay**. Nothing in this Section C prevents the [State Agency] from assessing Direct Partners or Indirect Partners for taxes they owe, using the best information available, in the event that a Partnership or Tiered Partner fails to timely make any report or payment required by this Section C for any reason.

SECTION D. De Minimis Exception

The [State Agency] at its discretion may promulgate regulations to establish a de minimis amount upon which a taxpayer shall not be required to comply with Sections B and C of this [Chapter].

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

The [State Agency] will assess additional tax, interest, and penalties arising from Final Federal Adjustments arising from an audit by the IRS, including a Partnership Level Audit, or reported by the Taxpayer on an amended federal income tax return or as part of an Administrative Adjustment Request by the following dates:

(1) **Timely Reported Federal Adjustments.** If a Taxpayer files with the [State Agency] a Federal Adjustments Report or an amended [State] tax return as required within the period specified in Sections B or C, the [State Agency] may assess any amounts, including in-lieu-of amounts, taxes, interest, and penalties arising from those Federal Adjustments if [State Agency] issues a notice of the assessment to the Taxpayer no later than:

(a) The expiration of the limitations period specified in [citation to State statute setting forth normal limitations period]; or

(b) The expiration of the one (1) year period following the date of filing with the [State Agency] of the Federal Adjustments Report.

(2) **Untimely Reported Federal Adjustments.** If the Taxpayer fails to file the Federal Adjustments Report within the period specified in Sections B or C, as appropriate, or the Federal Adjustments Report filed by the Taxpayer omits Final Federal Adjustments or understates the correct amount of tax owed, the [State Agency] may assess amounts or additional amounts including in-lieu-of amounts, taxes, interest, and penalties arising from the Final Federal Adjustments, if it mails a notice of the assessment to the Taxpayer by a date which is the latest of the following:

(a) The expiration of the limitations period specified in [citation to State statute setting forth normal limitations period]; or

(b) The expiration of the one (1) year period following the date the Federal Adjustments Report was filed with [State Agency]; or

(c) Absent fraud, the expiration of the six (6) year period following the Final Determination Date.

SECTION F. Estimated [State] Tax Payments During the Course of a Federal Audit

A Taxpayer may make estimated payments to the [State Agency], following the process prescribed by the [State Agency], of the [State] tax expected to result from a pending IRS audit, prior to the due date of the Federal Adjustments Report, without having to file the report with the [State Agency]. The estimated tax payments shall be credited against any tax liability ultimately found to be due to [State] ("Final [State] Tax Liability") and will limit the accrual of further statutory interest on that amount. If the estimated tax payments exceed the final tax liability and statutory interest ultimately determined to be due, the Taxpayer is entitled to a refund or credit for the excess, provided the Taxpayer files a Federal Adjustments Report or claim for refund or credit of tax pursuant to [citation to State statute setting forth claim for refund requirements] no later than one year following the Final Determination Date.

SECTION G. Claims for Refund or Credits of Tax Arising from Final Federal Adjustments Made by the IRS

Except for Final Federal Adjustments required to be reported for federal purposes under IRC section 6225(a)(2), a Taxpayer may file a claim for refund or credit of tax arising from Federal Adjustments made by the IRS on or before the later of:

(1) The expiration of the last day for filing a claim for refund or credit of [State] tax pursuant to [citation to State statute setting forth claim for refund requirements], including any extensions; or

(2) One year from the date a Federal Adjustments Report prescribed in Sections B or C, as applicable, was due to the [State Agency], including any extensions pursuant to Section G.

The Federal Adjustments Report shall serve as the means for the Taxpayer to report additional tax due, report a claim for refund or credit of tax, and make other adjustments (including to its net operating losses) resulting from adjustments to the Taxpayer's federal taxable income.

SECTION H. Scope of Adjustments and Extensions of Time.

(1) Unless otherwise agreed in writing by the Taxpayer and the [State Agency], any adjustments by the [State Agency] or by the Taxpayer made after the expiration of the [State's normal statute of limitations for assessment and refund] is limited to changes to the Taxpayer's tax liability arising from Federal Adjustments.

(2) The time periods provided for in [this subdivision of the State Code] may be extended:

(a) Automatically, upon written notice to [State agency], by 60 days for an Audited Partnership or Tiered Partner which has [10,000] or more Direct Partners; or

(b) By written agreement between the Taxpayer and the [State Agency] [pursuant to any regulation issued under this Section].

(3) Any extension granted under this Section G for filing the Federal Adjustments Report extends the last day prescribed by law for assessing any additional tax arising from the adjustments to federal taxable income and the period for filing a claim for refund or credit of taxes pursuant to [citation to State statute setting forth claim for refund requirements].

SECTION I. Effective Date

The amendments to this [section/chapter] applies to any adjustments to a Taxpayer's federal taxable income with a Final Determination Date occurring on and after [date].

APPENDIX B TO THE HEARING OFFICER'S REPORT

Model Uniform Statute for Reporting Federal Tax Adjustments with Accompanying Model Regulation

Adopted August 1, 2003

Model Uniform Statute for Reporting Federal Tax Adjustments
with Accompanying Model Regulation
Adopted August 1, 2003

Statute:

SECTION A. Reporting Federal Adjustments; assessment of additional tax

(1) As used in this section and Section B, unless the context requires otherwise, "final determination" shall refer to

(a) the allowance of a refund or credit under Section 6407 of the Internal Revenue Code of 1986; or

(b) the official act of assessment under Section 6203 of the Internal Revenue Code of 1986, except assessments that result from the following shall not be considered final determinations:

1. tax under a partial agreement,
2. tax in jeopardy, and
3. advance payments; or

(c) a final denial of a refund claim where a state refund claim has been filed or any other final action by the Internal Revenue Service that increases or decreases the state tax liability of a taxpayer for any tax year.

(2) Every Taxpayer or group of taxpayers whose federal taxable income, federal tax liability or federal tax return has been changed, adjusted, or corrected for any income tax year pursuant to a final determination under Section A.(1) shall, within one hundred eighty (180) days of the date of the final determination, file the report of federal changes or state amended return as prescribed herein reporting the changes, adjustments or corrections to taxpayer's federal taxable income, federal tax liability or federal tax return resulting from the final determination under Section A.(1) and pay additional state tax due. The taxpayer shall also submit available documentation sufficiently detailed to allow computation of the tax change.

(3) (a) If the taxpayer files the report of federal changes or state amended return as prescribed in and within the time limit specified in Section A.(2), any additional state tax resulting from the final determination under Section A.(1) may be assessed and a notice of assessment issued to the taxpayer by the [State Agency] on or before the later of:

{(i) The expiration of the limitations period specified in [citation to state statute setting forth normal limitations period]; *optional*} or

(ii) The last day of the one (1) year period following the due date of the report of federal changes or state amended return prescribed in Section A.(2).

(b) If the taxpayer fails to file a report of federal changes or state amended return as prescribed in and within the time limit specified in Section A.(2), any additional state tax resulting from the final determination under Section A.(1) may be assessed and a notice of assessment issued to the taxpayer by the [State Agency] on or before the later of:

{(i) The expiration of the limitations period specified in [citation to state statute setting forth normal limitations period]; *optional*} or

(ii) The last day of the one (1) year period following the date the report of federal changes or state amended return is actually filed with the [State Agency]; or

(iii) The last day of the one (1) year period following the date the [State Agency] is notified by the Internal Revenue Service in writing or by electronic means that a final determination has been made, provided the taxpayer has not filed a report of federal changes or state amended return prior to the [State Agency's] receipt of the IRS notification.

(4) The time periods provided for in this section may be extended by agreement between the taxpayer and the [State Agency]. Any extension granted for filing the report of federal changes or state amended return shall also be considered as extending the last day prescribed by law for any additional tax resulting from the final determination being assessed and a notice of assessment being issued to the taxpayer by the [State Agency].

SECTION B. Claim for refund or credit of tax

(1) Any claim for refund or credit related directly to changes, adjustments or corrections to the taxpayer's federal taxable income, federal tax liability or federal tax return resulting from a final determination under Section A.(1) shall be filed on or before the expiration of the later of the limitations period specified in [citation to state statute setting forth normal limitations period for allowing refund or credit {*optional*}] or the last day of the one (1) year period from the due date of the report of federal changes or state amended return prescribed in Section A.(2).

(2) An extension of time for filing the report of federal changes or state amended return extends the last day prescribed for filing the claim for refund to the extended date.

Regulation:

A. Examples of assessments considered to be final determinations include, but are not limited to:

1. A final judicial decision;
2. A closing agreement under Section 7121 of the Internal Revenue Code of 1986;
3. An uncontested assessment as defined by Regulation; or
4. The execution of a waiver of restriction on assessment that is not a partial agreement. Examples of an assessment that results from the execution of a waiver of restriction on assessment include assessments that result from the signing of Forms 870, 870AD, or 4549.

B. The term "uncontested assessment" shall mean:

1. An assessment pursuant to an amended return filed by the taxpayer or
2. an assessment that follows a taxpayer's receipt of a statutory notice of deficiency wherein the taxpayer does not petition the Tax Court.

APPENDIX C TO THE HEARING OFFICER'S REPORT

- **Minnesota Comments on Model Uniform Reporting Statute**
- **Letter from ABA supporting approval of the Model Uniform Reporting Statute**
- **Letter from Master Limited Partnership Association endorsing the proposed Model RAR Statute**
- **TEI's Endorsement of the Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Items as of July 18, 2018**
- **AICPA Position Paper on State Partnership Audits**
    - **AICPA one-pager: State Conformity to Federal Partnership Audit Rules**
- **Letter from COST endorsing the proposed Model RAR statute**

DEPARTMENT OF REVENUE

October 10, 2018

Helen Hecht
General Counsel
Multistate Tax Commission
444 N. Capitol Street, N.W., Suite 425
Washington, D.C. 20001

Re: Model Uniform Statute for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments

Dear Ms. Hecht:

Minnesota appreciates the thoughtful work of the uniformity committee thus far and the opportunity to provide written comment as part of the hearing process which allows many stakeholders and states to share their perspectives on this work.

We ask that you consider the possible addition of two author's notes to the model language to promote compatibility with significant portions of our tax systems.

Economic Substance

We note the workgroup considered a variety of anti-abuse approaches and an anti-abuse provision discussion draft is posted on the workgroup site. Such a provision, however, is not included in the proposed model. References to anti-abuse discussion is included in at least two staff reports dated April 3, 2018 and July 9, 2018. Ultimately, an option was proposed in the staff report dated June 15, 2018, and made available in the model that could be used to allow the partnership-pays election only for those partnerships with nexus within the state.

While we appreciate the draft option, in our review it seems the model as drafted is best suited for states with an economic substance doctrine codified or in common law. Economic substance doctrines are in place in a number of states to ensure that transactions have a business purpose other than for the sole purpose of avoiding taxation. Potential for the kinds of abuse discussed throughout the Partnership Workgroup process may be less of a concern for states with an economic substance doctrine since it could be determined that a particular structure or partnership-pays election was designed purely to avoid taxation. States without an economic substance doctrine would not have that safeguard.

We ask the model reflect an author's note, alerting states without an economic substance doctrine to consider enacting economic substance through the legislative process or otherwise amending the model as necessary.

Potential Revenue Impact

As it is currently written the model language may change the amount of tax owed compared to current law in certain states. If a partnership elects to pay state tax on behalf of its partners, in many cases it would pay the tax calculated in a different manner than the amount calculated if the original returns had

been filed correctly. It remains uncertain the extent to which the amount of tax may be different and whether the difference would have an impact on any particular state's forecast.

To ensure revenue agencies in each state are aware of this question, we ask the model reflect an author's note alerting state research analysts to the potential revenue impact of what is otherwise a model of administrative practice.

Thank you for your consideration.

Sincerely,

Cynthia Bauerly
Commissioner

Defending Liberty
Pursuing Justice

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A Section of the American Bar Association

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September 10, 2018

Gregory S. Matson
Executive Director
Multistate Tax Commission
444 North Capitol Street, NW
Washington, DC 20001-1538

Re: Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments (the "Model Uniform Reporting Statute")

Dear Mr. Matson:

This letter addresses the Model Uniform Reporting Statute, a copy of which is attached to this letter as Appendix A. We understand that the Model Uniform Reporting Statute was approved by the Multistate Tax Commission ("MTC") Uniformity Committee on July 24, 2018 for referral to the MTC Executive Committee.

