MTC Partnership Work Group

Report to the
Uniformity Committee
March 8, 2017

Essential partnership tax information.

BACKGROUND

Terminology

- Partnerships – Entities taxed under Subchapter K (including LLCs, etc.)
- Partners – Owners of entities taxed as partnerships (including limited partners, LLC members, etc.)
- Pass-through entities – partnerships and Subchapter S corporations*

* Which are simpler and don't have the same problems.

Terminology

- Reviewed year – the year audited
- Adjustment year – the year under federal provisions when the adjustment is final
- Adjustment – a generic term for a discrete change made in an audit to a partnership item or to an allocation between partners that gives rise to additional tax

Background

- Unlike C corporations:
  - There is no entity-level tax
  - Partners pay on income allocated to them (by agreement of the partners) rather than on income actually distributed to them
    - **This is the chief source of risk – that the tax results may not match the economic results (which they are supposed to under Subchapter K)**

MULTISTATE TAX COMMISSION

Partnership Tax Return (page 1)

Report of Partnership Income & Expense

Form **1065** Department of the Treasury Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2016, or tax year beginning ____________, 2016, ending ____________, 20 ____.

▶ Information about Form 1065 and its separate instructions is at *www.irs.gov/form1065*.

OMB No. 1545-0123

2016

A Principal business activity	Type or Print	Name of partnership	D Employer identification number
B Principal product or service		Number, street, and room or suite no. If a P.O. box, see the instructions.	E Date business started
C Business code number		City or town, state or province, country, and ZIP or foreign postal code	F Total assets (see the instructions) $

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return
(6) ☐ Technical termination - also check (1) or (2)

H Check accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶

J Check if Schedules C and M-3 are attached ☐

Caution. *Include* ***only*** *trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

Income	1a	Gross receipts or sales	1a		
	b	Returns and allowances	1b		
	c	Balance. Subtract line 1b from line 1a		1c	
	2	Cost of goods sold (attach Form 1125-A)		2	
	3	Gross profit. Subtract line 2 from line 1c		3	
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)		4	
	5	Net farm profit (loss) (attach Schedule F (Form 1040))		5	
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)		6	
	7	Other income (loss) (attach statement)		7	
	8	**Total income (loss).** Combine lines 3 through 7		8	
Deductions (see the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)		9	
	10	Guaranteed payments to partners		10	
	11	Repairs and maintenance		11	
	12	Bad debts		12	
	13	Rent		13	
	14	Taxes and licenses		14	
	15	Interest		15	
	16a	Depreciation (if required, attach Form 4562)	16a		
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b	16c	
	17	Depletion **(Do not deduct oil and gas depletion.)**		17	
	18	Retirement plans, etc.		18	
	19	Employee benefit programs		19	
	20	Other deductions (attach statement)		20	
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20		21	
	22	**Ordinary business income (loss).** Subtract line 21 from line 8		22	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

▶ Signature of general partner or limited liability company member manager ▶ Date

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11390Z Form **1065** (2016)

MULTISTATE TAX COMMISSION

Partnership Tax Return (page 4)

