

**To: Partnership Work Group**  
**From: MTC Staff**  
**Re: WORKING DRAFT State Issue List for Conforming to  
Federal Partnership Audit and Adjustment Rules**  
**Updated: December 8, 2016**

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This document addresses the issues raised by Sec. 1101 of the Bipartisan Budget Act of 2015 relevant to states that impose tax on partnership income on a pass-through basis consistent with Subchapter K of the Internal Revenue Code. 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**

Note that “reviewed year” means the year under audit and “adjustment year” typically means the year in which the notice of final partnership adjustment is mailed.<sup>1</sup> Unless otherwise noted, the term “partnership” includes multi-member LLCs treated as partnerships for federal tax purposes.

- 1) The TEFRA and “electing large partnership” audit rules are repealed.
- 2) With two main exceptions, the general rule for partnership audits now is 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.<sup>2</sup>
- 3) The first exception to the general rule is that small/simple partnerships will be allowed to elect out.<sup>3</sup> To qualify to elect out, the partnership must:
  - With some exceptions, issue no more than 100 Schedule K-1s<sup>4</sup> (where an S corporation is a partner, each shareholder counts toward this 100 limit); and
  - Have as partners only individuals, C corporations, S corporations, or the estates of deceased partners;<sup>5</sup> and
  - An S corporation partner must provide disclosure of its shareholders.<sup>6</sup> The IRS may also prescribe rules for other kinds of partners.<sup>7</sup>

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<sup>1</sup> Sec. 6225(d)(2). The adjustment year for an administrative adjustment requested by the partnership is the year the adjustment is made.

<sup>2</sup> Sec. 6221(a).

<sup>3</sup> Sec. 6221(b).

<sup>4</sup> Sec. 6221(b)(1)(B).

<sup>5</sup> Sec. 6221(b)(1)(C).

<sup>6</sup> Sec. 6221(b)(2)(B).

- Make the election annually on a timely filed return (with extensions).
- 4) The second exception to the general rule with respect to entity-level assessment and collection is that the partnership, through the partnership representative, may elect to “push out” the tax liability (determined by the partnership audit) to the reviewed year partners (who may or may not be the same as the adjustment year partners). That process is discussed further below.
  - 5) A partner’s treatment of tax items must be consistent with the partnership’s return.<sup>8</sup> If not, any resulting underpayment will be treated as a math error for purposes of expedited assessment and collection of that tax.<sup>9</sup> However, this treatment does not apply to cases where the partner has filed a notice of inconsistent treatment.<sup>10</sup> If there is a determination as to a partner’s inconsistent treatment of an item, it is not binding on the partnership.<sup>11</sup>
  - 6) Partnerships will need to designate a “partnership representative” (“PR”)(or the IRS will appoint one) to make decisions on behalf of the partnership (including electing out of the partnership-level audit, how to handle the audit, and various other elections and decisions) and the PR’s actions will be binding on all the partners.<sup>12</sup> The previous appointment of a “tax matters partner” will be nullified for tax years beginning after 12/31/17.
  - 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.”<sup>13</sup>
  - 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.<sup>14</sup>
  - 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 income tax rate in effect for the reviewed year (and mandated reductions in losses or credits are treated as increases in income),<sup>15</sup> and
    - the amounts resulting from reallocation of partners’ distributive shares (from one or more partners to one or more partners) of any item are not netted (so only increases in taxable amounts are included in computing the underpayment).<sup>16</sup>
  - 10) The imputed underpayment may be adjusted as follows after the proposed partnership adjustment is mailed under Sec. 6231 (provided that required information is supplied to the IRS within 270 days<sup>17</sup>):

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<sup>7</sup> Sec. 6221(b)(2)(C).

<sup>8</sup> Sec. 6222(a).

<sup>9</sup> Sec. 6222(b).

<sup>10</sup> Sec. 6222(c).

<sup>11</sup> Sec. 6222(d).

<sup>12</sup> Sec. 6223.

<sup>13</sup> Sec. 6225(a).

