

Ohio Tax

28th Annual

OhioTax

C O N F E R E N C E

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Hyatt Regency Columbus, Columbus, Ohio

Workshop KK

State Tax Implications
With the New Federal
Partnership Audit Rules

Wednesday, January 30, 2019

11 a.m. to 12:30 p.m.

Biographical Information

David M. Kall, Managing Member, McDonald Hopkins
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Dave is managing member of the Cleveland office, vice chair of the Tax and Benefits Department, chair of the Multistate Tax Practice Group, and chair of the Capital Markets Practice Group within the firm's Business Department. As chair of the Capital Markets Practice Group, Dave spends a considerable amount of time counseling early and growth-stage companies, capital providers and entrepreneurs in a vast array of legal areas. Prior to joining the firm in 1996, Dave was a senior tax manager at Coopers & Lybrand LLP. While at Coopers & Lybrand LLP, Dave was responsible for providing advice to publicly traded and large privately held companies on a wide range of technical issues, including corporate, partnership, and REIT taxation.

Since joining the firm, Dave has developed extensive experience in working with our clients on all matters and challenges facing them as it relates to the Capital Markets Practice Group including fund formation and structuring, securities and regulatory compliance, fund administration and transfers of fund interests, investments in portfolio companies and related issues, sophisticated financing transactions involving commercial secured and unsecured loans and loan syndications, public and private issuances of debt and equity securities, and corporate governance matters.

Because of Dave's breadth of knowledge, he routinely represents our clients in connection with their general business needs. In particular, Dave has extensive experience structuring business transactions, negotiating and drafting corporate governance and transaction agreements, counseling directors and officers regarding the fiduciary duties owed to creditors and owners of the business, and structuring business succession plans.

Dave's approach to managing the Capital Markets Practice Group as an integrated, multidisciplinary practice is supplemented by Dave's broad-based federal and state tax practice involving corporate, partnership and venture capital transactions, tax controversy, and domestic tax planning. Dave's transactional tax practice includes assisting clients with structuring, negotiating, and documenting corporate, partnership, and limited liability company formation, merger, acquisition, disposition (including spin-off transactions, asset sales, stock sales, and Section 338(h)(10) transactions), joint venture, and financing transactions. Dave also provides independent advice to tax directors with respect to tax minimization strategies proposed by others or developed in-house. He has advised two publicly traded real estate investment trusts ("REITs") on an ongoing basis with respect to various issues, including going public, secondary offerings of debt and equity, tax compliance and private letter ruling requests, UPREIT structures, DownREIT transactions, and structuring and negotiating joint ventures and limited liability company agreements with developers, and other non-REITs.

Dave's tax practice also has included a significant amount of controversy work at both the federal and state levels involving domestic tax issues. He has represented clients under audit, at IRS Appeals, before the Ohio Department of Taxation and the Ohio Board of Tax Appeals. Because of Dave's extensive tax background, he provides a unique perspective to his clients seeking business counseling and advice.

Dave earned a J.D., with honors, from The Ohio State University Moritz College of Law in 1993. He received a B.A., summa cum laude, with Distinction in Political Science and Honors in the Liberal Arts, from The Ohio State University in 1989.

Biographical Information

Fredrick J. Nicely, Senior Tax Counsel, Council On State Taxation (COST)
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Fred Nicely is Senior Tax Counsel for the Council On State Taxation. Fred's role as Senior Tax Counsel at COST extends to all aspects of the COST mission statement: "to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities."

Before joining COST, Fred served in the Ohio Department of Taxation for four years as Deputy Tax Commissioner over Legal and for the prior seven years as the Department's Chief Counsel. Fred's responsibilities at the Department included testifying before legislative committees, participating as an alternative delegate for Ohio at Streamlined Sales Tax Project meetings, and reviewing legal documents issued by the Department, including deciding the merits of filing an appeal.

He is a frequent speaker and author on Ohio's tax system and on multistate tax issues generally. Fred also has extensive experience in public utility tax law, having served as an administrator of the Department's public utility tax division.

Fred's undergraduate degree in psychology (with a concentration in accounting) is from the Ohio State University. He obtained his MBA and JD from Capital University in Columbus, Ohio.

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Dave is an attorney in McDonald Hopkins' Tax and Benefits Group who advises business clients on a multitude of tax issues, particularly state and local taxes. As a former Assistant Attorney General for the Ohio Attorney General, Dave has defended the Ohio Tax Commissioner in tax litigation before the Ohio Board of Tax Appeals and Ohio courts of appeal, including several cases argued before the Ohio Supreme Court. He has extensive experience with all types of state and local taxes. These taxes include the income tax, sales and use tax, excise tax, personal and real property tax, and Ohio's gross receipts tax, the CAT. Dave is also the author of the 2018 Edition of *Baldwin's Ohio Tax Law and Rules*.

Dave also represents and advises clients with respect to federal tax matters, including federal tax controversies, federal tax structuring and analysis for business transactions, executive compensation matters, and estate planning.

Dave attended The Ohio State University Max M. Fisher College of Business, where he earned his B.S. with honors in Accounting and Finance. He also attended The Ohio State University Moritz College of Law on a full ride merit scholarship and graduated with honors.

State Tax Implications With the New Federal Partnership Audit Rules – Troubles Ahead?

28th Annual Ohio Tax Conference

David Kall, McDonald Hopkins LLC

Fred Nicely, Council on State Taxation

David Ebersole, McDonald Hopkins LLC

January 30, 2019

Overview

- ▶ **The Bipartisan Budget Act of 2015 and the New Federal Centralized Partnership Audit Regime**
 - ▶ Final Regulations
 - ▶ Challenges with push-out election, tiered structures and new QBI deduction
 - ▶ Key planning techniques and best practices for tax professionals
- ▶ **State Issues Presented Under Federal Centralized Audit Regime**
 - ▶ General Considerations
 - ▶ Constitutional Limitations
 - ▶ Proposed Model Legislation and Recent Developments
- ▶ **Questions**

- ▶ New Federal Centralized Partnership Audit Regime

Partnership Audit Rules Background

- ▶ The Bipartisan Budget Act of 2015 Adopted New IRS Audit Procedures for Partnerships and Multi-Member LLCs
 - ▶ HR 1314 (P.L. 114-74) enacted in 2015
 - ▶ Projected \$9.3 Billion revenue-raiser (federal alone)
- ▶ Consolidated Appropriations Act of 2018, HR 1625 (P.L. 115-141), enacted in March 2018, made several useful technical corrections and added a unique new “pull-in procedure” described later in these slides
- ▶ The New Audit Rules For Taxable Years Beginning After December 31, 2017
 - ▶ Option to elect into the new rules for earlier years (few did so)
- ▶ Expected to raise additional tax revenue by enabling the IRS to more efficiently audit “large” partnerships and LLCs
 - ▶ According to Government Accountability Office (GAO), less than one percent of large partnerships were audited during 2012, compared to a 27 percent audit rate of corporations with assets exceeding \$100 million

Centralized Partnership Audit Regime Overview

- ▶ **Centralized Partnership Audit Regime (CPAR) Applies to All Subchapter K Entities**
 - ▶ All Partnership and Operating Agreements for entities taxed as a partnership (including most JV's) should be reviewed and amended.

