# MEMORANDUM

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| TO | **Helen Hecht, Esq./Multistate Tax Commission Staff** |
| FROM | **American Bar Association Tax Section, State & Local Tax Committee Task Force on the State Implications of the New Federal Partnership Audit Rules – Co-Chairs: Bruce P. Ely and William T. Thistle, II** |
| DATE | **September 15, 2016 [Restrictions on Distribution Removed September 27, 2016]** |
| SUBJECT | **Outline of Discussion Topics for September 16, 2016 Brainstorming Session on State Tax Implications of New Federal Partnership Audit Rules** |

Thank you for agreeing to meet with us Friday morning. As we discussed, the meeting will be very informal and the views expressed both in this Memorandum and at the meeting by members by our Task Force do not necessarily represent the views of the ABA or its Tax Section, those views being reserved until the formal comment period on any model conformity statute the MTC may propose. Likewise, we understand that any views you may express during the meeting are not necessarily the views of the MTC or its member states. The list of issues below is by no means exclusive and, in particular, we don't attempt to address the various state-specific issues that will arise as each state legislature and DOR administering a net income-based tax attempts to engraft the new federal partnership audit rules onto their existing tax statutes, regulations, procedures, etc.

For purposes of this Memorandum and subsequent discussions, we'll use the new federal tax nomenclature. The "reviewed year" is (are) the tax year(s) audited by the IRS. The "adjustment year" is the tax year in which the audit is resolved by settlement or final court ruling. The "imputed underpayment" is the amount of federal income tax determined to be due. A "partnership" means any entity governed by Subchapter K of the Internal Revenue Code, and a "partnership representative" or "PR" is the person or entity appointed to handle partnership audits conducted by the IRS (and presumably by state DORs as well). Lastly, the term "federal rules" refers to those provisions of the Bipartisan Budget Act of 2015, as amended by the PATH Act of 2015, which establish the new partnership audit and assessment regime and repeal the current TEFRA partnership audit rules, etc.

## ITEMS TO BE CONSIDERED IN MODEL CONFORMITY LEGISLATION

1. **Conformity to Federal Elections:** There are essentially six key elections available to partnerships or PRs under the federal rules:

    - the one-time election to opt-in early to the federal rules;
    - the annual election to opt-out of the federal rules entirely;
    - the appointment from time-to-time of a partnership representative;
    - the so-called "push-out" election of I.R.C. § 6226, requiring those who were partners during the reviewed year to pay additional federal income tax, etc. with their *adjustment year* return and relieving the partnership of liability whether amended returns are filed or not;
    - the so-called "pay up" election under I.R.C. § 6225, by which the partnership elects to notify those persons who were partners during the reviewed year, by means of a so-called Adjustment

K-1, of their duty (whether statutory or by agreement) to amend their *reviewed year* returns and pay their share of the appropriate federal tax due or file refund claims, as appropriate; and
- the election under I.R.C. § 6227(b)(2) to file an administrative adjustment request ("AAR") in the case of an IRS audit of a multi-tier partnership.

The Task Force believes that, generally, the states should conform to the federal rules and automatically adopt the federal elections, particularly with respect to a partnership that opts-out of the federal rules or a partnership that opts-in early. However, there are two notable exceptions to this general rule that we believe, if implemented, would increase compliance by reducing administrative burdens:

- Exception No. 1 – The "Push-Out Election": With respect to the I.R.C. § 6226 push-out election, we believe the states should allow partnerships to opt-out of their federal election so that the partnership itself remains liable for any state tax deficiency. The mutual advantage to a state-level election here would be to simplify compliance in situations where the partnership (through the PR) elected to push-out the adjustment at the federal level, but the state tax effects would be relatively insignificant and the benefits to relieving the partnership of liability for state tax purposes would be outweighed by the administrative burden of having the partnership calculate the liability of each reviewed year partner and asking each of them to include a relatively nominal adjustment in their income, rather than simply having the partnership pay the tax on a state-by-state basis. In essence, the partnership/PR would "check-the-box" on a timely filed state equivalent of Form 1065 so that it would remain liable for the state adjustment. On the other hand, if the partnership does not timely make a push-out election, then it should remain bound by that decision at the state level.

- Exception No. 2 – The Pay Up Election: We believe that a similar opt-out election should be available with respect to the I.R.C. § 6225 "pay-up" procedure so that the partnership would remain liable for the state adjustment if the partnership representative so elects, rather than asking all the reviewed year partners to prepare and file multiple amended state returns, etc. This would be especially true in the case of states that impose either composite return or non-resident withholding (or both) requirements at the partnership level.

2. **Imputed Underpayments:** Absent making a push-out or pay up election, partnerships will remain responsible for the imputed underpayment at the federal level. Currently, most state income tax levy statutes do not include partnerships as taxable entities and we expect most states will need to amend their statutes to permit partnerships to be assessed and to pay the state portion of the imputed underpayment [but see discussion of QIPs below].