<sup>14</sup> Sec. 6225(a)(2).

<sup>15</sup> Sec. 6225(b)(1).

<sup>16</sup> Sec. 6225(b)(2).

<sup>17</sup> Sec. 6225(c)(6).

- the IRS may allow a reduction in the imputed underpayment for one or more of the partners who file amended returns for the reviewed year if those partners take all the audit adjustments into account (both in terms of tax due and other adjustments to basis), and if they pay the resulting tax—provided that if the adjustment relates to a reallocation of distributive shares, then to receive a reduction in the imputed underpayment, all affected partners must file amended returns,<sup>18</sup>
- 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 (which involves a complex set of rules) is lower than the rate used to calculate the imputed underpayment;<sup>19</sup> and
- the IRS may also allow other adjustments by regulation.<sup>20</sup>

11) Rather than paying the final imputed underpayment (tax amount), the partnership has 45 days to elect to push the final partnership adjustments out<sup>21</sup> (“push-out election”) 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 distributive share of any adjustment to income, gain, loss, deduction, or credit.<sup>22</sup> If this is done, then the partnership is relieved of tax and any interest and penalties, and instead, each partner must take the adjustments into account as provided:<sup>23</sup> 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:<sup>24</sup>

- 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,”<sup>25</sup> 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<sup>26</sup>
- 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.<sup>27</sup>

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 but will be pushed out to the partners of the partnership for the reviewed year if the partnership timely makes a push-out election.<sup>28</sup>

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<sup>18</sup> Sec. 6225(c)(2).

<sup>19</sup> Sec. 6225(c)(3) and (4).

<sup>20</sup> Sec. 6225(c)(5).

<sup>21</sup> Sec. 6226(a)(1).

<sup>22</sup> Sec. 6226(a)(2).

<sup>23</sup> Sec. 6226(a)(2).

<sup>24</sup> Sec. 6226(b)(1).

<sup>25</sup> Sec. 6226(b)(2).

<sup>26</sup> Sec. 6226(b)(2)(A).

<sup>27</sup> Sec. 6226(b)(2)(B) and (C).

<sup>28</sup> Sec. 6226(c)(1).

- 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 Sec. 6621(a)(2), determined by substituting '5 percentage points' for '3 percentage points' in subparagraph (B) thereof.<sup>29</sup>
- 13) When a partnership asks the IRS for an administrative adjustment to 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,<sup>30</sup> or through the push-out process.<sup>31</sup> The rules also provide for a general 3-year limitation period on requested adjustments.<sup>32</sup>
- 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.<sup>33</sup>
- 15) The tax assessed under these provisions will generally be assessed and collected as if the tax was owed in the year of adjustment, rather than the reviewed year. Assessment or collection can be made or commenced 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 or commenced until the decision of the court has become final. (But see special rules for math or clerical errors.)<sup>34</sup>
- 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).<sup>35</sup> 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.<sup>36</sup>
- 17) Payments of tax made by the partnership will not be deductible for federal income tax purposes.<sup>37</sup>
- 18) A partnership may elect for the partnership audit and adjustment provisions to apply to the 2016 and 2017 tax years, rather than only for tax years after the effective date (tax years beginning after December 31, 2017).<sup>38</sup>

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<sup>29</sup> Sec. 6226(c)(2).

<sup>30</sup> Sec. 6227(a) and (b)(1).

<sup>31</sup> Sec. 6227(b)(2).

<sup>32</sup> Sec. 6227(c).

<sup>33</sup> Sec. 6231(a).

<sup>34</sup> Sec. 6232(a)-(c).

<sup>35</sup> Sec. 6232(d)(1)(A).

<sup>36</sup> Sec. 6232(d)(1)(B).

<sup>37</sup> Sec. 6241(4).

<sup>38</sup> Sec. 6241(g). The IRS has issued interim guidance on early opt-ins.

## State Issue List

This memo aims to capture issues with respect to requiring the reporting of state taxes associated with federal audit 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. Those regulations will likely affect how the federal changes will work in practice and how states may want to respond to some of the issues summarized here. There is also the possibility of a “technical corrections” bill next year in Congress.

