



## **STATE CONFORMITY TO FEDERAL PARTNERSHIP AUDIT RULES**

### **ISSUE**

The AICPA encourages state CPA societies to work with their state lawmakers in response to the new federal partnership audit regime (Regime) enacted by Congress in 2015. States are starting to implement their own rules, causing substantial variances across the nation.

If states do not respond appropriately to the new Regime, significant differences in state versus federal liabilities flowing from a federal partnership audit will create significant administrative burdens for taxpayers and their tax representatives. Even if states adopt rules similar to the new Regime, state specific issues, such as residency and apportionment as discussed below, will mean that the new state partnership audit rules are likely to impose significant administrative burdens on taxpayers and their representatives.

The AICPA supports efforts by state CPA societies who want to work with policymakers for fair, reasonable, and administrable state partnership audit rules that minimize the complexities and burdens to taxpayers and state tax authorities alike.

### **OVERVIEW OF RECOMMENDATIONS**

Given the current degree of uncertainty surrounding the eventual IRS regulations implementing the Regime and the likelihood of significant adjustments to the Regime itself through the pending technical corrections bill in Congress, if possible, *states should wait for federal clarifications before proceeding to draft and enact state specific legislation or regulations in this area.*

While waiting until the federal rules are further clarified, state CPA societies should start analyzing the impact of the Regime on their current state partnership audit rules. The AICPA recommends undertaking a process of identifying those state specific areas that the new Regime will impact and developing potential options to address these issues. To assist in this process, the AICPA provides the following recommendations that state CPA societies may want to consider as they work with their state legislatures and tax authorities:

- *Allow a partnership the ability to make different elections under the Regime for state purposes than the partnership makes for federal tax purposes, notably for the “push-out,” “pull-in,” or “pay-up” elections. However, it is recommended that the states require partnerships that elect out of the Regime at the federal level also to opt out at the state level.*
- *Provide for post federal audit group returns for all partners, including residents and nonresidents and disallowed taxpayers, of the reviewed year – even if original composite returns were not filed.*

- *States should base the apportionment and allocation of the federal adjustment on the apportionment and allocation factors of the reviewed year. The states should use the original apportionment and allocation factors of the reviewed year, adjusted for any federal audit changes. The states should determine the state-specific tax treatment of items based on the reviewed year apportionment factor.*
- *For tiered structures, allow flexibility and options to each tier for state-specific modifications that mirror (to the extent possible) any federal options.*
- *Provide for a single partnership representative for all states regardless of the state of residence of the partnership representatives. One partnership representative should apply for both federal and state purposes. The federal partnership representative may designate a state-specific partnership representative for each state.*
- *States should recognize for state purposes any modifications or adjustments to the imputed underpayment allowed at the federal level.*

## **BACKGROUND**

On November 2, 2015, Congress enacted the Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (BBA),<sup>1</sup> which made significant changes to the partnership audit rules set forth in the Internal Revenue Code of 1986, as amended (IRC). The Regime is a new centralized partnership audit process that replaces the existing audit process previously enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (TEFRA). The new Regime is generally effective for taxable years beginning on or after January 1, 2018, although under the BBA and temporary regulations effective August 5, 2016,<sup>2</sup> partnerships can elect into the Regime for any periods beginning after the date of enactment of the BBA (i.e., for taxable years beginning after November 2, 2015). Even though Congress authorized partnerships to elect into the Regime before the 2018 taxable year, it is generally considered unlikely that any partnership will do so given the uncertainties surrounding the IRS's implementation of the new federal Regime.<sup>3</sup> It is expected that the first Internal Revenue Service (IRS) audits may not begin until 2020, and the IRS likely will not complete those audits until 2021.

On December 6, 2016, towards the end of the 114th Congress, a bipartisan [technical corrections bill](#) (proposed Technical Corrections Bill) was introduced in both the House and Senate that clarifies certain elements of the new Regime, as well as adds some key new provisions.<sup>4</sup> It is anticipated that the 115<sup>th</sup> Congress will enact this bill in 2017.

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<sup>1</sup> [Pub. L. No. 114-74 \(11/2/15\)](#).

<sup>2</sup> [T.D. 9780 \(8/5/16\)](#).

<sup>3</sup> On [October 7, 2016](#), the AICPA submitted to the Treasury Department and the IRS comments on the proposed rules for the new Regime. In addition, on [November 17, 2016](#), the AICPA submitted to Congress recommended legislative changes to the new Regime enacted as part of the Bipartisan Budget Act of 2015.

