

## The Tax Adviser

# State Challenges With the New Federal Partnership Audit Rules

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A big surprise to many tax practitioners at the end of 2015 was the enactment by Congress of new partnership audit rules in the Bipartisan Budget Act (BBA) of 2015,<sup>1</sup> which President Barack Obama signed into law on Nov. 2, 2015. As summarized more clearly in many articles,<sup>2</sup> the new partnership audit rules radically expand the IRS's powers in dealing with audits of partnerships.

While the IRS has long had authority to audit partnerships, until the BBA was enacted, it could only assess and collect tax from partners individually. The new rules, when fully implemented and applicable to all partnerships for audits of tax years beginning on or after Jan. 1, 2018, will allow the IRS to assess and collect tax from the partnership itself. Partnerships that receive an IRS audit notice can elect into the new regime now.<sup>3</sup> Moreover, when the law is fully implemented, a partnership can pay an assessment directly or elect to "push out" the assessment to its partners.

A fundamental change, though, is the empowerment of the new "partnership representative" as the sole representative of the partnership in binding the partnership and its partners to all federal audit determinations and elections under the new regime. How partnerships will control the authority of the partnership representative and how a partnership representative will be indemnified for his or her actions will need to be addressed and will likely create tensions between the partners and the partnership representatives. This issue, hopefully, can be resolved through amendments to partnership agreements.

Many tax practitioners, and notably IRS Commissioner John Koskinen, have questioned whether, and how, the new partnership audit rules will work. No doubt, legislative technical corrections will be required, as well as new regulations and IRS procedural guidance and audit training for IRS auditors.<sup>4</sup> One objective of the new rules was to reduce the complexity of partnership audits and allow for the more efficient collection of federal income taxes. However, as tax authorities and practitioners peel back the new rules, they have discovered myriad significant questions that will have to be addressed. None of those questions are more complex than those affecting the area of state and local tax.

It is unlikely that Congress gave serious consideration to the state tax impact when it enacted the new rules. Although states generally rely on the Internal Revenue Code, at least in part, to determine their own state taxable income base, they generally rely on their own audit, assessment, and collection procedures. Thus, when the new federal partnership audit rules are fully implemented, nearly all of the states will have to take some legislative action to conform to them.

On the other hand, due to the information-sharing arrangements that the states have with the IRS, as the Service gears up to manage and resolve more partnership audits, the states may be inundated with partnership audit information. Many of them already recognize they are not fully prepared to deal with the increased volume. Moreover, just as there are 50 states, there are 50 ways they could choose to conform. Without some uniformity in critical areas, the "simple" federal reform of the partnership audit rules could result in an administrative nightmare at the state level not only for taxpayers but also for the states that will have to administer the information they will receive from the IRS.

For CPAs, the consequences are both professional and personal. As tax advisers to their clients, many of whom do business as partnerships, they need to understand the implications of the new rules not only to assist in the preparation of returns but to advise clients on their responsibilities and obligations. Likewise, many CPA firms are organized as partnerships, so CPAs will be directly affected by the rules.

The good news is that state taxing authorities and tax practitioners alike have recognized the potential tidal wave of regulatory change. They have come together in an unprecedented way to identify the issues and solutions.

The AICPA has formed the State Partnership Audits Task Force (AICPA Task Force), which is made up of members with expertise in state tax and partnership tax issues. The AICPA Task Force is part of a joint multi-organization task force that comprises other state tax groups, including the Council on State Taxation (COST), the State and Local Tax Committee of the Tax Section of the American Bar Association (the SALT Committee), and the Tax Executives Institute (TEI). Together, these groups are working on this issue and in dialogue with the Multistate Tax Commission (MTC) to provide input to state tax officials.<sup>5</sup> The MTC has started a partnership informational project that is considering an issue list (available at [www.mtc.gov](http://www.mtc.gov) (<http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/Partnership-Work-Group-Issue-List-12-9-2014.pdf.aspx>)) based on a comprehensive issue list developed by the multi-organization task force) related to these impending changes.<sup>6</sup>

The AICPA Task Force is developing a position paper with possible approaches that state CPA societies may want to consider in working with state legislatures and tax authorities in developing compliance policies regarding partnership audits. Several of the issues and thoughts are discussed below.