- ▶ **By Default, Audit Adjustments Assessed and Collected at the Entity Level**
 - ▶ The partnership pays the tax, interest, and penalties on any “imputed underpayments” in the adjustment year (partner allocation adjustments also flow-through in adjustment year).
 - ▶ The tax due is calculated at the highest corporate or individual rate.
 - ▶ Definitions
 - ▶ Reviewed Year – The partnership tax year that was under audit
 - ▶ Adjustment Year – The partnership tax year in which audit adjustments are determined
 - ▶ NOPPA – IRS “notice of proposed partnership adjustment” – initial adjustment notice
 - ▶ FPA – IRS “notice of final partnership adjustment”
 - ▶ Liability Mismatch: current partner group still retains liability for former partner group underpayment

- ▶ **Replaces Tax Matters Partner With “Partnership Representative”**
 - ▶ The Partnership Representative has the sole, exclusive authority to make decisions on behalf of the p'ship in IRS audit proceedings.
 - ▶ Important decisions: opt-out and audit rules elections, reporting decisions, appeal rights and decisions settlement authority, statute of limitations waivers, etc.
 - ▶ The Tax Matters Partner concept eliminated beginning with 2018 taxable year.

Imputed Underpayment

- ▶ Imputed Underpayment – Under the default rule, the amount that a partnership must pay if the IRS makes an adjustment
 - ▶ Computed based on the highest tax rate for an individual or corporate rate for a corporation
 - ▶ Partnership may request to modify the imputed underpayment if a partner is tax-exempt or the rate used in calculating the imputed underpayment is based on class of income and taxpayer (e.g. capital gain rate)

Centralized Partnership Audit Regime Overview

- ▶ Important Elections: There are at least three ways that partnerships may opt-out or otherwise adjust their liability under the new audit rules:
 - ▶ The True Opt-Out Election: Section 6221 Election
 - ▶ Applies only to “small” partnerships (more later)
 - ▶ Voluntary Reporting During 270-Day Period: Section 6225 Reporting
 - ▶ Partners affected by a reallocation must agree to file individual amended returns; OR
 - ▶ Partnership demonstrates that a portion of the imputed underpayment is allocable to a tax-exempt entity or a C corporation or individual with LTCDG or qualified dividends, i.e., with a lower max. tax rate than the highest marginal rate (37% in 2018); or
 - ▶ Partnership makes new “pull-in” election and enlists the help of its accounting firm.
 - ▶ The Push-Out Election: Section 6226 Election
 - ▶ The Partnership Representative elects on behalf of the Partnership to push-out the audit adjustment to the former partner group from the year under review.

Opting Out of Centralized Partnership Audit Regime

- ▶ “Small” Partnerships May Opt-Out of Centralized Partnership Audit Regime (Section 6221)
 - ▶ P’ships and their partners that opt-out are subject to pre-TEFRA rules for p’ship audits
- ▶ Criteria
 - ▶ 100 or Fewer K-Is: P’ship must have fewer than 100 partners all of whom must be “eligible”;
 - ▶ Eligible Partners: Partners must be individuals, C or S corporations, and/or estates of deceased partners; and
 - ▶ Disclose Partners: The names and taxpayer identification numbers (TINs) of each partner must be provided to the IRS (particularly applicable with S corporation partners)
- ▶ Annual Election
 - ▶ Partnership Must Make Annual Election: the partnership must make a “Section 6221 election” on its timely-filed federal tax return for the opt-out year
 - ▶ Notice to All Partners: P’ship must timely notify all partners of the election to opt-out

Sample Opt-Out Election Language

- ▶ The Company shall not elect into application of the audit procedures under Section 1101(g)(4) of the Bipartisan Budget Act of 2015 for any tax year ended on or before December 31, 2017.
- ▶ The Company shall elect out of application of those audit procedures in accordance with Section 6221(b) of the Internal Revenue Code for any tax year ended on or after January 1, 2018.

Centralized Partnership Audit Regime Timeline

If Partnership fails to timely opt-out, is ineligible, or chooses not to opt-out, then any IRS audit proceeds as follows:

1. IRS sends Notice of Administrative Proceeding to Partnership Representative and the Partnership itself.
2. After conducting audit, IRS will send a Notice of Proposed Partnership Adjustments (NOPPA)
3. Within 270 days of receiving the NOPPA, the partnership can request to modify the imputed underpayment under certain circumstances (see the earlier slide discussing voluntary reporting under Section 6225)

Centralized Partnership Audit Regime Timeline (cont.)

4. After 270 days, the IRS sends its Notice of Final Proposed Adjustments (FPA)
5. Within 45 days of receiving the FPA, the partnership may elect to push out the imputed underpayment to reviewed year partners OR pay at entity level
 - ▶ Operating Agreement should address P'ship Rep authority to make Push-Out Election
 - ▶ Push-Out Election brings with it increased interest rate (by 2 percent) on imputed underpayment
 - ▶ Election must be timely made even if tax petitioned
6. OR, within 90 days of receiving the FPA, the partnership may file a petition for readjustment with the U.S. Tax Court, appropriate U.S. district court, or the Court of Federal Claims

Push-Out Election

- ▶ Adjustment made to reviewed year partners
 - ▶ Not later than 45 days after the date of the FPA
 - ▶ The partnership furnishes statement to the IRS and to each reviewed-year partner of the partner's share of any adjustment to income, gain, loss, deduction or credit
- ▶ “6226 Statement” includes:
 - ▶ Share of initially reported items;
 - ▶ Share of adjustments for reviewed year;
 - ▶ Share of adjustments for intervening years;
 - ▶ Share of penalties (no opportunity to raise penalty defenses to any penalty reflected on the 6226 statement); and
 - ▶ “Safe Harbor Amount”.

Push Out Calculation

- ▶ Taxes increased in current year based as if amended for the reviewed year through the current year.
 - ▶ Includes all adjustments, including those that would have been disregarded in determining the imputed underpayment
 - ▶ Years when it would owe less taxes are disregarded
 - ▶ Additional taxes are due with the return for the taxable year for which the statement is received.
- ▶ Interest on the additional tax to the partner is determined from the due date of the partner's return for the reviewed year at the IRS interest rate on underpayments plus two percent
- ▶ Must also adjust intervening year tax attributes to reflect the adjustments

Sample Push-Out Election Language

- ▶ In the event of an audit of the Company, the Partnership Representative shall have the right to make any election(s) and to take any action(s) as provided under Section 1101 of the Bipartisan Budget Act of 2015, including any election under Section 6226 of the Internal Revenue Code. If an election is taken under Section 6226 of the Internal Revenue Code, each Member agrees to take his or her share of any adjustment into account as required under Section 6226(b) of the Internal Revenue Code. To the extent that any or all of an adjustment is paid by the Company, each Member agrees to immediately pay over to the Company the amount of the Member's share of the adjustment paid by the Company.

