To: **Partnership Work Group**

From: **MTC Staff**

Re: **State Issue List for Conforming to Federal Partnership Audit and Adjustment Rules**

Updated: **October 3, 2016**

This document has two main sections. The first contains a summary of the 2015 federal changes. (This section will be updated when proposed IRS regulations are issued.) The second contains summaries of the state-related issues.

2015 Federal Changes

The new federal statutory provisions from Sec. 1101 of the Bipartisan Budget Act of 2015 relevant to the states (including some of the procedural provisions) are summarized here.

Note that "reviewed year" means the year under audit and "adjustment year" typically means when the notice of final partnership adjustment is mailed.[1]

1) The TEFRA and "electing large partnership" audit rules are repealed.
2) With two main exceptions, the general rule for partnership audits is now that audits will be conducted at the partnership level and amounts, including interest and penalties, will be assessed and collected at the partnership level for all types of adjustments—including both Form 1065 return issues and Schedule K-1 allocation issues.[2]
3) The first exception to the general rule is that small/simple partnerships will be allowed to elect out.[3] To qualify to elect out, the partnership must:
    - Issue fewer than 100 Schedule K-1s,[4] and
    - Have partners that are individuals, C corporations, S corporations, or the estates of deceased partners.[5] (An S corporation partner must also provide disclosure of its shareholders.)[6] The IRS may also prescribe rules for other kinds of partners.[7]

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[1] Sec. 6225(d)(2). The adjustment year for an administrative adjustment requested by the partnership is the year the adjustment is made.
[2] Sec. 6221(a).
[3] Sec. 6221(b).
[4] Sec. 6221(b)(1)(B).
[5] Sec. 6221(b)(1)(C).

4) The second exception to the general rule with respect to assessment and collection is that the partnership may elect to "push out" the liability for tax (determined by the partnership audit) to the partners. (That process is discussed further below.)

5) A partner's treatment of tax items must be consistent with the partnership's return.[8] If not, any resulting underpayment will be treated as a math error for purposes of assessment and collection of that tax.[9] However, this treatment does not apply to cases where the partner has filed a notice of inconsistent treatment.[10] If there is a determination to a partner's inconsistent treatment of an item, it is not binding on the partnership.[11]

6) Partnerships will need to designate a "partnership representative" (or the IRS will appoint one) to make decisions on behalf of the partnership (including electing out of the partnership-level audit and adjustment) and the partnership's actions will be binding on all the partners.[12]

7) Audit adjustments to items of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share that would result in additional tax are the basis for computation of a partnership level "imputed underpayment."[13]

8) If the audit adjustment does not result in an imputed underpayment (that is, if tax was determined to be overpaid) that adjustment is taken into account by the partnership in the adjustment year as either a reduction in income, an increase in loss, or an addition to a credit.[14]

9) In determining the imputed underpayment from audit adjustments:

   - all adjustments of items of income, gain, loss, or deduction are first netted and then multiplied by the highest rate of tax in effect for the reviewed year (and decreases in losses or credits are treated as increases in income),[15] and
   - any reallocation of partners' distributive shares of any item are not netted (so only increases in taxable amounts are included in computing the underpayment).[16]

10) The imputed underpayment may be adjusted as follows after the proposed partnership adjustment is mailed under Sec. 6231 (if information is provided within 270 days[17]):

   - the IRS may allow a reduction in the imputed underpayment for one or more of the partners who file amended returns for the review year and take all the audit adjustments into account (both in terms of tax due and other adjustments to basis), and pay the resulting tax—provided that if the adjustment relates to a reallocation

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[6] Sec. 6221(b)(2)(B).
[7] Sec. 6221(b)(2)(C).
[8] Sec. 6222(a).
[9] Sec. 6222(b).
[10] Sec. 6222(c).
[11] Sec. 6222(d).
[12] Sec. 6223.
[13] Sec. 6225(a).
[14] Sec. 6225(a)(2).
[15] Sec. 6225(b)(1).
[16] Sec. 6225(b)(2).
[17] Sec. 6225(c)(6).

of distributive share, then to receive a reduction in the imputed underpayment, all affected partners must file amended returns,[18]

- the IRS may also allow a reduction in the imputed underpayment where the partnership has partners who are tax-exempt or where the partnership otherwise shows that the highest rate of tax for the partner or the type of income or gain at issue is less than the rate used (which involves a complex set of rules),[19] and
- the IRS may also allow other adjustments by regulation.[20]

11) Rather than paying the final imputed underpayment (tax amount), the partnership has 45 days to elect to push the final partnership adjustments down[21] by furnishing to each partner of the partnership for the reviewed year and to the IRS a statement (on a form and according to instructions to be created by the IRS) of each partner's share of any adjustment to income, gain, loss, deduction, or credit. [22] If this is done, then each partner must take the adjustments into account as provided:[23] Each partner (who was partner in the reviewed year) shall, in the year that the statement furnished by the partnership is received, increase that partner's tax appropriately for the aggregate of the adjustment amounts, as follows:[24]