<sup>4</sup> On December 6, 2016, the Chairman of the House Ways and Means Committee Kevin Brady (R-TX) introduced in the 114<sup>th</sup> Congress [H.R. 6439](#), the *Tax Technical Corrections Act of 2016*, which includes as Title II, *Technical Corrections Related to Partnership Audit Rules*.

The new Regime will centralize the ability of the IRS to audit, assess, and collect any determined underpayment directly from a partnership at the entity level, subject to certain available elections. Previously, the IRS could audit the partnership directly, but the IRS could only assess and collect from each individual partner.

Under the Regime, there is an opt-out election available under IRC section<sup>5</sup> 6221(b) for partnerships with 100 or fewer partners that meet certain eligibility requirements.

If a partnership has not opted out of the Regime, the new rules provide for a default approach for the IRS to assess any adjustments at the entity-level for a partnership that is audited. The amount owed by the partnership is referred to as the “imputed underpayment” under section 6225 and is calculated by applying the highest tax rate under section 1 or 11 of the IRC (currently, 39.6 percent). A partnership can reduce the imputed underpayment in a number of ways provided in section 6225(c), including by proving that a portion of the imputed underpayment is attributable to a tax-exempt entity or to a taxpayer subject to tax at a lower rate. The partnership can reduce the imputed underpayment by the portion allocated to a reviewed year partner who files an amended return reporting its share of the partnership adjustments resulting from the partnership audit.

Under the proposed technical corrections bill, Congress would add a new “pull-in” option, which would allow reviewed year partners to pay their allocable share of an adjustment without the need for filing amended returns. The amounts paid under the “pull-in” option reduce the partnership’s imputed underpayment. The proposed technical corrections bill also contains a provision allowing the IRS to assess the underpayment against the adjustment year partners if a partnership fails to pay the amount due in a timely manner.

Under the BBA, an election is also provided under IRC section 6226(b) to “push-out” the responsibility to the partners for payment of the partnership tax assessment. This election would require partners to make payments based on their pro rata allocation of the audit adjustments.

Upon the IRS providing a partnership with a final audit adjustment, a partnership making a “push-out” election must inform the partners who were partners in the reviewed year<sup>6</sup> of the final audit adjustment. The IRS will not require those partners to file amended federal returns for the reviewed years or the interim years. Instead, the tax adjustment resulting from the audit is taken into account in the adjustment year. Questions remain regarding the mechanics of the push-out election, which the IRS will likely address in regulations.

Each partnership must appoint a Partnership Representative to serve as the sole contact for the partnership in the audit with the IRS. The Partnership Representative will also have sole authority to make all decisions for the partnership relating to the new Regime and any audit conducted under its rules. The implementation of the Regime will require balancing a simplified assessment and

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<sup>5</sup> All references herein to “section” or “§” are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

<sup>6</sup> The tax years audited by the IRS are commonly referred to as the “reviewed years,” and the year in which the audit adjustments are taken into income is commonly referred to as the “adjustment year.” This same nomenclature is followed in this document.

collection process imposed at the partnership level against the general expectation that tax is imposed only on the appropriate taxable individual or entity, only on the properly calculated amount of taxable income, and only at the appropriate rate of tax for each partner as enacted in the applicable section of the IRC.

## RECENT STATE ACTIVITY

To date, Arizona is the only state that has enacted legislation to address the federal changes. Governor Doug Ducey (R) signed Arizona [S.B. 1288](#) into law on May 11, 2016. Arizona's legislation provides some [insight](#) on how states might address these issues, though it will need to address additional items (presumably through its administrative regulatory process) to ensure the proper amount of state tax is paid by partnerships or their partners following the conclusion of a federal partnership audit under the Regime. It is now considered likely that Arizona will need to amend its enacted law to reflect anticipated changes to the Regime included in the proposed technical corrections bill when it is ultimately enacted.

In addition, on December 8, 2016, [House Bill No. 47](#) was pre-filed in the Montana legislature for consideration during its 2017 legislative session. It would revise the Montana laws for partnership audits and is similar in many respects to the legislation enacted in Arizona. On January 11, 2017, the Montana House Taxation Committee held an initial [hearing](#) on the bill.<sup>7</sup> On February 3, 2017, the bill was [tabled in committee](#), and the bill is now on hold. It is possible that the committee may instead consider a study bill that would require an interim committee to track the issue leading up to the 2019 session.