Schedule K – Distributive Share Items

Schedule K — Partners' Distributive Share Items

				Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)	1	
	2	Net rental real estate income (loss) (attach Form 8825)	2	
	3a	Other gross rental income (loss) — 3a		
	b	Expenses from other rental activities (attach statement) — 3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4	Guaranteed payments	4	
	5	Interest income	5	
	6	Dividends: a Ordinary dividends	6a	
		b Qualified dividends — 6b		
	7	Royalties	7	
	8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))	8	
	9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))	9a	
	b	Collectibles (28%) gain (loss) — 9b		
	c	Unrecaptured section 1250 gain (attach statement) — 9c		
	10	Net section 1231 gain (loss) (attach Form 4797)	10	
	11	Other income (loss) (see instructions) Type ▶	11	
Deductions	12	Section 179 deduction (attach Form 4562)	12	
	13a	Contributions	13a	
	b	Investment interest expense	13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶	13c(2)	
	d	Other deductions (see instructions) Type ▶	13d	
Self-Employment	14a	Net earnings (loss) from self-employment	14a	
	b	Gross farming or fishing income	14b	
	c	Gross nonfarm income	14c	
Credits	15a	Low-income housing credit (section 42(j)(5))	15a	
	b	Low-income housing credit (other)	15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	15c	
	d	Other rental real estate credits (see instructions) Type ▶	15d	
	e	Other rental credits (see instructions) Type ▶	15e	
	f	Other credits (see instructions) Type ▶	15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶		
	b	Gross income from all sources	16b	
	c	Gross income sourced at partner level	16c	
		Foreign gross income sourced at partnership level		
	d	Passive category ▶ e General category ▶ f Other ▶	16f	
		Deductions allocated and apportioned at partner level		
	g	Interest expense ▶ h Other ▶	16h	
		Deductions allocated and apportioned at partnership level to foreign source income		
	i	Passive category ▶ j General category ▶ k Other ▶	16k	
	l	Total foreign taxes (check one): ▶ Paid ☐ Accrued ☐	16l	
	m	Reduction in taxes available for credit (attach statement)	16m	
	n	Other foreign tax information (attach statement)		
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment	17a	
	b	Adjusted gain or loss	17b	
	c	Depletion (other than oil and gas)	17c	
	d	Oil, gas, and geothermal properties—gross income	17d	
	e	Oil, gas, and geothermal properties—deductions	17e	
	f	Other AMT items (attach statement)	17f	
Other Information	18a	Tax-exempt interest income	18a	
	b	Other tax-exempt income	18b	
	c	Nondeductible expenses	18c	
	19a	Distributions of cash and marketable securities	19a	
	b	Distributions of other property	19b	
	20a	Investment income	20a	
	b	Investment expenses	20b	
	c	Other items and amounts (attach statement)		

MULTISTATE TAX COMMISSION

651113

Schedule K-1 (Form 1065) — 2016

Department of the Treasury
Internal Revenue Service

For calendar year 2016, or tax year beginning ________, 2016 ending ________, 20____

Partner's Share of Income, Deductions, Credits, etc. ▸ See back of form and separate instructions.

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Part I Information About the Partnership

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS Center where partnership filed return

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number

F Partner's name, address, city, state, and ZIP code

G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner?

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

K Partner's share of liabilities at year end:

Nonrecourse $
Qualified nonrecourse financing $
Recourse $

L Partner's capital account analysis:

Beginning capital account $
Capital contributed during the year $
Current year increase (decrease) $
Withdrawals & distributions $ ( )
Ending capital account $

☐ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ **Yes** ☐ **No**
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	18	Tax-exempt income and nondeductible expenses
11	Other income (loss)		
		19	Distributions
12	Section 179 deduction		
13	Other deductions	20	Other information
14	Self-employment earnings (loss)		

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. IRS.gov/form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2016

Schedule K-1

Partner's Share of Income, Deductions (Gains, Losses, Credits, etc.)

Background

- Also, unlike C corporations:
  - Closely affiliated partnerships file separate returns (rather than some kind of consolidated return), nor are partnerships included in consolidated or combined returns (exception – SMLLCs)
- But like C corporations –
  - Contributions of property to partnerships are typically non-recognition events

Withholding

- At the federal level – partnerships must withhold on U.S. income allocated to foreign partners
- At the state level – partnerships with state source income must withhold on income allocated to nonresident partners

This is a critical enforcement tool.

Individual Partners

Federal Tax System

- US partners –
  - Taxed on 100% of partnership income
- Foreign partners
  - Taxed on U.S. source income

State Tax Systems

- Residents –
  - Taxed on 100% of income with credit for other state tax paid.
- Nonresidents –
  - Taxed on state source income apportioned at partner-ship level

Corporate Partners

Federal Tax System

- Include Schedule K-1 allocation of items of partnership income, expense, gain and loss, etc.

State Tax Systems

- Depends on whether –
  - The partnership is part of the unitary business
    - If so, a portion of its factors may be included
  - The income is allocable nonbusiness

