

New Federal Partnership Audit Rules Create State Tax Issues

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In this article, the authors discuss new federal partnership audit rules and their potential effects on state income tax enforcement. The authors discuss the Arizona statute enacted to address the federal changes and conclude that although it is a reasonably good start, several key issues remain unresolved.

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The information in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

The IRS and most states have struggled with how best to audit partnerships. Because partnerships generally are not subject to income tax at the entity level, taxing authorities have collected partnership-related income tax deficiencies from the partners, not the entity. With some partnership structures having multiple tiers and partners numbering in the thousands, some lawmakers have been concerned with the ability of taxing authorities to effectively audit partnerships, find sources of income, and determine partners' shares of adjustments.

The Bipartisan Budget Act of 2015 made significant changes to the way partnerships and entities treated as partnerships for federal tax purposes (such as many limited liability companies) will be audited and assessed. Those new federal rules generally go into effect for partnership returns for tax

years beginning after December 31, 2017, but some partnerships may be able to adopt the new federal rules earlier.¹

Generally (absent some elections), the new federal rules allow the IRS to make adjustments and collect related underpayments at the partnership level, rather than separately from each of the partners. The character of those imputed underpayments as an entity-level tax on the partnership or a withholding by the partnership of taxes that otherwise would be owed by the partners remains uncertain.² If an imputed underpayment is a tax on the partnership, states may find they have no mechanism in their laws to assess state tax on the amounts generating the imputed underpayment because most states do not impose an entity-level tax on partnerships. However, even if it is not a tax on the partnership, the information shared with the state by the IRS on the completion of a federal audit may not be sufficient for the state to properly assess related underpayments of state tax.

Although a partnership's imputed underpayment relates to income, gain, loss, deduction, or credit of the partnership for a past tax year (the year reviewed by the IRS under audit, referred to as the reviewed year), the default rule is that the partnership pays the imputed underpayment in its tax year during which the adjustment is finally made (the adjustment

¹On August 4 the IRS released temporary and proposed regulations (T.D. 9780) allowing partnerships that meet the procedural requirements and that can make some representations to elect to apply the new federal rules to partnership returns filed for tax years beginning after November 2, 2015 (the date the new regime was enacted), and before January 1, 2018. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986 as amended.

²See, e.g., Jenna Summer, Katie LeBlanc, and Ashby Corum, "Potential Financial Reporting Implications of Changes to Partnership Examinations," *What's News in Tax*, Jan. 6, 2016, available at <http://bit.ly/2bcrRvv>.

year).³ That potentially shifts the economic burden of an understatement of income in the reviewed year from the reviewed-year partners to the adjustment-year partners, not all of whom may have been partners during the reviewed year.

Rather than paying the imputed underpayment at the partnership level, however, a partnership may elect to push out the audit adjustments to the reviewed-year partners, who compute tax on the underpayment and pay the relevant tax with their current tax year return (using a formula to determine the amount by which to increase their current-year tax). In this situation, the partnership provides the reviewed-year partners (and the IRS) with statements showing those partners' shares of adjustments to the partnership's items (adjusted schedules K-1). Each reviewed-year partner then increases its chapter 1 tax liability for the year that includes the date on which that statement is furnished (the current year) by an amount that reflects the hypothetical increase in its chapter 1 tax liability for each tax year between the reviewed year and the current tax year in a manner that takes into account the adjustment in the reviewed year.

Some smaller partnerships can elect out of the new federal audit provisions altogether. In that case, adjustments generally would be determined in separate proceedings for each partner using the current procedures applicable to audits of smaller partnerships and their partners.

Although the effective date is still months away (unless a partnership elects to apply the rules early) and the related audits may be years away, partnerships and states will need to consider the collateral state implications of the federal changes. If states do not address the changes, their taxing authorities may find that they lack authority and information necessary to assess and collect related state taxes. If partnerships do not prepare for the changes now, they may not be able to easily obtain information to comply with any state requirements for reporting to the states and their partners.

Arizona is the only state that has enacted legislation to address the federal changes. Arizona's legislation provides

³New IRC section 6225(d)(2) defines adjustment year as the partnership tax year in which (1) in the case of an adjustment under the decision of a court in a proceeding brought under the new rules' judicial review provisions, such decision becomes final; (2) in the case of an administrative adjustment request, such request is made; or (3) in any other case, notice of the final partnership adjustment (FPA) is mailed. See new code section 6225(d)(2). The "General Explanation of Tax Legislation Enacted in 2015" prepared by the staff of the Joint Committee on Taxation provides an example indicating that the adjustment year would be 2021 if an adjustment with respect to partnership tax year 2018 results in an imputed underpayment being asserted in 2020 but the partnership litigates the adjustment in Tax Court, the decision becomes final in 2021, and it is not appealed. See p. 62. The new federal rules define reviewed year as the partnership tax year to which the item being adjusted relates. See new IRC section 6225(d)(1).

insight into what might be enacted in other states. A review of the legislation uncovers areas yet to be addressed to ensure the proper amount of state tax is paid by partnerships or their partners on the conclusion of a federal partnership audit under the new rules.