### **Separate State Elections**

The new federal law will allow partnerships to make certain elections. While administrative symmetry suggests that taxpayers should follow the same federal elections for state tax purposes, the AICPA Task Force believes that it may be administratively less costly for state tax authorities and taxpayers alike to allow for a state election that differs from the federal one, particularly when the partnership elects to push out the assessment to its members. In these cases, the AICPA Task Force believes states should allow the partnership the option to simply pay the amount even if the partnership chooses for federal income tax purposes to push out the payment obligations to its partners, since dilution by apportionment of the actual audit adjustments may make the administrative costs for each partner to individually report in each state far greater than if the partnership paid the state directly.

### **Optional Special Composite Return to Report Federal Partnership Changes**

Along these lines, states should consider developing composite adjustment returns for all partners, including residents, nonresidents, and disallowed taxpayers, of the reviewed year even if original composite returns were not filed.

### **Apportionment/Allocation: Use Only the Reviewed Year**

All states should clarify that, in applying audit changes, they will use the apportionment and allocation of the reviewed year (i.e., the year that was audited) and not the adjustment year (i.e., the year in which the assessment is made) against the adjusted taxable income. Unless the state undertakes separate audit procedures for the reviewed year under the regular applicable statute of limitation, it should allow for adjustments to apportionment or allocation based only on the federal changes (e.g., if the IRS audit results in an adjustment of revenue recognition that changes the total amount of gross receipts, only the sales factor should be adjusted to reflect the federal change).

### **Flexibility in Tiered Structures**

For tiered structures, states should allow for additional flexibility in the reporting of federal audit changes at each tier for state-specific modifications. For the same reasons that the states should allow partnerships to make elections different from the corresponding federal elections, they should likewise allow similar, separate state election flexibility at each tier of a multitiered structure. Again, the objective would be to minimize the administrative costs both to the state and taxpayers of reporting the state impact of federal changes.

### **One Universal Partnership Representative**

States should automatically recognize the designated partnership representative for federal and all state tax purposes, regardless of the state of residence or organization of the partnership representative. States should allow the federal partnership representative to designate a state-specific partnership representative for each state. However, this could raise constitutional nexus problems that would have to be addressed through, for example, contractual consent by the partnership representative to a state's jurisdiction or designation of a specific agent or representative of the partnership representative who would be subject to state jurisdiction and process.

### **Exclusion of State Exempt Entities From Federal Audit Adjustments**

States should provide a mechanism to adjust for the share of partnership audit payments for entities that are subject to federal income taxation but are exempt from state income taxation (e.g., insurance companies), or that might be subject to state tax at rates or under apportionment methods that are different from the general state tax rates or apportionment methods (e.g., financial institutions). Similarly, if a partner is exempt from federal income tax but not state income tax, the state rules should reflect that the entity would be subject to the state tax rules in the applicable state.

### **Nexus Problems for Partnerships and Partners From the Reviewed Year to the Adjustment Year**

Partnerships and their partners can change their states of residence or states of operations between the reviewed year and the adjustment year, so serious nexus considerations have to be addressed.<sup>7</sup> Partners move. Partnerships can change their bases of operations and leave the state entirely. Partnerships could relocate to a new state between the reviewed and adjustment year. States may find that they do not have sufficient jurisdiction to assess and collect against either the partnership or individual partners from the reviewed year or to interact with the partnership representative. In cases in which the state still has jurisdiction over the partnership, use of a composite return may assist in collections. Alternatively, other contractual mechanisms may need to be created.