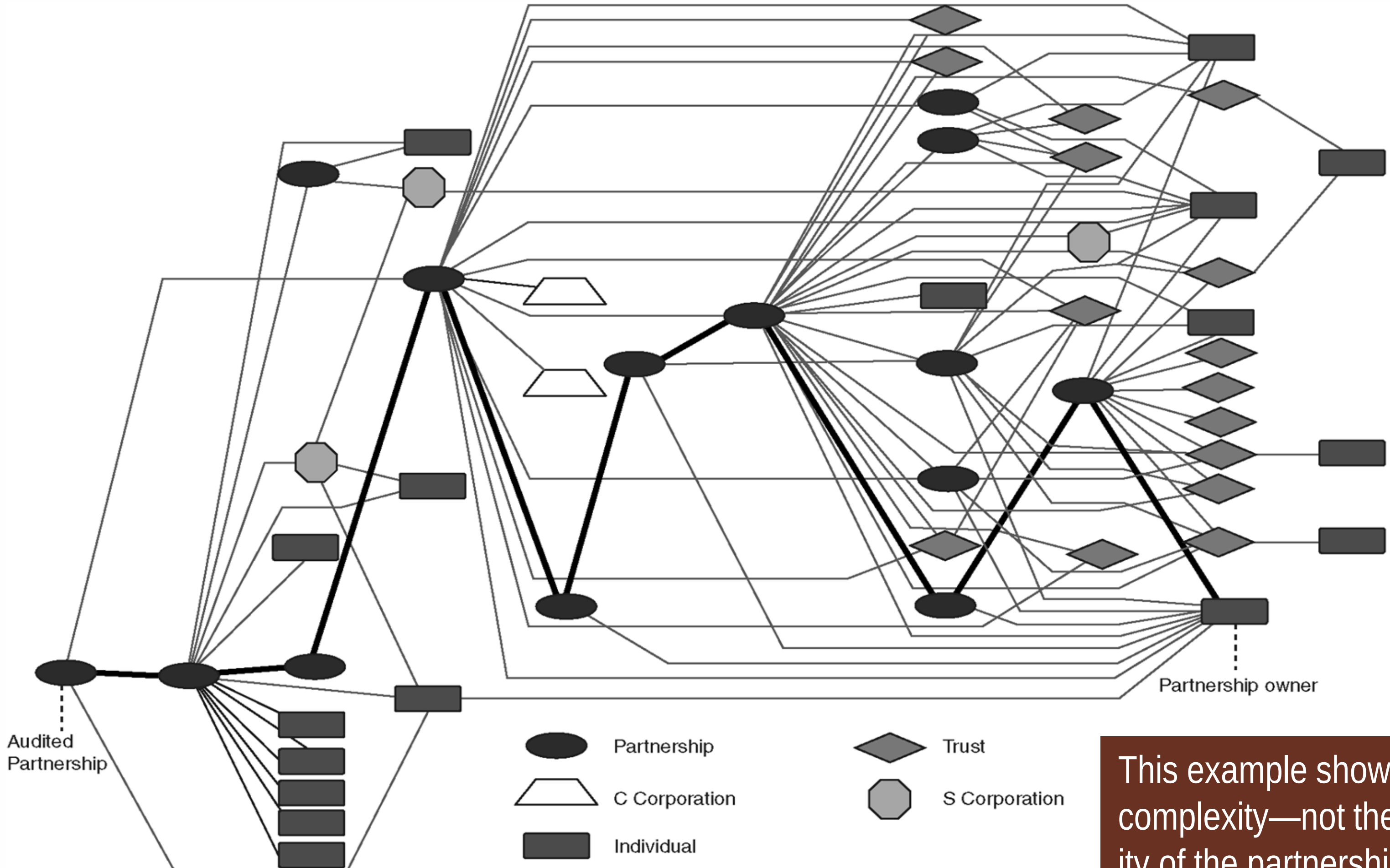
Why the federal changes happened.