We support approval of the Model Uniform Reporting Statute. We believe the need for a Model Uniform Reporting Statute is especially acute now. We would expect that many states will consider adapting their laws to address the dramatically changed audit regime for partnerships at the federal level, and we believe that the provision of a model statute will greatly assist them in accomplishing this task. The immense complexity of the new federal rules gives even more value to a model statute that addresses the common related state issues associated with determining the state effects of federal audits. The Model Uniform Reporting Statute incorporates the insight of state administrators and seasoned practitioners regarding these difficult issues, providing a resource states can use when amending their laws to address the new federal partnership audit rules. In addition, a model statute increases the potential for uniformity among the partnership audit rules that will be adopted by the states. Uniformity is important for reducing the burden on taxpayers and state administrators who will need to apply these complex reporting regimes.

In addition to the promotion of uniformity, we endorse the Model Uniform Reporting Statute because it reflects the following principles, each of which is designed to support ease of administration and compliance while ensuring the proper state tax is paid as a result of federal partnership audit adjustments:

- *Allows an audited partnership the ability to make different elections under the partnership audit regime for state tax purposes than the partnership makes for federal tax purposes, notably for the "push-out" election (i.e., partnership audit adjustments pushed out to the partnership's ultimate partners) or the decision to pay the imputed underpayment (i.e., partnership pays the tax on the partnership audit adjustments).*

- *Provides that states should use the apportionment and allocation factors from the reviewed year to apply to the partnership audit adjustments flowing from the federal audit of the reviewed year.*
- *Provides that for an imputed underpayment those apportionment factors should be applied at the partnership level for adjustments allocable to all partners except direct resident partners.*
- *For tiered structures, allows flexibility and options to each tier for reporting and payment elections that mirror the federal options.*
- *For administrative ease, offers partnerships the ability to use alternative reporting and payment solutions subject to state approval.*
- *Provides a default rule that the federal partnership representative will serve as the state partnership representative regardless of the state of residence of the partnership or its partners and gives partnerships the option to instead designate a state-specific partnership representative for each state on a state-by-state basis.*

The American Bar Association Section of Taxation hereby endorses the Model Uniform Reporting Statute. This letter is submitted on behalf of the American Bar Association Section of Taxation and has not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, this letter and endorsement should not be construed as representing the position of the American Bar Association.

Sincerely,

Eric Solomon, Chair
ABA Tax Section

cc: Helen Hecht, General Counsel, Multistate Tax Commission

Draft as of July 18, 2018 with minor edits (redlined) discussed at the Uniformity Committee Meeting on July 24, 2018 and approved for referral to the Executive Committee.

(WITHOUT SUGGESTED REGULATIONS)

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

This draft was produced by a working group consisting of representatives of the Council On State Taxation (COST), Tax Executives Institute (TEI), the ABA Section of Taxation's SALT Committee, the American Institute of CPAs (AICPA), the Institute for Professionals in Taxation (IPT) and the Master Limited Partnership Association (MLPA) as well as a work group set up by the MTC uniformity committee. As of this date, this draft has not been officially endorsed by these organizations.

This draft has been reformatted with line numbering as well as internal citations simplified and underlined to aid in the final review.

1 **SECTION A. Definitions**

2 The following definitions apply for the purposes of [this subdivision of the State Code]:

3 **(1)** "**Administrative Adjustment Request**" means an administrative adjustment request
4 filed by a Partnership under IRC section 6227.

5 **(2) "Audited Partnership"** means a Partnership subject to a Partnership Level Audit
6 resulting in a Federal Adjustment.

7 **(3)** "**Corporate Partner**" means a Partner that is subject to tax under [reference to State
8 law].

9 **(4) "Direct Partner"** means a Partner that holds an interest directly in a Partnership or
10 Pass-Through Entity.

11 **(5) "Exempt Partner"** means a Partner that is exempt from taxation under [reference to
12 State law] [except on Unrelated Business Taxable Income[1]].

13 **(6)** "**Federal Adjustment**" means a change to an item or amount determined under the
14 Internal Revenue Code that is used by a Taxpayer to compute [State tax] owed whether that
15 change results from action by the IRS, including a Partnership Level Audit, or the filing of an
16 amended federal return, federal refund claim, or an Administrative Adjustment Request by the
17 Taxpayer. A Federal Adjustment is positive to the extent that it increases state taxable income as
18 determined under [reference to State laws] and is negative to the extent that it decreases state

[1] Drafting note: This portion of definition should only be used by the [State] if it taxes unrelated business income.

taxable income as determined under [reference to State laws].

(7) "**Federal Adjustments Report**" includes methods or forms required by [State Tax Agency] for use by a Taxpayer to report Final Federal Adjustments, including an amended [State] tax return, information return, or a uniform multistate report.

(8) "**Federal Partnership Representative**" means the person the Partnership designates for the taxable year as the Partnership's representative, or the person the IRS has appointed to act as the Federal Partnership Representative, pursuant to IRC section 6223(a).

(9) "Final Determination Date" means the following**:**

(a) Except as provided in Section A(9)(b) and (c), if the Federal Adjustment arises from an IRS audit or other action by the IRS, the Final Determination Date is the first day on which no Federal Adjustments arising from that audit or other action remain to be finally determined, whether by IRS decision with respect to which all rights of appeal have been waived or exhausted, by agreement, or, if appealed or contested, by a final decision with respect to which all rights of appeal have been waived or exhausted. For agreements required to be signed by the IRS and the Taxpayer, the Final Determination Date is the date on which the last party signed the agreement.

(b) For Federal Adjustments arising from an IRS audit or other action by the IRS, if the Taxpayer filed as a member of a [combined/consolidated return/report under State law], the Final Determination Date means the first day on which no related Federal Adjustments arising from that audit remain to be finally determined, as described in Section A(9)(a), for the entire group.

(c) If the Federal Adjustment results from filing an amended federal return, a federal refund claim, or an Administrative Adjustment Request, or if it is a Federal Adjustment reported on an amended federal return or other similar report filed pursuant to IRC section 6225 (c), the Final Determination Date means the day on which the amended return, refund claim, Administrative Adjustment Request, or other similar report was filed.

(10) "**Final Federal Adjustment"** means a Federal Adjustment after the Final Determination Date for that Federal Adjustment has passed.

(11) "Indirect Partner" means a Partner in a Partnership or Pass-Through Entity that itself holds an interest directly, or through another Indirect Partner, in a Partnership or Pass-Through Entity.

(12) "**IRC**" means the Internal Revenue Code of 1986, as codified at 26 United States Code (U.S.C.) Section 1, et seq., [insert State's current practice to incorporate IRC] and applicable

regulations as promulgated by the U.S. Department of the Treasury.[2]

(13) "**IRS**" means the Internal Revenue Service of the U.S. Department of the Treasury.

(14) "**Non-Resident Partner**" means an individual, trust, or estate Partner that is not a Resident Partner.

(15) "Partner" means a person that holds an interest directly or indirectly in a Partnership or other Pass-Through Entity.

(16) "Partnership" means an entity subject to taxation under Subchapter K of the IRC.

(17) "**Partnership Level Audit**" means an examination by the IRS at the partnership level pursuant to Subchapter C of Title 26, Subtitle F, Chapter 63 of the IRC, as enacted by the Bipartisan Budget Act of 2015, Public Law 114-74, which results in Federal Adjustments.

(18) "Pass-Through Entity" means an entity, other than a Partnership, that is not subject to tax under [reference to State law imposing tax on C corporations or other taxable entities].

(19) "**Reallocation Adjustment"** means a Federal Adjustment resulting from a Partnership Level Audit or an Administrative Adjustment Request that changes the shares of one or more items of partnership income, gain, loss, expense, or credit allocated to Direct Partners. A positive Reallocation Adjustment means the portion of a Reallocation Adjustment that would increase federal income for one or more Direct Partners, and a negative Reallocation Adjustment means the portion of a Reallocation Adjustment that would decrease federal income for one or more Direct Partners [pursuant to Regulations under IRC section 6225].

(20) "**Resident Partner**" means an individual, trust, or estate Partner that is a resident in [State] under [reference to state laws] for the relevant tax period.

(21) "**Reviewed Year**" means the taxable year of a Partnership that is subject to a Partnership Level Audit from which Federal Adjustments arise.

(22) "**Taxpayer**" means [insert reference to State definition] and, unless the context clearly indicates otherwise, includes a Partnership subject to a Partnership Level Audit or a Partnership that has made an Administrative Adjustment Request, as well as a Tiered Partner of that Partnership.

(23) "**Tiered Partner**" means any Partner that is a Partnership or Pass-Through Entity.

(24) "**Unrelated Business Taxable Income**" has the same meaning as defined in IRC section 512.[3]

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[2] Drafting note: A State may need to address undefined terms. Suggested language – "To the extent terms used in this [article] are not defined in this Section or elsewhere in [citation to chapter in which this article is contained], it is the intent of the Legislature to conform as closely as possible to the terminology used in the amendments to the IRC pertaining to the comprehensive partnership audit regime as contained in the Bipartisan Budget Act of 2015, Public Law 114-74, as amended, and this [article] shall be so interpreted."

[3] Drafting note: This term should only be used by the [State] if it taxes unrelated business income.

SECTION B. Reporting Adjustments to Federal Taxable Income – General Rule

Except in the case of Final Federal Adjustments that are required to be reported by a Partnership and its Partners using the procedures in Section C, and Final Federal Adjustments required to be reported for federal purposes under IRC section 6225(a)(2), a Taxpayer shall report and pay any [State] tax due with respect to Final Federal Adjustments arising from an audit or other action by the IRS or reported by the Taxpayer on a timely filed amended federal income tax return, including a return or other similar report filed pursuant to IRC section 6225(c)(2), or federal claim for refund by filing a Federal Adjustments Report with the [State Tax Agency] for the Reviewed Year and, if applicable, paying the additional [State] tax owed by the Taxpayer no later than 180 days after the Final Determination Date.

Section C. Reporting Federal Adjustments – Partnership Level Audit and Administrative Adjustment Request

Except for adjustments required to reported for federal purposes pursuant to IRC section 6225(a)(2), and the distributive share of adjustments that have been reported as required under Section B, Partnerships and Partners shall report Final Federal Adjustments arising from a Partnership Level Audit or an Administrative Adjustment Request and make payments as required under this Section C.

(1) **State Partnership Representative.**

(a) With respect to an action required or permitted to be taken by a Partnership under this Section C and a proceeding under [reference to provisions for State administrative appeal or judicial review] with respect to that action, the State Partnership Representative for the Reviewed Year shall have the sole authority to act on behalf of the Partnership, and the Partnership's Direct Partners and Indirect Partners shall be bound by those actions.

(b) The State Partnership Representative for the Reviewed Year is the Partnership's Federal Partnership Representative unless the Partnership designates in writing another person as its State Partnership Representative.

(c) The [State Tax Agency] may establish reasonable qualifications for and procedures for designating a person, other than the Federal Partnership Representative, to be the State Partnership Representative.

(2) **Reporting and Payment Requirements for Partnerships Subject to a Final Federal Adjustment and their Direct Partners.** Final Federal Adjustments subject to the requirements of this Section C, except for those subject to a properly made election under Section C(3), shall be reported as follows:

(a) No later than 90 days after the Final Determination Date, the Partnership shall:

(i) File a completed Federal Adjustments Report, including information as required by [State Tax Agency ~~rule or instruction~~ regulation], with [State Tax Agency];

and

(ii) Notify each of its Direct Partners of their distributive share of the Final Federal Adjustments including information as required by the [State Tax Agency ~~rule or instruction~~ regulation]; and

(iii) File an amended composite return for Direct Partners as required under [reference to State law] and/or an amended withholding return for Direct Partners as required under [reference to State law] and pay the additional amount under [reference to State law(s)] that would have been due had the Final Federal Adjustments been reported properly as required.

(b) [Except as provided under State law for minimal tax liabilities][4], no later than 180 days after the Final Determination Date, each Direct Partner that is taxed under [reference to State law imposing tax on individuals, trusts, estates, C corporations, etc.] shall:

(i) File a Federal Adjustments Report reporting their distributive share of the adjustments reported to them under Section C(2)(a)(ii) as required under [reference to State laws]; and

(ii) Pay any additional amount of tax due as if Final Federal Adjustments had been properly reported, plus any penalty and interest due under [reference to State law] and less any credit for related amounts paid or withheld and remitted on behalf of the Direct Partner under Section C(2)(a)(iii).