In Georgia, on February 7, 2017, [House Bill 283](#), was introduced and on February 16, 2017, the Georgia House Ways and Means Committee passed and reported out to the Rules Committee, a revised [substitute House Bill 283](#), which did not contain the partnership audits provision that was in the original bill.<sup>8</sup>

On February 15, 2017, [HF 1227](#) was introduced in Minnesota. It is limited to partnerships that opt-in early to the new federal Regime and is only effective for taxable years prior to 2018.

Most recently, on March 1, 2017, [SB 521](#) was introduced in Missouri. The bill provides that for tax years beginning on or after January 1, 2018, a partnership that is audited by the IRS and is assessed an imputed underpayment must pay income tax on the adjustment rather than passing the adjustment through to each partner. The state would require the partnership to file a return for the

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<sup>7</sup> The Montana Society of CPAs testified at the hearing. [Information](#) on the bill and hearing, including an audio archive, is available at [http://laws.leg.mt.gov/legprd/LAW0210W\\$BSIV.ActionQuery?P\\_BILL\\_NO1=47&P\\_BLTP\\_BILL\\_TYP\\_CD=HB&Z\\_ACTION=Find&P\\_SESS=20171](http://laws.leg.mt.gov/legprd/LAW0210W$BSIV.ActionQuery?P_BILL_NO1=47&P_BLTP_BILL_TYP_CD=HB&Z_ACTION=Find&P_SESS=20171). Also see the Multistate Tax Commission [comparison](#) of its issue list to the proposed Montana legislation available at <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/Comparison-of-Montana-Legislation-to-Issue-List-with-attachment.pdf.aspx>.

<sup>8</sup> The Georgia Society of CPAs was actively engaged in discussions that resulted in the [substitute House Bill 283](#), available at <http://www.legis.ga.gov/Legislation/20172018/165723.pdf>.

reviewed year within ninety days after the final determination of the partnership adjustments by the IRS.<sup>9</sup>

## **IMPORTANCE TO CPAs**

Many CPA firms are structured as partnerships. CPAs also assist clients that operate as partnerships with tax compliance and planning. CPAs offer advice to businesses and their owners on the tax consequences of organizing or restructuring business operations as either partnerships or corporations and interact with the state tax authorities on behalf of their partnership clients.

It is best to develop sound tax and administrative processes and policies regarding the state implementation of the Regime. The goal is to have fair, reasonable, and administrable state partnership audit rules that minimize the complexities and burdens for taxpayers, CPAs, and the state tax authorities. CPAs are interested in working with state tax authorities and state legislatures as new partnership audit rules are contemplated and developed for each state.

## **INFORMATION, CONCERNS, AND COMPLEXITIES FOR CPAs**

The new Regime will bring challenges that CPAs will need to address as they and their clients learn and deal with the new rules. Not all states will respond in the same way to the new Regime, which will contribute to additional complexity in resolving audit matters when dealing with a partnership operating in multiple states. For example, assume State A adopts the “push-out” provisions and State B does not. If partners during the adjustment year bear the economic burden of the imputed underpayment, the preferred option may be to adopt the “push-out” provisions and push the audit adjustments to the reviewed year partners. Since State B does not allow the “push-out,” the partnership would need to follow different sets of procedures in each state. This nonconformity results in administrative inconvenience, which would rise to an onerous level when a partnership is doing business in 40 or more states.

Numerous additional concerns exist at the state level. Partnerships and their partners will need to consider whether nexus existed in a particular state for the reviewed year but not the adjustment year. Resident/nonresident considerations may arise when individual partners move from one state to another between the reviewed and adjustment year. As an example, partners that resided in New York, a state with a significant personal income tax, during a partnership’s reviewed year, move to Florida, a state without a personal income tax, prior to the partnership’s adjustment year. The Regime envisions taxpayers reporting and paying any additional federal tax in the adjustment year, raising possible state concerns regarding the taxpayer’s reviewed year state (in the example, New York) authority to impose additional tax. In addition, statute of limitations considerations for partners in overpayment situations are likely to exist. Additional concerns relate to the increased compliance burden of filing amended returns and obtaining enough detailed information from the federal audit to make proper adjustments at the state level.

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<sup>9</sup> The Missouri Society of CPAs is in discussions on the legislation, which is available at <http://www.senate.mo.gov/17info/pdf-bill/intro/SB521.pdf>.

