

S CORPORATIONS, PARTNERSHIPS AND LLCs

A State Tax Administrator's Perspective on Partnership Taxation

Entity-level assessment will require states to consider the implications with respect to nexus, apportionment, and conformity.

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To say that taxing partnership¹ income on a pass-through basis creates enforcement challenges for tax administrators would be an understatement. At best, pass-through taxation is just inherently more complicated than imposing tax directly on a business entity. At worst, pass-through taxation can provide a convenient mechanism for all sorts of aggressive tax planning, starting in the 1970s with simple passive loss schemes and evolving, most recently, into complex structures with memorable acronyms like FLIP, BLIPS, OPIS, BOSS, and of course, Son of BOSS.²

The response of federal lawmakers to these tax schemes has not made things simpler. The federal substantive rules, as set out in IRC Subchapter K and the related IRS regulations, as well as the judicial opinions interpreting them, have become a tangled web of patches for the holes drilled into the pass-through system by tax shelters. This complex web of rules applies to all partnerships, including those not engaged in any sort of questionable tax planning. It also applies to determination of state taxes, since states have almost uniformly tied themselves to the federal pass-through rules.

Even without these complex rules, pass-through taxation would raise enforcement challenges due to the need to collect tax, not from the entity, but from the owners. As far as basic enforcement tools, the states

generally rely on withholding and reporting obligations imposed on partnerships for income allocated to nonresident partners, or on requirements to file composite returns.³

When it comes to making sure taxpayers comply with the complexities of Subchapter K, the states are largely dependent upon the ability of the Internal Revenue Service to do at least a minimum level of administrative enforcement. Recently, however, Congress recognized that the IRS lacks this ability. It therefore passed the Bipartisan Budget Act of 2015 (BBA) in an attempt to overhaul the partnership audit process.⁴

This article takes a look at partnership tax enforcement from the perspective of a state tax administrator and the possible effect that the BBA may have on certain issues unique to the states. (Although due to the exceedingly complex nature of the issues, it can only scratch the surface.)

Choosing the Partnership Structure

So much attention is given to C corporations by tax practitioners and the tax press that one might get the impression all business activity takes that form. But in 2012, of the 34 million-plus businesses in the United States, only 1.6 million were C corporations. The vast majority (and by far the fastest growing category) were sole proprietorships (Schedule C businesses). Partnerships and S corporations outnumbered C corporations 7-to-1. The numbers of C corporations are actually in decline.⁵ And while C corporation assets and receipts still exceed those of pass-through entities by roughly a factor of 3 (and non-farm proprietorships by a factor of about 20),⁶ C corporations account for less than half of all net taxable business income.⁷

Among C corporations, S corporations and partnerships, there is a concentration of receipts, as well as income and assets, in the hands of a relatively few firms. For example, the largest 1% of C corporations—only about 19,504 firms—report about 90% of C corporation receipts. About 84% of total receipts of partnerships are reported by the largest 1%, or 37,845 firms. And about 89% of total receipts of S corporations are reported by the largest 2%, or 81,110 firms.⁸

Both S corporations and partnerships impose only one level of taxation. As a result, an equity investment in a C corporation is subject to an effective rate of taxation about 8 points higher than an investment in a pass-through entity.⁹ This has undoubtedly driven some portion of the growth of pass-throughs.

However, importantly for this article, there are two differences in how S corporations and partnerships are treated for tax purposes. First, while an S corporation can have only one class of stock and must allocate its

tax items uniformly,¹⁰ partnerships have significant flexibility in allocating tax items to owners. Second, there are strict limits on the number and types of owners an S corporation may have,¹¹ while partnerships have few limits with respect either to numbers or types of owners. Because these features of partnerships greatly complicate tax enforcement, the remainder of this article focuses solely on the pass-through taxation of partnerships.