This article summarizes the new federal rules and explains and analyzes the Arizona legislation. It then addresses the state tax considerations for taxpayers when states are planning to implement the new federal rules.⁴ This article also raises issues that states may want to consider when drafting legislation to address state audit procedures in light of the new federal rules.⁵

I. New Federal Rules and the Budget Act of 2015

Generally effective for income tax returns filed for partnership tax years beginning after 2017, the new federal rules repeal and replace the current Tax Equity and Fiscal Responsibility Act audit rules with a single system of centralized audit, adjustment, and collection of tax. Those rules generally apply to all entities classified as partnerships that are required to file federal income tax returns (that is, tax partnerships).⁶

The new federal rules address a host of issues, including partnership adjustments and assessments, consistency between the partnership return and its partners' returns, designation of a partnership representative,⁷ administrative adjustment requests, amending schedules K-1, and statutes of limitations on assessments and refunds. Under the new federal rules:

- If the IRS determines that the partnership *understated* income or gain (or overstated losses or deductions) in

⁴For a summary of these rules, see Appendix: Comparison of Federal and Arizona Procedures.

⁵See also Carol Kulish Harvey et al., "New Partnership Audit Rules — What We Know So Far, Part 1," *Tax Notes*, Aug. 8, 2016, p. 829, (hereafter "New Partnership Audit Rules") and "New Partnership Audit Rules — What We Know So Far, Part 2," *Tax Notes*, Aug. 15, 2016, p. 991.

⁶See new IRC section 6241(1), which defines partnership for purposes of the new federal rules as a partnership required to file a return under section 6031(a). References to new IRC sections or new federal rules are to sections added by the Budget Act, as amended by the Protecting Americans from Tax Hikes (PATH) Act of 2015, the title of the Consolidated Appropriations Act, which will become effective when the new law takes effect. As indicated above, a partnership that meets some requirements may elect to apply the new federal rules for any partnership return filed for partnership tax years beginning after the date of enactment (November 2, 2015). The rules for making such an election are found in section 301.9100-22T of the Treasury regulations.

⁷Under new IRC section 6223(a), each partnership is required to designate a partner (or other person) with a substantial presence in the United States as a partnership representative. That representative has "sole authority to act on behalf of the partnership" with respect to federal partnership audits.

the reviewed year, the IRS determines the amount required to be paid based on some simplifying assumptions — the imputed underpayment — and mails the partnership a notice of proposed partnership adjustment (NOPA).⁸

- If the IRS determines that the partnership *overstated* income or gain (or understated losses and deductions) in the reviewed year, the partnership must adjust its non-separately-stated income or loss for the year for which the adjustment is made (with the reduced income or increased deductions generally benefiting the adjustment-year partners).⁹
- The partnership has 270 days after the date of the NOPA to submit information that can be used to reduce the amount of the imputed underpayment.¹⁰ For example, the new law directs Treasury and the IRS to establish procedures to modify the amount of the imputed underpayment if (1) the partnership demonstrates a portion is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity; (2) the adjustment relates to income and gain allocable to C corporation partners or to capital gains and qualified dividends of individuals and S corporations; or (3) the reviewed-year partners file amended returns and pay additional tax due regarding understated income or gain.¹¹
- After the IRS reviews that information, it issues a notice of final partnership adjustment (FPA).¹²
- The partnership has 45 days after the date of the FPA to decide whether to make an election to push out to each partner in the audited (reviewed) year that partner's share of any adjustment to partnership items, instead of paying at the partnership level (also known as paying up).¹³
- If the partnership elects to push out an adjustment to the partnership's items of income, gain, loss, deduction, or credit, each reviewed-year partner must take its share of the adjustment into account on its current-year tax return. Specifically, each reviewed-year partner increases the tax imposed by chapter 1 of the IRC (the income taxes imposed by sections 1 through 1400) for the tax year that includes the date when the

adjusted Schedule K-1 is furnished (the current tax year) to reflect the sum of (1) in the case of the tax year of the partner that includes the end of the reviewed year, the amount by which the tax imposed under chapter 1 would *increase* if the partner's share of the adjustments were taken into account for such year, plus (2) in the case of a tax year after the year described above and before the current tax year, the amount by which the tax imposed under chapter 1 would *increase* by reason of tax attributes that would have been affected by some adjustments.¹⁴

- The statute does not provide a person who is allocated a share of the adjustment with the right to challenge the adjustment or the amount allocated to that person.¹⁵

The new federal law also allows some partnerships to elect out of the new federal rules and be subject to the non-TEFRA audit rules that apply to some small partnerships. Absent administrative guidance otherwise, a partnership is generally ineligible to make the election out unless it is required to furnish 100 or fewer schedules K-1 and meets other requirements, including the absence of partners that are partnerships. It is important, however, that the election out must be made with the timely filed partnership return for each year to which it is to apply; the partnership cannot wait to make the election until the year is examined.