(3) **Election – Partnership Pays.** Subject to the limitations in Section C(3)(c), an Audited Partnership making an election under this Subsection (3) shall:

(a) No later than 90 days after the Final Determination Date, file a completed Federal Adjustments Report, including information as required by the [State Tax Agency rule or instruction], and notify the [State Tax Agency] that it is making the election under this Subsection (3);

(b) No later than 180 days after the Final Determination Date, pay an amount, determined as follows, in lieu of taxes owed by its Direct and Indirect Partners:

(i) Exclude from Final Federal Adjustments the distributive share of these adjustments reported to a Direct Exempt Partner not subject to tax under [reference state law taxing certain income to tax-exempt entities].

(ii) For the total distributive shares of the remaining Final Federal Adjustments reported to Direct Corporate Partners subject to tax under [reference to State law] and to Direct Exempt Partners subject to tax under [reference state law taxing certain in-

[4] DRAFTER'S NOTE: If the state adopts a de minimis rule as further set out in this model, then this section would need to be conditioned on a reference to that rule.

come to tax-exempt entities], apportion and allocate such adjustments as provided under [reference to existing multi-state business activity allocation/apportion law or regulation] and multiply the resulting amount by the highest tax rate under [reference to State law(s)];

(iii) For the total distributive shares of the remaining Final Federal Adjustments reported to Non-Resident Direct Partners subject to tax under [reference to State law applying to individuals and /or trusts], determine the amount of such adjustments which is [State]-source income under [reference to existing non-resident partner sourcing law or regulation], and multiply the resulting amount by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(iv) For the total distributive shares of the remaining Final Federal Adjustments reported to Tiered Partners:

(A) Determine the amount of such adjustments which is of a type that it would be subject to sourcing to the [State] under [reference to existing State rules for allocating/apportioning income of non-resident partners]; and then determine the portion of this amount that would be sourced to the state applying [these rules];

(B) Determine the amount of such adjustments which is of a type that it would not be subject to sourcing to the [State] by a Nonresident Partner under [reference to existing State rules for income fully sourced based on a taxpayer's residency];

(C) Determine the portion of the amount determined in Section C(3)(b)(iv)(B) that can be established, under regulation issued by [State Agency], to be properly allocable to Nonresident Indirect Partners or other Partners not subject to tax on the adjustments; or that can be excluded under procedures for Modified Reporting and Payment Method allowed under Paragraph (5).

(v) Multiply the total of the amounts determined in Section C(3)(b)(iv)(A) and (B) reduced by the amount determined in Section C(3)(b)(iv)(C) by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(vi) For the total distributive shares of the remaining Final Federal Adjustments reported to Resident Direct Partners subject to tax under [reference to State law applying to individuals and /or trusts], multiply that amount by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(vii) Add the amounts determined in Section C(3)(b)(ii), (iii), (v), and (vi), along with penalty and interest as provided in [reference to State law.

(c) Final Federal Adjustments subject to this election exclude:

DRAFTER'S NOTE: THE EXCLUSION IN (i) IS INTENDED TO ADDRESS THE PARTICULAR STATE'S LAW WITH RESPECT TO ADJUSTMENTS THAT WOULD FLOW THROUGH

TO CORPORATE PARTNERS AND MIGHT BE TREATED AS PART OF THE UNITARY BUSINESS OF THE CORPORATION.

(i) The distributive share of Final Audit Adjustments that under [reference to State law] must be included in the unitary business income of any Direct or Indirect Corporate Partner, provided that the Audited Partnership can reasonably determine this; and

(ii) Any Final Federal Adjustments resulting from an Administrative Adjustment Request.

(d) {OPTIONAL PROVISIONS}

Option A - An Audited Partnership not otherwise subject to any reporting or payment obligation to [State] that makes an election under this Subsection (3) consents to be subject to [State] laws related to reporting, assessment, payment, and collection of [State] tax calculated under the election.

Option B - An Audited Partnership not otherwise subject to any reporting or payment obligation to [State] may not make an election under this Subsection (3).

(4) **Tiered Partners.** The Direct and Indirect Partners of an Audited Partnership that are Tiered Partners, and all of the Partners of those Tiered Partners that are subject to tax under [reference to State laws imposing tax on individuals, trusts, corporations, etc.] are subject to the reporting and payment requirements of Section C(2) and the Tiered Partners are entitled to make the elections provided in Section C(3) and (5). The Tiered Partners or their Partners shall make required reports and payments no later than 90 days after the time for filing and furnishing statements to Tiered Partners and their Partners as established under IRC section 6226 and the regulations thereunder. The [State Agency] may promulgate regulations to establish procedures and interim time periods for the reports and payments required by Tiered Partners and their Partners and for making the elections under this Section C.

(5) **Modified Reporting and Payment Method.** Under procedures adopted by and subject to the approval of the [State Agency], an Audited Partnership or Tiered Partner may enter into an agreement with the [State Agency] to utilize an alternative reporting and payment method, including applicable time requirements or any other provision of this Section C, if the Audited Partnership or Tiered Partner demonstrates that the requested method will reasonably provide for the reporting and payment of taxes, penalties, and interest due under the provisions of this Section C. Application for approval of an alternative reporting and payment method must be made by the Audited Partnership or Tiered Partner within the time for election as provided in Section C(3) or (4), as appropriate.

(6) **Effect of Election by Audited Partnership or Tiered Partner and Payment of Amount Due.**

(a) The election made pursuant to Section C(3) or (5) is irrevocable, unless [State

Agency], in its discretion, determines otherwise.

(b) If properly reported and paid by the Audited Partnership or Tiered Partner, the amount determined in Section C(3)(b), or similarly under an optional election under Section C(5), will be treated as paid in lieu of taxes owed by its Direct and Indirect Partners, to the extent applicable, on the same Final Federal Adjustments. The Direct Partners or Indirect Partners may not take any deduction or credit for this amount or claim a refund of the amount in this State. Nothing in this Subsection(C)(6) shall preclude a Direct Resident Partner from claiming a credit against taxes paid to this State pursuant to [reference to State law], any amounts paid by the Audited Partnership or Tiered Partner on the Resident Partner's behalf to another state or local tax jurisdiction in accordance with the provisions of [State law or regulation allowing credit for taxes paid to another state or locality].

(7) **Failure of Audited Partnership or Tiered Partner to Report or Pay**. Nothing in this Section C prevents the [State Agency] from assessing Direct Partners or Indirect Partners for taxes they owe, using the best information available, in the event that a Partnership or Tiered Partner fails to timely make any report or payment required by this Section C for any reason.

SECTION D. De Minimis Exception

The [State Agency] at its discretion may promulgate regulations to establish a de minimis amount upon which a taxpayer shall not be required to comply with Sections B and C of this [Chapter].

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

The [State Agency] will assess additional tax, interest, and penalties arising from Final Federal Adjustments arising from an audit by the IRS, including a Partnership Level Audit, or reported by the Taxpayer on an amended federal income tax return or as part of an Administrative Adjustment Request by the following dates:

(1) **Timely Reported Federal Adjustments.** If a Taxpayer files with the [State Agency] a Federal Adjustments Report or an amended [State] tax return as required within the period specified in Sections B or C, the [State Agency] may assess any amounts, including in-lieu-of amounts, taxes, interest, and penalties arising from those Federal Adjustments if [State Agency] issues a notice of the assessment to the Taxpayer no later than:

(a) The expiration of the limitations period specified in [citation to State statute setting forth normal limitations period]; or

(b) The expiration of the one (1) year period following the date of filing with the [State Agency] of the Federal Adjustments Report.

(2) **Untimely Reported Federal Adjustments.** If the Taxpayer fails to file the Federal Adjustments Report within the period specified in Sections B or C, as appropriate, or the Federal

Adjustments Report filed by the Taxpayer omits Final Federal Adjustments or understates the correct amount of tax owed, the [State Agency] may assess amounts or additional amounts including in-lieu-of amounts, taxes, interest, and penalties arising from the Final Federal Adjustments, if it mails a notice of the assessment to the Taxpayer by a date which is the latest of the following:

(a) The expiration of the limitations period specified in [citation to State statute setting forth normal limitations period]; or

(b) The expiration of the one (1) year period following the date the Federal Adjustments Report was filed with [State Agency]; or

(c) Absent fraud, the expiration of the six (6) year period following the Final Determination Date.

SECTION F. Estimated [State] Tax Payments During the Course of a Federal Audit

A Taxpayer may make estimated payments to the [State Agency], following the process prescribed by the [State Agency], of the [State] tax expected to result from a pending IRS audit, prior to the due date of the Federal Adjustments Report, without having to file the report with the [State Agency]. The estimated tax payments shall be credited against any tax liability ultimately found to be due to [State] ("Final [State] Tax Liability") and will limit the accrual of further statutory interest on that amount. If the estimated tax payments exceed the final tax liability and statutory interest ultimately determined to be due, the Taxpayer is entitled to a refund or credit for the excess, provided the Taxpayer files a Federal Adjustments Report or claim for refund or credit of tax pursuant to [citation to State statute setting forth claim for refund requirements] no later than one year following the Final Determination Date.

SECTION G. Claims for Refund or Credits of Tax Arising from Final Federal Adjustments Made by the IRS

Except for Final Federal Adjustments required to be reported for federal purposes under IRC section 6225(a)(2), a Taxpayer may file a claim for refund or credit of tax arising from Federal Adjustments made by the IRS on or before the later of:

(1) The expiration of the last day for filing a claim for refund or credit of [State] tax pursuant to [citation to State statute setting forth claim for refund requirements], including any extensions; or

(2) One year from the date a Federal Adjustments Report prescribed in Sections B or C, as applicable, was due to the [State Agency], including any extensions pursuant to Section G.

The Federal Adjustments Report shall serve as the means for the Taxpayer to report additional tax due, report a claim for refund or credit of tax, and make other adjustments (including to its net operating losses) resulting from adjustments to the Taxpayer's federal taxable income.

SECTION H. Scope of Adjustments and Extensions of Time.

(1) Unless otherwise agreed in writing by the Taxpayer and the [State Agency], any adjustments by the [State Agency] or by the Taxpayer made after the expiration of the [State's normal statute of limitations for assessment and refund] is limited to changes to the Taxpayer's tax liability arising from Federal Adjustments.

(2) The time periods provided for in [this subdivision of the State Code] may be extended:

(a) Automatically, upon written notice to [State agency], by 60 days for an Audited Partnership or Tiered Partner which has [10,000] or more Direct Partners; or

(b) By written agreement between the Taxpayer and the [State Agency] [pursuant to any regulation issued under this Section].

(3) Any extension granted under this Section G for filing the Federal Adjustments Report extends the last day prescribed by law for assessing any additional tax arising from the adjustments to federal taxable income and the period for filing a claim for refund or credit of taxes pursuant to [citation to State statute setting forth claim for refund requirements].

SECTION I. Effective Date

The amendments to this [section/chapter] applies to any adjustments to a Taxpayer's federal taxable income with a Final Determination Date occurring on and after [date].

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MLPA
The Voice of America's
Master Limited Partnerships

September 19, 2018

Mr. Gregory Mason
Executive Director
Multistate Tax Commission
444 North Capitol Street, NW
Washington DC 20001-1538

Re: Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments (the Model Statute)

Dear Mr. Mason:

This letter is written in support of the Model Statute which we understand was approved by the Multistate Tax Commission (MTC) Executive Committee on September 11, 2018 and will be subject to a public hearing on October 15, 2018.

The Master Limited Partnership Association (MLPA) has worked on the Model Statute over the last two plus years with the MTC Partnership Project Group and the Interested Parties Group which includes Tax Executives Institute, the American Bar Association's State and Local Tax Committee, the Council on State Taxation, the American Institute of CPAs, and the Institute for Professionals in Taxation. Given the publicly traded nature of our MLP members which conduct business throughout the United States, it is imperative for states to adopt a generally consistent response to the United States federal centralized partnership audit regime.

Background

Publicly traded partnerships (PTPs), also known as master limited partnerships (MLPs), are limited partnerships, the interests in which (units) are traded each day on the New York, American and NASDAQ exchanges. Under section 7704 of the Internal Revenue Code, PTPs are taxed as partnerships as long as they meet certain statutory requirements. Currently, there are roughly 140 publicly traded partnerships in the country.

Rules added to the federal tax code in 1987 require any partnership that is publicly traded to receive 90 percent of its income from specified sources in order to be treated as a partnership rather than a corporation for income tax purposes. These qualified sources include mineral or natural resource activities such as exploration, production, mining, refining, marketing and transportation (including pipelines), of oil and gas, minerals, geothermal energy and timber, as well as income and gains from real property.

