

## **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.<sup>1</sup> 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.<sup>2</sup> 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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<sup>1</sup> 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](#).

<sup>2</sup> 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.<sup>3</sup> 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.

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<sup>3</sup> 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.<sup>4</sup>

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),<sup>5</sup> 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).

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<sup>4</sup> 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.

<sup>5</sup> [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.<sup>6</sup> 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.<sup>7</sup> Over the past years, AICPA submitted many comments to Congress and to the IRS on the proposed federal rules.<sup>8</sup> 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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<sup>6</sup> [Pub. L. No.115-141 \(3/23/18\)](#)

<sup>7</sup> 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).

<sup>8</sup> 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.<sup>9</sup>

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.<sup>10</sup> 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.

<sup>9</sup> 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.

<sup>10</sup> 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<sup>11</sup>].

(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

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<sup>11</sup> 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.<sup>12</sup>

**(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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<sup>12</sup> 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.<sup>13</sup>

## **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**

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<sup>13</sup> 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]<sup>14</sup>, no later than 180 days after the Final Determination Date, each Direct Partner that is taxed under [reference to

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<sup>14</sup> 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 sourcing 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.