Pull-in Method

- ▶ Added by Technical Corrections
- ▶ Alternative Method for filing Amended Returns
- ▶ IRS determines Partnership Imputed Underpayment, which is reduced by adjustments to partnership-related items that direct and indirect review year partners take into account
- ▶ Provide IRS with information necessary to make calculation of tax
- ▶ Partner pays tax as would be calculated under push-out method
- ▶ All partners do not have to participate
- ▶ Partner tax information is due within 270 days after NOPPA (unless extended by IRS)
- ▶ Payment due 270 days after NOPPA is mailed

Sample Amended Return Election Provision

- ▶ Upon the request of the Partnership Representative, each member agrees to file an amended U.S. federal income tax return for the taxable year to which an Imputed Underpayment Amount relates and to pay any tax due in accordance with Section 6225(c)(2) of the Internal Revenue Code. Each member further agrees to comply with requests by the Partnership Representative for information necessary to determine whether any Imputed Underpayment Amount may be modified under Section 6225(c) of the Internal Revenue Code, including information related to determining the portion of the Imputed Underpayment Amount allocable to (i) a tax-exempt entity, (ii) a C Corporation, or (iii) an Individual

Statute of Limitations

- ▶ The statute of limitations structure for auditing partnership also significantly changed in light of the new centralized audit regime.
- ▶ Code Section 6235 provides a single partnership statute of limitations of 3 years after the later of:
 - ▶ (i) the date of filing the partnership return (IRS Form 1065);
 - ▶ (ii) the due date of the partnership return; or
 - ▶ (iii) the date the partnership files an “administrative adjustment request” (e.g., an amended return)

Partnership Representative

- ▶ Each Partnership must have a partnership representative (Treas. Reg. 301.6223-1(a)).
- ▶ There may be only one partnership representative for a partnership taxable year at any given time.
- ▶ Each partnership is required to designate a partnership representative for each taxable year (as provided by the Final Regulations).
- ▶ A partnership representative may not be designated pursuant to a power of attorney (Form 2848).
- ▶ Designation stays in effect until terminated by resignation, revocation or IRS determination that it is no longer in effect.
- ▶ The partnership representative has the sole authority to act on behalf of the partnership – can bind partnership and partners

Who is eligible to serve as Partnership Representative?

- ▶ Any person as defined in IRC 7701(a)(1), including an entity, may serve as a partnership representative if he, she or it has a “substantial presence” in the United States.
- ▶ The final regulations made clear that a partnership may designate itself as its own partnership representative, and that a disregarded entity may also be designated as a partnership representative.
- ▶ In the case where a disregarded entity, a partnership or other entity is appointed as Partnership Representative, the partnership must also appoint a designated individual or a person through whom “Entity Partnership Representative” acts.
- ▶ The designated individual must be appointed at the same time as designation of the entity partnership representative – need not be employee

What is meant by Substantial Presence?

- ▶ The “person” appointed to serve as Partnership Representative must have a substantial presence in the United States. Substantial presence is determined as follows:
 - ▶ The person makes themselves available to meet in person with the IRS in the United States at a reasonable time and place; and
 - ▶ The person has a United States taxpayer identification number, street address that is in the United States, and a telephone number with a United States area code.
- ▶ Final regulations removed the capacity-to-act requirement, which was initially intended to apply when a person died, became incapacitated, or was unable to serve as Partnership Representative because the IRS determined that the partnership should have great flexibility in selected who shall serve as Partnership Representative so long as the person meets the “substantial presence” requirement.

How do you change the Partnership Representative?

- ▶ Final regulations maintain the rule that a partnership representative may only be changed in the context of an administrative proceeding; or in connection with the filing of an administrative adjustment request.
- ▶ To change the partnership representative prior to the beginning of an administrative proceeding, the regulations were revised to allow the partnership to make a change by revocation when the partnership is notified that its return was selected for examination.

Resignation of Partnership Representative

- ▶ A Partnership Representative may not resign at the same time he, she or it files an administrative adjustment request, but he, she or it may resign after a notice of administrative adjustment.
- ▶ Unlike the proposed regulations, a Partnership Representative or designated individual may not appoint his, her or its successor. The IRS reasoned that the resignation should be the last act of the Partnership Representative.
- ▶ Written Notice to IRS – Partnership Representative must serve written notice to the IRS as prescribed.
 - ▶ Within 30 days of receipt of that notice, the IRS will send written confirmation of receipt of written notification to the partnership.
 - ▶ Effective Date of Resignation: Effective immediately upon the IRS written receipt.

Sample Partnership Representative Language

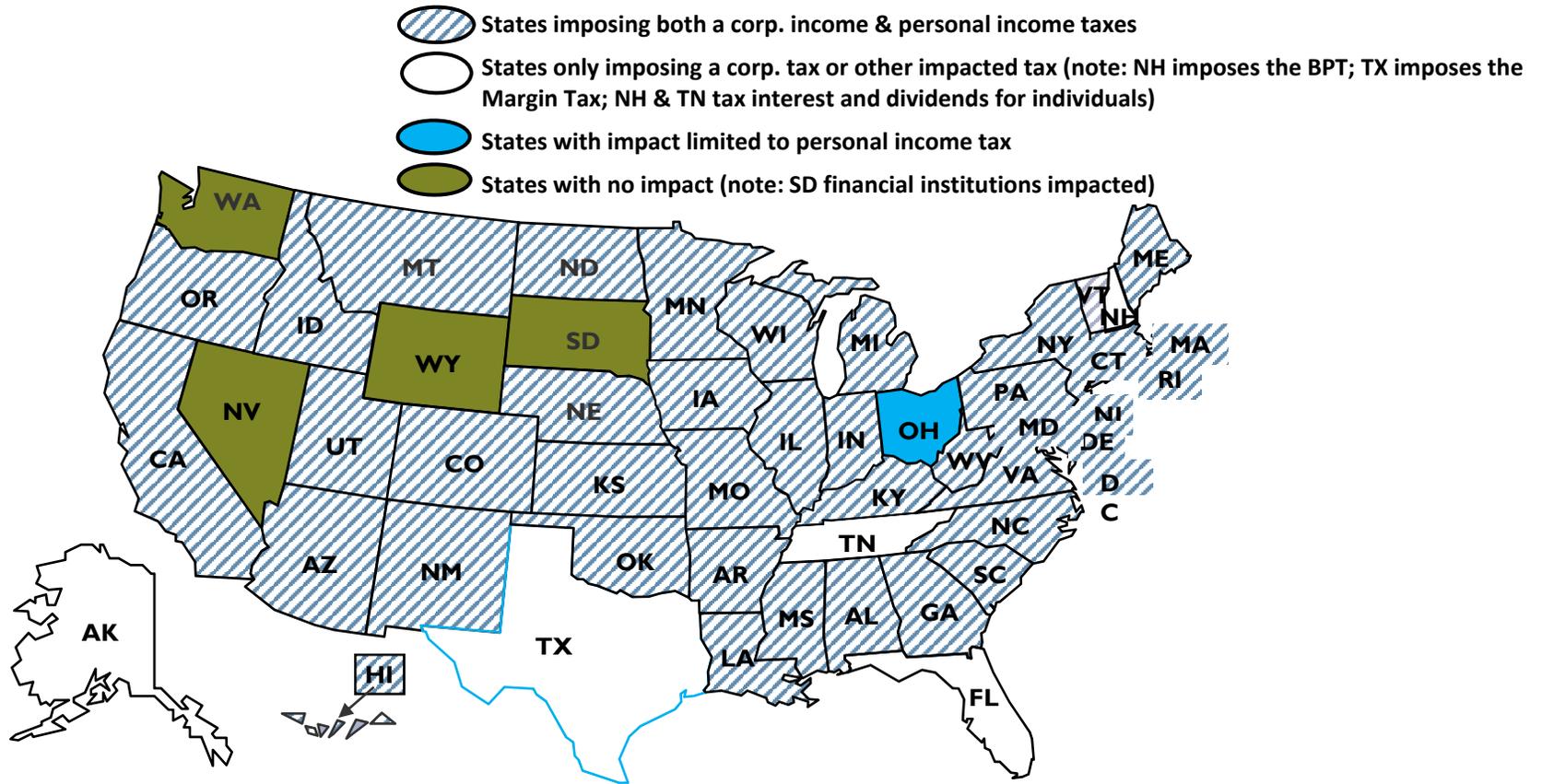
- ▶ For the tax years beginning on or after January 2, 2018, [Name of Appointee] shall serve as the Partnership Representative of the Company (as provided in Section 6223(a) of the Bipartisan Budget Act of 2015). The Partnership Representative may be replaced by Members holding a majority of membership interests if he or she resigns, dies or is unable to act.
- ▶ The Partnership Representative shall give notice to the Members concerning any audit and all significant developments in that audit; and shall make no major audit decision except with the consent of Members holding a majority of membership interests.
- ▶ The Company shall reimburse and indemnify the Partnership Representative for all reasonable out-of-pocket costs and expenses, as well as damages incurred by the Partnership Representative in connection with any administrative or judicial proceedings with respect to any tax liability of the Company or Members (as the case may be).