- The amount of tax the partner (who was a partner in the reviewed year) reports in the year of adjustment will include tax on the aggregate of the "adjusted amounts,"[25] which are composed of –
- The tax that would have been due in the reviewed year for that partner had the amounts been taken into account in that year, and[26]
- The tax that would have been due in years subsequent to the reviewed year (but prior to the adjustment year) as a result of the effect of the adjustments on the partner's tax attributes.[27]

12) Penalties and interest are determined based on rules under Sec. 6226 and 6233. In general:

- Penalties shall still be determined at the partnership level and pushed down to partners of the partnership for the reviewed year.[28]
- Interest is computed at the partner level from the due date of the return for the taxable year to which the increase is attributable at the underpayment rate under section 6621(a)(2), determined by substituting '5 percentage points' for '3 percentage points' in subparagraph (B) thereof.[29]

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[18] Sec. 6225(c)(2).
[19] Sec. 6225(c)(3) and (4).
[20] Sec. 6225(c)(5).
[21] Sec. 6226(a)(1).
[22] Sec. 6226(a)(2).
[23] Sec. 6226(a)(2).
[24] Sec. 6226(b)(1).
[25] Sec. 6226(b)(2).
[26] Sec. 6226(b)(2)(A).
[27] Sec. 6226(b)(2)(B) and (C).
[28] Sec. 6226(c)(1).
[29] Sec. 6226(c)(2).

13) When a partnership asks the IRS for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for any partnership taxable year the adjustment may be made at the partnership level for the year in which the request is received,[30] or through the push-down process.[31] The rules also provide for a general 3-year limitation period on requested adjustments.[32]

14) The IRS will provide the following three official notices to the partnership, through the partnership representative:

- A notice of any administrative proceeding initiated at the partnership level with respect to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, or any partner's distributive share thereof,
- A notice of any proposed partnership adjustment resulting from such proceeding, and (no sooner than 270 days later)
- A notice of any final partnership adjustment resulting from such proceeding.[33]

15) The tax assessed under these provisions will general be assessed and collected as if the tax was owed in the year of adjustment. Assessment or collection can be made no sooner than 90 days following the notice of a final partnership adjustment was mailed. If a petition is filed with the appropriate court with respect to such notice, assessment or collection cannot be made until the decision of the court has become final. (But see special rules for math or clerical errors.)[34]

16) If the assessment is due to an adjustment deemed to be a mathematical or clerical error, an assessment can be made without the normal notice provisions in the manner set out in Sec. 6213(b).[35] If a partnership is a partner in another partnership, any adjustment on account of such partnership's failure to disclose an inconsistent filing position will generally be treated as a mathematical or clerical error.[36]

17) Payments of tax made by the partnership will not be deductible of income tax purposes.[37]

18) A partnership may elect for the partnership audit and adjustment provisions to apply prior to the effective date (tax years beginning January 1, 2018).[38]

[30] Sec. 6227(a) and (b)(1).
[31] Sec. 6227(b)(2).
[32] Sec. 6227(c).
[33] Sec. 6231(a).
[34] Sec. 6232(a)-(c).
[35] Sec. 6232(d)(1)(A).
[36] Sec. 6232(d)(1)(B).
[37] Sec. 6241(4).
[38] Sec. 6241(g).

State Issue List

This memo aims to capture issues with respect to requiring the reporting of state taxes associated with federal adjustments (sometimes called RAR, or Revenue Agent Report, rules) and also issues associated with state audit and adjustment procedures which states may wish to amend in order to mirror the federal changes (allowing state audits at the partnership level). Within these two sections, the possible effects on three main areas specific to state taxation are also noted: 1) apportionment, 2) withholding for nonresident partners, and 3) composite returns.

As of the date of this memo, the IRS has not issued proposed regulations which may affect how the federal changes will work in practice and how states may want to respond to these issues.

RAR Rules

While this section mainly deals with the requirements for reporting federal adjustments to taxable income which affect state taxes, states also require taxpayers to report the state effects of self-reported (amended) federal amounts that may affect state taxes. Therefore, this section notes changes states may want to make with respect to amended returns (which may be filed in the course of a partnership audit).