There are many unanswered questions about the new law, including questions about how the push-out election applies in tiered structures.¹⁶ Additional legislative clarification and administrative guidance are needed.¹⁷

¹⁴For example, assume that in 2020 the IRS determines that Partnership X understated \$1 million of ordinary income on its 2018 return. That income would have been allocated equally to A (an individual) and B Corp. (a C corporation). In 2018 B had a net operating loss of \$650,000 that B could have used to offset its \$500,000 share of understated income if Partnership X had reported the income in 2018. However, B used the full amount of the NOL to offset other income earned in 2019. Both Partnership X and B Corp. use the calendar year. Partnership X elects to use the push-out method for the imputed underpayment and sends B Corp. a statement in 2020 showing B Corp.'s \$500,000 share of the adjustment. For B Corp.'s 2020 tax return, B Corp. presumably must include the sum of (1) the amount by which its tax liability for 2018 would be increased by virtue of the adjustment (that is, zero, because of the NOL) and (2) the amount by which its tax liability for 2019 would increase given that none of the NOL would have been available to offset B Corp.'s income in that year.

¹⁵For more details on these requirements, see New Partnership Audit Rules, *supra* note 5.

¹⁶For a detailed analysis of the unanswered questions, see "New Partnership Audit Rules," *supra* note 5.

¹⁷In Notice 2016-23, IRB 2016-13 (Mar. 28, 2016), the IRS requested comments on the new partnership provisions. Rochelle Hodes, attorney-adviser, Treasury Office of Tax Legislative Counsel, noted at a recent Federal Bar Association Tax Section meeting that there are "hundreds" of issues with implementation of the statute. William R. Davis, "IRS Wants Comments on Key Partnership Audit Issues," *Tax Notes*, Mar. 14, 2016, p. 1273.

⁸See new IRC sections 6225 and 6231.

⁹See new IRC section 6225(a)(2). See also new IRC section 6225(d)(2), *supra* note 3.

¹⁰See new IRC section 6225(c).

¹¹The imputed underpayment also can be adjusted in some situations involving passive activity losses and publicly traded partnerships. Further, the IRS and Treasury have broad authority to provide additional procedures for modifying the amount of the imputed underpayment based on other factors, as appropriate.

¹²See new IRC sections 6231 and 6235, as amended by the PATH Act. The FPA cannot be issued until 270 days after the NOPA. However, new IRC section 6235, as amended by the PATH Act, provides the IRS extension periods to issue the FPA.

¹³See new IRC section 6226.

II. Arizona SB 1288

Arizona's new statute¹⁸ requires a partnership that is assessed an imputed underpayment under the new federal rules to file an Arizona return for the reviewed year, showing the adjustments to income or the gain, loss, or deduction on which the federal imputed underpayment was based.¹⁹ Partnerships that elect to push out adjustments to the reviewed-year partners for federal purposes also must file amended Arizona returns for the reviewed years regardless of whether the adjustments result in an underpayment or overpayment for federal tax purposes.²⁰

How the adjustments are treated for state tax purposes depends on whether the adjustments result in a net increase or net decrease in Arizona taxable income and whether the partnership pays the federal imputed underpayment at the partnership level or pushes out the federal adjustments to the partners. If the adjustments result in a net increase in Arizona taxable income and the partnership files and pays the imputed underpayment at the partnership level (the pay-up method) for federal tax purposes, the Arizona statute imposes a tax on the partnership at the entity level levied on the Arizona share of the adjustments. The partnership must file an amended Arizona return for the reviewed year and pay the associated Arizona tax within 90 days after the final IRS determination.²¹ If the partnership elects to push out the adjustments to the reviewed-year partners for federal income tax purposes, the partnership must provide its reviewed-year partners²² with a statement of the federal adjustment and any correlative Arizona income tax modifications.²³ That is considered a change in the partners' taxable income by the IRS for the reviewed year, and the partners must each file an amended Arizona return for the reviewed year within 150 days after the final determination of the partnership adjustments by the IRS.²⁴

¹⁸Arizona SB 1288, amending Rev. Ariz. Stat. sections 43-327 and 43-1414 (signed by the governor on May 11, 2016).

¹⁹Ariz. Rev. Stat. section 43-1414(A).

²⁰*Id.*

²¹Ariz. Rev. Stat. section 43-327(B)(1). The Arizona statute imposes a tax on the partnership at the entity level levied on the Arizona share of the adjustments. *Id.*

²²The Arizona statute does not specify whether the statement must be provided to the adjustment-year partners or the reviewed-year partners. However, because the statute provides that a partnership may not claim a refund of tax that it did not actually pay and the related adjustments must be made to the partners' reviewed year returns, it may be reasonable to assume this statement should be distributed to the reviewed-year partners. See Ariz. Rev. Stat. sections 43-327(B)(1) and 43-1414(D)(2)(b). The Arizona Department of Revenue may consider clarifying this in regulations.