Authority of Partnership Representative

- ▶ Binding nature of actions: The actions taken by the Partnership Representative and partnership bind the partnership, all partners of the partnership and other persons whose tax liability is determined in part or whole by the agreed upon adjustments.
 - ▶ Partnership Representative has sole authority to act on behalf of the partnership.
 - ▶ In the case of an “Entity Partnership Representative”, the designated individual has sole authority to act on behalf of the Entity Partnership Representative and the partnership.
 - ▶ No partner or any other person may participate in an administrative proceeding without the IRS consent.
 - ▶ Designation of the Partnership Representative on the partnership tax return provides the authority to bind the partnership.
 - ▶ A partnership that has to appoint a designated individual acts through such individual, so designated individual has authority to not only bind the partnership, but also bind the entity partnership representative.
- ▶ A resignation or revocation does not affect the validity of any actions taken prior to such resignation or revocation.

- ▶ State Issues Presented Under Federal Centralized Audit Regime

States Impacted by the Change



Source: Bloomberg Tax – Excludes Local Taxes

State Effects – Reporting Federal Tax Adjustments

- ▶ Three important issues with taxpayers reporting federal tax adjustments to the states (and their localities):
 - ▶ What is the “trigger” that requires reporting?
 - ▶ Should be when all tax issues and appeal for tax period are final (e.g., not require serial/multiple reporting of partial agreements) – the “final determination”
 - ▶ What is the timeframe to report?
 - ▶ At least 180 days is the preferred time period (both COST and the MTC follow this)
 - ▶ How is the change reported?
 - ▶ Not properly reporting change can be a trap for the unwary – some states have no assessment limitation if fully completed amended tax return is not filed

▶

State Effects – General Partnership Concerns

- ▶ Issues the states need to address:
 - ▶ State procedural rules need to be amended to match the new federal partnership audit and adjustment process
 - ▶ Whether to allow different treatment at the state level
 - ▶ How to treat amended federal returns taxpayers may file during the modification period
 - ▶ How are partnerships that pay the tax subject to state reporting requirements
 - ▶ Can partnerships simply file amended returns (entity returns along with any composite or withholding returns) and K-1s for partners and have partners file amended returns for the reviewed year?
 - ▶ Proper allocation and apportionment of federal adjustments
 - ▶ How to collect tax owed when the liability will have occurred years earlier and the partnership may be defunct or partners may have moved from the state



Constitutional Limitations



Constitutional Limitations – Due Process & Commerce Clause Limitations

▶ **Due Process Clause**

- ▶ *J. McIntyre Machinery* (564 U.S. 873 (2011))
- ▶ Minimum contacts and purposively directed activity to forum state

▶ **Commerce Clause**

- ▶ *Complete Auto* (430 U.S. 274 (1977)) – Four-Prong Test
 - ▶ **Substantial Nexus**
 - *Wayfair* (585 U.S. ____ (2018)) – economic or virtual presence in the state
 - ▶ **Fair Apportionment**
 - *Jefferson Lines* (514 U.S. 175 (1995)) – tax must be fairly apportioned internally and externally
 - ▶ **Not Discriminatory**
 - *Oregon Waste* (511 U.S. 93 (1994)) – tax or fee cannot favor instate business over interstate business
 - ▶ **Fairly Related to Services**
 - *Commonwealth Edison* (453 U.S. 609 (1981)) – taxpayer must have some benefit, but no required matching of tax to benefits provided by a state

Constitutional Limitations – Nexus/Non-resident & Out-of-state Partnerships

- ▶ At the federal level, the IRS has jurisdiction to collect tax from all partnerships and partners. States, however, may only impose and collect tax on taxpayers with the requisite contacts and substantial nexus (pesky Constitution!).
 - ▶ Should/can the new audit rules expand the state's ability to impose and collect tax from out-of-state partners or partnerships?
 - ▶ Nexus can vary year by year – partnership activity in state can change along with partners' residency status in a state
- ▶ Generally, states tax residents on their worldwide income (and provide a credit) and tax non-residents only on their state source income
- ▶ State concerns:
 - ▶ Partnership pays election not resulting in 100 percent of the tax that would otherwise be owed
 - ▶ Indirect resident partners – MTC Model addresses this issue

Constitutional Limitations – Nexus/Non-resident & Out-of-state Partnerships Example

- ▶ Nevada partnership with five partners—four are California individual residents and one is a Nevada individual.
 - ▶ Original Return Filing: The partnership does not file a California return because it does not do business in the State.
 - ▶ California partners report 100 percent of their partnership income on their California individual returns.
 - ▶ If the partnership pays at the federal level, can California require the partnership to pay California tax?
 - ▶ Will California partners be required to report their share of the partnership assessment to California?

Constitutional Limitations – Fair Apportionment

- ▶ At the federal level, the IRS can impose tax on 100 percent of any adjustment. For state purposes, that adjustment often needs to be apportioned and/or allocated if the partnership is operating or doing business in multiple states.
- ▶ *Wynne* case (575 U.S. ____ (2015)) – U.S. Supreme Court reaffirmed tax imposed by a state must be internally consistent in that if all states imposed the same tax—there would be no duplicative taxation
- ▶ States give credit to resident taxpayers for tax paid by a partner to another state to avoid this problem.
- ▶ Issues arise on who is the taxpayer for credit to be claimed – many states will not allow a resident partner to claim a tax credit for tax paid at the partnership level (at the entity)
- ▶ A partnership's elections could result in potential double taxation based on different apportionment formulas used by the states – SCOTUS has allowed that treatment

Constitutional Limitations – Fair Apportionment Cont'd

- ▶ Many states use different apportionment rules for partnerships that are part of a unitary business (e.g., often those owned by C corporations)
- ▶ If the partnership pays, the payment is being made on behalf of its partners.
 - ▶ Can the partnership's apportionment factor be used as a general rule?
 - ▶ How do resident individual partners calculate their credits for taxes paid to other states by the partnership?
- ▶ Can a partnership seeking to pay the tax on behalf of its direct and indirect partners be forced to know (and certify?) the residency status of its indirect partners?