The General Policy Behind Partnership Taxation

At the policy level, partnership taxation illustrates that perennial tension between economic theory and administrative feasibility. Despite its complexity, Subchapter K, the portion of the Internal Revenue Code that governs the tax treatment of partnership-related income and losses by partners, has been said to have a special kind of logic.¹² There are four core elements. First, contributions to the partnership and distributions from the partnership (to the extent of basis) are not taxed.¹³ Second, it is the partnership that will value and characterize the various tax items of the business—represented by the federal Form 1065.¹⁴ Third, the partnership will allocate shares of those items to the partners according to their agreement (subject to certain constraints)—represented by the federal Schedule K-1.¹⁵ Fourth, rather than waiting until income is distributed, the taxable owners will pay tax on their share of those partnership items in the year items are recognized—most often on a 1040 or 1120 tax return.¹⁶

What is the policy rationale behind this pass-through system? First, tax-free contributions and distributions are necessary for creating a system with a single level of tax. Second, because it is the partnership that engages in transactions giving rise to income and expense, it makes sense to characterize those items in the hands of the partnership—and for that characterization to flow through to the owners. Third, allowing partners to agree as to how partnership items will be shared means that the tax effects will, ideally, track the real economic agreement between the owners. And finally, taxing income in the year earned, rather than when distributed, prevents unlimited deferral.

But the overarching rationale, at least from an economist's standpoint, for this pass-through system is that the partner's tax profile ultimately determines how much tax is paid. So, if two partners invest in the same partnership and derive equal amounts of income from it, they will not necessarily pay the same amount of tax. Rather, the tax they pay will depend on all their personal tax-related characteristics—filing methods; number of dependents; marginal tax rates; offsetting income, gains or losses from other sources; ability to deduct certain partnership expenses; etc.¹⁷

The Administrative Challenges

From an administrator's standpoint, the concept of collecting tax on an entity's income from the owners, rather than from the entity, is easier to describe than it is to effectively implement. Nor should there be any doubt where the blame for this lies. Subchapter K's pass-through system has been described as: "a mess," "a disaster," "a magic circle of tax abuse," "a deeply flawed system," and, even in its early days, "one of the most complex and confused subjects in the entire area of the income tax."¹⁸

Four things, in particular, complicate matters. First, whether allocation of tax items to the partners actually reflects the true economic arrangement between them depends on the ultimate economic settlement of their interests, which will typically occur at some indeterminate future time (through distributions or liquidation). This makes it virtually impossible for tax administrators to confirm in "real time" that the tax effects and benefits claimed are based on an ultimate economic reality. Subchapter K, therefore, imposes recognition rules and accounting requirements to help ensure that benefits or costs ultimately realized by each partner will match the taxes that partner reported. But these rules are effective only if they are properly agreed to and observed over the life of the partnership. For this reason, such accounting rules have had to be backed up by bright-line standards or anti-abuse rules.¹⁹

Second, it is possible to have a complex multi-tiered partnership structure where tax items pass through a number of entities, each with its own potentially complex agreement, before those items wind up on some taxable owner's return. By that time, the item may bear little resemblance to the original item recognized by the lowest-tier partnership. This makes it difficult to stay true to the principle that items will be characterized in the hands of the partnership that earns or incurs them. It also further complicates the tax administrator's job of confirming that tax allocations reflect the true economic deal between the partners. (The nature of these multi-tiered structures, some of which involve hundreds of pass-through entities, also casts some doubt on the efficacy of the BBA's partnership-level audit approach, given that auditing only one entity in such a structure would appear grossly inadequate, but that's a subject for another article.)

Third, partnerships are inherently opaque. Some agreements between partners may not even be written down. And partners in multi-tiered structures generally have little information about the partnerships in which they effectively hold indirect interests. (They receive a Schedule K-1 only from the partnership in which they own a direct interest, even if the income was generated in a lower-tier partnership.)

Finally, partnerships are generally not liable for the taxes of the partners, nor are partners liable for each other's taxes. Even if a derivative liability were imposed on the partnership, the informal nature and flexibility

of partnership structures would provide various means to avoid having significant assets subject to that liability. So tax authorities would typically need to look to each partner, and that partner's assets, to collect a share of the tax due (with the exception of withholding requirements that may be imposed on nonresident or foreign partners²⁰).

The Enforcement Problem—and a Possible Partial Solution

So how big can the enforcement problems possibly be? As it turns out, pretty big. The IRS has now admitted what many tax experts long suspected—that it is simply impossible to perform an effective audit on the income of the largest partnerships and make adjustments at the partner level. In 2012, the audit rate for large corporations was 27% while the audit rate for large partnerships was less than 1%.²¹ This apparently convinced Congress that the enforcement problem had to be addressed and in 2015 it passed the BBA in an attempt to remedy it.