### RAR Rules

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

<b>Federal Audit &amp; Adjustment Process</b>	<b>Effect on States and Related Requirements</b>
<i>Election Out</i>	
Under Sec. 6221(b), certain smaller, simpler partnerships will be allowed to elect out annually—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.
<i>Partners Who Take Inconsistent Positions</i>	
Under Sec. 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 Sec. 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, and those decisions will be binding on the partnership and all the partners. At the federal level, these decisions may include whether the reviewed year partners will be required to file amended returns under Sec. 6225(c)(2), whether to contest any proposed or final audit adjustment, or whether to push out the final audit adjustment to the reviewed year partners under Sec. 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 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.
3. Will the state allow the partnership to designate a partnership representative different than the PR designated for federal purposes?

### *Effect of an Adjustment that Does Not Result in an Imputed Underpayment*

Under Sec. 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 form of documentation 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 reviewed 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 and partner basis for state and federal tax 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?)
2. Will the state’s existing RAR statute cover this situation (see below)?

### *Calculation of the State-Level Imputed Underpayment of Partnership Tax*

Under Sec. 6225(b), the IRS will compute an “imputed underpayment” which may ultimately be paid by the partnership (if not completely reduced under Sec. 6225(c), see below, or if no “push out election” is made). 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 income 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 = \$4 million (\$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) The manner in which 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 to other states, and
  - c) If apportioned, what year’s apportionment factors will be used to apportion the imputed underpayment? Can a state constitutionally require the use of adjustment year factors rather than reviewed year factors?
  - d) Will the state allow the partnership to use the apportionment factor in the originally-filed return as opposed to re-computing the factor, for purposes of administrative ease?
2. What tax rate will apply at the state level, especially if there are state income tax-exempt entities (which may not coincide with the federal definition or are subject to a non-income based tax regime such as insurance companies or banks) or partners with lower state tax rates?

### *Partnership Response to Proposed Audit Adjustment*

Under Sec. 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 reviewed year partners (with proof of payment) (commonly known as the “pay-up election”), (2) information on (lower) tax rates or tax-exempt status 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 state returns in response to a proposed federal audit adjustment?
2. If a partnership elected to file a composite return, will partners be allowed to file separate amended returns or will the partnership have to file an amended composite return? If the latter, will the partners who are included be relieved of filing individual amended returns?

3. 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 certain partners are lower than the highest applicable state rate or that certain partners are exempt from state income tax?

4. Similar to 3, will the state consider other information that might affect the final audit adjustment amount at the state level? What should that information be?



*Reduction in Proposed Audit Adjustment (Imputed Underpayment)*

Under Sec. 6225(c), the IRS will allow a reduction in the proposed audit adjustment (imputed underpayment) where, among other things (see above) the reviewed year partners file amended returns taking the adjustments into account and make a related payment of the tax. It does not appear that the statute requires 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 conform to the federal pay-up election and allow the partnership to reduce its state tax liability related to the federal adjustments for reviewed year partners who file amended returns/pay tax?
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. Similarly, can a partnership reduce its federal imputed underpayment by presenting information to the IRS to reduce the final audit adjustment amount, but choose not to do so for a particular state, thereby causing the partnership to remain liable for the full amount of the state tax?
4. Will the state allow a state level pay-up election if the partnership did not make a federal pay-up election, so that certain partners will file a state amended return and pay the state tax but will not file a federal amended return? If this is allowed, will it be allowed where all partners do not file state amended returns and pay the state tax?
5. Will the state require the partnership and, if applicable, 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?
6. Will the state require some showing that the IRS has allowed the amended returns in order to reduce the state-level proposed audit adjustment?
7. Assuming state law requires the partners to file a state amended return if they also file a federal amended return, in what way will the partnership need to prove that a state amended return was indeed filed?
8. Will partnerships be allowed to file composite returns for this purpose?
9. If some amount of the federal proposed audit adjustment remains, will the state accept the federal reductions in that amount as the basis for any remaining partnership assessment?
10. Will the states allow a partnership that is itself a partner of the audited partnership to push-out the state adjustment to lower-tier partners if that is elected for federal tax purposes under Sec. 6227(b)??