Constitutional Limitations – Discrimination & Fairly Related

- ▶ **Discrimination** - States' attempts to treat in-state and out-of-state partnerships differently would likely run afoul of the Commerce Clause
 - ▶ Facially unconstitutional – strict scrutiny and burden is on state to justify discriminatory treatment
 - ▶ So far no indication states intend to go down this path
 - ▶ A partnership's election to pay the tax versus have its partners pay the tax could result in more tax being owed; however, because it is an election (self inflicted), there would not be a constitutional violation
- ▶ **Fairly Related** – Post-*Wayfair* this could be raised as an issue if a partnership is forced to make a tax payment where it conducts no activity in a state (it also raises Due Process Clause and substantial nexus issues)

Proposed Model Legislation & Recent Developments

New Federal Partnership Audit Rules: State Implications

- ▶ MTC “Partnership Project” work group referred model to Uniformity Committee -
 - ▶ Website: <http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project>
- ▶ Current Status
 - ▶ July 24, 2018, MTC Uniformity Committee approved and referred model to MTC Executive Committee
 - ▶ October 15, 2018 public hearing held on the model act
 - ▶ October 26, 2018, Hearing Officer Report issued
 - ▶ November 8, 2018, MTC Executive Committee tentatively OK'd
 - ▶ January 24, 2019, MTC to vote on the model act

How It's Accomplished: Interested Parties

- ▶ The Interested Parties that prepared the Draft Model Statute are:
 - ▶ ABA Section of Taxation SALT Committee Task Force (ABA)
 - ▶ American Institute of CPAs (AICPA)
 - ▶ Council On State Taxation (COST)
 - ▶ Institute for Professionals in Taxation (IPT)
 - ▶ Master Limited Partnership Association (MLPA)
 - ▶ Tax Executives Institute (TEI)
- ▶ The Interested Parties have been working with the Multistate Tax Commission (MTC), this presentation is based on revisions to the Draft Model as of July 24, 2018
- ▶ Note: Interested Parties have formally endorsed the Draft Model

How It's Accomplished: Draft Model Statute – Overview of MTC's May 2018 Version

Section A—Definitions

Section B—Reporting Adjustments to Federal Taxable Income – General Rule

**Section C—Reporting Adjustments to Federal Taxable Income – Partnership
Level Audit and Administrative Adjustment Request**

Section D—*De Minimis* Exception

Section E—Assessments of Additional [State] Tax, Interest, and Penalties Arising from
Adjustments to Federal Taxable Income – Statute of Limitations

Section F—Estimated [State] Tax Payments During the Course of a Federal Audit

Section G—Claims for Refund or Credits of [State] Tax Arising from Federal
Adjustments Made by the IRS

Section H—Scope of Adjustments and Extensions of Time

Section I—Effective Date

Optional Regulations

How It's Accomplished: Key General Definitions

▶ **Federal Adjustments**

- ▶ Change to item or amount used by the taxpayer to compute state tax owed, whether resulting from an IRS audit, amended federal return, or administrative adjustment request by the taxpayer

▶ **Federal Adjustments Report (FAR)**

- ▶ Method or form required to report Federal Adjustments to state
- ▶ Includes an amended state tax return or uniform multistate report

▶ **Final Determination Date**

- ▶ For IRS audits, date on which no Federal Adjustments arising from an audit remain to be finally determined
- ▶ For combined/consolidated returns, applies to entire group
- ▶ For amended federal returns, refund claims, and administrative adjustment requests, the date on which the requests were filed

How It's Accomplished: General Reporting Process

- ▶ **Reporting Adjustments to Federal Taxable Income – General Rule**
 - ▶ Taxpayers shall file a Federal Adjustments Report within **180 days** after the Final Determination Date for Reviewed Year and Subsequently Affected Years
- ▶ This provision does **not** apply to a partnership or their partners (unless the partner filed an amended return during the modification period) subject to a partnership level audit

How It's Accomplished: Key Partnership Definitions

- ▶ **Direct Partner**
 - ▶ Partner holding an interest directly in Partnership or Pass-Through Entity
- ▶ **Indirect Partner**
 - ▶ Partner in a Partnership or Pass-Through Entity that also holds an interest in another Partnership or Pass-Through Entity
- ▶ **Resident Partner**
 - ▶ Individual, trust or estate Partner domiciled in the state
- ▶ **Tiered Partner**
 - ▶ Partner that itself is a Partnership or Pass-Through Entity

How It's Accomplished: Key Partnership Definitions

- ▶ **Audited Partnership**
 - ▶ Partnership directly subject to Partnership Level Audit
- ▶ **Partnership Level Audit**
 - ▶ BBA audit (IRC Section 6221(b))
- ▶ **Reallocation Adjustment**
 - ▶ Federal Adjustment that changes the distributive shares of partnership income, gain, loss, expense, or credit allocated to partners
 - ▶ Positive reallocation adjustment increases income owed by Partner
 - ▶ Negative reallocation adjustment decreased income owed by Partner