Under the BBA, audits of large partnerships (see below) will be done at the partnership level and a partnership representative will make all audit-related decisions on behalf of the partners.²² If the audit turns up proposed adjustments, taxable partners are given time (a 270-day "modification period") in which they may choose to file amended returns and pay tax for the affected years (the "pay-up election").²³ After that, tax on any remaining adjustments is computed and assessed to the partnership, which must then pay that assessment ("partnership pays") or elect to have the affected partners report and pay their share (the "push-out election").²⁴

In determining the partnership level liability (the "imputed underpayment"), adjustments to the 1065 (partnership tax items recognized) are treated differently than adjustments to Schedule K-1 allocations (each partner's share of those items). Adjustments to partnership items that would result in under- and over-reported tax will be netted, but adjustments to allocations between partners will not.²⁵ Also, the tax rate applied will generally be the highest marginal rate.²⁶

To be clear, under this new system, if the partnership pays, it will simply pay the final partnership adjustment and will not provide any tax document to the partners, who will have no federal tax filing requirement or liability. (The partnership will presumably make an internal allocation of the cost of the tax paid to the partners, as appropriate). If, instead of paying the tax, the partnership elects to push out the remaining adjustments to the partners, it will be responsible for doing so on a new tax information return designed to allow the IRS to confirm that the adjustments have been properly allocated and also allow the

partners to report and pay any additional tax on their current year ("adjustment year") returns. If the partnership wishes to contest the audit, it must make a deposit of the amount of the final partnership liability first, even if it elects to push out the adjustments.²⁷

The IRS issued regulations to implement these provisions on January 18, 2017, which were withdrawn as part of the new administration's regulatory freeze.²⁸ Congress also introduced a technical corrections bill in late 2016, but the bill was not enacted.²⁹ One significant unknown is whether audited partnerships with partnership partners (multi-tiered entities) will be allowed to elect to push-out audit adjustments. This article assumes they will not.

Suffice it to say, in the context of federal audits of large partnerships, the rationale that underpins the pass-through system takes a backseat to the need for effective enforcement, especially assuming the partnership chooses to (or is required to) pay the tax on the final partnership adjustment. In that case, the tax paid will likely exceed the tax that would be paid if the partnership and the partners had properly reported on original returns.

What About the States?

The starting point for most states' income tax calculations is federally reported income. So if a taxpayer files an amended federal return, or is audited by the IRS, it affects state taxes owed. For this reason, existing state laws require taxpayers to report federal changes and pay any additional state tax due.³⁰ But it is not clear exactly how states will adapt to the new partnership audit and adjustment rules under the BBA.

Consequently, the Multistate Tax Commission's Uniformity Committee³¹ has convened a partnership work group to study the audit and adjustment rules and make recommendations to the states on how to adapt to those rules. That work group has been meeting for almost a year and has been fortunate to receive the attention of a number of other groups including the American Bar Association Tax Section, the AICPA, the Council On State Taxation, and the Tax Executives Institute. The MTC uniformity process typically goes through multiple stages—information gathering, issue identification, policy formulation, model drafting, model approval, public hearing, Bylaw 7 survey, and recommendation by the Commission to the states.

The MTC Uniformity Committee and the partnership work group spent over six months soliciting comments on and discussing potential state tax issues. Copies of the issue lists developed by the work group and submitted by the ABA/AICPA task force are available on the MTC project web page.³² Uncertainty over federal developments, including whether the IRS will reissue proposed regulations or whether Congress will

enact technical corrections has impeded the work group's progress. Nevertheless, because states need time to enact and implement changes, the uniformity committee has asked the work group to proceed as best it can.

While the authors cannot predict the outcome of the work group's efforts, it appears from discussions that states should expect a significant number of audited partnerships will be required to (because they have partnership partners), or will choose to, pay the tax liability on federal adjustments rather than push those adjustments out to partners. Partnerships that are not required to pay the partnership liability may do so because of the substantial administrative cost for both partnerships and partners of doing otherwise. Where the partnership agrees to pay the liability, states will have little practical choice but to acquiesce. Also, it appears likely that in the course of adapting state law to the new federal rules, practitioners and others will ask that states allow partnerships to pay the state-level tax at the partnership level, even if the partnership has elected to push out the adjustments for federal purposes.

Assuming, therefore, that partnership-level assessment may be the normal result under federal audits, there are certain issues that states must consider which the federal government does not face. Those issues are the focus of the remainder of this article.

The Typical Large Partnership

Before turning to the unique state issues implicated by entity-level taxation, it's useful to first describe the typical large partnership that would be subject to the audit provisions of the BBA. In general, a large partnership is defined as any partnership with more than 100 partners,³³ or more than a single tier (that is, a partnership that has partners that are partnerships).³⁴ But other than having large, complex structures, what will these partnerships typically look like?