²³Ariz. Rev. Stat. section 43-327(B)(2).

²⁴Ariz. Rev. Stat. section 43-327(B)(1). Also note that, because the partners' due date is based on the date of the federal audit, the partnership will need to provide this information to the partners as well.

If the adjustment that gives rise to the federal imputed underpayment results in a net reduction in Arizona taxable income, the process is the same regardless of whether, at the federal level, the imputed underpayment is paid by the partnership or pushed out to the partners.²⁵ The partnership is not authorized to claim a refund for amounts not actually paid by the partnership. Therefore, the partnership must notify the reviewed-year partners of the adjustment within 90 days.²⁶ Each partner must file an amended return for the reviewed year to claim a refund within 150 days of the date of the final determination of the IRS adjustment.²⁷

If the partnership incorrectly reports the adjustments to Arizona, the partnership must pay the tax on any resulting understatement of Arizona taxable income.²⁸ If the error results in an overstatement of Arizona taxable income, then identification of who receives the refund depends on who paid the tax. If the tax was paid by the partnership, the partnership may claim a refund.²⁹ Otherwise, only the partners who paid the tax may receive a refund of the overpaid taxes.

III. Lessons Learned From Arizona

What can we learn from the Arizona legislation? First, it piggybacks onto the federal process to a large extent. So when the partnership representative decides to pay the federal imputed underpayment or push out the federal adjustments to the partners, the decision should take into account the state ramifications as well.

A. Filing Requirements

Assume, for example, all states adopted provisions similar to those adopted by Arizona. A decision to push out the federal adjustments to the partners means that each partner may need to file an amended return in each state in which the partner originally filed. Most states, including Arizona, require a state return to be filed whenever there is a change at the federal level.³⁰ Therefore, each state where a partner originally filed may be expecting a return, even those states where the partnership itself did not file a return. For example, an individual partner who is a Michigan resident may be required to file an amended Michigan personal income tax return to reflect adjustments pushed out from the federal audit of a partnership that did business only in Illinois and Indiana.

Further, if the federal change results in a substantial change in the partnership's apportionment factors that pass through to the partners, that could significantly change the partner's apportionment factors in every state in which the partner originally filed. Therefore, pushing the change out

²⁵Ariz. Rev. Stat. section 43-1414(B)(2).

²⁶*Id.*

²⁷Ariz. Rev. Stat. section 43-327(B)(1).

²⁸Ariz. Rev. Stat. section 43-1414(D).

²⁹Ariz. Rev. Stat. section 43-141(D)(1)(b).

³⁰Ariz. Rev. Stat. section 43-327(D).

to the partners could impose a costly administrative burden on the partners to file amended returns. Also, the partnership itself would need to maintain current contact information regarding former partners to ensure they receive all data necessary for completing those returns.

In the Arizona law, the partners' responsibilities in the push-out method are significantly different from those under federal law. Under federal law, the reviewed-year partners are not required to amend past federal returns to report the adjustment. Instead, they include in tax owed an amount that is determined based on their share of the federal adjustment in their current-year returns. Under the Arizona law, those partners are required to file an amended return for the reviewed year.

Filing an amended Arizona return may have numerous ramifications, including an extension of the statute of limitations. Under Arizona law, it is not clear whether filing an amended return would extend the statute for all items on the return or just those that were adjusted because of the federal audit.

B. Information Shared With State by IRS

At that point, it is uncertain what information the IRS will share with a state at the conclusion of a federal audit. The partners presumably will each receive a K-1 type form³¹ explaining the partner's share of adjustments determined by the audit. However, that is likely to be reported on a net basis. Therefore, if the IRS adjusts to an item of income or expense that requires a state adjustment, the state and partner may not receive sufficient information to properly adjust state income.

For example, assume the IRS adjusts several items of ordinary income for ABC partnership, including an item of ordinary income that was treated as non-apportionable, nonbusiness income in Arizona. The net of the adjustments will be reported as an adjustment to line 1 of the ABC partner's federal K-1. Without details regarding the nature of the adjustments, the partners may not have the information necessary to back out the adjustment attributable to nonbusiness income, potentially over reporting the income attributable to the state.

C. Calculation of Tax

If the partnership chooses to pay the imputed underpayment at the federal level in the adjustment year, it is also required to pay at the state level under the Arizona law. However, it must do so by filing an amended Arizona return for the reviewed year. The tax is imposed at the highest rate for individuals, which in Arizona is 4.54 percent, imposed

³¹ See "Technical Explanation of the Protecting Americans From Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029," prepared by the JCT staff, JCX-144-15 (Dec. 17, 2015) at p. 249.

on income greater than \$304,868.³² Obviously, many individuals would not fall into that tax bracket, and thus the rate of tax would be higher than what they would ordinarily pay.

Corporate partners, on the other hand, could benefit, as the corporate tax rate in Arizona is 4.9 percent for tax years beginning after December 30, 2016.³³ By largely conforming to the new federal pay-up rules, Arizona's new law simplifies the process for partners when the partnership pays the imputed underpayment and related state tax at the entity level, but taxpayers should be aware of the tax rate implications.