### **Impact on Nonresident State Tax Credits Allowed to Individual Resident Partners**

States imposing an income tax on individual residents generally provide a credit for taxes paid to nonresident states on income from sources outside the individual's state of residence. Presumably, if a partnership elects to use the push-out method, any additional tax assessed on individual partners on income from sources outside the individual partner's state of residence would qualify for this type of credit. It is unclear, however, whether the same treatment would apply to taxes paid by a partnership at the entity level using the "pay up" method. States will need to address these complex issues and avoid limiting the credit in any manner that may violate the U.S. Constitution's Commerce Clause.<sup>8</sup>

### **Development of Uniform State RAR Rule**

Facing the possibility that the states could adopt a variety of approaches to reporting the changes resulting from federal partnership audits, the AICPA Task Force and the multi-organization task force have identified a collateral issue on a similar path: The lack of state uniformity with respect to reporting federal changes, generally referred to as reporting the revenue agent's report (RAR). Generally, states have statutes providing that when the IRS reports a federal change to state tax authorities, the state is automatically granted additional time to make adjustments to the taxpayer's state return. The time period used by these states varies from 90 days to five years. In some states, the report of an IRS change may not extend the time for a refund claim, even though it extends the time for a state assessment, producing an inequitable result.

Further compounding the problem is the disparity among the states in extending the statute of limitation for purposes of the federal change. Some states limit the extension only to the federal changes, but a large number believe it opens up the entire state return for review (not just the federal changes). Thus, a taxpayer doing business in multiple jurisdictions is presented with an administrative nightmare when a change is made to its federal income tax return.

A single change triggers a bewildering array of reporting requirements and deadlines among the states. If the taxpayer can comply with all of these reporting requirements, it is then faced with up to five years of uncertainty regarding additional adjustments that the state may make through the extension of the statute of limitation on assessments. Uniform state laws for reporting federal changes would eliminate this uncertainty and administrative complexity. The AICPA Task Force and the multi-organization task force believe that the current discussion of the complexity of the federal reporting of partnership audit changes would be a good starting point for tackling the difficult problems with reporting RAR adjustments generally, convincing the states to develop a uniform RAR reporting rule.

The AICPA is developing a position paper on RAR issues by updating a part of its 1995 *Report on Corporate State Tax Administrative Uniformity*. On Dec. 14, 2016, the multi-organization task force started discussions with the MTC Uniformity Committee on an updated proposed Model RAR Statute.<sup>9</sup> The AICPA and the multi-organization task force plan to continue discussions with the MTC on the partnership audits and RAR issue this year.

Although tax practitioners, the IRS, and state tax authorities recognize that the first audits under the new partnership audit regime will likely not commence until 2020 (for returns filed for the tax years beginning on or after Jan. 1, 2018), they all recognize the complications and significant preparations that taxpayers, tax practitioners, and taxing authorities must undertake to be ready for the new regime. The AICPA and the state CPA societies, in conjunction with the multi-organization task force and state tax authorities, intend to be ready for this significant change in the way partnerships will face audits, assessments, and collections.

### Footnotes

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<sup>1</sup>Bipartisan Budget Act of 2015, P.L. 114-74, §1101 (to be codified as amended Secs. 6221-6241).

<sup>2</sup>See, e.g., Harvey et al., "New Partnership Audit Rules—What We Know So Far, Part 1," 152 *Tax Notes* 829 (Aug. 8, 2016); Harvey et al., "New Partnership Audit Rules—What We Know So Far, Part 2," 152 *Tax Notes* 991 (Aug. 15, 2016); Joyce, "IRS in 'Guidance Mode' for New Partnership Audit Rules," *Weekly State Tax Report* (Nov. 21, 2016); Nevius, "Congress Makes Changes to Partnership Audit and Adjustment Rules (<http://www.journalofaccountancy.com/news/2015/oct/partnership-audit-and-adjustment-rules-201513294.html>)," *Journal of Accountancy* (Oct. 30, 2015); Radde, "New Partnership Audit Procedures Will Have a Profound Impact (</newsletters/2016/oct/federal-audit-procedure-rules-impact-partnerships.html>)," *Tax Insider* (Oct. 6, 2016); Schreiber, "IRS Issues Temporary Regulations on Early Elections of New Partnership Audit Procedures (</news/2016/aug/new-irs-partnership-audit-procedures-201614954.html>)," *Journal of Accountancy* (Aug. 4, 2016); and Williamson, "Partnership Audit Rules for the Next Decade (</issues/2016/jul/partnership-audit-rules-for-next-decade.html>)," *The Tax Adviser* (July 2016).