We know something about the breakdown of partnership owners generally. C corporations are estimated to own only 1-10% of the total number of partnership interests (represented by Schedule K-1s).³⁵ It's reasonable to expect that many of the partnership interests held by C corporations are part of a closely held corporate structure and would either not be large partnerships under the BBA's definition or would be audited as part of the corporate audit. It is far more likely, therefore, that the vast majority of the owners of the typical large partnership subject to audit under the BBA will be individuals (or those taxed as individuals), rather than C corporations.

Also, research shows that the typical individual owner of a partnership interest is in the top 1% in terms of total earnings. In fact, almost 70% of pass-through income earned accrues to households in that top 1%.³⁶

This fact likely means that they are subject to high marginal tax rates.

As far as a description of the partnerships themselves, one might imagine (incorrectly) that they are generally comprised of small businesses and professional firms. But even if one includes all partnerships, large and small, there appear to be very few that look like a typical small business. Nor would many small businesses likely fit the definition of a large partnership under the BBA's definition.³⁷ And professional firms (doctors, lawyers, accountants, etc.) now comprise only about 15% of total partnership income.

Instead, about 70% of allocated income goes to partnerships in finance or those that classify themselves as holding companies.³⁸ Many in this group are the private equity firms that have taken on an increasingly larger role in financing business in the United States.³⁹ As such, their main assets will be holdings in other businesses, their main revenue will be distributions from and gains on the sale of those holdings, and their main expense will be interest on borrowed funds used to leverage their own capital.⁴⁰

What about the nature of the partner's interests? With the exception of the professional firms that have more than 100 partners, we should expect that the remainder of the large partnerships would have mainly limited partners who do not take an active role in the partnership but act instead as passive investors. The management of such partnerships is often accomplished through a separate entity which holds a very small (active) interest in a number of partnerships, all with limited partners, and is responsible for performing the investment activities of the partnership for a guaranteed share of profits.⁴¹ These management entities are likely to be headquartered in financial centers, like New York, or areas with substantial investment opportunities, like California.

Exactly how large and complex are the related structures of audited partnerships likely to be? In 2014, the U.S. Government Accountability Office (GAO) published a study of what it defined as "large" partnerships—those that had more than 100 partners and more than \$100 million in assets. This study is, in part, what prompted Congress to enact the BBA. These are the same partnerships that will undoubtedly be the focus of any enhanced IRS audit process. The GAO report found that in 2011, two-thirds of these large partnerships (over 6,000 entities) had in excess of 1,000 partners.⁴² In addition, the report found that more than two-thirds of large partnerships had at least 100 or more pass-through entities as direct and indirect partners.⁴³

The remainder of this article, which addresses particular enforcement issues unique to the states, will do so mainly in the context of large, complex multistate partnerships engaged primarily in investing in other businesses and with limited/passive individual partners.

Unique State Tax Enforcement Implications

In a perfect world, the states would derive an undiluted benefit from any new IRS audits of large partnerships. In other words, the states would be able to assess and collect any tax due on a related federal audit adjustment, making them whole (or better) for taxes underreported on the partners' original state returns. But three primary hurdles, unique to the states, may prevent this. The first is nexus. The second is apportionment. The third is conformity.

The first hurdle—nexus

There are two important nexus issues in this area: (1) nexus over a nonresident partner in a state where the partnership does business, and (2) nexus over an out-of-state partnership in a state where a partner is resident. The U.S. Supreme Court has never directly addressed the first question. State courts have split over this issue.⁴⁴ The ongoing effect on the states of any lingering doubt, however, is largely mitigated by states adopting withholding and composite return rules, which impose on the partnership doing business in the state the duty to pay taxes owed by the nonresident partners.⁴⁵

The second question—whether a resident partner can create nexus for an out-of-state partnership—is even less certain and may turn out to be more important in the context of federal audits. While courts will generally hold that partners acting on behalf of a partnership confer jurisdiction over the partnership, it is the particular actions of the partners that provide the jurisdictional hook. Cases outside of this general context are rare, and courts search for other contacts the partnership may have in a state before finding jurisdiction.⁴⁶ Assuming that the resident partner holds a limited, passive interest in the out-of-state partnership, can the residency state require the partnership to comply with tax-related requirements? For now, states should assume the answer is no.⁴⁷

This is obviously not an issue created by the BBA's federal audit and adjustment process, but the issue may be a hurdle for making that process work for the states in a way that it is not for general tax filing purposes. When it comes to state tax filing generally, while the state of the resident partner may not be able to require reporting by the out-of-state partnership, the resident partner will have a federal Schedule K-1 from the partnership which can be used to confirm the partner's share of partnership items and other information.