D. Taxation of Residents as Nonresidents

Arizona's statute does not appear to require partnerships to distinguish between Arizona resident and nonresident individual partners when computing the amount to be paid to the state using the pay-up approach. Generally, resident individuals would be taxed on their shares of the entire income earned by the partnership, not just the amount of income attributable to Arizona, and would be eligible for credits for taxes paid to other states on that income.

The approach taken by Arizona in the pay-up method simplifies the process. Instead of paying tax on a pro rata share of the entire amount of income from partnerships, partnerships will compute tax for residents in the same manner as nonresidents, by determining their share of the adjustments that arose from the federal audit, adjusted for Arizona law, and allocated or apportioned to Arizona under the state's corporate apportionment provisions.³⁴

That approach simplifies the compliance process. Determining whether a partner was a resident or nonresident could be burdensome for a partnership as having a mailing address is not determinative of residency. That approach also resolves any questions that may arise if a partner has changed residency since the reviewed year. Also, credits allowed for taxes paid to other states could offset the amount of tax due by an Arizona resident. Thus, the difference in tax ultimately owed using the approach in the statute might not differ significantly from an approach that required resident partners to report all income and offset the Arizona liability with taxes paid to other states. As a result, the Arizona approach appears to forgo some degree of technical accuracy in favor of simplicity and administrative convenience.

³² Ariz. Rev. Stat. sections 43-1414(B)(1)(b) and 43-1011. The income amounts for each bracket are adjusted annually by the DOR according to the average annual change in the metropolitan Phoenix consumer price index. Ariz. Rev. Stat. section 43-1011(C).

³³ Ariz. Rev. Stat. section 43-1111(5). Of course, the reverse could be true in states where the individual rate is higher than the corporate tax rate.

³⁴ Ariz. Rev. Stat. section 43-1414(E)(1). The statute does not state whether the apportionment factors of the reviewed or adjustment year should be used. Presumably, this is something the DOR can address in regulations.

E. Nexus

When federal adjustments are pushed out to the partners, the reviewed-year partners make an adjustment to the tax paid with their current-year federal returns. However, a partner in the reviewed year may not have any connection to Arizona in the current year (for example, a nonresident of Arizona may have sold her partnership interest in the intervening years) and thus may not be required to file an Arizona return in the current year.

If Arizona required the partners to make an adjustment to the current-year return, it is questionable whether Arizona would have authority under the U.S. Constitution to require that partner to file an Arizona return in the current year (assuming the partner had severed all connections with the state when she sold her partnership interest). By requiring the push-out of partnership adjustments to be made to the reviewed-year partners and reported on an amended reviewed-year return, Arizona isolates the adjustments to a year in which the partner had a taxable connection to the state. That reduces the chances that partnership adjustments will be pushed out to partners who cannot be compelled to pay an associated increase in Arizona income tax.

Nevertheless, that negates one of the purported advantages of the federal approach: that partners do not need to file amended returns. Filing an amended return raises a host of issues, including the extension of the statute of limitations for the reviewed year.

F. Statute of Limitations

It is unclear how a state's ability to assess tax at the partner level may be affected by a state's statute of limitations. Arizona law provides that if a taxpayer enters into an agreement with the IRS to extend the statute of limitations, the period for state purposes is also extended for six months after the expiration of the extended federal statute of limitations.³⁵ However, if the *partnership* extends the federal statute of limitations, there are no provisions that would automatically extend the statute of limitations for the *partners*. Thus, the Arizona statute of limitations for a partner may be closed before the federal audit is complete.

How those provisions will work when the partnership chooses the push-out method is not entirely clear. In an email to Tax Analysts, Sean Laux, chief legislative liaison and public information officer for the Arizona Department of Revenue, explained that the notice provided by the partnership to the partners under the new Arizona provisions would be treated as a change in taxable income by the IRS for the tax year of the partner during which the reviewed year of the

partnership ends.³⁶ The partner then has 150 days after the final determination of the partnership adjustments to file an amended return.³⁷ The DOR may assess tax up to four years after a return is filed or required to be filed.³⁸ Because the statute of limitations for claiming a refund is the same as the statute of limitations for the DOR to assess a deficiency,³⁹ the taxpayer may claim a refund during the same period.

Thus, it appears that while a partner's statute of limitations may be closed for a particular year, the resolution of a partnership audit may reopen the return. For example, assume Able is a calendar-year individual taxpayer who is a partner in the ABC partnership. Able files his individual return in Arizona for year 1 on April 15 of year 2. Under Arizona law, the state may assess tax four years after a return is filed.⁴⁰ Thus the statute of limitations for Able's year 1 return closes on April 14 of year 6. Assume further that the IRS begins an audit of ABC in year 5 and issues a NOPA on April 1 of year 5. ABC has 270 days after the NOPA to submit information that can be used to reduce the amount of the imputed underpayment. The IRS receives that information on December 30 of year 5 and, after processing the information, issues an FPA on January 20 of year 6. ABC must furnish to Able information within 90 days of the FPA, and Able has 150 days from the date of the FPA to file an amended return.