THE PROBLEM

Problem

MULTISTATE TAX COMMISSION

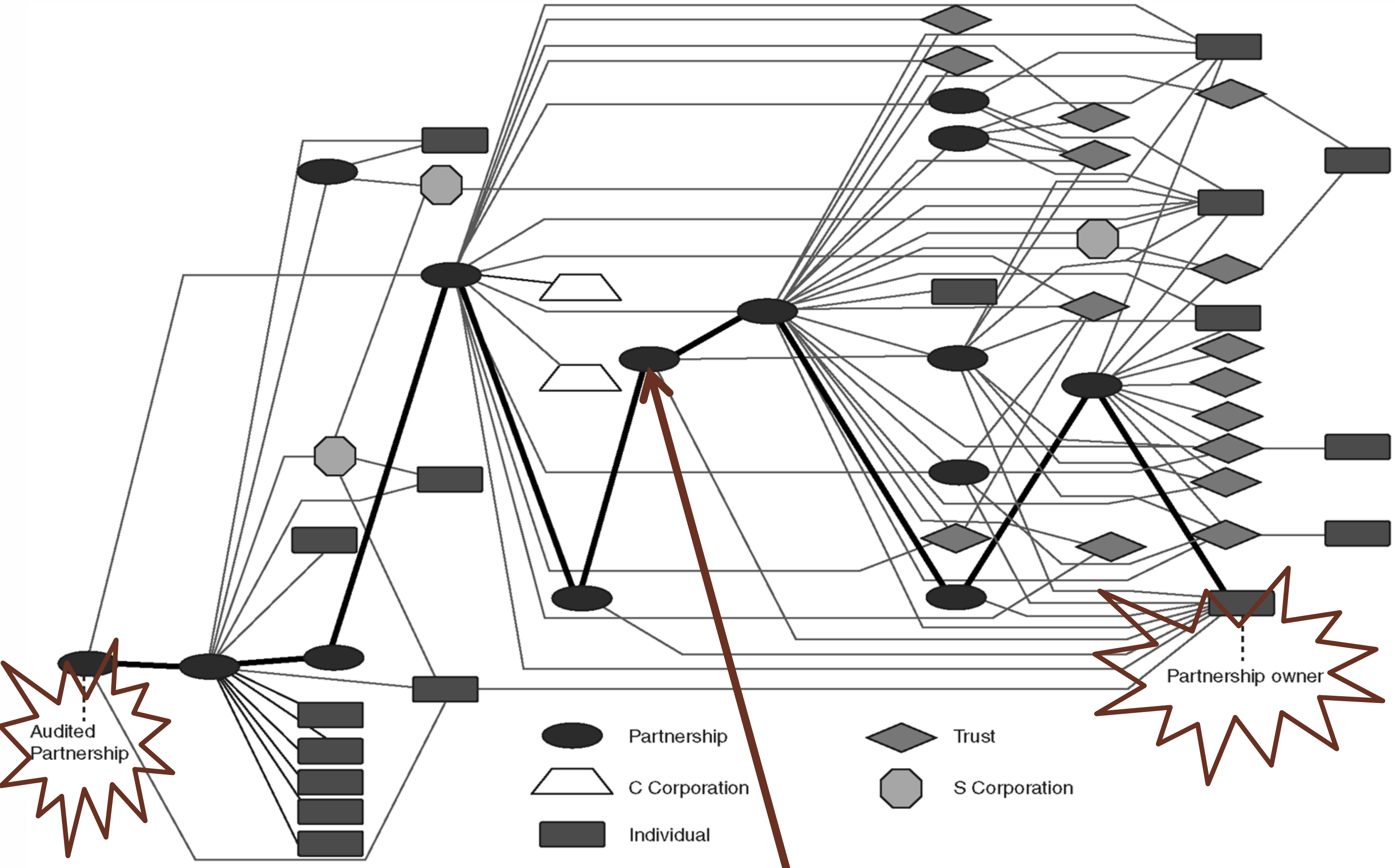
- The IRS is unable to audit large, complex partnerships—which by their nature also lack the transparency of other businesses.
- States are affected because they depend on federal audit enforcement to help insure income is reported, especially when there is a lack of publicly available information.



Source: GAO analysis of IRS documentation. I GAO-14-732

Typical Complex Partnership

This example shows only structural complexity—not the potential complexity of the partnership agreements that may vary the allocation of income, expense, gain and loss among the various partners.