The reason the United States Congress provided for this treatment of PTPs was to stimulate the development and delivery of capital intensive businesses with low or controlled rates of return. Levying a tax directly on a PTP, or their lower-tier entities, defeats the very purpose of the structure and will result in the overpayment of state tax. It is also important to note that investors in PTPs do not receive any additional state liability protection by virtue of investing in these entities.

Partnership Audit Concerns

Publicly traded partnerships each have tens of thousands, and in some cases, more than 100,000 limited partners commonly referred to as unitholders. The size and overall complexity of the PTP structure result in a series of issues that make certain aspects of many proposed responses to the federal centralized partnership audit regime unworkable for PTPs.

In addition to the sheer volume of impacted taxpayers, PTPs are required to treat each publicly traded unit as fungible pursuant to Securities and Exchange trading requirements. As such, the tax treatment, including partnership audit responses, must be consistent for all unitholders in a PTP. Some PTP unitholders, including tax-exempt organizations, may not be taxable in each state on their full share of distributive income. Unitholders may also have their own state activity or state tax attributes, including passive activity losses, which potentially offset income received from a PTP.

Accordingly, it is imperative that state responses to the federal centralized partnership audit regime include the ability for partnerships, including PTPs, to push-out adjustments to their partners. Additionally, to the extent it is determined to be beneficial for both the partnership and the state taxing authority, the ability to come to an agreement on an alternative reporting or payment method is expected to have a significantly positive impact on the efficiency of the partnership audit response process.

The Model Statute appropriately addresses these concerns along with others raised over the last several years. MLPA endorses the Model Statue and encourages state legislatures to utilize the Model Statute in their upcoming 2019 legislative sessions.

Please let us know if we can provide additional information about this issue or be of assistance.

Best,

Lori Ziebart
Executive Director, MLPA

TAX EXECUTIVES INSTITUTE, INC.

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Chief Tax Counsel

September 11, 2018

Mr. Gregory Matson
Executive Director
Multistate Tax Commission
444 North Capitol Street NW
Washington, DC 20001-1538

RE: Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Items as of July 18, 2018

Dear Mr. Matson:

As you are aware, the Multistate Tax Commission (MTC) formed the Partnership Project in Fall 2016 to address whether new state statutes are needed to address the Bipartisan Budget Act of 2015's (BBA) new federal centralized partnership audit regime, what states should do to audit and track partnership adjustments, whether withholding statutes are effective for multiple-tiered entities, and how old statutes intersect with entity-level federal liability.

Tax Executives Institute (TEI), along with stakeholders such as the American Bar Association's State and Local Tax Committee, the Council on State Taxation, the American Institute of CPAs, the Institute for Professionals in Taxation, and the Master Limited Partnership Association created a working group (Interested Parties) to participate in the MTC's Partnership Project and work on a model statute for reporting federal adjustments to the state. The Interested Parties recognize that consistency among state rules and ease of reporting are essential to efficiently implement the federal partnership audit rules at the state level.

With input from the Interested Parties and the states, the MTC's Partnership Project concluded its work in July 2018, culminating in the Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Items as of July 18, 2018 (Model Uniform Statute). The MTC's Uniformity Committee is presenting the Model Uniform Statute to the MTC's Executive Committee on September 12, 2018.

In conjunction with and in support of this effort, TEI updated its State and Local Tax Policy Statement Regarding State Implementation of the Federal

Partnership Audit Rules to reflect the principles contained in the Model Uniform Statute. TEI endorses these principles and supports states' adoption of the Model Uniform Statute as they seek to enact legislation implementing the federal partnership audit rules at the state level. A copy of TEI's updated policy statement is attached for your reference.

TEI welcomes the opportunity to work with the MTC and the states as they continue efforts on this important matter.

Respectfully submitted,

Tax Executives Institute

James P. Silvestri
International President

cc: Helen Hecht, General Counsel, Multistate Tax Commission

TAX EXECUTIVES INSTITUTE, INC.

State and Local Tax Policy Statement
Regarding State Implementation of the Federal Partnership Audit Rules

Tax Executives Institute maintains that consistency among state rules and ease of reporting are essential to efficiently implement the Bipartisan Budget Act of 2015's (BBA) federal partnership audit rules at the state level.

Partnerships subject to partnership-level audits under the BBA should have the right to appoint state partnership representative(s) that differ from the federal partnership representative and that vary by state.

Imputed underpayments and overpayments arising from partnership level audits should be allocated among the partners as specified in the partnership agreement in effect for the year subject to audit (reviewed year), using the reviewed year's apportionment data as adjusted by the federal audit.

Reporting partnership-level audit adjustments to states should not be triggered until a final determination, which should be deemed to occur after all adjustments made by the IRS to the federal taxable income of the partnership have become final and all appeal rights under the IRC are exhausted or have been waived for the partnership's taxable year. If the taxpayer was a member of a combined or consolidated group, the final determination triggering these reporting obligations should be after no adjustments remain to be finally determined for the entire group.

Subject to exceptions for partnerships subject to composite return/withholding obligations for non-resident direct partners and adjustments attributable to direct and indirect partners that are members of a unitary business, partnerships should have the option to (1) push adjustments out to their partners for their payment of state tax or (2) pay the state tax on the adjustments, in lieu of tax due from direct and indirect partners. This option shall be provided to partnerships regardless of how the partnership handled the payment of federal income tax on such adjustments.

Background

In 2015, Congress passed the Bipartisan Budget Act of 2015 (BBA), which adopted a new federal centralized partnership audit regime for certain partnerships and became effective for taxable years beginning after December 31, 2017. Since the BBA's enactment, Congress passed a technical corrections bill and Treasury released proposed and final regulations providing taxpayers and the Internal Revenue Service (IRS) with further guidance regarding the new federal partnership audit rules.

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The new federal partnership rules, which allow the IRS to audit and assess partnerships at the partnership level, have important implications for how partnerships and their partners report federal adjustments and pay taxes to the states. The Multistate Tax Commission (MTC) thus formed the Partnership Project in Fall 2016 to address whether new state statutes are needed, what states should do to audit and track partnership adjustments, whether withholding statutes are effective for multiple-tiered entities, and how old statutes intersect with entity-level federal liability.

TEI, along with stakeholders such as the American Bar Association's State and Local Tax Committee, the Council on State Taxation, the American Institute of CPAs, the Institute for Professionals in Taxation, and the Master Limited Partnership Association created a working group (Interested Parties) to participate in the MTC's Partnership Project, monitor proposed state legislation, and work on a model statute for reporting federal adjustments to the state. The Interested Parties recognize that consistency among state rules and ease of reporting are essential to efficiently implement the federal partnership audit rules at the state level.

With input from the Interested Parties and the states, the MTC's Partnership Project concluded its work in July 2018, culminating in the Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Items as of July 18, 2018 (Model Uniform Statute). The MTC's Uniformity Committee is presenting the Model Uniform Statute to the MTC's Executive Committee on September 12, 2018, at which time the MTC may open a formal public hearing to seek approval of the Model Uniform Statute. It is anticipated that states will look at the Model Uniform Statute as they consider state legislation addressing how to implement the federal partnership audit rules.

This policy statement summarizes the key principles of the Model Uniform Statute and confirms TEI's endorsement of the principles contained therein for taxpayers to report federal partnership adjustments to states.[1]

Summary of the BBA's Federal Partnership Audit Rules

Under the BBA and subject to certain exceptions, the IRS will audit partnership items at the partnership level and issue a proposed adjustment to the partnership for the reviewed year. For 270 days, the reviewed year partners may file amended returns and pay their share of the tax (the pay-up method), and/or the partnership may submit modifications to the imputed underpayment. After that period, the IRS issues a notice of final partnership audit adjustment. The partnership then has 45 days to elect whether the partnership will use a push-out or partnership pays method. Under the push-out method, the partnership allocates the adjustments to the reviewed year partners and files an informational statement with the IRS, and the reviewed year partners pay the tax on their current year (adjustment year) returns. Under the partnership pays method, the partnership pays the tax on its adjustment year return, causing the current year partners to effectively bear the liability. These practices create complexity at the state level because partners and apportionment data may be different in the reviewed year and the adjustment year.

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[1] This policy statement updates TEI's June 2017 policy statement on this same topic. It also supplements TEI's January 2017 policy statement regarding the Reporting of Federal Income Tax Adjustments, which outlines TEI's position regarding the timing, triggers, and method for reporting federal adjustments to states generally, and identifies other provisions that would be useful to taxpayers and states.

The BBA also requires partnerships to designate a federal partnership representative who has sole authority to act on behalf the partnership with the IRS. The partnership and its partners are bound by the federal partnership representative's actions and decisions.

Model Uniform Statute

The Model Uniform Statute adopts these key provisions for the reporting and payment of tax on final adjustments to the federal taxable income of partnerships and their partners:

- **State Partnership Representative:** The federal partnership representative shall serve as the state partnership representative unless the partnership designates another person as its state partnership representative. Such designations shall be made in writing. States may establish reasonable qualifications for state partnership representatives and reasonable procedures for making such designations. The partnership may designate different people as the state partnership representative for different states.

- **Calculation of Partners' Share of the Adjustments:** Each partner's share of under or over-reported taxable income shall be determined as specified in the partnership agreement in effect for the taxable year subject to audit. The share of the partnership's income apportionable to the state shall be based upon the reviewed year's apportionment data, as adjusted.

- **Final Determination Date:** The partnership's final determination shall occur when all adjustments made by the IRS to the federal taxable income of the partnership have become final and all appeal rights under the IRC are exhausted or have been waived for the partnership's taxable year. If the taxpayer was a member of a combined or consolidated group, the final determination triggering these reporting obligations shall be the first day on which no adjustments remain to be finally determined for the entire group.

- **Default Method of Reporting:** The state partnership representative shall be provided at least 90 days from the partnership's final determination date to (1) file a federal adjustments report with the state, (2) notify its direct partners of their distributive share of the adjustments, and (3) file amended composite and/or withholding returns for direct nonresident partners as required by state law and pay any additional state tax, interest, and penalties for such nonresident partners. Direct partners shall have at least 180 days from the partnership's final determination date to file a federal adjustments report reporting their distributive share of such adjustments and pay any additional state tax, interest, and penalties.

- **Partnership Pays Election:** The partnership alternatively may elect to pay the tax, interest, and penalties in lieu of such amounts its direct and indirect partners owe. Partnerships making this election shall have at least 90 days from the partnership's final determination date to (1) notify the state it is making the election and (2) file a federal adjustments report with the state. The partnership shall have at least 180 days from the partnership's final determination date to make the payment in lieu of amounts owed by

its direct and indirect partners. The partnership pays election shall not apply to portions of the federal adjustment that are includable in the unitary business income of any direct or indirect corporate partner or that result from an administrative adjustment request. Tax, interest, and penalties owed under this methodology shall be calculated as follows:

- **Direct Exempt Partners:** The distributive share of adjustments attributable to direct exempt partners not subject to tax on such income shall be excluded from the calculation.

- **Direct Corporate Partners and Direct Exempt Partners:** The distributive share of adjustments attributable to direct corporate partners and direct exempt partners subject to tax on such income (e.g., unrelated business income) shall be apportioned and allocated to the state using the state's existing multistate business activity apportionment and allocation laws/regulations and shall be subject to tax at the highest rate applicable to such entities.

- **Non-Resident Direct Partners:** The distributive share of adjustments attributable to non-resident direct partners subject to tax as individuals or trusts shall be sourced to the state using the state's existing non-resident partner sourcing laws/regulations and shall be subject to tax at the highest rate applicable to individuals and trusts.

- **Resident Direct Partners:** The distributive share of adjustments attributable to resident direct partners subject to tax as individuals or trusts shall be subject to tax at the highest rate applicable to individuals and trusts.

- **Tiered Partners:** The distributive share of adjustments attributable to tiered partners (partners that are pass-through entities themselves) shall be subject to tax according to the type of underlying income –

  - Income that would be sourced to the state if ultimately attributable to non-resident partners (e.g., business income) shall be sourced to the state using the sourcing rules attributable to such income;

  - Income that would be sourced to the state if attributable to non-resident partners (e.g., investment income) shall be sourced to the state and shall be subject to tax at the highest rate applicable to individuals and trusts, except to the extent the partnership can demonstrate the adjustment is attributable to non-resident indirect partners or partners not subject to tax on such income.