As described above, however, it is not clear what documentation partners will be provided during a federal partnership audit, especially if the partnership pays. States may have to consider imposing requirements on

resident partners, therefore, to obtain and provide information from the partnership, assuming that the partnership cannot be made to provide that information directly. Also, if the partnership chooses to pay tax on the audit adjustments, the states in which it does not do business, but has resident partners, will need to consider whether any liability for tax should be imposed on those partners. This brings us to the second hurdle.

The second hurdle—apportionment

In being able to effectively adapt to entity-level assessment, it is the issue of apportionment that potentially involves the greatest complexity. Again, for purposes of this discussion, it is assumed that the particular partnership subject to federal audit is a large partnership with mostly investment holdings and mainly limited partners with only passive-type interests. And, again, this article can only scratch the surface of the potential issues.⁴⁸

State apportionment rules have evolved to suit the taxation of C corporations. When applying the entity-level tax to C corporations doing business in multiple jurisdictions, all states use formulary apportionment to determine their share of taxable income. Corporate distributions to individual shareholders are then sourced to the individual's state of residence. In the partnership area, general state apportionment rules may be applied differently and, in the case of investment-type partnerships, may not be a good fit at all.

While most states generally apply entity-level apportionment to the business income of partnerships when allocated to nonresidents, they do not (with limited exceptions⁴⁹) apportion the partnership income or otherwise apply tax on a source basis to items allocated to residents. Instead, states tax 100% of the partnership income or other tax items allocated to residents and then give a credit for taxes paid to other states—where those individuals might be taxed as nonresidents on a source basis. Furthermore, a number of states do not treat passive investment income from partnerships as apportionable for nonresident limited partners, but instead source that income to the domicile of those partners.⁵⁰

Entity-level assessment of partnerships may shift the state to which taxes are reported and paid. This can be illustrated by two simplified examples:

Example 1: Partnership P, an active business, has all of its apportionment factors (assets and operations) in State A, but all of P's partners (investors) live in State B. State A imposes a 1% tax, while State B imposes an 11% tax. The IRS audits P, determines that it has underreported income by \$1 million, and assesses the

partnership. P pays the tax, rather than pushing the adjustment out to the partners. Had P properly reported income on its original filing, State B would have collected an additional \$100,000 (\$110,000 less a credit of \$10,000 for tax paid by the partners to State A). But if States A and B follow federal treatment, then P, as an entity, would be assessed \$10,000 in A and nothing in State B (since P has no apportionment factors in State B).

Example 2: Assume the same facts as Example 1, except that P's sole activities are investing in financial assets. Assume also that both States A and B treat such partnerships as passive investment entities—attributing the income to the partner's domicile. If the income of P had been properly reported on original returns, State A would not have received any tax and State B would have received an additional \$110,000. If both States A and B follow the federal treatment with respect to the audit adjustment, however, they can only achieve the same result if they apportion partnership-level liability by the *residency* of the partners, rather than the location of the partnership operations.

These are obviously extreme examples but they serve to illustrate the possible effects of entity-level assessments on state taxes.

Even if states were to apply the general UDITPA formula in order to assess state tax at the partnership level to partnerships that engage in investment activities, that formula may be a poor fit. The following is just a sampling of the issues that may arise in attempting to use the standard apportionment formula as applied to investment partnerships:

- Partners who participate in the partnership business might do so only sporadically and, in any case, will not be treated as employees receiving compensation, so calculating the payroll factor may be difficult.
- The assets of investment partnerships will be intangible property and, under the standard formula, such assets are not included in the property factor and, if they are included, there would be sourcing questions.
- The receipts of investment partnerships will be from dividends, interest, gains, etc., and the Multistate Tax Commission currently has a work group addressing how such receipts might be sourced in special circumstances where they will need to be included in the receipts factor.⁵¹

This is not the end to the questions concerning partnership-level state tax assessment. States that tax partnership income on a pass-through basis generally have no rules for combining related partnership entities. But any practical effects of this are mitigated under the pass-through system, where the tax is paid by individual partners.