*“Push-Out” of the Final Partnership 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 out” the final audit adjustment to partners who were partners in the reviewed year. If it does so, the partnership is relieved of liability but must 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 out may affect the taxes those partners owed in the reviewed year and subsequent years. However, 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. No amended returns (for the reviewed year(s) or interim year(s)) are required.

NOTE: There is some question about how exactly the IRS will allow push-out 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 (which is likely):

1. Will the state allow the partnership to push out the state tax amount related to the federal audit adjustments if the partnership makes a federal push-out election?
  - 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 by the partners can be properly calculated?
  - b) Will the relevant apportionment information be that related to the reviewed year (and subsequent years) in order to avoid constitutional concerns?
  - c) How will the state handle the partner who was a state resident in the reviewed year but is now a nonresident or no longer a partner? And vice versa? What jurisdictional issues are presented?
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? (see question above)
3. If the state normally allows or requires a composite return for nonresident partners to be filed by the partnership, will it allow an amended composite return, or a current year composite return that includes reviewed year adjustments, in this situation? What jurisdictional issues are presented?
4. Will states permit partnerships to file withholding or composite returns for resident partners or will they each be required to file amended returns? If they are allowed to be included, how will their liability be computed?
5. Can the composite return include corporate partners who were not included on the originally filed composite return? If they are allowed to be included, how will their liability be computed?
6. If the partnership elects to push out the federal adjustments, will the state allow it to pay the state-

related tax at the partnership level, without pushing that liability out to the partners? In other words, if a federal push-out election is made, will the state allow the partnership to opt-out of that election for a particular state and remain liable for the tax?

7. Conversely, if a partnership does not make a federal push-out election, may it nevertheless do so at the state level? Under what conditions?

### *Treatment of Partnership Payment of Tax*

If a partnership does not elect to push out the final audit adjustments to the reviewed year partners, then it will have to pay any amount of unreduced imputed underpayment (see above) remaining in the year of the final adjustment. 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 the federal adjustments, how will the state provide for apportionment of that liability when there are resident partners in the state (who would otherwise pay tax 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 by the partnership against their own taxes and how will this be computed and shown?
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). Would using adjustment year factors be constitutionally permissible?
5. If the partnership pays some or all of the federal adjustment, will that tax payment be treated by the state as a deductible or a creditable tax for the partners?

### *Statutes of Limitation, Penalties & Interest*

The federal changes include specific provisions for calculating penalties and interest on the tax ultimately due and also provide a specific statute of limitations.

Issues:

1. Does the state have the authority to impose penalties and interest under this system depending upon whether:
  - a) The partners filed amended returns,
  - b) The partnership pushes out the final adjustments to the partners, or
  - c) The partnership pays the unreduced amount of the final imputed underpayment?
2. Does the state have the authority to assess under existing statutes of limitation, either against the partnership or the reviewed year partners, where the final audit adjustment is issued to the partnership and the tax due is required to be paid in the year of adjustment? For example, does the existing RAR statute allow the state to assess tax against a partnership as a result of a federal audit adjustment?
3. Is the state's authority under its existing RAR

statute limited to a review/adjustment of the items adjusted by the IRS in the RAR?

*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 on the process.

Issues:

1. Will the partnership/partners have to separately appeal or challenge the state-related taxes if the federal adjustment is appealed?
2. If so, does the existing appeal process contemplate such an appeal?
3. If any adjustments relate to reallocated amounts between partners, which would reduce certain partners' taxes (assuming the partnership elects to push out the adjustments), how will the state provide for refunds of state-related taxes?

*Other Apportionment Issues*

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 reviewed year, 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: Within the confines of the existing RAR statute, or under the normal statute of limitations, can a state make a change to apportionment factors where the federal adjustment might have some effect on apportionment?

State Audit & Adjustment Rules

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