  - The partnership pays election shall be irrevocable unless the state taxing agency determines otherwise. Direct and indirect partners cannot claim deductions, credits, or refunds of amounts paid by the partnership to the state; however, resident direct partners may claim a credit for amounts paid by the partnership or tiered partner on the resident partner's behalf to another state.

- **Tiered Partners:** Tiered partners are subject to the above reporting and payment requirements and may use the default reporting method or the partnership pays election at each tier. Tiered partners and their partners must make all reports and payments within 90 days following the time for filing and furnishing statements to tiered partners under IRC section 6226. State taxing agencies may promulgate regulations to establish procedures and interim deadlines for reports and payments required by tiered partners and their partners.

- **Modified Reporting and Payment:** State taxing agencies and tiered partners may enter into agreements to use alternative reporting and payment methods if the partnership or tiered partner can demonstrate the requested method will reasonably provide for the reporting and payment of taxes, penalties, and interest due.

- **De Minimis Exceptions:** The state may promulgate regulations to establish a de minimis amount upon which taxpayers shall not be required to comply with the aforementioned reporting and payment obligations.

Approved: September 11, 2018

STATE CONFORMITY TO THE IRS CENTRALIZED PARTNERSHIP AUDIT REGIME

ISSUE

The AICPA encourages state CPA societies to work with state lawmakers in response to the federal centralized partnership audit regime (Regime) enacted by Congress in 2015. States are considering the implementation of rules to conform to these federal changes, creating the potential for substantial variance across the nation. State CPA societies are encouraged to work with their state legislatures and tax authorities on adopting the attached model statute.

In order for a state to collect its share of liabilities flowing from an Internal Revenue Service (IRS) partnership audit and not face substantial legal and administrative concerns, the state should adopt the model statute. The model statute provides uniformity and incorporates the changes needed for states to conform to the Regime, as well as establishes more uniform standards for reporting federal audit adjustments for all taxpayers to the states. The model statute also addresses the changes made to federal audit procedures by the Regime that impact state specific issues, such as residency and apportionment.

OVERVIEW OF RECOMMENDATIONS

During the upcoming 2019 legislative sessions, many states are likely to consider enactment of legislation to conform to the federal Regime. State CPA societies should carefully analyze the effect of the current state partnership audit rules and start working with their state legislatures and tax authorities on adopting the attached model statute.

The AICPA previously advised states in March 2017 to wait for federal clarifications before proceeding to draft and enact state specific legislation or regulations in this area given the uncertainty surrounding the IRS proposed regulations (original and recently reproposed) and the adjustments to the Regime in the technical corrections Consolidated Appropriations Act, 2018 enacted by Congress in March 2018. Audits under the new Regime will not begin until late 2019, and the first completed audits are unlikely to occur until late 2020 or early 2021. States should have sufficient time to establish any necessary guidance or procedures before any audits are completed at the Federal level under the new Regime.

The guiding principles behind the model statute, and the issues that state CPA societies should consider as they work with state legislatures and tax authorities are:

- *Allow a partnership the ability to make different elections under the Regime for state purposes than the partnership makes for federal tax purposes, notably for the "push-out" or "pay-up"*

- *elections.*[1] *However, it is recommended that the states require partnerships that elect out of the Regime at the federal level also to opt out at the state level.*

- *Base the apportionment and allocation of the federal adjustment on the apportionment and allocation factors of the reviewed year.*[2] *Use the original apportionment and allocation factors of the reviewed year, adjusted for any federal audit changes. Determine the state-specific tax treatment of items based on the reviewed year apportionment factor.*

- *For the "pay-up" election, apply apportionment factors at the partnership level for all adjustments allocable to all partners except direct resident partners.*

- *For tiered structures, allow flexibility and options to each tier for reporting and payment elections that mirror the federal options.*

- *For administrative ease, offer partnerships the ability to use alternative reporting and payment solutions subject to state approval.*

- *Provide for a single partnership representative for all states regardless of the state of residence of the partnership representatives. One partnership representative should apply for both federal and state purposes. The federal partnership representative may designate a state-specific partnership representative for each state.*

IMPORTANCE TO CPAS

Many CPA firms are structured as partnerships. CPAs also assist clients that operate as partnerships with tax compliance and planning. CPAs offer advice to businesses and their owners on the tax consequences of organizing or restructuring business operations as either partnerships or corporations and interact with the state tax authorities on behalf of their partnership clients.

It is best to develop sound tax and administrative processes and policies regarding the state implementation of the Regime. The goal is to have fair, reasonable, and administrable state partnership audit rules that minimize the complexities and burdens for taxpayers, CPAs, and the

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[1] For federal purposes, if a partnership has not opted out of the Regime, the new federal Regime rules provide for a default approach for the IRS to assess any adjustments at the entity-level for a partnership that is audited. The amount owed by the partnership is referred to as the "imputed underpayment" under section 6225 and is calculated by applying the highest tax rate under section 1 or 11 of the IRC (currently, 37 percent). All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder. A federal election is also provided under IRC section 6226(b) to "push-out" the responsibility to the partners for payment of the partnership tax assessment. This federal election would require partners to make payments based on their pro rata allocation of the audit adjustments. Upon the IRS providing a partnership with a final audit adjustment, a partnership making a "push-out" election must inform the partners who were partners in the reviewed year of the final audit adjustment. For more details regarding the new federal Regime (and the AICPA comments on the proposed regulations), see an article published in *The Tax Adviser* and on the AICPA Partnership Audits Webpage.

[2] The tax years audited by the IRS are commonly referred to as the "reviewed years," and the year in which the audit adjustments are taken into income is commonly referred to as the "adjustment year." This same nomenclature is followed in this document.

state tax authorities. CPAs are interested in working with state tax authorities and state legislatures as new partnership audit rules are contemplated and developed for each state.

INFORMATION, CONCERNS, AND COMPLEXITIES FOR CPAS

The new Regime will bring challenges that CPAs will need to address as they and their clients learn and implement the new rules. Not all states will respond in the same way to the Regime, which will contribute to **additional complexity** in resolving audit matters when dealing with a partnership operating in multiple states. For example, assume State A adopts the "push-out" provisions and State B does not. If partners during the adjustment year bear the economic burden of the imputed underpayment, the preferred option may be to adopt the "push-out" provisions and push the audit adjustments to the reviewed year partners. Since State B does not allow the "push-out," the partnership would need to follow **different sets of procedures in each state**. This nonconformity results in administrative inconvenience, which would rise to an onerous level when a partnership is doing business in multiple states.

Numerous additional concerns exist at the state level. Partnerships and their partners will need to consider whether **nexus** existed in a particular state for the reviewed year but not the adjustment year. **Resident/nonresident considerations** may arise when individual partners move from one state to another between the reviewed and adjustment year. As an example, partners that resided in New York, a state with a significant personal income tax, during a partnership's reviewed year, move to Florida, a state without a personal income tax, prior to the partnership's adjustment year. The Regime envisions taxpayers reporting and paying any additional federal tax in the adjustment year, raising possible state concerns regarding the taxpayer's reviewed year state (in the example, New York) authority to impose additional tax. To address this issue, the model statute provides that nexus applies to the reviewed year, the same year as the original return filings. In addition, **statute of limitations** considerations for partners in overpayment situations are likely to exist. Additional concerns relate to the increased compliance burden of filing amended returns and obtaining enough detailed information from the federal audit to make proper adjustments at the state level.

CONSIDERATIONS FOR STATE CPA SOCIETIES TO ADDRESS WITH STATE LEGISLATURES AND STATE TAX AUTHORITIES

The AICPA encourages state CPA societies to work with policymakers to develop fair, reasonable, and administrable state partnership audit rules that minimize the complexities and burdens to taxpayers and state tax authorities alike.

State CPA societies should carefully analyze the effect of the Regime on current state partnership audit rules and work with their state legislatures and tax authorities on adopting the attached model statute. The AICPA recommends undertaking a process of identifying those state specific areas that the Regime will impact and developing potential options to address them.

State CPA societies may want to reach out to their state tax authority and begin a dialogue on what state specific concerns the state may need to address. One of these considerations is that each of the states must decide whether it will (1) conform to the Regime, (2) partially adopt the new

provisions, or (3) determine the consequences of not adopting them. The laws of many states do not allow for the direct assessment of partnerships as these entities are not taxpayers upon which the state may assess, collect, or levy a tax. In other states, the partnership itself is the taxpayer, and individual assessment is not permitted as the state may not subject individuals to state income taxes. Therefore, many states will need to enact legislation in this area, and state tax authorities will need to issue guidance to explain how the states will implement any changes.

A major issue to address is whether the additional tax resulting from the audit adjustment and paid by the partnership is treated as a partnership-level tax or a partner-level tax paid on behalf of the partners by the partnership. Taxpayers and state tax administrators will need to address the corresponding impact on basis computations, as well as the ability of the individuals to claim credits for taxes paid to other states against their personal resident income tax obligations.

Each state will need to address the application of other state-specific income tax issues to partnerships and their partners, particularly the effect of apportionment and allocation. If a state conforms to the Regime, and, thus, the state requires the assessment, levy, and collection of a state imputed underpayment at the partnership level, presumably the state will need a mechanism to determine what portion of that tax is attributable to the state. States typically use a system of allocation and apportionment to arrive at this result.[3] If a state permits partnerships to push-out the partnership audit adjustments to their reviewed year partners, similar issues exist. In most instances, the allocation and apportionment of the audited partnership would determine the portion of the adjustment sourced to the state. In some situations, however, partners are required to include their unapportioned share of partnership income or loss in pre-apportionment taxable income and their shares of the partnership's apportionment attributes in their partner-level apportionment calculations. This situation typically occurs when a corporate partner owns a controlling interest in a partnership and operates as part of a unitary business with the partnership. These issues can become especially confusing in complex, multi-tiered partnership structures. States will need to provide detailed guidance to taxpayers, their advisors, and specify a clear path to compliance.

The AICPA has developed this paper and is available as a resource to state CPA societies as they assist state authorities develop new state partnership audit rules.

The current version of the model statute is attached as **Appendix A** and a description of model statute is attached as **Appendix B**.

RECENT STATE ACTIVITY

To date, Arizona, Hawaii, and Georgia have enacted legislation to address the federal changes.

Arizona S.B. 1288 was signed into law on May 11, 2016. Arizona's legislative language does not reflect the principles outlined in this paper and does not take into account the guidance issued by the IRS since then. It is now considered likely that Arizona will eventually amend its enacted law to reflect subsequent events, including the development of the draft model statute.

[3] Both Arizona S.B. 1288 and Montana House Bill No. 47 require the use of apportionment for determining the portion of the state imputed underpayment attributable to the state.

The Georgia legislation, H.B. 849, was signed into law by Governor Nathan Deal (R) on May 3, 2018. It generally follows the attached model statute.

The Hawaii legislation, S.B. 2821, was enacted on June 13, 2018. The impact of the bill on partnerships subject to a federal audit is unclear, and it is likely that the state legislature will need to amend the statute.[4]

In California, S.B. 274 was introduced on April 9, 2018, and was subsequently amended several times. It passed the California legislature on August 31, 2018, and now is awaiting the Governor's expected signature. The current version follows the attached model statute, although the default reporting method in the California bill requires a partnership to follow the reporting and payment methodology used at the federal level, while the model statute requires the partners to report and pay any additional state tax on an amended return. However, the California bill, similar to the model statute, allows for a separate state election. The California bill is expected to pass the legislature this year.

In Minnesota, H.F. 3411 was introduced on March 22, 2018 containing some significant differences from the attached model statute and amended several times during the legislative session. Ultimately, the governor vetoed an omnibus tax bill containing the partnership audit provisions.

In Missouri, S.B. 897 was introduced on January 10, 2018, did not include any provisions from the attached model statute, and was not considered further by the legislature.

During the 2017 legislative sessions, Georgia (House Bill 283 and revised substitute House Bill 283), Minnesota (HF 1227), Missouri (SB 521), and Montana (House Bill No. 7), considered bills that did not adopt the model statute and were all ultimately dropped due to the efforts of the local state CPA societies and others.

In addition, a number of state tax departments have indicated formally or informally that they anticipate waiting until the 2019 legislative session to pursue partnership audit conformity legislation. These states include Alabama, Missouri, Indiana, Kentucky, New York and Oregon.

BACKGROUND

On November 2, 2015, Congress enacted the Bipartisan Budget Act of 2015, Pub. L. No.114-74 (BBA),[5] which made significant changes to the partnership audit rules set forth in the Internal Revenue Code of 1986, as amended (IRC). The Regime is a new centralized partnership audit process that replaces the existing audit process previously enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (TEFRA).