## **AICPA SUGGESTED CONSIDERATIONS FOR STATE CPA SOCIETIES TO ADDRESS WITH STATE LEGISLATURES AND STATE TAX AUTHORITIES**

The AICPA encourages state CPA societies to work with policymakers for fair, reasonable, and administrable state partnership audit rules that minimize the complexities and burdens to taxpayers and state tax authorities alike.

Given the current degree of uncertainty surrounding the eventual IRS regulations implementing the Regime and the likelihood of significant adjustments to the Regime itself through the pending technical corrections bill in Congress, if possible, *states should wait for federal clarifications before proceeding to draft and enact state specific legislation or regulations in this area.*

The new partnership audit rules under the Regime present many unresolved federal tax questions, and raise even more questions at the state level. State CPA societies may want to reach out to their state tax authority and begin a dialogue on what state specific concerns the state may need to address once the Regime's provisions become clearer at the federal level through additional IRS issued guidance and Congressional technical corrections legislation. One of these considerations is that each of the states must decide whether it will conform to the Regime, partially adopt the new provisions, or determine the consequences of not adopting them. The laws of many states do not allow for the direct assessment of partnerships as these entities are not taxpayers upon which the state may make an assessment or collect or levy a tax. In other states, the partnership itself is the taxpayer, and individual assessment is not permitted as the state may not subject individuals to state income taxes. Therefore, many states will need to enact legislation in this area, and state tax authorities will need to issue guidance to explain how the states will implement any changes.

A major issue to address is whether the additional tax resulting from the audit adjustment and paid by the partnership is treated as a partnership-level tax or a partner-level tax paid on behalf of the partners by the partnership. Taxpayers and state tax administrators also will need to address the corresponding impact on basis computations, as well as the ability of the individuals to claim credits for taxes paid to other states against their personal resident income tax obligations.

Each state will need to address the application of other state-specific income tax issues to partnerships and their partners, particularly the effect of apportionment and allocation. If a state conforms to the Regime, and, thus, the state requires the assessment, levy, and collection of a state imputed underpayment at the partnership level, presumably the state will need a mechanism to determine what portion of that tax is attributable to the state. States typically use a system of allocation and apportionment to arrive at this result.<sup>10</sup> If a state permits partnerships to push-out the partnership audit adjustments to their reviewed year partners, similar issues exist. In most instances, the allocation and apportionment of the audited partnership would determine the portion of the adjustment sourced to the state. In some situations, however, partners are required to include their unapportioned share of partnership income or loss in pre-apportionment taxable income and their shares of the partnership's apportionment attributes in their partner-level apportionment calculations. This situation typically occurs when a corporate partner owns a controlling interest in a partnership and operates as part of a unitary business with the partnership. These issues can

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<sup>10</sup> Both Arizona S.B. 1288 and Montana House Bill No. 47 require the use of apportionment for determining the portion of the state imputed underpayment attributable to the state.

become especially confusing in complex, multi-tiered partnership structures. States will need to provide detailed guidance to taxpayers, their advisors, and specify a clear path to compliance.

The AICPA has formed an AICPA State Partnership Audits Task Force, comprised of members with expertise in state tax and partnership tax issues. The AICPA task force has developed this paper and is available as a resource to state CPA societies as they help state authorities develop new state partnership audit rules. The AICPA task force is working with the Multistate Tax Commission (MTC) and is part of a multi-organization task force with other state tax groups, including the Council on State Taxation (COST), the American Bar Association, and Tax Executives Institute (TEI) on this issue.<sup>11</sup> The MTC has a [partnership informational project](#) that is considering an [issue list](#) and the multi-organization task force's [comprehensive list of issues](#) related to these impending changes and [checklist for partnership conformity](#). In addition, the MTC has developed a [comparison](#) of the MTC issue list to the proposed Montana legislation.

The AICPA task force is working with the multi-organization task force on a related project to draft an updated proposed Model Uniform Statute for Reporting Adjustments to Federal Taxable Income (RAR) as states will likely need to update their RAR statutes for the new partnership audit rules. The AICPA has developed a position paper on reporting to state tax authorities of federal tax examination adjustments and their effect on state tax liability.

Recently issued Presidential Executive Orders regarding federal regulations have increased the uncertainty on when the IRS will provide additional clarity on their implementation procedures for the Regime. Accordingly, the AICPA task force has started working with the multi-organization task force on a suggested framework for state legislation. The goal of the framework is to provide a model system that states could implement independent of the ultimate IRS regulations. The framework is also designed to incorporate the proposed RAR statute changes referenced above. A current working draft of this suggested framework is attached as **Appendix A**.