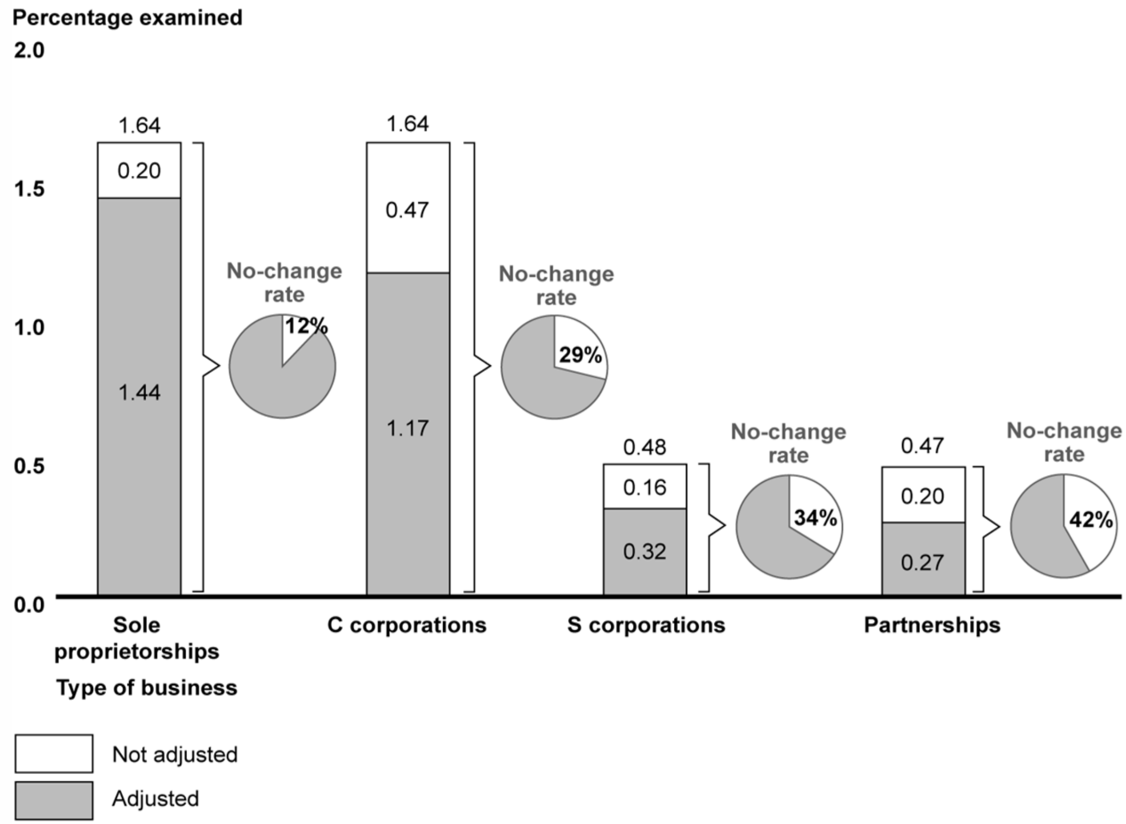


Source: GAO analysis of IRS documentation. I GAO-14-732

In addition to the complexity of the structure, now assume that this partnership makes special allocations of partnership items to its direct owners, including other partnerships. If the IRS wanted to determine whether the partnership owner (far right) had paid proper tax on income from the partnership to the far left, how could this be done effectively?

How Big is the Problem?

The Joint Committee estimated that the IRS would be able to generate around $1 billion per year in additional revenue through partnership audits. This revenue estimate does not appear to take into account increases in revenue due to additional voluntary compliance which the ability to audit is sure to create.



Source: IRS.

But It Gets Worse

In 2013, the GAO reported –

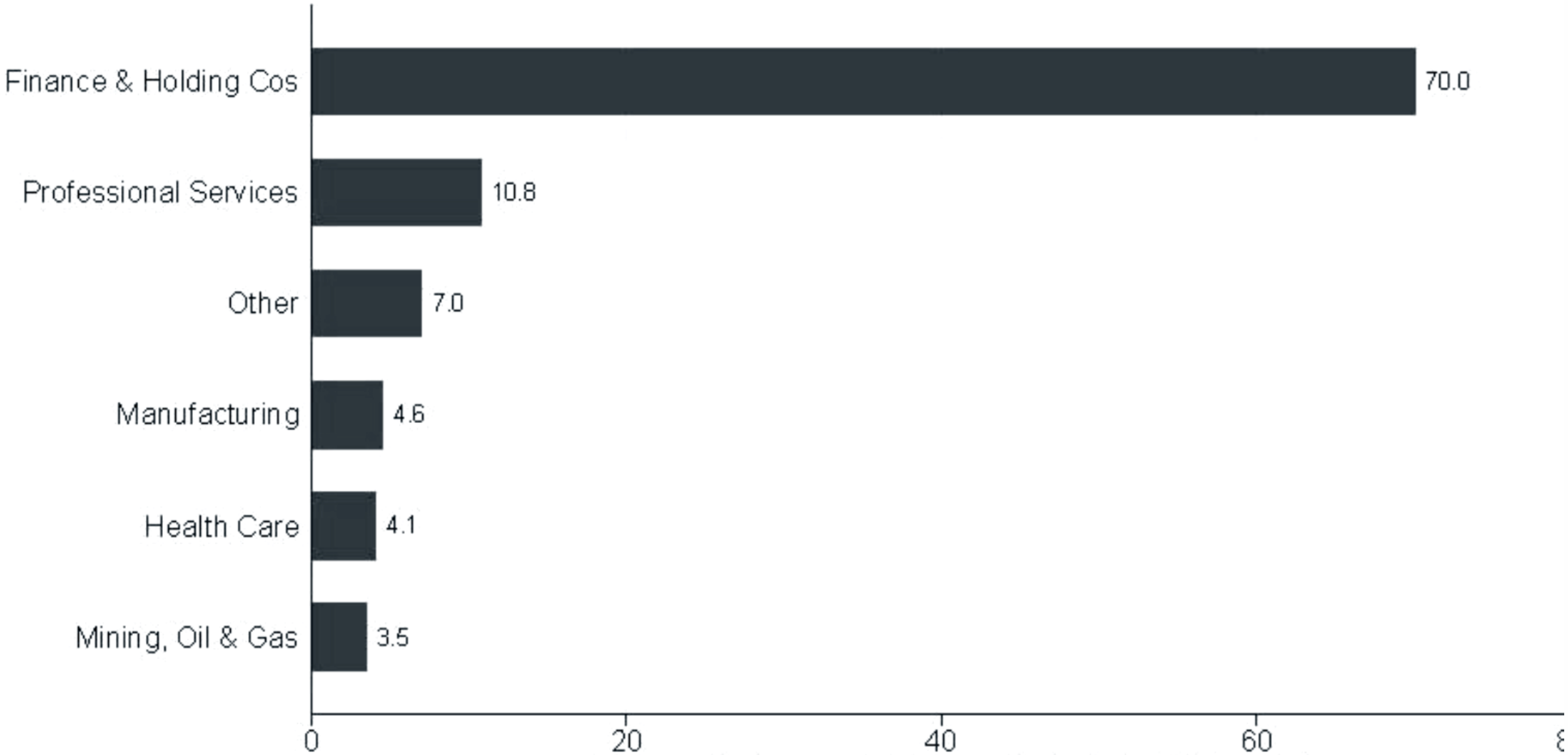
- The number of large partnerships (more than 100 partners and $100 million in assets) had tripled from 2002 to 2011
- But compared to the audit rate for large corporations (27%) the rate for large partnerships was 0.8%.