[4] The Hawaii statute conforms to many of the IRC provisions on the new Regime, creating an audit procedure similar to the federal Regime for state audits of state tax returns. However, the bill but does not appear to address what the state will do following the completion of a federal audit of a partnership.

[5] Pub. L. No. 114-74 (11/2/15).

The Regime is generally effective for taxable years beginning on or after January 1, 2018. It is expected that the first Internal Revenue Service (IRS) audits will not begin until late 2019, and the IRS likely will not complete those audits until 2021 or later.

The Regime will centralize the ability of the IRS to audit, assess, and collect any determined underpayment directly from a partnership at the entity level, subject to certain available elections. Previously, the IRS could audit the partnership directly, but the IRS could only assess and collect from each individual partner.

Under the Regime, there is an opt-out election available under IRC section 6221(b) for partnerships with 100 or fewer partners that meet certain eligibility requirements. The IRS, on January 2, 2018, issued final regulations (T.D. 9829) regarding the opt-out election.

On March 23, 2018, Congress approved a package of technical corrections to the Regime as part of the Consolidated Appropriations Act, 2018, Pub. L. No.115-141.[6] The changes enacted provided for a new "pull-in" procedure in lieu of partners filing amended returns, clarified that tiered partnerships may elect to use the "push-out" procedures, and included a number of definitional revisions.

On August 6, 2018, Treasury and the IRS issued final regulations on partnership representatives and the election to apply the Regime (TD 9839).

On August 17, 2018, Treasury and the IRS published in the Federal Register updated proposed regulations that withdraw and re-propose certain portions of previously issued proposed regulations implementing the centralized partnership audit regime that the Treasury and IRS had not yet finalized to reflect the changes made by the Technical Corrections Act of 2018.[7] Over the past years, AICPA submitted many comments to Congress and to the IRS on the proposed federal rules.[8] Additional Treasury and IRS proposed guidance is expected later this year on several areas not yet addressed. Final Treasury and IRS regulations are expected in late 2018 or early 2019.

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[6] Pub. L. No.115-141 (3/23/18)

[7] On August 17, 2018, IRS issued new updated proposed regulations (REG-136118-15, REG-119337-17; REG-118067-17; REG-120232-17 and REG-120233-17) that affect partnerships with respect to partnership taxable years beginning after December 31, 2017, as well as partnerships that make the election under the BBA, to apply the centralized partnership audit regime to partnership taxable years beginning on or after November 2, 2015 and before January 1, 2018. The new updated proposed regulations replace the December 19, 2017 issued proposed regulations (REG-120232-17 and REG-120233-17), which covered much of the details for the federal "push-out" election, including rules for applying it to tiered partnership structures. The new updated proposed regulations also replace the previously issued proposed regulations on general rules and procedures (REG-136118-15) (published in the Federal Register on June 14, 2017), affected international tax provisions (REG-119337-17) (published in the Federal Register on November 30, 2017), and the treatment of certain tax attributes under the new Regime (REG-118067-17) (published in the Federal Register on February 2, 2018).

[8] On October 7, 2016, the AICPA submitted to the Treasury Department and the IRS comments on the proposed rules for the new Regime. In addition, on November 17, 2016, the AICPA submitted to Congress recommended legislative changes to the new Regime enacted as part of the Bipartisan Budget Act of 2015. On January 4, 2018, the AICPA submitted to Congress a request to delay for a year the Bipartisan Budget Act of 2015 partnership audits regime due to the remaining uncertainties and lack of final guidance. On May 16, 2018, the AICPA submitted to the Treasury Department and the IRS comments on the proposed regulations (REG-118067-17) regarding adjusting tax attributes.

More details regarding the new federal Regime and the AICPA comments on the proposed regulations are provided in an article published in *The Tax Adviser* and on the AICPA Partnership Audits Webpage.

In addition to AICPA advocacy efforts on the federal action on this issue, assisting with Congressional legislation and interpretive guidance provided by Treasury and the IRS, the AICPA formed an AICPA State Partnership Audits Task Force, comprised of members with expertise in state tax and partnership tax issues. The AICPA task force developed this paper and is available as a resource to state CPA societies as they help state authorities develop new state partnership audit rules.[9]

For the past two years, the AICPA task force also worked with a group of other interested state tax stakeholders (known collectively as the "Interested Parties"), which includes the Council on State Taxation (COST), Tax Executives Institute (TEI), the ABA Section of Taxation's State and Local Tax Committee, the Institute for Professionals in Taxation (IPT), and the Master Limited Partnership Association (MLPA), to develop the attached uniform model statute that incorporates both the changes needed for states to conform with the Regime and establishes more uniform standards for reporting all federal audit adjustments to the states (RAR), a priority for the AICPA and the other organizations.[10] The Interested Parties have worked in conjunction with a project group established by the Multistate Tax Commission (MTC) Uniformity Committee on this issue. The Interested Parties' model statute was accepted as the starting point for the MTC's own draft model statute, and the attached model statute represents the single combined proposal that resulted from those efforts.

On July 24, 2018, the MTC's Uniformity Committee voted to move forward with the attached model statute. On September 12, 2018, the MTC's Executive Committee voted to move forward with an October 15, 2018 public hearing on the attached model statute.

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On August 14, 2017, the AICPA submitted to the Treasury Department and the IRS comments on the general rules and procedures proposed regulations (REG-136118-15). In addition, on September 18, 2017, the AICPA testified at an IRS hearing on the general rules and procedures proposed regulations.

[9] In addition to the AICPA State Partnership Audits Task Force, the AICPA State and Local Tax Technical Resource Panel, AICPA Partnership Tax Technical Resource Panel, and AICPA Tax Executive Committee approved this paper.

[10] In February 2017, the AICPA developed and shared with the state CPA societies a separate paper on Reporting to State Tax Authorities of Federal Tax Examination Adjustments and Their Effect on State Tax Liability RAR and supported a proposed Model Uniform Statute for Reporting Adjustments to Federal Taxable Income.

As of: September 12, 2018

APPENDIX A

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

This draft has internal citations simplified and underlined to aid in the final review.

SECTION A. Definitions

The following definitions apply for the purposes of [this subdivision of the State Code]:

(1) "**Administrative Adjustment Request**" means an administrative adjustment request filed by a Partnership under IRC section 6227.

(2) "Audited Partnership" means a Partnership subject to a Partnership Level Audit resulting in a Federal Adjustment.

(3) "**Corporate Partner**" means a Partner that is subject to tax under [reference to State law].

(4) "Direct Partner" means a Partner that holds an interest directly in a Partnership or Pass-Through Entity.

(5) "Exempt Partner" means a Partner that is exempt from taxation under [reference to State law] [except on Unrelated Business Taxable Income[11]].

(6) "**Federal Adjustment**" means a change to an item or amount determined under the Internal Revenue Code that is used by a Taxpayer to compute [State tax] owed whether that change results from action by the IRS, including a Partnership Level Audit, or the filing of an amended federal return, federal refund claim, or an Administrative Adjustment Request by the Taxpayer. A Federal Adjustment is positive to the extent that it increases state taxable income as determined under [reference to State laws] and is negative to the extent that it decreases state taxable income as determined under [reference to State laws].

(7) "**Federal Adjustments Report**" includes methods or forms required by [State Tax Agency] for use by a Taxpayer to report Final Federal Adjustments, including an amended [State] tax return, information return, or a uniform multistate report.

(8) "**Federal Partnership Representative**" means the person the Partnership designates for the taxable year as the Partnership's representative, or the person the IRS has appointed to act as the Federal Partnership Representative, pursuant to IRC section 6223(a).

(9) "Final Determination Date" means the following**:**

(a) Except as provided in Section A(9)(b) and (c), if the Federal Adjustment arises from an IRS audit or other action by the IRS, the Final Determination Date is the first day on which no Federal Adjustments arising from that audit or other action remain to be finally determined, whether by IRS decision with respect to which all rights of appeal have been waived or

[11] Drafting note: This portion of definition should only be used by the [State] if it taxes unrelated business income.

exhausted, by agreement, or, if appealed or contested, by a final decision with respect to which all rights of appeal have been waived or exhausted. For agreements required to be signed by the IRS and the Taxpayer, the Final Determination Date is the date on which the last party signed the agreement.

(b) For Federal Adjustments arising from an IRS audit or other action by the IRS, if the Taxpayer filed as a member of a [combined/consolidated return/report under State law], the Final Determination Date means the first day on which no related Federal Adjustments arising from that audit remain to be finally determined, as described in Section A(9)(a), for the entire group.

(c) If the Federal Adjustment results from filing an amended federal return, a federal refund claim, or an Administrative Adjustment Request, or if it is a Federal Adjustment reported on an amended federal return or other similar report filed pursuant to IRC section 6225 (c), the Final Determination Date means the day on which the amended return, refund claim, Administrative Adjustment Request, or other similar report was filed.

(10) "**Final Federal Adjustment"** means a Federal Adjustment after the Final Determination Date for that Federal Adjustment has passed.

(11) "Indirect Partner" means a Partner in a Partnership or Pass-Through Entity that itself holds an interest directly, or through another Indirect Partner, in a Partnership or Pass-Through Entity.

(12) "**IRC**" means the Internal Revenue Code of 1986, as codified at 26 United States Code (U.S.C.) Section 1, et seq., [insert State's current practice to incorporate IRC] and applicable regulations as promulgated by the U.S. Department of the Treasury.[12]

(13) "**IRS**" means the Internal Revenue Service of the U.S. Department of the Treasury.

(14) "**Non-Resident Partner**" means an individual, trust, or estate Partner that is not a Resident Partner.

(15) "Partner" means a person that holds an interest directly or indirectly in a Partnership or other Pass-Through Entity.

(16) "Partnership" means an entity subject to taxation under Subchapter K of the IRC.

(17) "**Partnership Level Audit**" means an examination by the IRS at the partnership level pursuant to Subchapter C of Title 26, Subtitle F, Chapter 63 of the IRC, as enacted by the Bipartisan Budget Act of 2015, Public Law 114-74, which results in Federal Adjustments.

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[12] Drafting note: A State may need to address undefined terms. Suggested language – "To the extent terms used in this [article] are not defined in this Section or elsewhere in [citation to chapter in which this article is contained], it is the intent of the Legislature to conform as closely as possible to the terminology used in the amendments to the IRC pertaining to the comprehensive partnership audit regime as contained in the Bipartisan Budget Act of 2015, Public Law 114-74, as amended, and this [article] shall be so interpreted."

(18) "Pass-Through Entity" means an entity, other than a Partnership, that is not subject to tax under [reference to State law imposing tax on C corporations or other taxable entities].

(19) "**Reallocation Adjustment"** means a Federal Adjustment resulting from a Partnership Level Audit or an Administrative Adjustment Request that changes the shares of one or more items of partnership income, gain, loss, expense, or credit allocated to Direct Partners. A positive Reallocation Adjustment means the portion of a Reallocation Adjustment that would increase federal income for one or more Direct Partners, and a negative Reallocation Adjustment means the portion of a Reallocation Adjustment that would decrease federal income for one or more Direct Partners [pursuant to Regulations under IRC section 6225].

(20) "**Resident Partner**" means an individual, trust, or estate Partner that is a resident in [State] under [reference to state laws] for the relevant tax period.

(21) "**Reviewed Year**" means the taxable year of a Partnership that is subject to a Partnership Level Audit from which Federal Adjustments arise.

(22) "**Taxpayer**" means [insert reference to State definition] and, unless the context clearly indicates otherwise, includes a Partnership subject to a Partnership Level Audit or a Partnership that has made an Administrative Adjustment Request, as well as a Tiered Partner of that Partnership.

(23) "**Tiered Partner**" means any Partner that is a Partnership or Pass-Through Entity.

(24) "**Unrelated Business Taxable Income**" has the same meaning as defined in IRC section 512.[13]

SECTION B. Reporting Adjustments to Federal Taxable Income – General Rule

Except in the case of Final Federal Adjustments that are required to be reported by a Partnership and its Partners using the procedures in Section C, and Final Federal Adjustments required to be reported for federal purposes under IRC section 6225(a)(2), a Taxpayer shall report and pay any [State] tax due with respect to Final Federal Adjustments arising from an audit or other action by the IRS or reported by the Taxpayer on a timely filed amended federal income tax return, including a return or other similar report filed pursuant to IRC section 6225(c)(2), or federal claim for refund by filing a Federal Adjustments Report with the [State Tax Agency] for the Reviewed Year and, if applicable, paying the additional [State] tax owed by the Taxpayer no later than 180 days after the Final Determination Date.