Federal Audit & Adjustment Process	Effect on States and Related Requirements
Election Out	
Under IRC 6221(b), certain smaller, simpler partnerships will be allowed to elect out—and so the partners must be audited and assessed individually.	Federal adjustments may be made to individual or corporate partners (of partnerships that can and do elect out) or to partnerships that cannot or do not elect out. This issue list assumes that states currently have rules for addressing audit adjustments made by the IRS to individual and corporate partners.
Partners Who Take Inconsistent Positions	
Under IRC 6222, partners must generally report partnership items consistently with the partnership's reporting of those items. If not, the IRS may assess any tax resulting from inconsistent treatment to the partner in a summary fashion as a math error.	Again, this issue list assumes that the states currently provide rules for what individual or corporate partners must do if they are assessed additional tax by the IRS.

Role of the Partnership Representative	
Under IRC 6223, the partnership must designate a partnership representative (or the IRS will designate someone for the partnership) who will make decisions in the event of any audit which will be binding on the partnership and all the partners. At the federal level, these decisions may include whether the partners will be required to file amended returns under IRC 6225(c)(2), whether to contest any audit adjustment proposed, whether to push down the adjustment under IRC 6226, etc.	Issues: 1. Will the state recognize the role of the partnership representative with respect to state tax effects of the federal adjustment which may include: a) Notifying the state of the federal adjustment, b) Reporting any related state attributes (e.g. apportionment information), c) Fling any required returns for the partners or the partnership, d) Handling any related issues (such as any appeal of the state assessment). 2. The state may also want to consider whether a nonresident or out-of-state whether the partnership representative will be allowed to act on behalf of a resident partner in a case where the partnership itself is not doing business in the state.
Effect of an Adjustment that Does Not Result in an Imputed Underpayment	
Under IRC 6225(a)(2), if the audit adjustment does not result in an imputed underpayment (that is, if tax was determined to be overpaid) that adjustment is taken into account by the partnership in the adjustment year as either a reduction in income, an increase in loss, or an addition to a credit. It's not clear what the IRS will issue to the partnership to recognize this treatment for the partnership and the partners.	Issues: 1. Will the state recognize this kind of adjustment as being properly recognized in the adjustment year (rather than the review year). a) If so, this may require a mechanism to ensure that there is no "double-counting" of tax reductions. b) If not, there will be differences in partnership attributes for state and federal purposes. Will the partnership in that case need to provide state level information returns showing the effect of the adjustment on the state taxes for the partners in the adjustment year? (Will any apportionment of the adjustment be made in the adjustment year in that case?)

Calculation of the State-Level Imputed Underpayment or Partnership Tax	
Under IRC 6225(b), the IRS will compute an "imputed underpayment" which may ultimately be paid by the partnership (if not completely reduced under IRC 6225(c), see below). This amount is computed as follows: 1) take any 1065 (partnership) items and net the increases and decreases in revenue, expense, gain and loss, 2) take only the positive amounts of reallocations among the partners and then 3) apply the highest federal tax rate to that amount to determine the "imputed underpayment." So, for example, if the audit finds that revenues should be increased by $3 million, expenses should also be increased by $1 million, and $2 million of gain should be reallocated from certain partners to other partners, then the amount of the imputed underpayment will = (($3 million - $1 million) + $2 million) X Tax Rate. If the partnership takes no other action in response, this will be the partnership's tax liability.	Issues: 1. Assuming the state will also need to calculate an amount that may have to be paid by the partnership, the issues for the state will include: a) Whether a multistate partnership will be allowed to apportion the imputed underpayment for state purposes, b) Does the answer to a) depend on whether the state was the residence of affected partner(s) who therefore would be required to report 100% of the partnership income and take a credit for taxes paid, and c) if apportioned, what year's apportionment factors will be used to apportion the imputed underpayment. 2. What tax rate will apply at the state level.
Partnership Response to Proposed Audit Adjustment	
Under 6225(c), the imputed underpayment, calculated as described above, will become the proposed audit adjustment which will then trigger a 270-day period in which the partnership can present information to the IRS to lower the final audit adjustment amount. There are three types of information contemplated: 1) amended returns filed by the partners (with payment), 2) information on the tax rates of the partners, and 3) other information that might affect the final audit adjustment amount.	States currently provide requirements for taxpayers who file amended federal returns to file amended state returns. Presumably, the amended returns filed for this purpose would also trigger a state-filing requirement. Other Issues: 1. Will the state require any other information from the partnership in a case where the partners file amended returns in response to a proposed audit adjustment? 2. Also, if the state calculates the imputed underpayment for state purposes in a manner similar to the federal calculation (see above) then will the state also allow the partnership to show that the tax rates of the partners are lower than the highest applicable rate? 3. Similar to 2, will the state consider other information that might affect the final audit adjustment amount at the state level?