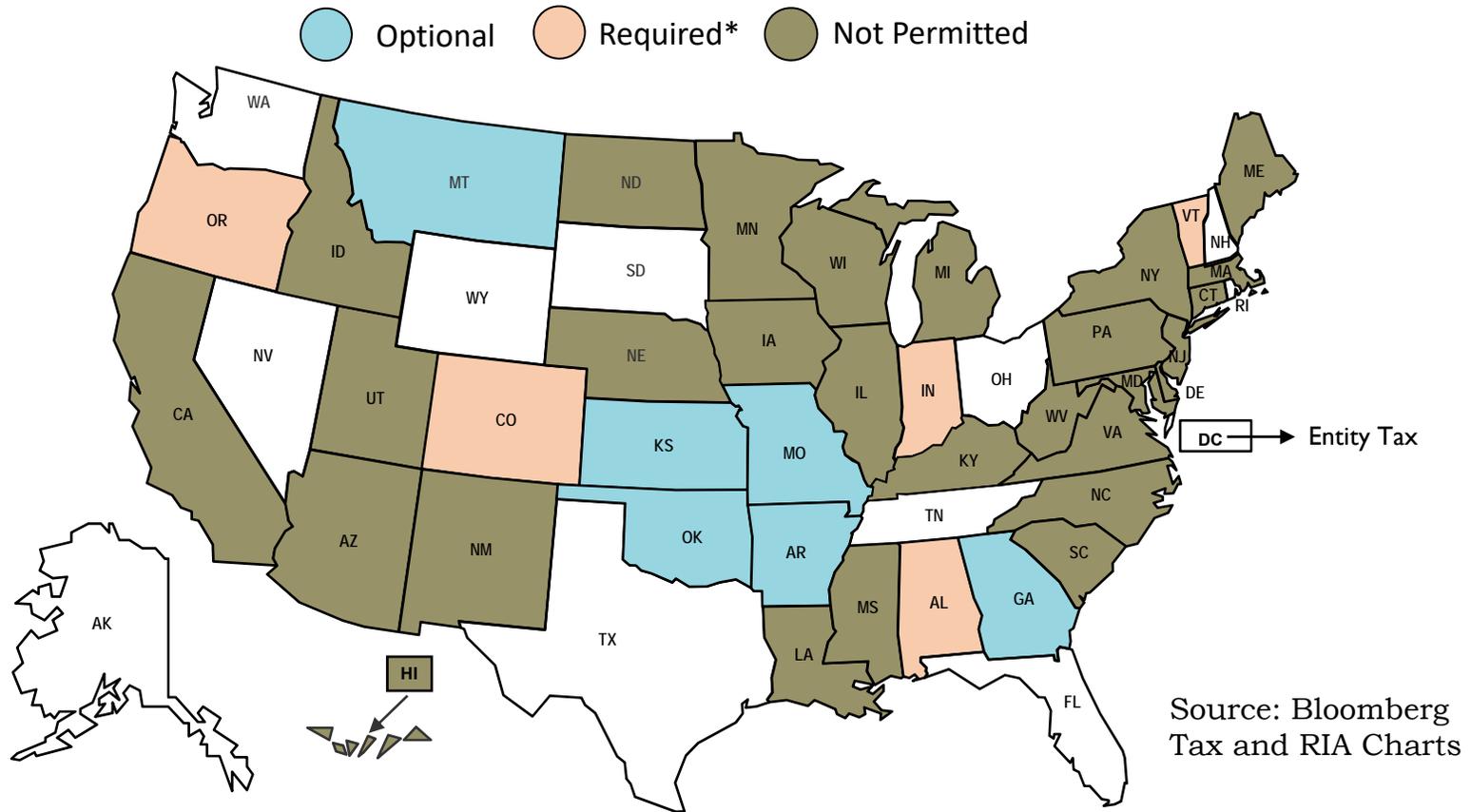
How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Default Rule

- ▶ For Reviewed Years, Audited Partnership shall:
 - ▶ Within 90 days of the Final Determination Date
 - ▶ File a Federal Adjustments Report;
 - ▶ Notify Direct Partners of their distributive share adjustments; and
 - ▶ File amended composite/withholding returns and pay the related tax liability on behalf of such partners
 - ▶ Within 180 days of the Final Determination Date, excluding Tiered Partners, each Direct Partner
 - ▶ File an Federal Adjustment Report to the state; and
 - ▶ Pay the additional tax, including penalty and interest, to the state (less any applicable credits)

How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Default Rule

- ▶ For Tiered Partners
 - ▶ Within 90 days after the date of federal deadline for Tiered Partners the Tiered Partners shall:
 - ▶ Complete all the above reporting requirements; and
 - ▶ Make all payments
 - ▶ Upon request, Audited Partnership or Tiered Partner with over 10,000 Direct Partners can request an additional 60-day extension