3. **Ability to Reduce State Income Tax Liability:** Consistent with I.R.C. § 6225, any state conformity statute should provide a mechanism for a partnership to reduce its state income tax liability by proving that lower tax rates are applicable to the state share of the imputed underpayment, e.g., by showing that a partner is a tax-exempt entity under state law, or is subject to a lower state tax rate, or not subject to a state's income tax regime at all, such as an insurance company or a financial institution (in many states). Additionally, to the extent that a push-out election is made under I.R.C. § 6226, reviewed year partners who have sold all or a portion of their interest in the partnership prior to the adjustment year should be permitted to reduce the imputed underpayment by the reduction in tax in the year of the sale that would have been attributable to the corresponding increase in basis.

4. **Credit for Taxes Paid:** If the partnership pays the state income tax deficiency, any state conformity statute should specifically provide that the adjustment year partners receive a credit for the taxes paid by the partnership for the state imputed underpayment in the adjustment year (similar to credits available to nonresident partners with respect to withholding tax remitted by the partnership).

5. **Composite Returns:** There will be cases where a partner could be required to file "an amended return" with a state DOR, e.g., if the partnership makes the I.R.C. § 6225 pay up election, even though the partner never filed an initial return because it was part of a composite return filed by the partnership. The Task Force believes that the states should allow amended composite returns by the partnership in lieu of multiple returns filed by the partners who were included in the initial composite return.

6. **Nonresident Partner Withholding with Federal Adjustments:** Nonresident withholding statutes likely will need to be revised to address whether the partnership will have to withhold additional amounts in the event of a federal audit adjustment, particularly if the partnership makes the I.R.C. § 6226 push-out election (or comparable state election).

7. **Qualified Investment Partnerships:** These entities, recognized by at least sixteen states either by statute or by regulation, should remain exempt from state income tax unless their state qualification as a QIP is lost due to some aspect of the federal audit adjustment, e.g., excess non-passive income.

8. **Apportionment Rules:** The Task Force believes that in any scenario where those who were partners during the reviewed year file amended state tax returns for the reviewed year as the result of an adjustment, the partnership's apportionment factor for the reviewed year should be applied, not the apportionment factor applicable to the adjustment year.

9. **Information Included on Federal Adjustment Notice:** The AICPA and our Task Force are filing comments with the IRS to encourage them to provide sufficient detail in their form notice of proposed partnership adjustments, etc. so that both the partnership and the states can discern how the federal audit adjustment will impact them (and the partners) in terms of apportionment factors / sourcing, business / non-business income items, etc. We hope the MTC will file similar comments.

10. **RAR Statutes:** We believe that a number of state RAR statutes must be amended in order to conform to the federal rules and this may be an opportunity to develop and jointly advocate for a "model RAR statute" that both the MTC and COST / TEI and their respective members believe will foster good tax administration. We have reviewed the MTC's model RAR statute and believe that it has a number of balanced features. However, it also has several deficiencies. For example, it's not clear that the MTC statute would limit a state DOR to auditing and assessing income tax only with respect to the items that are the subject of or changed by the federal audit adjustment. Attached are copies of the COST and TEI whitepapers on RAR statutes for your and your staff's consideration.

11. **The Moving Partner:** As you are aware, one of the most common issues at the state level will be how to handle, both legally and practically, the partner who was a resident of a particular state during one or more of the reviewed years, but is not a resident of that state during the adjustment year. That item remains open to discussion, taking into account obvious Due Process concerns. We note that, for

partnerships electing to push-out audit adjustments, the Arizona conformity statute departs from the new federal rules to address this issue by requiring partners from reviewed years to file amended Arizona returns for the reviewed years rather than reporting partnership audit adjustments on their adjustment year returns.

12. **The Moving Partnership:** Similar issues arise with a partnership that was doing business in or otherwise taxable by a state during the reviewed year (one or more) but was not doing business in or otherwise taxable in that state during the adjustment year or vice versa.

13. **Dealing with Tiered Structures:** As you may know, the IRS is in the process of determining if a technical corrections bill is necessary or if regulations can cover how to deal with tiered partnership structures, including the possible I.R.C. § 6227(b)(2) election mentioned above. Again, we believe the partnership should be able to opt-out of its federal election and remain liable for the state taxes, etc. due, or file a refund claim in its own right.

14. **Designation of Partnership Representative**: The Task Force believes that any MTC conformity statute should provide that the designation of a PR for federal audit purposes should be accepted by the states as well, unless the PR or the partnership specifically designates otherwise.

15. **Constitutional Limitations**: States have both U.S. and state constitutional limits that prevent them from imposing their taxes on businesses engaged in interstate commerce that do not exist at the federal level, e.g., the apportionment of interstate businesses income. The Task Force believes that any MTC model statute should be designed to avoid violating any constitutional provisions, specifically the Commerce and Due Process Clauses.

16. **Regulatory Authority:** It's obvious that this list of issues is non-exclusive and the list will grow longer as state-specific issues are encountered. The Task Force acknowledges that any MTC model statute would authorize an adopting state to issue regulations to implement the provisions of the state statute. The Task Force believes, however, that any substantive guidance should be issued through the state's Administrative Procedure Act process, and the state DOR should seek input from the partnership and tax practitioner communities not only during the APA process but beforehand as well.

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Thank you in advance for your consideration of these informal suggestions. We look forward to meeting with you on Friday and to further discussions. Our Task Force members are also willing to work with the legislatures and state DORs of the states in which they practice.

cc: Jaye A. Calhoun, Esq., Chair, SALT Committee

Attachments (2)