Section C. Reporting Federal Adjustments – Partnership Level Audit and Administrative Adjustment Request

[13] Drafting note: This term should only be used by the [State] if it taxes unrelated business income.

Except for adjustments required to reported for federal purposes pursuant to IRC section 6225(a)(2), and the distributive share of adjustments that have been reported as required under Section B, Partnerships and Partners shall report Final Federal Adjustments arising from a Partnership Level Audit or an Administrative Adjustment Request and make payments as required under this Section C.

(1) **State Partnership Representative.**

(a) With respect to an action required or permitted to be taken by a Partnership under this Section C and a proceeding under [reference to provisions for State administrative appeal or judicial review] with respect to that action, the State Partnership Representative for the Reviewed Year shall have the sole authority to act on behalf of the Partnership, and the Partnership's Direct Partners and Indirect Partners shall be bound by those actions.

(b) The State Partnership Representative for the Reviewed Year is the Partnership's Federal Partnership Representative unless the Partnership designates in writing another person as its State Partnership Representative.

(c) The [State Tax Agency] may establish reasonable qualifications for and procedures for designating a person, other than the Federal Partnership Representative, to be the State Partnership Representative.

(2) **Reporting and Payment Requirements for Partnerships Subject to a Final Federal Adjustment and their Direct Partners.** Final Federal Adjustments subject to the requirements of this Section C, except for those subject to a properly made election under Section C(3), shall be reported as follows:

(a) No later than 90 days after the Final Determination Date, the Partnership shall:

(i) File a completed Federal Adjustments Report, including information as required by [State Tax Agency regulation], with [State Tax Agency]; and

(ii) Notify each of its Direct Partners of their distributive share of the Final Federal Adjustments including information as required by the [State Tax Agency regulation]; and

(iii) File an amended composite return for Direct Partners as required under [reference to State law] and/or an amended withholding return for Direct Partners as required under [reference to State law] and pay the additional amount under [reference to State law(s)] that would have been due had the Final Federal Adjustments been reported properly as required.

(b) [Except as provided under State law for minimal tax liabilities][14], no later than 180 days after the Final Determination Date, each Direct Partner that is taxed under [reference to

[14] DRAFTER'S NOTE: If the state adopts a de minimis rule as further set out in this model, then this section would need to be conditioned on a reference to that rule.

State law imposing tax on individuals, trusts, estates, C corporations, etc.] shall:

(i) File a Federal Adjustments Report reporting their distributive share of the adjustments reported to them under Section C(2)(a)(ii) as required under [reference to State laws]; and

(ii) Pay any additional amount of tax due as if Final Federal Adjustments had been properly reported, plus any penalty and interest due under [reference to State law] and less any credit for related amounts paid or withheld and remitted on behalf of the Direct Partner under Section C(2)(a)(iii).

(3) **Election – Partnership Pays.** Subject to the limitations in Section C(3)(c), an Audited Partnership making an election under this Subsection (3) shall:

(a) No later than 90 days after the Final Determination Date, file a completed Federal Adjustments Report, including information as required by the [State Tax Agency rule or instruction], and notify the [State Tax Agency] that it is making the election under this Subsection (3);

(b) No later than 180 days after the Final Determination Date, pay an amount, determined as follows, in lieu of taxes owed by its Direct and Indirect Partners:

(i) Exclude from Final Federal Adjustments the distributive share of these adjustments reported to a Direct Exempt Partner not subject to tax under [reference state law taxing certain income to tax-exempt entities].

(ii) For the total distributive shares of the remaining Final Federal Adjustments reported to Direct Corporate Partners subject to tax under [reference to State law] and to Direct Exempt Partners subject to tax under [reference state law taxing certain income to tax-exempt entities], apportion and allocate such adjustments as provided under [reference to existing multi-state business activity allocation/apportion law or regulation] and multiply the resulting amount by the highest tax rate under [reference to State law(s)];

(iii) For the total distributive shares of the remaining Final Federal Adjustments reported to Non-Resident Direct Partners subject to tax under [reference to State law applying to individuals and /or trusts], determine the amount of such adjustments which is [State]-source income under [reference to existing non-resident partner sourcing law or regulation], and multiply the resulting amount by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(iv) For the total distributive shares of the remaining Final Federal Adjustments reported to Tiered Partners:

(A) Determine the amount of such adjustments which is of a type that it would be subject to sourcing to the [State] under [reference to existing State rules for allocating/apportioning income of non-resident partners]; and then determine the

portion of this amount that would be sourced to the state applying [these rules];

(B) Determine the amount of such adjustments which is of a type that it would not be subject to sourcing to the [State] by a Nonresident Partner under [reference to existing State rules for income fully sourced based on a taxpayer's residency];

(C) Determine the portion of the amount determined in Section C(3)(b)(iv)(B) that can be established, under regulation issued by [State Agency], to be properly allocable to Nonresident Indirect Partners or other Partners not subject to tax on the adjustments; or that can be excluded under procedures for Modified Reporting and Payment Method allowed under Paragraph (5).

(v) Multiply the total of the amounts determined in Section C(3)(b)(iv)(A) and (B) reduced by the amount determined in Section C(3)(b)(iv)(C) by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(vi) For the total distributive shares of the remaining Final Federal Adjustments reported to Resident Direct Partners subject to tax under [reference to State law applying to individuals and /or trusts], multiply that amount by the highest tax rate under [reference to State law applying to individuals and/or trusts];

(vii) Add the amounts determined in Section C(3)(b)(ii), (iii), (v), and (vi), along with penalty and interest as provided in [reference to State law.

(c) Final Federal Adjustments subject to this election exclude:

[DRAFTER'S NOTE: THE EXCLUSION IN (i) IS INTENDED TO ADDRESS THE PARTICULAR STATE'S LAW WITH RESPECT TO ADJUSTMENTS THAT WOULD FLOW THROUGH TO CORPORATE PARTNERS AND MIGHT BE TREATED AS PART OF THE UNITARY BUSINESS OF THE CORPORATION.]

(i) The distributive share of Final Audit Adjustments that under [reference to State law] must be included in the unitary business income of any Direct or Indirect Corporate Partner, provided that the Audited Partnership can reasonably determine this; and

(ii) Any Final Federal Adjustments resulting from an Administrative Adjustment Request.

(d) {OPTIONAL PROVISIONS}

Option A - An Audited Partnership not otherwise subject to any reporting or payment obligation to [State] that makes an election under this Subsection (3) consents to be subject to [State] laws related to reporting, assessment, payment, and collection of [State] tax calculated under the election.

Option B - An Audited Partnership not otherwise subject to any reporting or payment obligation to [State] may not make an election under this Subsection (3).

(4) **Tiered Partners.** The Direct and Indirect Partners of an Audited Partnership that are Tiered Partners, and all of the Partners of those Tiered Partners that are subject to tax under

[reference to State laws imposing tax on individuals, trusts, corporations, etc.] are subject to the reporting and payment requirements of Section C(2) and the Tiered Partners are entitled to make the elections provided in Section C(3) and (5). The Tiered Partners or their Partners shall make required reports and payments no later than 90 days after the time for filing and furnishing statements to Tiered Partners and their Partners as established under IRC section 6226 and the regulations thereunder. The [State Agency] may promulgate regulations to establish procedures and interim time periods for the reports and payments required by Tiered Partners and their Partners and for making the elections under this Section C.

(5) **Modified Reporting and Payment Method.** Under procedures adopted by and subject to the approval of the [State Agency], an Audited Partnership or Tiered Partner may enter into an agreement with the [State Agency] to utilize an alternative reporting and payment method, including applicable time requirements or any other provision of this Section C, if the Audited Partnership or Tiered Partner demonstrates that the requested method will reasonably provide for the reporting and payment of taxes, penalties, and interest due under the provisions of this Section C. Application for approval of an alternative reporting and payment method must be made by the Audited Partnership or Tiered Partner within the time for election as provided in Section C(3) or (4), as appropriate.

(6) **Effect of Election by Audited Partnership or Tiered Partner and Payment of Amount Due.**

(a) The election made pursuant to Section C(3) or (5) is irrevocable, unless [State Agency], in its discretion, determines otherwise.

(b) If properly reported and paid by the Audited Partnership or Tiered Partner, the amount determined in Section C(3)(b), or similarly under an optional election under Section C(5), will be treated as paid in lieu of taxes owed by its Direct and Indirect Partners, to the extent applicable, on the same Final Federal Adjustments. The Direct Partners or Indirect Partners may not take any deduction or credit for this amount or claim a refund of the amount in this State. Nothing in this Subsection(C)(6) shall preclude a Direct Resident Partner from claiming a credit against taxes paid to this State pursuant to [reference to State law], any amounts paid by the Audited Partnership or Tiered Partner on the Resident Partner's behalf to another state or local tax jurisdiction in accordance with the provisions of [State law or regulation allowing credit for taxes paid to another state or locality].

(7) **Failure of Audited Partnership or Tiered Partner to Report or Pay**. Nothing in this Section C prevents the [State Agency] from assessing Direct Partners or Indirect Partners for taxes they owe, using the best information available, in the event that a Partnership or Tiered Partner fails to timely make any report or payment required by this Section C for any reason.

SECTION D. De Minimis Exception

The [State Agency] at its discretion may promulgate regulations to establish a de minimis amount upon which a taxpayer shall not be required to comply with Sections B and C of this [Chapter].

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

The [State Agency] will assess additional tax, interest, and penalties arising from Final Federal Adjustments arising from an audit by the IRS, including a Partnership Level Audit, or reported by the Taxpayer on an amended federal income tax return or as part of an Administrative Adjustment Request by the following dates:

(1) **Timely Reported Federal Adjustments.** If a Taxpayer files with the [State Agency] a Federal Adjustments Report or an amended [State] tax return as required within the period specified in Sections B or C, the [State Agency] may assess any amounts, including in-lieu-of amounts, taxes, interest, and penalties arising from those Federal Adjustments if [State Agency] issues a notice of the assessment to the Taxpayer no later than:

(a) The expiration of the limitations period specified in [citation to State statute setting forth normal limitations period]; or

(b) The expiration of the one (1) year period following the date of filing with the [State Agency] of the Federal Adjustments Report.

(2) **Untimely Reported Federal Adjustments.** If the Taxpayer fails to file the Federal Adjustments Report within the period specified in Sections B or C, as appropriate, or the Federal Adjustments Report filed by the Taxpayer omits Final Federal Adjustments or understates the correct amount of tax owed, the [State Agency] may assess amounts or additional amounts including in-lieu-of amounts, taxes, interest, and penalties arising from the Final Federal Adjustments, if it mails a notice of the assessment to the Taxpayer by a date which is the latest of the following:

(a) The expiration of the limitations period specified in [citation to State statute setting forth normal limitations period]; or

(b) The expiration of the one (1) year period following the date the Federal Adjustments Report was filed with [State Agency]; or

(c) Absent fraud, the expiration of the six (6) year period following the Final Determination Date.

SECTION F. Estimated [State] Tax Payments During the Course of a Federal Audit

A Taxpayer may make estimated payments to the [State Agency], following the process prescribed by the [State Agency], of the [State] tax expected to result from a pending IRS audit, prior to the

due date of the Federal Adjustments Report, without having to file the report with the [State Agency]. The estimated tax payments shall be credited against any tax liability ultimately found to be due to [State] ("Final [State] Tax Liability") and will limit the accrual of further statutory interest on that amount. If the estimated tax payments exceed the final tax liability and statutory interest ultimately determined to be due, the Taxpayer is entitled to a refund or credit for the excess, provided the Taxpayer files a Federal Adjustments Report or claim for refund or credit of tax pursuant to [citation to State statute setting forth claim for refund requirements] no later than one year following the Final Determination Date.

SECTION G. Claims for Refund or Credits of Tax Arising from Final Federal Adjustments Made by the IRS

Except for Final Federal Adjustments required to be reported for federal purposes under IRC section 6225(a)(2), a Taxpayer may file a claim for refund or credit of tax arising from Federal Adjustments made by the IRS on or before the later of:

(1) The expiration of the last day for filing a claim for refund or credit of [State] tax pursuant to [citation to State statute setting forth claim for refund requirements], including any extensions; or

(2) One year from the date a Federal Adjustments Report prescribed in Sections B or C, as applicable, was due to the [State Agency], including any extensions pursuant to Section G.