Again, a simple example illustrates: Assume that State X has a 10% tax on income and State Y has no income tax. A, B, and C all reside in State X and are partners in ABC1 and ABC2. ABC1 does business in State Y. ABC2 does business in State X. ABC1 pays ABC2 an intercompany charge, effectively reducing ABC1's income to zero. Under the pass-through system, the income of both entities would simply be allocated to the partners and reported by them, 100%, to their state of residence. If the partners paid tax to another state on an apportioned basis, they would be entitled to take a credit for the tax paid in their state of residence. But since ABC2, the profitable entity, earns its income in a state without an income tax, the partners would pay no tax and would not be entitled to any credit.

Now assume that instead of having the partners pay tax on the collective incomes of the partnerships on a pass-through basis, ABC1 and ABC2 are taxed at the partnership level. If the partnerships are not combined, each will apportion its income separately at the entity level. All of the income of ABC2 would be sourced to state Y, which has no income tax.

State tax professionals will, no doubt, recognize this scenario as the same type of tax planning arrangement that can occur in the corporate income tax area when combined filing (or some other remedial provision addressing related company transactions) is not used. To the extent tax assessments are made at the entity level, rather than on a pass-through basis, this issue will need to be addressed.

As far as the need for combination when assessing business entities at the entity level generally, the history of the Texas franchise tax may be instructive. Until 2006, Texas law imposed a franchise tax only on corporations and certain limited liability companies conducting business in Texas. This tax structure, combined with the fact that at that time Texas was a separate filing state, meant that Texas companies could—and did—significantly reduce their tax burden by restructuring to a limited or general partnership. In response to a budget crisis in 2006, the Texas Legislature foreclosed this tax avoidance tactic via House Bill 3, enacting a new tax structure that combined elements of a gross receipts tax with elements of a net income tax, later codified at Texas Code Annotated, Tax Code tit. 2, subtit. F, ch. 171.

This new "Texas Margin Tax" expanded the state's taxing reach to any limited liability entity conducting business in Texas, including limited partnerships and limited liability partnerships. Because a pass-through entity whose income is apportioned at the entity level can still restructure to avoid state tax, Texas also adopted combined reporting. Under Tex. Tax Code Ann. § 171.1014, taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report.⁵²

The third hurdle-conformity

This article has referred to the term "enforcement" throughout. What is enforcement? At its simplest, it means that the government collects the tax owed. Auditing is one thing, but collection is another. As was suggested earlier, complexity and lack of transparency not only make auditing difficult, they can also put collection at risk. The BBA's provisions set up a process with elements that work together not only to facilitate federal audits but also federal tax collection. While it will be challenging for states to conform to every aspect of the BBA, it would also be dangerous for states to focus only on conforming or adapting to certain elements, while ignoring others.

It is unlikely to shock anyone that federal and state tax enforcement efforts would be particularly concerned with potential audits that might generate significant adjustments. Assume that a federal audit does, in fact, result in a significant amount of tax due. There are two possibilities—that the partnership and its partners made a reasonable mistake, or that they deliberately took aggressive filing positions. Given the history of tax shelter use in the partnership area, tax administrators would have to be naive not to anticipate the latter. Assuming they're right, then they should also anticipate difficulties in collecting the additional tax due, especially given the complexity of many large partnership structures and the lack of transparency.

In addition to imposing entity-level tax, in general, three provisions of the BBA seem specifically geared toward the ultimate goal of tax collection. First, in order for the partnership to qualify for an adjustment to the proposed partnership liability on account of partners filing amended returns, the partnership must show that the partners not only reported all the adjustments, but also paid the tax due.⁵³ Second, the partnership will remain liable for the final tax determined to be owed unless and until it properly pushes out the adjustments to all the partners, and failure to do so will count as an invalid election.⁵⁴ Third, in the event that the partnership chooses to contest the final adjustments in court, the liability must be paid as a deposit before it can do so.⁵⁵

States should consider whether similar safeguards are necessary when imposing state tax on the federal adjustments and should not let the difficulties in conforming to the BBA distract from the overarching goal of achieving enforcement and tax collection. It is also possible that states will find their own creative solution (whether through existing withholding or composite filing systems, or otherwise) to address risks associated with tax collection in this area. For example, states where an audited partnership has filed a composite return might require the partnership to report federal audit adjustments by way of amending that return.