State CPA societies should carefully analyze the effect of the Regime on current state partnership audit rules. The AICPA recommends undertaking a process of identifying those state specific areas that the new Regime will impact and developing potential options to address them.

## **SPECIFIC RECOMMENDATIONS FOR CONSIDERATION**

State CPA societies may want to consider the following recommendations in working with their state legislatures and tax authorities.

### Flexibility of Elections

Certain elections are available under the new Regime that should also extend to the state level.

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<sup>11</sup> On February 6, 2017, COST presented on [New Federal Partnership Audit Procedures – Issues to Consider and When to Act](#) as part of the [California Bar Taxation Section's Sacramento Delegation Project](#).



*The AICPA suggests that as the default method, the states allow partnerships to follow the same method (“pay-up,” “pull-in,” or “push-out”) used by the partnership at the federal level to report the changes resulting from a federal partnership audit. Notwithstanding this default rule, the AICPA also suggests that states allow partnerships to make a state-level election to either pay state tax on the apportioned and adjusted federal imputed underpayment at the partnership level (and report amounts paid to individual partners) or use a state-level “push-out” option.*

There are circumstances where the state adjustments are much smaller than federal adjustments once the state apportionment factor is applied or state modifications are made to the federal adjustments. For ease of administration, the partnership and its partners may prefer to pay the state tax at the partnership level, as opposed to burdening the partners with having to file separate amended returns in each state. In some cases, the administrative costs for filing the amended returns would far exceed the amount of tax the state would collect from the partners, and also processing amended tax returns and collecting from all the partners increases the administrative costs and compliance burdens to the state taxing authorities.

*In contrast to the general flexibility in allowing state-specific elections that are independent of the federal elections made with respect to the Regime, the AICPA suggests that states consider requiring partnerships that elect out of the Regime at the federal level to also opt out of the Regime at the state level. Similarly, states should provide that partnerships that do not opt out of the Regime at the federal level may not opt out of the Regime at the state level.*

#### Post Federal Audit Group Returns

The federal “push-out” election causes concerns as to the treatment at the state level.

*The AICPA suggests that states permit post federal audit group returns for all partners, including residents and nonresidents and disallowed taxpayers, of the reviewed year.*

*Because post federal audit group returns will simplify the compliance process and administrative burdens for the taxpayer and the state, the state should allow a post federal audit group return that includes any reviewed year partner. It should not matter whether the partner was included on the original composite return filing, whether the state normally allows that type of taxpayer (such as a corporation or a resident with a filing obligation in the state in the review year or adjustment year) as part of a post federal audit group return filing, or even if there was an original composite return filed. To simplify the process, the states should allow partnerships to include all reviewed year partners on a post federal audit group return to report the effects of a federal partnership audit.*

#### Apportionment and Allocation Factors

*The AICPA suggests for consistency, that states base the apportionment and allocation of the federal adjustment on the apportionment and allocation factors and rules that apply in the reviewed year. States should use the original apportionment and allocation factors of the reviewed year, adjusted for any effects resulting from federal audit changes. The states should determine the state-specific tax treatment of items based on the reviewed year apportionment factor.*



## Tiered Structures

*The AICPA suggests that states allow any upper-tier partnerships in a tiered ownership structure to make any state-level election to use the “pay-up,” “pull-in,” or “push-out” election by an audited partnership.*

The AICPA has [proposed](#) a procedure to the IRS for the time and process of such upper-tier elections.<sup>12</sup> The AICPA suggests the states should implement a similar procedure.

*The AICPA also suggests that states make available to any upper-tier partnership any modifications of an imputed underpayment permitted by a state for application by an audited partnership.*

The purpose of allowing a partnership to modify the imputed underpayment for the tax attributes of either its partners or the nature of the adjusted income item, as well as allowing partners to use the “pull-in” payment option is to closely align the additional tax imposed with the actual tax that would have resulted had the partnership properly reported the adjusted items on an original return. The ability for a partnership to elect to “push-out” the adjustment to its reviewed year partners serves a similar purpose. To ensure that this goal is fully and appropriately reached requires allowing an upper-tier partnership the same options as the audited partnership.