Note that in that scenario ABC is not required to furnish information to Able until April 20 of year 6. However, the statute of limitations for Arizona to assess tax on Able, or for Able to file a claim for refund, presumably closed on April 15. Unless ABC notified its partners of the audit, Able would have no way of knowing that the statute of limitations might be extended. Under Laux's explanation, the statute of limitations would be reopened so that Able would have 150 days from the date of the FPA to file a claim for refund or file an amended return.

It is unclear, but presumably the state would then have four years to issue a deficiency assessment under Arizona's

³⁵Ariz. Rev. Stat. section 43-1104(B)(7).

³⁶Ariz. Rev. Stat. section 43-327(B)(2). While the Arizona statute section 43-1414(B)(2), which includes the provisions explained above, does not contain the words "by the IRS," the revisions to section 43-327 state that the notice provided by the partnership to the partners is treated as a change in taxable income of the partner "by the commissioner of internal revenue." It is not clear whether the IRS treats the imputed underpayment as a change in taxable income of the partners or an entity-level tax on the partnership.

³⁷Ariz. Rev. Stat. section 43-1414(B)(2).

³⁸Ariz. Rev. Stat. section 42-1106.

³⁹Ariz. Rev. Stat. section 42-1106.

⁴⁰Ariz. Rev. Stat. section 42-1104(A).

statute of limitations for assessments.⁴¹ It is also unclear whether the period for assessments or refunds would be opened for all issues reported on the original return or whether assessments or refunds would be available only for those issues relating to the changes in the partnership's income.⁴² One hopes the DOR can address those issues in regulations.

G. Adjustments That Result in Overpayment of Arizona Tax

If a partnership's federal imputed underpayment nevertheless results in an overpayment of Arizona tax, the partnership must push out the adjustments, and the adjustment-year partners must file a refund claim. In that circumstance, the partnership would need to both file an amended Arizona partnership return for the reviewed year and provide its partners with the information necessary for them to file amended Arizona income tax returns for the reviewed year to claim their Arizona refunds.

For example, assume a federal audit results in an increase in federal taxable income (an imputed underpayment of tax) but a decrease in Arizona taxable income (eligible for tax refund). Assume further that the partnership does *not* make an election to push out the tax to the partners. For federal tax purposes, the imputed underpayment must be paid by the partnership and thus absorbed by the adjustment-year partners.

In contrast, Arizona will require the partnership to file an amended return for the reviewed year. Further, the reviewed-year partners must file an amended Arizona return to claim a refund of overpaid Arizona taxes. Therefore, the partners who ultimately bear the burden of the imputed underpayment under the federal rules may be different from the partners who receive the refund of overpaid Arizona taxes. At a minimum, that can cause confusion for the former partners who are eligible for a refund of Arizona taxes but do not receive any information from the partnership about the federal tax implications.

The Arizona statute does not address how to account for a federal adjustment that does not result in a federal imputed underpayment. For federal purposes, a net adjustment that reduces federal taxable income generally is taken into account as a reduction in the partnership's non-separately stated income in the adjustment year.⁴³

The language in the Arizona statute addresses only those circumstances in which a federal audit results in an imputed *underpayment* or the partnership has elected to push out the audit adjustments to the partners. In other words, it does

not address a situation in which a federal audit results in an *overpayment* of federal taxes.⁴⁴

It is therefore unclear how that situation will be treated in Arizona. It appears that the partnership would follow the federal approach and take the adjustment into account in determining the non-separately stated income or loss for the adjustment year. Presumably, Arizona Revised Statutes sections 43-1021 and 1022, which provide Arizona addition and subtraction modifications, would provide any necessary adjustments.

For example, assume the IRS audits year 1 (the reviewed year) of ABC Partnership in year 3 (the adjustment year). Originally, ABC reported \$100 ordinary income for year 1. The federal audit identified \$4 additional ordinary income and \$6 less interest income from U.S. obligations. The net change in income for the partnership is -\$2 from a federal perspective. That would be taken into account on the federal return in the adjustment year and passed through as a reduction in non-separately stated income or an increase in non-separately stated loss (or, in the case of a credit, as a separately stated item).⁴⁵

Because Arizona does not tax interest on U.S. obligations,⁴⁶ the \$6 interest subtracted for federal tax purposes would be added back under Arizona Revised Statutes section 43-1022(4). However, it is uncertain how the \$4 additional ordinary income would be reported in Arizona. Absent additional guidance, it appears the adjustment would be reported by the adjustment-year partners in their current-year return. Perhaps an example in the Arizona regulations could help clarify the matter.