Is the Problem Growing?

- Yes – in part due to private equity
  - "Private equity assets under management could grow nearly three-and-a-half fold over the next 10 years, to $15 trillion, or to an estimated 3 percent of global financial assets from today's 1.5 percent, if historic growth rates repeat."

See "Private Equity is Set to Grow Much Bigger," Antoine Drean, Forbes, Nov. 8, 2016 - https://www.forbes.com/sites/antoinedrean/2016/11/08/private-equity-is-set-to-grow-much-bigger/print/

Partnership Income Share by Industry



What About States?

- Recently FTB officials said federal rules raise state compliance issues that could reduce state revenue:
  - FTB is seeing an uptick in the number of partnerships with many partners, even hundreds of thousands
  - If partnerships facing assessments choose to "push out" the assessment to the partners, the FTB is concerned about its ability to collect tax.
  - "If we have a $100,000 adjustment and 10,000 partners, it's a lot easier to get the adjustment from the partnership."
  - Langston said the FTB is also concerned that if the IRS makes an adjustment to a partnership's tax liability, states will be unable to "pick up" the adjustments.

Laura Mahoney, Wait for Federal Partnership Audit Rules, California Advised, Bloomberg Daily Tax Report, Feb. 7, 2017

MULTISTATE TAX COMMISSION

How new federal audit & adjustment rules work.

OVERVIEW OF NEW RULES

Partnership-Level Audits

Recognizing the problem faced by the IRS, Congress passed the Bipartisan Budget Act (2015), giving it authority to audit and assess complex partnerships at the partnership level.

New Provisions - Basics

Step 1: “Imputed Underpayment”

- IRS audits partnership
- Adjustments are determined
  - If made to 1065 items, offsetting items may be netted
  - If made to allocations between partners—the adjustments are not netted (only the positive tax effect is counted)
- The highest tax rate is applied

New Provisions - Basics

Step 2: “Pay-Up Election”

- After imputed underpayment is issued, partnership is given 270 days to provide information to modify the imputed underpayment (*not* the adjustments)—
  - Including information on tax-exempt partners, and
  - Information showing that partners have filed amended returns showing the related adjustments and paying the tax
- Not all partners have to pay up

New Provisions - Basics

Step 3: Assessment & "Push-Out" Election

- At the end of the 270-day period, partnership is assessed the modified imputed underpayment (including effects on intervening years):
  - The partnership may then choose to pay that assessed amount, or
  - Push out the adjustments to the reviewed-year partners following procedures to be adopted by the IRS.