## Partnership Representative

*States should recognize for state purposes a partnership’s selection at the federal level of a Partnership Representative.*

Having a single individual responsible for all decisions relating to the audit, whether federal or state related, will provide certainty and simplicity to the process.

*The states should allow the federal Partnership Representative to designate a state specific Partnership Representative for each state to act in the place of the federal Partnership Representative for that state. The federal Partnership Representative would coordinate all the state specific Partnership Representative designations.*

## Modifications

*States should recognize for state purposes any modifications or adjustments to a partnership’s imputed underpayment allowed at the federal level and accepted by the IRS under section 6225(c).*

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<sup>12</sup> See AICPA [comments](#) to the Treasury Department and the IRS on the proposed rules for the new Regime, dated [October 7, 2016](#). On January 18, 2017, the Treasury Department and the IRS issued proposed regulations ([REG-136118-15](#)) on the centralized partnership audit regime. Because the proposed regulations were not yet published in the Federal Register by January 20, 2017, the Trump Administration issued an executive order ([M-17-16](#)), implementation of regulatory freeze, withdrawing all regulations that were not yet published, including these regulations. Treasury and IRS will need to reissue the proposed regulations.

Once the IRS has audited the partnership at the federal level and modified and adjusted the partnership's imputed underpayment, not respecting such modifications to the imputed underpayment at the state level may create an undue burden and could result in states applying tax on different amounts or allocations of income. State recognition of modifications or adjustments to the imputed underpayment at the federal level should take into account the statutory allocations and also such additional procedures to modify imputed underpayment amounts on the basis of such factors as Treasury has determined are necessary or appropriate and are provided for in federal regulations or other federal guidance. States should also allow such modifications to the imputed underpayment to adjust the state's apportionment factors, to the extent the modifications affect one or more of the factors.

*States should allow further modifications to the imputed underpayment for situations similar to sections 6225(c)(3) (tax-exempt partners) and (c)(4) (modification of applicable highest rates) where the Partnership Representative can provide documentation showing that a partner is tax-exempt or subject to a lower tax rate (such as insurance companies, banks and other financial institutions, utilities, etc.). States with taxes imposed on bases other than corporate net income should similarly allow such modifications as are necessary to make sure such taxes are assessed appropriately.*

Section 6225(c)(4) does not contemplate the different tax regimes and rate structures used by the various states in their taxation of business entities. Each state will need to examine its system to determine based on its own state specific tax treatment what additional modifications to the federal imputed underpayment are necessary to make sure the state tax assessed is fair and equitable.

*Each state should treat the federal audit adjustment items (for an imputed underpayment and the other methods available under the Regime) separately based on its own state specific tax treatment to permit proper computations of state tax that take into account federal/state differences such as bonus depreciation, certain types of interest income, etc.*

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## **APPENDIX A**

### **AICPA Suggested Framework for State Legislation and Regulatory Rules Related to Federal Partnership Audits Under the New BBA Regime**

#### **Description of Framework**

The following suggested framework was designed to provide states with a uniform, simplified method to apply the results of a partnership audit conducted by the Internal Revenue Service (IRS) using the Bipartisan Budget Act of 2015 (BBA) federal partnership audits regime (Regime) in effect for tax years beginning January 1, 2018.

The suggested framework provides uniform, simple, easy to administer, and practical implementation procedures for state legislatures and departments of revenue to use in developing a workable process for applying the results of a federal partnership audit at the state level.

At the present time, there remains a great deal of uncertainty on precisely how the IRS intends to implement the new audit Regime, including what elections the IRS will allow partnerships and partners to make, as well as what the end result of an IRS audit will look like.

Therefore, the suggested framework was developed based on what is already in effect in many states regarding existing rules to apply the results of federal audits under current (pre-Regime) IRS rules, including the TEFRA rules applying to partnerships. Rather than impose the various options and complications of the new federal regime onto the states, this proposal attempts to adapt a state's current system of handling a federal partnership audit adjustment to reflect the ultimate outcome of the various federal assessment and collection options. It is designed to work irrespective of which options are selected by a partnership within the new federal regime. The suggested framework is designed to provide a fair, equitable and simple method of applying at the state level the results of a BBA Regime partnership audit regardless of the content of the ultimate IRS regulations governing the actual workings of the process prior to the final IRS assessment and collection or any potential technical corrections to the Regime currently under discussion in Congress.