H. Apportionment

In addition to the tax base, the decision to push out the partnership adjustments could affect the amount of income apportioned to the state. Many states, including Arizona, require each corporate partner to include factors of the partnership in its own apportionment calculations in some circumstances.⁴⁷ Thus, the amount of tax due when calculated at the partnership level could be significantly different from the amount that would be due if calculated at the corporate partner level. Whether the tax is higher or lower under the push-out approach depends entirely on the facts and circumstances of the partners and the partnership. The

⁴¹ *Id.*

⁴² See, e.g., Ariz. Rev. Stat. section 42-1104(B)(6) (permitting the state to assess deficiencies arising from adjustments made by the IRS that are reported to the state within six months of filing the required report with the state).

⁴³ New IRC section 6225(a)(2).

⁴⁴ The new provisions also do not address situations in which all the partners have filed an amended return for the tax year that includes the end of the partnership's reviewed year. If all the partners file such an amended return, the federal imputed adjustment will be zero, and there is no imputed underpayment. Because the filing of an amended federal return triggers a requirement to file an amended state return, presumably such a situation would be covered by the previously existing rules in Ariz. Rev. Stat. section 43-327(D). Under that section, a taxpayer has 90 days after the final determination to file an Arizona amended return.

⁴⁵ New IRC section 6225(a)(2).

⁴⁶ Ariz. Rev. Stat. section 43-1022(4).

⁴⁷ Arizona Corporate Tax Ruling 94-2 (Apr. 4, 1994).

Arizona legislation is unclear on what apportionment information must be provided to reviewed-year partners when a partnership has elected to push out the federal adjustments. Presumably, that will be clarified once Arizona releases the forms and instructions regarding the new filing requirements.

Likewise, it is unclear how the apportionment factors apply when the partnership pays the tax. Presumably, the income would be apportioned to Arizona using the partnership's apportionment factors for the reviewed year. Again, one hopes, the state can clarify that in regulations.

I. Composite Returns

Finally, although Arizona allows composite returns for nonresident individual partners, the legislation does not address them. A partnership that elects to push out the payment to the partners must push it out for all partners. It does not appear as though an amended composite return would be allowed for those partners who elected to file as part of a composite return in the reviewed year. Instead, it seems that those nonresidents would need to file individual Arizona returns for the reviewed year and pay any additional tax due. Again, that may result in confusion as partners attempt to file an amended return in states where they did not file an original return (as they originally joined in the filing of a composite return in the reviewed year).

IV. Considerations for Partnership Representatives

Making a decision to pay up or push out the imputed underpayments may require the partnership representative to balance the amount of tax to be paid against the administrative burden of compliance. There likely will be situations in which the partners have conflicting state tax profiles (for example, for one partner, use of the entity-level payment might be better, and for another partner, the push-out method could be better). The partnership representative should be prepared to explain why he chose one method over another and to support that explanation with relevant data.

In many situations, it may be advisable to amend the partnership agreement, addressing the partnership representative's authority to make those decisions for the partners and providing guidance to the partnership representative. Some partnership agreements may be revised to avoid possible conflicts between partners who disagree on whether to pay up or push out an underpayment. However, it likely will be difficult to address those issues until more is known regarding the new federal rules and the impact on financial statement provisions, which will inform the decision-making process as to pay up or push out.

V. Considerations for States

The Multistate Tax Commission has opened a project to consider the ramifications to states of the new federal rules. The Partnership Informational Project, which is in the

initial stages of gathering information and identifying issues, intends to address the following questions:

- Are new state statutes called for?
- What more should the states be doing to audit and track partnership information?
- Are withholding statutes effective enough given multiple tiered entities?
- How will old statutes intersect with entity-level liability?⁴⁸

States should seriously consider enacting legislation to address procedural issues that may arise at the state level as a result of the new federal rules. If they do not, they may find that the information provided by the federal government is insufficient for the state to determine the appropriate amount of additional state tax due. Also, the state may not be able to determine whether a refund claim filed by a partner is appropriate.

In drafting legislation, states may want to consider the approach taken by Arizona plus additional procedural concerns that are not addressed in its statute. For example, states may consider addressing how to classify the payment made by the partnership — that is, is it a payment of tax? And if so, on whom is it a tax — current-year partners, review-year partners, or the partnership? Many states do not allow a taxpayer to deduct state income taxes; therefore, amounts paid to other states may not be deducted. Should the payment be treated as withholding of tax paid for the partners? In such case, might a partner with a significant NOL carryforward from prior years be able to file an amended return to seek a refund of the taxes paid on its behalf? How should a partner's capital account and basis in the partnership interest be adjusted to reflect imputed underpayments paid to federal or state governments?

VI. Constitutional Considerations

At the state level, requiring the burden of state income tax arising from a reviewed year to be borne by partners in the adjustment year invokes constitutional concerns. In general the due process clause requires the taxpayer to have a minimum connection with the taxing state. If a taxpayer has no connection with a state, the due process clause prohibits the state from taxing that partner.