New Provisions - Basics

Step 4: Payment

- In the year of adjustment
  - Partnership pays – and presumably determines the treatment of the payment following any IRS rules, unless
  - Partnership can and does push out the underlying adjustments to the partners (including, if permitted, indirect partners) using procedures to be determined by the IRS
    - In this case – the partners report and pay the audit tax due on their returns in the adjustment year.

MULTISTATE TAX COMMISSION

Materials Available on MTC Webpage For the Partnership Project

http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Inf

Multistate Tax Commission ...

III. Background Information

- Issue List - 1/31/17
- Draft ABA-AICPA Checklist for Partnership Conformity 1-27-17
- Georgia IRC Update Bill w/Partnership Audit Provisions

IV. Discussion of How the Group Would Like to Proceed

V. Adjournment

Partnership Informational Project Reference Information

Drafting Resources:

- Uniform Law Commission Style Guide

Agendas, working documents, and other project-related information from previous meetings:

- Todd J. Gluth, *Building a Better BBA: A History of, and Proposal for, Partnership Audit and Collection Rules*
- Proposed IRS Regulations 1/18/2017
- Comparison of MTC Issue List to Proposed Montana Legislation
- Proposed Montana legislation - House Bill no. 47
- Evaluation of the "Push-Out" Election in its Current Form
- Issue List, updated Dec. 8, 2016
- Issue List, updated Nov. 14, 2016
- TEI Comments
- ABA Comments
- COST Comments
- Issue List, updated edits, Oct. 24, 2016
- Issue List, updated Oct. 3, 2016
- State RAR Rules
- Partnership Withholding Rules by State
- Report on federal changes to partnership rules – Bruce Fort, MTC, December 10, 2015
  - Pennsylvania entity level taxation structure

Materials related to federal legislative revisions to the partnership audit regime:

- IRC Partnership Audit and Adjustment Provisions Effective after 12-31-17
- IRC Partnership Audit and Adjustment Provisions Effective after 12-31-17 with proposed tech corrections
- Joint Committee Analysis of Technical Corrections Bill
- Technical Corrections Bill - HR 6439
- AICPA Comments to Congress on Proposed Legislative Revisions to the Partnership Audit Regime
- Joint Committee - Blue Book
- Joint Committee - Choice of Entity
- Bipartisan Budget Act of 2015

Proposal from ABA/AICPA Task Force for Uniform Model RAR Statute

- TEI State and Local Tax Policy Statement
- 2016 Survey – Reportable Adjustments
- Proposed Amended RAR Draft
- Letter from COST, TEI, the ABA SALT Committee, and the AICPA State Tax Working Group
- Proposed Model Report of Federal Audit Changes developed by Tax Executives Institute
- COST Policy Statement

Other relevant publications:

- Marianne Evans, Dan De Jong, Shirley K. Sicilian, & Julia Flanagan, *New Federal Partnership Audit Rules Create State Tax Issues*
- Bruce P. Ely, Christopher R. Grissom & William T. Thistle, *Blurred Lines: State Taxation of Nonresident Partners*
- Partnerships & Partners: Who and How Much?
- New Partnership Audit Rules - Part 1
- New Partnership Audit Rules - Part 2
- "*Business in the United States: Who Owns It and How Much Tax do They Pay?*" - NYU School of Law Colloquium on Tax Policy and Public Finan
- A recent Tax Analysts' presentation summarized the partnership audit and adjustment changes in the Bipartisan Budget Act of 2015.
  - PowerPoint slides
  - Link to video: https://www.youtube.com/watch?v=D2UNsbSvdGQ&feature=youtu.be
- Office of Tax Analysis: *Business in the United States: Who Owns it and How Much Tax Do They Pay?*
- Office of Tax Analysis: *Methodology to Identify Small Businesses and Their Owners*

On March 2, 2016 the Uniformity Committee agreed that a work group should be formed to "analyze what comes from the IRS and also maybe to review best practices of the states."

WORK GROUP CHARGE

Focus

- States already have statutes and regulations requiring taxpayers to report federal adjustments, along with related state taxes due.
  - So, for example, if the IRS audits an individual partner and finds unreported income, or if the individual files an amended federal return to report partnership income, that income must be reported to the affected states as well.