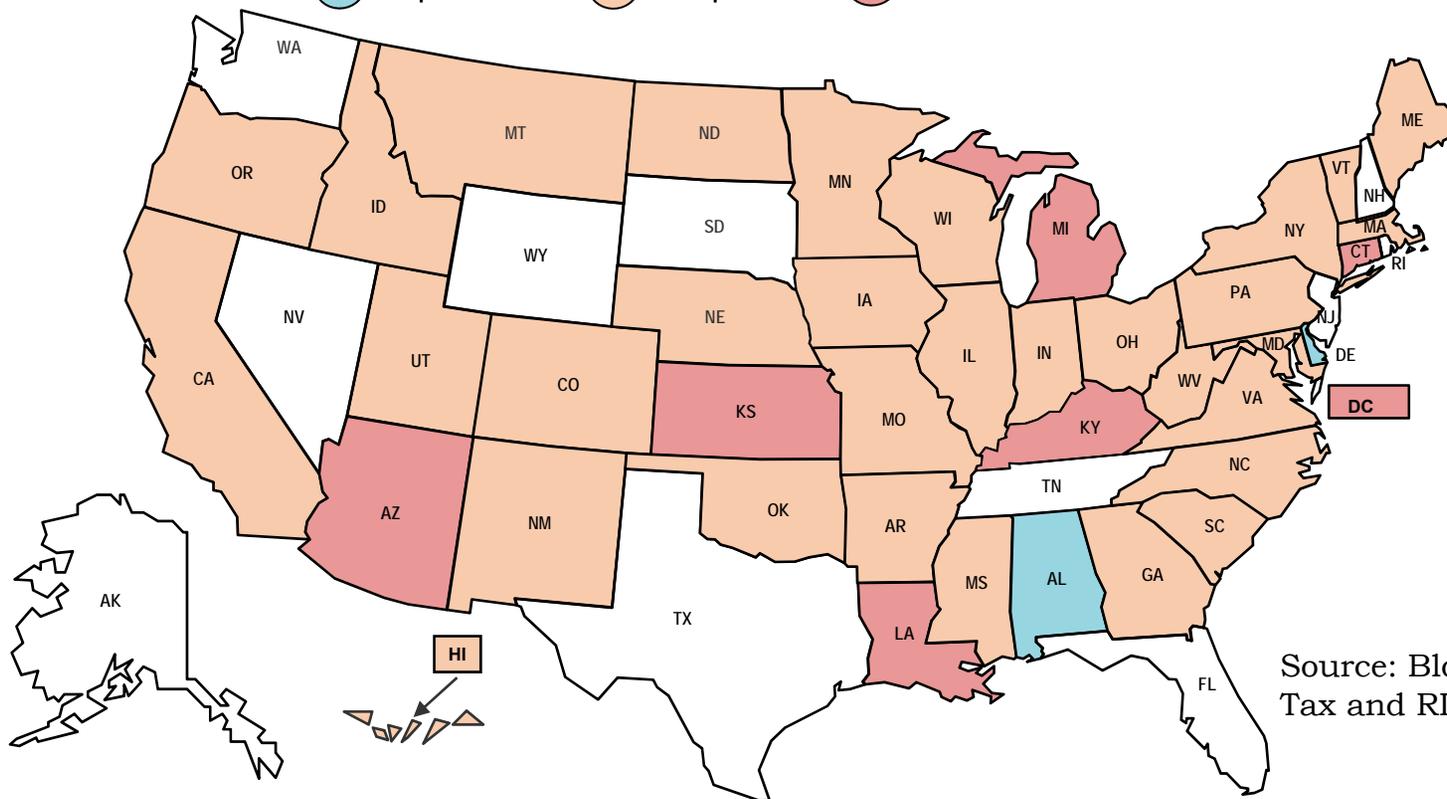
Composite Returns for Corporations



*Required returns may be limited to certain circumstances

Withholding for Individuals

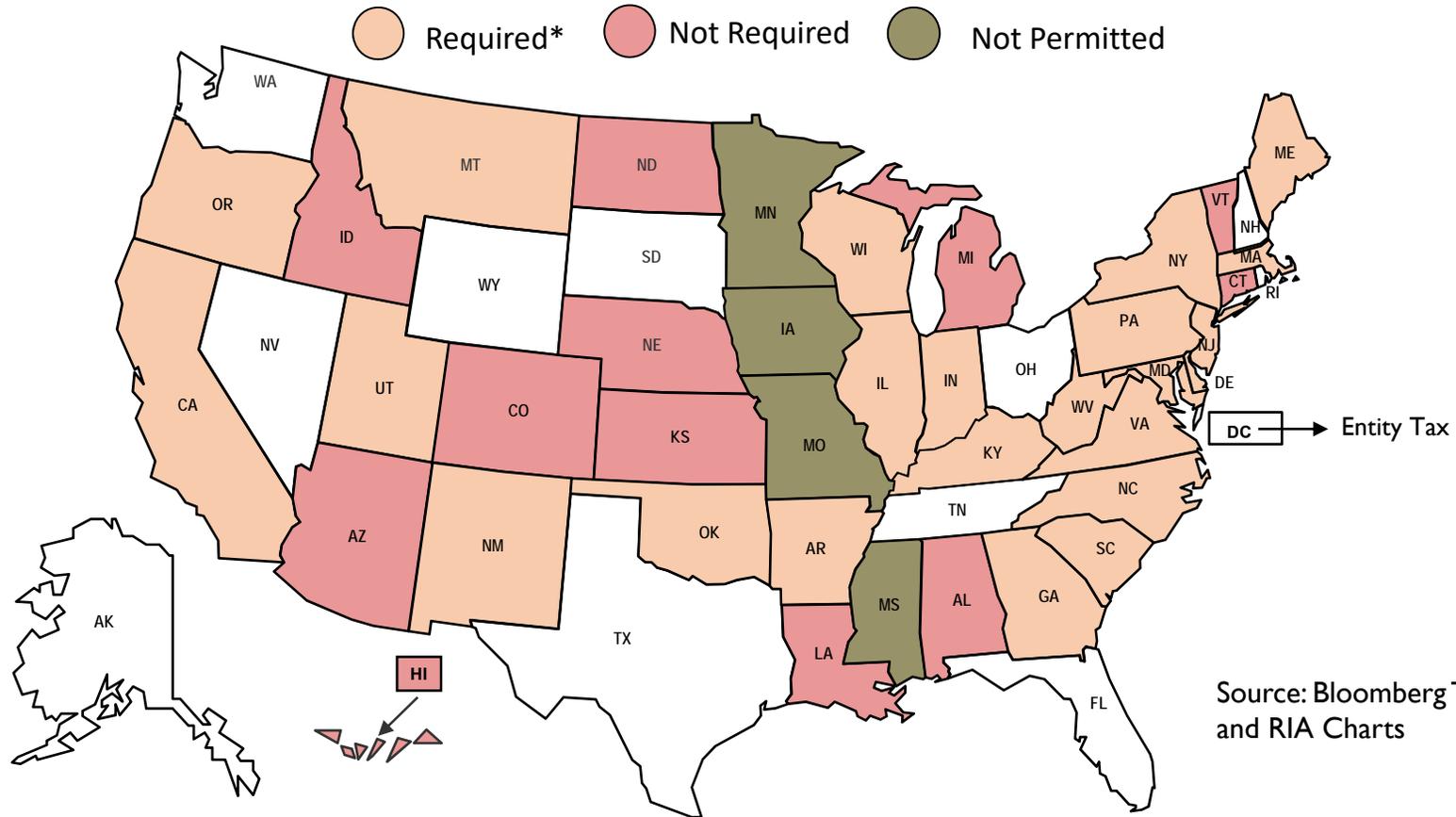
Optional Required* Not Required



Source: Bloomberg Tax and RIA Charts

*Required withholding may be limited to certain circumstances

Withholding for Corporations



*Required withholding may be limited to certain circumstances

Source: Bloomberg Tax and RIA Charts

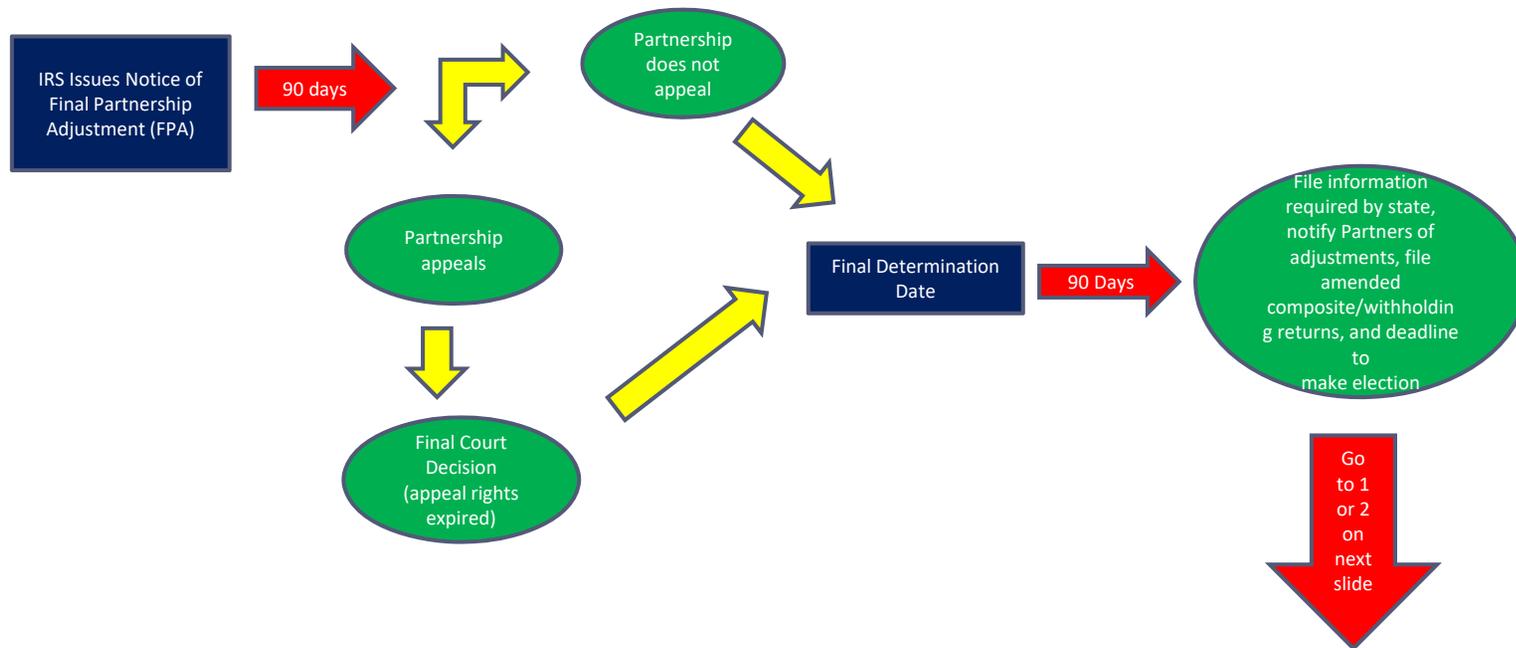
How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Election