Conclusion

While the action by Congress under the BBA to facilitate federal audits of large partnerships is a welcome development to state tax administrators, clearly there are a number of issues that states will need to address. In particular, entity-level assessment will require states to consider the implications of the BBA's provisions with respect to nexus, apportionment, and conformity. For the benefit of taxpayers, partnership tax professionals, and state tax administrators, all state requirements necessary for adapting to the federal audit process should be thought out and spelled out.

¹ In this article, the term "partnership" is used to refer to any entity taxed under Subchapter K including limited liability companies, limited partnerships, limited liability partnerships, certain publicly traded partnerships, etc.

² For a history of tax shelters in this area, see Andrea R. Monroe, *Integrity in Taxation: Rethinking Partnership Tax*, 64 Ala. L. Rev. 289 (2012); and Tanina Rostain and Milton C. Regan, Jr., *Confidence Games: Lawyers, Accountants, and the Tax Shelter Industry*, (MIT Press 2014).

³ See Bruce P. Ely and William T. Thistle II, *An Update on the State Tax Treatment of LLCs and LLPs*, 27 JMT 14 (May 2017), and the Multistate Tax Commission Model Law on Reporting Options for Non-resident Members of Pass-through Entities with Withholding Requirement, adopted December 18, 2003, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/ProposedStatLanguageReportingOptions.pdf.

⁴ Pub. L. No. 114-74 (Nov. 2, 2015).

⁵ Joint Committee on Taxation, *Choice of Business Entity: Present Law and Data Relating to Corporations, Partnerships, and S Corporations (JCX-71-15)*, April 10, 2015, pp. 18-20, available at <https://www.jct.gov>.

⁶ *Id.* at 24-26, 29.

⁷ Michael Cooper, John McClelland, James Pearce, Richard Prinszano, Joseph Sullivan, Danny Yagan, Owen Zidar, and Eric Zwick, *Business in the United States: Who Owns it and How Much Tax Do They Pay?*, Office of Tax Analysis, Working Paper 104, p. 2, available at <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-104.pdf>.

⁸ *Choice of Business Entity: Present Law and Data Relating to Corporations, Partnerships, and S Corporations*, *supra* note 5 at 24-26.

⁹ Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options*, December 2014, p. 2, available at <https://www.cbo.gov/publication/49817>.

¹⁰ See I.R.C. Section 1361(b)(1)(D).

¹¹ See I.R.C. Section 1361(b)(1)(A) and (B).

¹² See Cunningham and Cunningham, *The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships*, 5th (West, 2017); and Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 Ga. L. Rev. 717 (2009).

¹³ See I.R.C. Sections 721 and 731.

¹⁴ See I.R.C. Section 702(b).

¹⁵ See I.R.C. Section 704(b).

¹⁶ See I.R.C. Section 702(a).

¹⁷ The precise limits on such offsets or deductions are beyond the scope of this article.

¹⁸ See *Integrity in Taxation: Rethinking Partnership Tax*, *supra* note 2, at 295.

¹⁹ See I.R.C. Section 724(b), an example of the former, and I.R.C. Section 751(b), an example of the latter.

²⁰ See *supra* note 3, and I.R.C. Sections 1445 and 1446.

²¹ Governmental Accountability Office, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, GAO-14-732, September 2014, cover page.

²² I.R.C. Section 6223.

²³ I.R.C. Section 6225(c)(2).

²⁴ I.R.C. Section 6226.

²⁵ I.R.C. Section 6225(b).

²⁶ I.R.C. Section 6225(b)(1)(A).

²⁷ I.R.C. Section 6234(b)(1).

²⁸ U.S. Treasury Department, Internal Revenue Service, REG-136118-15, 26 C.F.R. Part 301.

²⁹ See H.R. 6439 (114th Cong.).

³⁰ For example, see the model reporting requirement approved by the Multistate Tax Commission in 2003 which is representative of the kind of requirements that states impose. Multistate Tax Commission, *Model Uniform Statute for Reporting Federal Tax Adjustments with Accompanying Model Regulation*, adopted August 1, 2003, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/ReportingFederalTaxAdj.pdf.

³¹ Forty-eight states and the District of Columbia currently participate in the MTC's programs and activities, including the Uniformity Committee. *Compact members*: Alabama, Alaska, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Missouri, Montana, New Mexico, North Dakota, Oregon, Texas, Utah, Washington. *Sovereignty members*: Georgia, Kentucky, Louisiana, Michigan, Minnesota, New Jersey, West Virginia. *Associate members*: Arizona, California (FTB) (SBE), Connecticut, Delaware, Florida, Illinois, Indiana, Iowa, Maine, Maryland, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Vermont, Wisconsin, Wyoming.