Assume first that the payment to the state made by a partnership is treated as a tax imposed directly on the partnership. If the partnership's only connection with a state is that a partner resides in the state, is there sufficient nexus for the state to require the partnership to pay an entity-level tax? What if the in-state partner is a limited partner that has no management authority and that partner owns only a small interest in the partnership? Would it matter that the limited partner acquired its interest in the

⁴⁸More information about the project can be found on the MTC website at <http://bit.ly/2bcSmMd>.

partnership from another partner that did not have nexus with the state? Or if the limited partner moved to the state after acquiring the interest?

It is easy to see that, in some scenarios, one could argue that the partnership itself did not purposely direct its activities to the taxing state.⁴⁹ An argument can be made that there is no rational relationship between a partnership and a state in which the partnership has no activities or connection other than a passive investment, non-managing partner residing in the state.

Similar constitutional concerns may arise if the payment is considered to be withholding of tax paid for the benefit of the partners. The due process clause also requires a rational relationship between the income attributed to the state and the intrastate values of the taxpayer.⁵⁰ If, for example, a partner purchases an interest in a partnership doing business in the state, the ownership of that partnership interest generally is sufficient for the state to tax income earned in the state. However, if the income on which the tax is imposed was generated before the partner became a partner in the partnership, an argument might be made that the due process clause prohibits the state from taxing that partner. It is hard to envision a rational relationship between the taxpayer and the income earned before the time when the taxpayer owned an interest in the partnership.

It is unlikely that a state could successfully argue that such an approach would be justified, because the state is merely conforming to the system adopted at the federal level. In *Kraft General Foods v. Iowa*,⁵¹ the U.S. Supreme Court struck down an Iowa statute that allowed a deduction for dividends received from U.S. subsidiaries but not subsidiaries formed outside the United States. Although the case involved discrimination under the commerce clause,

⁴⁹See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). See also *Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 12 CVS 8740 (Wake County Super. Ct. 2015).

⁵⁰*Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980).

⁵¹505 U.S. 71 (1992).

the Court concluded that “adoption of the federal system in whole or in part, however, cannot shield a state statute from commerce clause scrutiny.”⁵² Similarly, it is unlikely that adoption of the federal partnership audit rules would shield a state statute from due process clause scrutiny.

VII. Conclusion

How the new federal partnership audit rules will be applied remains a work in progress. The IRS is drafting regulations to put meat on the statutory bones enacted at the end of 2015. In the meantime, taxpayers must make decisions about changing existing and new partnership agreements, and state governments must decide about developing state rules for how to integrate the federal changes into state partnership filing regimes.

As indicated above, partnership representatives will face many decisions regarding the new audit rules and will have to factor in both facts about the partners and partnership and details of guidance that has not yet been issued. Similarly, states must carefully consider the ramifications for audits in their own states. Without legislative changes, states may not be able to track how changes resulting from federal audits should flow through to the state level. Also, on the administrative front, states will need to be careful in drafting the necessary forms and related guidance to ensure that the information required of partnerships that have been audited can reasonably be obtained by partnerships and satisfies the level of detail needed to make correlative state adjustments. The various implications for both adjustment-year and reviewed-year partners must be carefully considered. In enacting legislation, states must be careful to ensure those new laws comport with the restrictions of the U.S. Constitution. Resolving those issues also requires consideration of jurisdictional limitations over both partners and the income generated by partnerships.

The next few years may be challenging for states and taxpayers alike as both adapt to the new process. Let us hope that both sides can exercise patience during the audit process and work together to develop a system that works for all.

⁵²*Id.*

Appendix Comparison of Federal and Arizona Procedures			
	Federal Procedures	Arizona Procedures	
		Net Increase in Arizona Taxable Income	Net Decrease in Arizona Taxable Income
Pay-Up Approach	<ul style="list-style-type: none"> • <i>Partnership</i> reports net adjustment from reviewed year as adjustment in <i>adjustment</i> year • <i>Partnership</i> pays imputed underpayment 	<ul style="list-style-type: none"> • <i>Partnership</i> files amended return for <i>reviewed</i> year • <i>Partnership</i> makes payment to state 	<ul style="list-style-type: none"> • <i>Partnership</i> files amended return for <i>reviewed</i> year; partnership provides statement of federal adjustments to partners • <i>Partners</i> file amended return for <i>reviewed</i> year and receive <i>refund</i> of tax from state
Push-Out Approach	<ul style="list-style-type: none"> • <i>Partners</i> of <i>reviewed</i> year compute tax on net adjustment from reviewed year and pay tax in <i>current</i> year 	<ul style="list-style-type: none"> • <i>Partnership</i> files amended return for <i>reviewed</i> year; partnership provides statement of federal adjustments to partners • <i>Partners</i> of <i>reviewed</i> year file amended return for <i>reviewed</i> year and <i>pay tax to state</i> 	<ul style="list-style-type: none"> • <i>Partnership</i> files amended return for <i>reviewed</i> year; partnership provides statement of federal adjustments to partners • <i>Partners</i> of reviewed year file amended return for <i>reviewed</i> year and receive <i>refund</i> of tax from state

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