<sup>3</sup>On Aug. 4, 2016, the IRS issued temporary regulations (T.D. 9780) providing guidance on early elections of new partnership audit procedures (Temp. Regs. Sec. §301.9100-22T). In addition, on March 4, 2016, the IRS issued Notice 2016-23, requesting comments on the new partnership audit rules. On Oct. 7, 2016, the AICPA submitted to Treasury and the IRS suggestions (available at [www.aicpa.org](http://www.aicpa.org) ([http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA\\_%20Comment\\_Letter\\_Notice\\_2016-23\\_%20BBA\\_Partnership\\_Audit\\_Procedures\\_10\\_7\\_16.pdf](http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA_%20Comment_Letter_Notice_2016-23_%20BBA_Partnership_Audit_Procedures_10_7_16.pdf))) for further IRS guidance as requested in Notice 2016-23.

<sup>4</sup>In fact, on Dec. 6, 2016, House Ways and Means Committee Chairman Kevin Brady, R-Texas, introduced in the 114th Congress the Tax Technical Corrections Act of 2016, H.R. 6439, which includes as Title II, "Technical Corrections Related to Partnership Audit Rules." Congress did not enact the bill before it adjourned on Dec. 9, 2016, but it is expected to be reintroduced in the 115th Congress. The bill contained several recommendations (available at [www.aicpa.org](http://www.aicpa.org) (<http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comment-Letter-Proposed-Legislative-Changes-BBA-Partnership-Audits-11-17-16.pdf>)) for technical corrections related to the partnership audit rules that the AICPA submitted to Congress on Nov. 17, 2016. As indicated above, the IRS has released some procedural guidance on the issues addressed in the bill.

<sup>5</sup>The co-chairs of the multi-organization task force are Bruce Ely and Will Thistle of Bradley Arant Boult Cummings LLP. The task force sent a memo to the MTC identifying many issues related to state tax implications of the partnership audits (available at [www.mtc.gov](http://www.mtc.gov) ([http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/BHM-4074415-v3-ABA\\_SALT\\_Task\\_Force\\_-\\_Memo\\_re\\_partnership\\_audit\\_rules.pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/BHM-4074415-v3-ABA_SALT_Task_Force_-_Memo_re_partnership_audit_rules.pdf.aspx))).

<sup>6</sup>See the MTC Partnership Informational Project webpage for details on what the MTC is considering on this issue (available at [www.mtc.gov](http://www.mtc.gov) (<http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project>)).

<sup>7</sup>See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>8</sup>See *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. \_\_\_\_ (2015).

<sup>9</sup>See MTC Uniformity Committee December 2016 meeting information (available at [www.mtc.gov](http://www.mtc.gov) (<http://www.mtc.gov/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016>)) for further details on the RAR issue discussion, including the proposed draft amended Model RAR Statute ([www.mtc.gov](http://www.mtc.gov) ([http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/Proposed-Model-RAR-Statute\\_FINAL-DRAFT.pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/Proposed-Model-RAR-Statute_FINAL-DRAFT.pdf.aspx))), the COST policy position ([www.mtc.gov](http://www.mtc.gov) (<http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/COST-Policy-Statement-Reporting-Federal-Changes.pdf.aspx>)), the TEI policy statement ([www.mtc.gov](http://www.mtc.gov) (<http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/2015-11-17-SALT-Policy-Reporting-Federal-Changes-and-Template-FINAL.pdf.aspx>)), the TEI proposed model report of federal audit changes ([www.mtc.gov](http://www.mtc.gov) (<http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/2015-11-17-RAR-Template-MTC-Proposal.pdf.aspx>)), a letter from the multi-organization task force ([www.mtc.gov](http://www.mtc.gov) ([http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/section18-status-memorandum-for-december-2016-final-\(1\).pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/section18-status-memorandum-for-december-2016-final-(1).pdf.aspx))), and the 2016 survey of reportable adjustments ([www.mtc.gov](http://www.mtc.gov) ([http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/2016-Survey\\_Reportable-Adjustments.pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/2016-Survey_Reportable-Adjustments.pdf.aspx))).

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