The Federal Adjustments Report shall serve as the means for the Taxpayer to report additional tax due, report a claim for refund or credit of tax, and make other adjustments (including to its net operating losses) resulting from adjustments to the Taxpayer's federal taxable income.

SECTION H. Scope of Adjustments and Extensions of Time.

(1) Unless otherwise agreed in writing by the Taxpayer and the [State Agency], any adjustments by the [State Agency] or by the Taxpayer made after the expiration of the [State's normal statute of limitations for assessment and refund] is limited to changes to the Taxpayer's tax liability arising from Federal Adjustments.

(2) The time periods provided for in [this subdivision of the State Code] may be extended:

(a) Automatically, upon written notice to [State agency], by 60 days for an Audited Partnership or Tiered Partner which has [10,000] or more Direct Partners; or

(b) By written agreement between the Taxpayer and the [State Agency] [pursuant to any regulation issued under this Section].

(3) Any extension granted under this Section G for filing the Federal Adjustments Report extends the last day prescribed by law for assessing any additional tax arising from the adjustments to federal taxable income and the period for filing a claim for refund or credit of taxes pursuant to

[citation to State statute setting forth claim for refund requirements].

SECTION I. Effective Date

The amendments to this [section/chapter] applies to any adjustments to a Taxpayer's federal taxable income with a Final Determination Date occurring on and after [date].

APPENDIX B

Description of Provisions in the Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments

The below description of the model statute was developed by the AICPA to assist state CPA societies in understanding the various sections of the model statute.

Section A. Definitions

This section includes the necessary definitions and references to the IRC for both the general RAR provisions and the Regime specific provisions. State CPA societies may want to work with their state's tax department to identify any existing provisions in state law or regulation that may conflict with these definitions and require modification.

A key provision is the definition of "Final Determination Date." This is currently undefined or unclear under the existing statutes in many states. Establishing a consistent definition of this term is an important element of both the RAR and the Regime projects.

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

This section covers the procedure for reporting adjustments to a taxpayer's return other than those adjustments resulting from a partnership level audit under the Regime. It is intended to establish consistency among the states as to timing and procedure for reporting changes resulting from IRS audits and taxpayer prepared amended federal returns.

Section C. Reporting Federal Adjustments – Partnership Level Audit and Administrative Adjustment Request

This section contains the new procedures to allow states the ability to process adjustments from a federal audit conducted under the Regime and collect the appropriate amount of tax regardless of the reporting and payment options selected by the partnership at the federal level.

Specifically, the attached model statute provides for the following recommended procedures.

Flexibility of Elections

Certain elections are available under the Regime that should also extend to the state level.

The model statute provides that the default method used to report the changes resulting from a federal partnership audit to the state is similar to the federal "push-out" method. Unlike the federal procedure, partners would file amended returns for the reviewed (i.e., audited) year. This default method is effectively the same as the current procedure in use following a TEFRA audit. Notwithstanding this default rule, the model statute also provides that states allow partnerships to make a state-level election to pay state tax on the apportioned and allocated federal imputed

underpayment at the partnership level (and report amounts paid to individual partners) or request a modified reporting and payment method for use, subject to approval by the state tax authority.

There are circumstances in which the state adjustments are much smaller than federal adjustments once the state apportionment factor is applied or state modifications are made to the federal adjustments. For ease of administration, the partnership and its partners may prefer to pay the state tax at the partnership level, as opposed to burdening the partners with having to file separate amended returns in each state. In some cases, the administrative costs for filing the amended returns would far exceed the amount of tax the state would collect from the partners; processing amended tax returns and collecting from all the partners increases the administrative costs and compliance burdens to the state taxing authorities.

In contrast to the general flexibility in allowing state-specific elections that are independent of the federal elections made with respect to the Regime, the model statute envisions partnerships that elect out of the Regime at the federal level are not subject to the provisions of Section C. This treatment is because their partners will file amended returns at the federal level and thus have a requirement, under state law, to file amended state returns as well.

Apportionment and Allocation Factors

For consistency and to avoid any potential constitutional issues, the model statute provides that states base the apportionment and allocation of the federal adjustment on the apportionment and allocation factors and rules that apply in the reviewed year. States should use the original apportionment and allocation factors of the reviewed year, adjusted for any effects resulting from federal audit changes. The states should determine the state-specific tax treatment of items based on the reviewed year apportionment factor.

Tiered Structures

The model statute provides that states allow any upper-tier partnerships in a tiered ownership structure to make a state-level election to use the "pay-up" election in the same manner as the audited partnership.

Under the federal regime, as modified by the technical corrections enacted in 2018, all partners and partnerships in a tiered ownership structure must report and pay the additional tax due by the extended due date of the audited partnership's adjustment year. For example, if the IRS completes an audit and issues a final notice on July 1, 2021, the adjustment year is 2021, and the extended due date is September 15, 2022. Under the model statute, partners and partnerships in a tiered ownership structure must report and pay the additional tax due to the states no later than 90 days after the federal date – in the example, this date is December 15, 2022. States are permitted to establish interim deadlines for each tier if desired.

Partnership Representative

The model statute provides that states should recognize for state purposes a partnership's selection at the federal level of a Partnership Representative.

Having a single individual responsible for all decisions relating to the audit, whether federal or state related, will provide certainty and simplicity to the process.

In addition, the model statute would allow the federal Partnership Representative to designate a state specific Partnership Representative for each state to act in the place of the federal Partnership Representative for that state. The federal Partnership Representative would coordinate all the state specific Partnership Representative designations.

Calculation of Tax Under Partnership Pays Election

The model statute provides specific guidelines on how a partnership calculates the amount of tax due to each state in which it elects to pay on behalf of its direct partners. It also excludes the distributive share of adjustments for certain partners from the partnership pays election, requiring those partners to report and pay their share of the additional tax directly to the state.

Corporate Partners – Direct and Indirect Corporate Partners of which the partnership is aware, subject to a unitary business filing requirement, are excluded from the partnership pays election. For all other Direct Corporate Partners, the adjustments are apportioned and allocated based on the partnership's factors under state law related to multi-state business activity. The tax is calculated using the state's highest corporate tax rate.

Tax-Exempt Partners – Any adjustment to income subject to a state's Unrelated Business Income Tax (or similar) is treated similarly to adjustments for Corporate Partners.

Resident Partners – The full distributive share of federal adjustments assigned to Direct Resident Partners is taxed at the state's highest individual tax rate.

Non-Resident Partners – For Direct Non-Resident Partners, the adjustments are apportioned and allocated based on the partnership's factors under state law related to non-resident sourcing rules. The tax is calculated using the state's highest individual tax rate.

Tiered Partners – The distributive share of adjustments attributed to Direct Tiered Partners is separated into two buckets. One bucket consists of income typically not subject to a state's non-resident souring rules (usually "investment type" income). The second bucket is all other types of adjustments. This second group is treated the same as income attributed to Non-Resident Partners. The first group (the "investment type" income) is treated the same as income attributed to Resident Partners except for any portion a partnership establishes to the satisfaction of the state tax authority is attributable to an Indirect Partner that is not subject to tax as a resident of the state (as an example – an Indirect Non-Resident Partner).

The detailed procedures for calculating the amount of tax owed under the partnership pays elections were developed with significant input from state tax authorities through the MTC as a fair and equitable trade-off between the amount collectible under the push-out procedures and the administrative ease provided to both taxpayers and the states.

Sections D, E, F, G, H and I

These remaining sections of the model statute contain provisions covering statute of limitations on assessments and refund claims, a de minimis exception, estimated payment procedures and an effective date clause. All or most of these provisions already exist in many states' current tax statutes in some form. We recommend that states consider adopting these items or modifying their existing provisions to further the goals of uniformity, which helps ease administrative burdens and costs for both taxpayers and state tax departments.

AICPA State Regulatory and Legislative Affairs

State Conformity to the IRS Centralized Partnership Audit Regime

ISSUE

The AICPA encourages state CPA societies to work with state lawmakers to adopt the model statute in response to the federal centralized partnership audit regime (Regime) enacted by Congress in 2015. States are considering the implementation of rules to conform to these federal changes, creating the potential for substantial variance across the nation.

In order for a state to collect its share of liabilities flowing from an Internal Revenue Service (IRS) partnership audit and not face substantial legal and administrative concerns, the state should adopt the model statute. The model statute provides uniformity and incorporates the changes needed for states to conform to the Regime, as well as establishes more uniform standards for reporting federal audit adjustments for all taxpayers to the states. The model statute also addresses the significant changes made to federal audit procedures by the Regime that impact state specific issues, such as residency and apportionment.

BACKGROUND

In November 2, 2015, Congress enacted the Bipartisan Budget Act of 2015, making significant changes to the Internal Revenue Code partnership audit rules. The new rules centralize the ability of the IRS to audit, assess, and collect any determined underpayment directly from a partnership at the *entity level*. Previously, the IRS could audit the partnership directly, but the IRS could only assess and collect from each *individual partner*.

On March 23, 2018, Congress approved technical corrections to the Regime as part of the Consolidated Appropriations Act, 2018, Pub. L. No.115-141. The enacted changes provided for a new "pull-in" procedure in lieu of partners filing amended returns, clarified that tiered partnerships may elect to use the "push-out" procedures, and included a number of definitional revisions.

The IRS is unlikely to begin the partnership audits before 2020. Treasury and the IRS issued a series of proposed regulations on the implementation of the Regime. Additional Treasury and IRS proposed guidance is expected later this year on several areas not yet addressed. Final Treasury and IRS regulations are expected in late 2018 or early 2019.

IMPORTANCE TO CPAs

Many CPA firms are structured as partnerships. CPAs also assist clients that operate as partnerships with tax compliance and planning, and CPAs interact with state tax authorities on behalf of their partnership clients. CPAs are interested in working with state tax authorities and state legislatures as new partnership audit rules are contemplated and developed for each state.

AICPA POSITION

The AICPA encourages state CPA societies to work with policymakers to develop fair, reasonable, and administrable state partnership audit rules that minimize the complexities and burdens to taxpayers and state tax authorities.

State CPA societies should carefully analyze the effect of the Regime on current state partnership audit rules and work with their state legislatures and tax authorities on adopting the model statute developed by a coalition of interested organizations, including the AICPA, in conjunction with the Multistate Tax Commission. The AICPA recommends undertaking a process of identifying those state specific areas that the new Regime will impact and developing potential options to address them.

STATE ACTIVITY

To date, Arizona, Hawaii and Georgia are the only states that have enacted legislation to address the federal changes. During the 2018 legislative session, Georgia adopted into law, and California recently passed, bills that generally follow the model statute. The California bill passed the legislature on August 31, 2018, and now is awaiting the Governor's expected signature. Hawaii passed a law, but the impact of the bill on partnerships subject to a federal audit is unclear, and it is likely that the state legislature will need to amend the statute. Minnesota and Missouri considered bills that were ultimately not enacted. During the 2017 legislative sessions, Georgia, Minnesota, Missouri, and Montana considered bills that did not adopt the model statute and were all ultimately dropped due to the efforts of the local CPA state societies and others.

As of September 12, 2018

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October 11, 2018

Helen Hecht
General Counsel/Hearing Officer
Multistate Tax Commission
444 North Capitol Street, NW
Washington, DC 20001-1538

RE: Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Items as of July 24, 2018

Dear Hearing Officer Hecht:

I am writing to inform you that the Board of Directors of the Council On State Taxation (COST) has officially endorsed the above referenced model statute (hereinafter referred to as "Model RAR Statute"). In addition, COST is in the process of revising its policy statement on Reporting Requirements for Federal Changes to reflect certain provisions in the Model RAR Statute and to suggest that the model be adopted by the states as the gold standard for the reporting of federal changes. We appreciate the MTC's work on this model, and specifically thank the Uniformity Committee, Partnership Working Group as well as the states for collaboration with COST and the other Interested Parties (American Bar Association's State and Local Tax Committee, American Institute of CPAs, Institute for Professionals in Taxation, Master Limited Partnership Association and Tax Executives Institute).

COST encourages you to recommend the Model RAR Statute for endorsement by the Executive Committee of the MTC at the MTC's Fall Meeting being held in Orlando next month. This model addresses not only the new federal partnership audit provisions, which most states will need to address in 2019, but also the reporting of federal changes generally. The MTC's endorsement of this model will allow states to move forward with 2019 legislative proposals to adopt the Model RAR Statute, which will promote uniformity and provide greater compliance.

Respectfully,

Douglas L. Lindholm

cc: COST Board of Directors
Gregory S. Matson, Executive Director, MTC