³² See the project webpage here: <http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project>.

³³ I.R.C. Section 6221(b)(1)(B).

³⁴ I.R.C. Section 6221(b)(1)(C).

³⁵ See *Business in the United States: Who Owns it and How Much Tax Do They Pay?*, *supra* note 7 at 10.

³⁶ *Id.* at.3.

³⁷ Many small businesses organize as S corporations rather than partnerships, in part because of advantages that S corporations provide to owner-employees.

³⁸ See *Business in the United States: Who Owns it and How Much Tax Do They Pay?*, *supra* note 7 at 11.

³⁹ See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 *Stan. L. Rev.* 1067 (2003).

⁴⁰ See a summary of how private equity firms work and, especially, their use of leveraged buy-outs in Brian Cheffins and John Armour, *The Eclipse of Private Equity*, 33 *Del. J. Corp. L.* 1 (2008).

⁴¹ *Id.* at 9-10.

⁴² Governmental Accountability Office, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, GAO-14-732, September 2014, p. 15.

⁴³ *Id.* at 16.

⁴⁴ For a survey of some of these decisions, see Peter L. Faber, *State and Local Tax Planning for Partnerships*, 83 State Tax Notes 463 (May 1, 2017). While the authors of this article do not agree with all of Mr. Faber's analysis, he offers an intriguing theory that limited partners have impliedly consented to state tax jurisdiction by their agreement to enter into the partnership and thereby be taxed on the partnership's income.

⁴⁵ These requirements are presumed constitutional, see *International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944).

⁴⁶ For an example of how courts look for more than just the presence of a limited partner in the state, see *Singer v. Unibilt Dev. Co.*, 43 So. 3d 784 (Fla. Dist. Ct. App. 2010) (an out-of-state partnership can be sued by a resident limited partner because the partnership had operated in the state at one time).

⁴⁷ See Restatement (Second) of Conflict of Laws § 40 (1971).

⁴⁸ For a deeper dive into an example of the complexity in this area generally, see Amy Hamilton, *News Analysis: Harbert Management's Side of the \$40 Million Tax Settlement Story*, Tax Analysts, 2017 STT 84-1.

⁴⁹ See N.M. Admin Code 3.3.11.12 which allows resident owners to apportion the distributive shares of income from unincorporated business entities.

⁵⁰ Ala. Code § 40-18-24.2(c)(3)(b); Ark. Code Ann. § 26-51-202(e)(1); Cal. Rev. & Tax. Code § 23040.1(a)(1); Conn. Gen. Stat. § 12-711(f); Ga. Code Ann. § 48-7-24(c); Idaho Code Ann. § 63-3026A(3)(c); 35 Ill. Comp. Stat. 5/305(c-5); Ky. Rev. Stat. Ann. § 141.206(15); Md. Admin. Release No. 6 (Md. Comptroller's Office, Revenue Admin. Div., 09/01/2007); Minn. Stat. § 290.17, subd. 2(c); N.J. Stat. Ann. § 54:10A-15.11(a); N.Y. Tax Law § 631(d); N.C. Admin. Code 6B.3503(c); N.M. Admin. Code 3.3.11.14(A); Ohio Rev. Code Ann. § 5733.401; Utah Code Ann. § 59-10-117(2); Va. Tax Bulletin No. 05-6, (Va. Dept. of Tax'n, 05/06/2005).

⁵¹ This is the Compact Article IV Section 18 Proposed Model Regulations Working Group which has its project web page at: <http://www.mtc.gov/Uniformity/Project-Teams/Section-18-Regulatory-Project>.

⁵² In addition, certain "passive entities" are not taxed and are therefore excluded from the combined report. In order to be "passive," an entity must be a general or limited partnership or a nonbusiness trust, and must

receive at least 90% of its federal gross income from "passive" sources identified in the statute. Tex. Tax Code Ann. § 171.0003. However, a taxable entity, including a combined group, must include its pro rata share of a passive entity's net income in calculating its total revenue. A passive entity's revenue is includible in margin to the extent it was not generated by another taxable entity's margin.

⁵³ I.R.C. Section 6225(c)(2)(A)(iii).

⁵⁴ See IRS Proposed Regulations, REG-136118-15, 26 C.F.R. Part 301, p. 107.

⁵⁵ I.R.C. Section 6234(b)(1).