Focus

- Specifically, state procedural provisions currently provide for:
  - Filing amended return if federal amended return is filed
  - Filing amended return if there is a federal audit adjustment
  - Triggering event (final determination) for requirements to file or provide notice
  - Waiver of statute of limitations
  - Specific penalties for failure to comply
  - Late payment penalties and interest
  - Regulatory rules

Challenges

- The IRS issued proposed regulations but then had to withdraw them leaving some questions unanswered
- A proposed technical corrections bill was introduced in the last Congress, but not passed—and it may be that changes will be made this year

Proposed Regulations -

- The regulations indicate there may be two types of imputed underpayments – general and specific – in the same audit. (Specific would be limited to partners that participated in a particular transaction.)
  - The IRS will issue a "Notice of Proposed Partnership Adjustment" prior to the 270-day modification period with the imputed underpayments set out and the related adjustments.
- If there are multiple imputed underpayments – the partnership may make push-out election for some but not all (and so pay some instead).

Proposed Regulations -

- The IRS will modify the imputed underpayment if a partner files an amended return, provided that the partner takes into account all adjust-ments affecting her, pays the tax, and amends other years affected by change in tax attributes.
- The IRS will also adjust the rate applied (e.g. for capital gains or tax-exempt partners).

Issues

- The goal is identification of potential issues and discussion of those that seem most critical
  - The work group has developed an issues list
  - The ABA/AICPA has also submitted a separate issues list
- State focus - conformity in result – not in procedure

Detailed Issue List

MULTISTATE TAX COMMISSION

- Election out
- Inconsistent positions
- **Role of the partnership representative**
- Effect of an adjustment that does not result in an imputed underpayment
- **Calculation of the state-level imputed underpayment of partnership tax**

Detailed Issue List

- Partnership response to proposed audit adjustment
- Reduction in proposed audit adjustment (imputed underpayment)
- **"Push-out" of the final partnership audit adjustment**
- Treatment of partnership payment of tax
- Statutes of limitation, penalty, interest

Partnership Representative

MULTISTATE TAX COMMISSION

Under Federal Rules

- PR will handle all audit matters and will bind the partners to any decisions made.
- PR will represent the partnership and all the partners with respect to audit appeals.
- Doesn’t have to be a partner.
- Doesn’t have to be an individual.

At the State Level

- Notifying state of the federal adjustment?
- Reporting any related state attributes (e.g., apportionment)?
- Fling any required returns?
- Handling any related issues (such as appeal of the state assessment)?
- Designation of a state-level PR?

State Entity-Level Liability

- Should adjustment year or reviewed year apportionment factors be used?
  - Reviewed year
- What tax rate should be used?
  - Highest marginal – or composite rate
- Treatment of partnership taxes paid?
  - Do partners get a state deduction for any portion of federal taxes paid (if allowed)?
  - Do partners get credit for state taxes paid?

State Push-Out

- Will it be possible for states to follow the push-out treatment –
  - Residents versus nonresidents
  - What if not all states allow
  - See November 29, 2016 MTC Staff Memo on the subject
- Must partnership pay or push-out at the state level same as federal?

Other issues states may want to address.

OTHER RELATED ISSUES

No Clean Slate

- There is likely no "plug-and-play" model given the differences in existing state law.
- Instead, most of the issues will need to be addressed by the states in the context of their statutes and regulations
  - Also—states will need to determine whether to address certain issues by statute or by regulation

Administrative Adjustments

- The new federal provisions also cover the process for a partnership to correct a prior-year partnership return and either:
  - Pay the resulting imputed underpayment (no modifications), or
  - Push out the adjustment to the partners in a manner similar to an audit adjustment

Assessment is Just the Beginning

- While the new rules make auditing partnerships feasible, the process will still take years.
  - The new rules require that partnerships be given time after the audit is completed to allow partners to "pay up" or to make other adjustments
  - An IRS audit of the tax year 2016 started in 2018 will be resolved, at the earliest, in 2020-21, and perhaps not until as late as 2024-25

Challenges to Collection

- Liability for taxes is traditionally separate –
  - Tax is imposed on owners separately
  - Pass-through entities themselves do not have liability for taxes owed by owners
  - Owners typically don’t have personal liability for entity taxes
  - Owners do not have joint liability for taxes owed by other owners

Challenges to Collection

- The federal reforms originally included a provision making partners jointly and severally liable for the partnership-level tax assessment, but this provision was removed
- Collection of tax owed to states is doubly difficult because the partnership may have few assets in the state

Challenges to Collection

- Partnerships do not necessarily have information on the location or residence of partners and the proposed IRS regulations only require that the partnership provide the address known to the partnership for reviewed year partners when pushing out the adjustments.

Questions

MULTISTATE TAX COMMISSION