#### **Partnership Elections**

A partnership may elect on a state by state basis:

- 1) The Default Method,
- 2) The Modified Default Method (excluding resident taxpayers from group return), or
- 3) The Optional Elective Method.

A partnership can elect to use one method in one state and use another method in another state.

#### **Partnership Representative**

States should respect a partnership's selection of a Partnership Representative at the federal level. However, the federal Partnership Representative should have the ability to select a state specific

representative – either using existing Power of Attorney rules or a new grant of specific authority under state law, if necessary.

### **Default Method**

- 1) The partnership files a “post federal audit group return” for all partners (resident, non-resident, otherwise ineligible entities) in any state where returns (individual or partnership) were originally filed for the reviewed year. The partnership is not required to have filed an original composite return in the state for the reviewed year.
- 2) The partnership pays the combined tax owed for two taxpayer groups (based on partners that are taxable (*i.e.*, excludes known entities not subject to tax under the state’s rules)). Group one is comprised of partners representing individuals and pass-through entities (such as partnerships, S corporations and trusts) and taxed on each state’s share of the adjustment for that group at that state’s highest individual income tax rate. Group two is comprised of C corporations and taxed on each state’s share of the adjustment for that group at that state’s highest corporate income tax rate. Interest and penalties apply from the original due date of the reviewed year state return.
- 3) Allocation and apportionment calculations are based on the reviewed year data, adjusted (if necessary) for changes resulting from the federal audit.
- 4) The partnership provides each reviewed year partner with a schedule of filings and payments made to states on their behalf.
- 5) The partnership may not claim a refund using this Default Method. The partnership must use the Optional Elective Method described below in any state where the federal audit change results in an overall reduction of state income.
- 6) The partnership may elect to exclude resident taxpayer partners from the “post federal audit group return” in any state. For any such resident taxpayer partner not included in the “post federal audit group return,” the Optional Elective Method would apply. If this approach is elected, it is called the “**Modified Default Method.**”
- 7) If a partnership is insolvent, dissolved, or does not timely comply/remit the tax due under the Default Method, any state in which a filing obligation exists may require the reviewed year partners to use the Optional Elective Method.

### **Optional Elective Method**

- 1) The partnership files with a state an amended return for the reviewed year. It is possible that in certain states, a partnership may file both an amended return (covering resident partners) and a “post federal audit group return” (covering non-resident partners).
- 2) The partnership must make the election by the due date of the “post federal audit group return.”

- 3) To facilitate filing, the partnership provides all reviewed year partners with amended Schedules K-1, including all required state specific information.
- 4) If a partner is not included in a “post federal audit group return,” that partner is responsible for filing an amended return for the reviewed year (and if necessary, subsequent years).
- 5) Allocation and apportionment calculations are based on the reviewed year data, adjusted (if necessary) for changes resulting from the federal audit.
- 6) Taxpayer partners are allowed on their reviewed year resident amended return to claim a credit for taxes paid to other jurisdictions. Amounts that a partner may claim a credit for taxes paid will come from either an amended Schedule K-1 or a partnership provided schedule of filings and payments that resulted from application of the Default Method.

### **General Rules**

- 1) Determination of the resident/non-resident states for each partner, allocation and apportionment calculations, etc., are based on reviewed year data, adjusted (if necessary) for changes resulting from the federal audit.
- 2) Any partner who files an amended federal return for the reviewed year under Internal Revenue Code (IRC) section 6225<sup>13</sup> is excluded from the “post federal audit group return” for their resident state.
- 3) The statute of limitations, filing, assessment and refund process should correspond to those in the ABA/AICPA/COST/TEI Draft Updated Proposed Model Uniform Statute for Reporting Adjustments to Federal Taxable Income presented to the Multistate Tax Commission (MTC) Uniformity Committee at its December 14, 2016, meeting. (see attached AICPA policy paper).
- 4) A partnership that files a “post federal audit group return” and pays the tax due to the state on behalf of a partner should relieve that partner from filing an amended return in that state for the year(s) affected.
- 5) A partnership that is a partner (direct or indirect) of a federal audited partnership that uses the Optional Elective Method is itself eligible to use the Default Method, Modified Default Method, or Optional Elective Method. The availability of this option also applies to any partnership that may have elected out of the audit Regime at the federal level. For purposes of this provision, an S corporation is treated as a partnership.
- 6) States should respect any election by a partnership to opt-out of the federal partnership audit rules.

As of: March 6, 2017

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<sup>13</sup> All references herein to “section” or “§” are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.