Reduction in Proposed Audit Adjustment (Imputed Underpayment)	
Under 6225(c), the IRS will allow a reduction in the proposed audit adjustment (imputed underpayment) where, among other things (see above) the partners file amended returns taking the adjustments into account and making a related payment of the tax. It does not appear that the IRS will require all partners to do so, however, so it is possible that the imputed underpayment would only be reduced partially—for those partners who have filed amended returns and paid the additional tax.	Issues: 1. Will the state allow the partnership to reduce state taxes related to the federal adjustments for partners who file amended returns? 2. Will the state require that the reduction be made for state purposes only for the partners who file amended state returns, as well as federal returns? 3. Will the state require the partnership and the partners to file information returns disclosing the federal proposed audit adjustment (including the underlying issues) and demonstrate that the amended returns filed for state purposes take these issues into account? 4. Will the state require some showing that the IRS has allowed the amended returns to have the effect of reducing the proposed audit adjustment? 5. If some amount of federal proposed audit adjustment remains, will the state accept the federal reductions in that amount as the basis for any remaining partnership assessment?

"Push-Down" of the Final Audit Adjustment	
The IRS will ultimately provide the partnership with a final audit adjustment (after taking into account any reductions under Sec. 6225). Then, under Sec. 6226, the partnership may elect to push down the final audit adjustment to partners who were partners in the review year. If it does so, the partnership will need to provide the partners with information on the adjustments (and related partnership information that may be relevant) so that the taxes owed can be properly calculated. The adjustments pushed down may affect the taxes those partners owed in the reviewed year and subsequent years. The amount of the additional tax due for each partner for the reviewed and subsequent years will then be reported and paid with the partner's adjustment year taxes.	NOTE: There is some question about how exactly the IRS will allow push-down of the partnership audit adjustments—whether as a portion of the imputed underpayment (that is, a share of the tax computed at the partnership level) or as adjustments that each partner would recognize and be taxed on separately. Issues: Assuming it is the latter: 1. Will the state allow the partnership to push down the state tax amount related to the federal audit adjustments? a) If so, will the state require the partnership to provide additional state-related information (such as apportionment information) so that the state tax owed can be properly calculated? b) Will the relevant apportionment information be that related to the reviewed year (and subsequent years)? 2. If the state normally requires withholding for nonresident partners will the state require the partnership to withhold on nonresident partners for their tax liabilities? 3. If the state normally allows a composite return be filed by the partnership, will it allow a composite return in this situation? If the partnership elects to push down the federal adjustments, will the state allow it to pay the state-related tax at the partnership level, without pushing that liability down to the partners?

Treatment of Partnership Payment of Tax	
If a partnership does not push down the final audit adjustments to the partners, then it will have to pay any amount of unreduced imputed underpayment (see above) remaining in the year of the final adjustment. Presumably, at the federal level, this will also have the effect of relieving partners from any liability for the same adjustments.	Issues: 1. Most states do not have the statutory authority to impose liability at the partnership level, so the state may need to enact new law allowing for this. 2. If the state allows the partnership to pay the state tax related to adjustments, will the state provide for apportionment of that liability even when there are resident partners in the state (who would otherwise pay on 100% of their partnership income and claim a credit for other state taxes paid)? 3. If the partnership pays the state taxes in other states due to the audit adjustments, will resident partners be entitled to take any credit for taxes paid? 4. If the partnership apportions the tax, would it use the reviewed year apportionment factors rather than those of the adjustment year (in which the tax would be reported and paid for federal purposes).
Statute of Limitations, Penalties & Interest	
The federal changes include specific provisions for calculating penalties and interest on the tax ultimately due and also provides a specific statute of limitations.	Issues: 1. Does the state have the ability to impose penalties and interest under this system depending upon whether the partnership: a) Has the partners file amended returns, b) Pushes down the final adjustments to the partners, or c) Pays the unreduced amount of the final imputed underpayment. 2. Does the state have the ability to assess under existing statutes of limitation, either against the partnership or the partners, where the final audit adjustment is issued to the partnership and the tax due is required to be paid by in the year of adjustment?
General Administrative and Other Provisions	
The federal changes provide for how partnerships may appeal or challenge the federal adjustments and the effect that any challenge may have.	Issues: 1. Will the partnership/partners have to separately appeal or challenge the state-related taxes if the federal adjustment is appealed? 2. If any adjustments relate to reallocated amounts between partners which would reduce certain partners' taxes (assuming the partnership elects to push down the adjustments) will the state allow refunds of state-related taxes?

Other Apportionment	
An adjustment at the federal level may have an effect on state level apportionment. For example, if the federal adjustment determined that a gain was improperly deferred and should have been recognized in the review year, then this might also affect the receipts factor (since the receipts from the transaction might then be included in the receipts factor in that same year, rather than in a later year).	Issue: Can a state make a corresponding change to apportionment where the federal adjustment might have some effect on apportionment?

State Audit & Adjustment Rules

(The issues in this section have yet to be identified.)