- ▶ Alternatively, Audited Partnership can make an election to pay the tax for Reviewed Years
- ▶ Within 90 days of Final Determination Date the Audited Partnership shall:
 - ▶ File a Federal Adjustments Report; and
 - ▶ Notify the state of the election
- ▶ Within 180 days of Final Determination Date, the Audited Partnership shall:
 - ▶ Pay tax on behalf of partners based on calculation prescribed
 - ▶ Tax calculated at the highest tax rate for each partner type
- ▶ Tiered Partners – Also eligible to make the election but are not subject to the interim time restrictions – must finalize all elections, reporting, and payment of the tax within 90 days after the date of federal deadline for Tiered Partners
 - ▶ Federal deadline is extended due date of the Audited Partnership's return for the adjustment year

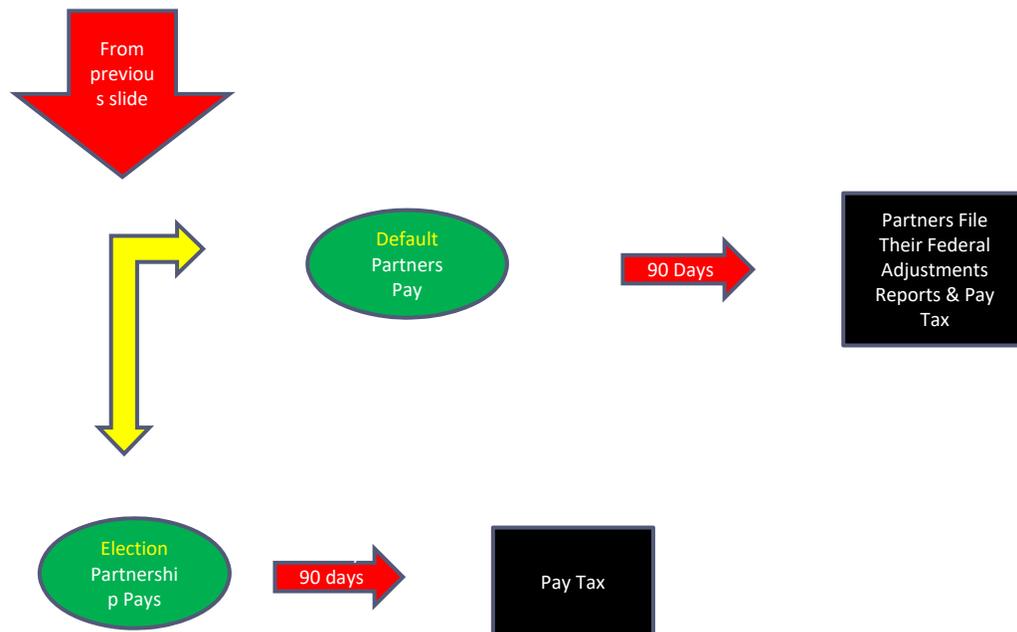
How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Election

- ▶ Exceptions to the Partnership Pays Election
 - ▶ Distributive share for unitary Direct Corporate Partners excluded – adjustment must be reported by those corporate partners
 - ▶ Distributive share for tax exempt partners excluded
 - ▶ Presumption that Indirect Partners are treated as residents unless partnership proves otherwise – which allows for specific sourcing of certain types of income that are generally subject to special state sourcing rules (e.g., investment income)
- ▶ Optional provisions to either allow or disallow partnership pays election where partnership did not have an initial filing obligation with a state in the reviewed year

Flow Chart following Federal Partnership Audit Adjustment – Slide 1



Flow Chart following Federal Partnership Audit Adjustment – Slide 2



* For Composite Return Partners, Option I is used

Alternative Election by Mutual Agreement

- ▶ To address unique situations, the Model allows the Audited Partnership or Tiered Partners to enter into a mutual agreement with the [State Agency]
 - ▶ Can agree to use:
 - ▶ A different reporting method
 - ▶ A different payment method
 - ▶ Audited Partnership & Tiered Partners required to demonstrate requested method is reasonable

Other Items of Note

- ▶ Partnership Representative

- ▶ Federal Partnership Representative is the default, but taxpayer can request a separate State Partnership Representative be appointed
- ▶ State may establish “reasonable qualifications” by rule

- ▶ Pay-up/Pull-in

- ▶ At the federal level, partners are able to file amended federal returns for the reviewed year or simply pay their share of the tax during the 270 day modification period.
- ▶ These partners are excluded from the partnership reporting requirements of Section C of the Draft Model Statute and required to report under the general reporting provisions of Section B (*i.e.*, file separate amended state returns)

New Federal Partnership Audit Rules: State Implications

- ▶ **State Legislative Activity to Date**
 - ▶ 2016—only Arizona passed a bill
 - ▶ Arizona bill does not comprehensively address federal changes (e.g., fails to address tiered partnerships)
 - ▶ 2017—five states proposed legislation but all died/failed
 - ▶ 2018— California, Georgia and Hawaii enacted conformity legislation; Minnesota introduced legislation but bill died
 - ▶ Hawaii’s legislation is problematic because as it merely incorporates by reference certain IRC audit procedure provisions
- ▶ **2019 will be the time to act!**

Comparison of Federal Process to Draft State Model

Federal Audit Reporting Process	Draft MTC State Model Process
Default – Partnership pays the tax using highest individual/corporate income tax rates	Default – Partnership notifies partners and partners pay the tax (composite/withholding filers still subject to partnership paying the tax)
Has option for partners to file amended returns (or simply pay (“pull-in”)) to remit tax	Such partners required to report under the general reporting requirements at the state level (<i>i.e.</i> , file separate amended state return). Those partners are <u>not</u> be included in any partnership pays tax calculation.
Has option for partnership to “push-out” tax to review year partners to remit the tax when they file their tax return for the year IRS completes the audit (adjustment year)	“Push-out” option requires reporting and payment on an amended return for original (“reviewed”) year. Ability to report/pay tax on current year tax return unavailable (likely an administrative systems issue w/most states)
Tiered Partners – must complete all filings by the extended due date of the Audited Partnership's return for the adjustment year	Subject to extension, Tiered Partners must complete all reporting and payments 90 days after the extended due date of the Audited Partnership's return for the adjustment year

Comparison of Federal Process to Draft State Model

Federal Audit Reporting Process	Arizona SB 1288 (2016)
Default – Partnership pays the tax using highest individual/corporate income tax rates	Follows federal, but partnership is required to file an amended return for the reviewed year
Has option for partners to file amended returns (or simply pay (“pull-in”)) to remit tax	Not addressed in SB 1288; unclear whether covered by general reporting provisions
Has option for partnership to “push-out” tax to review year partners to remit the tax when they file their tax return for the year IRS completes the audit (adjustment year)	If partnership “pushed-out” at the federal level, partners will be required to report and pay any additional tax on an amended return for original (“reviewed”) year. Ability to report/pay tax on current year tax return unavailable (likely an administrative systems issue w/most states)
Tiered Partners – must complete all filings by the extended due date of the Audited Partnership's return for the adjustment year	Not addressed in SB 1288

Comparison of Draft State Model to California Legislation

Draft MTC State Model Process	California Legislation Process
Default – Partnership notifies partners and partners pay the tax (composite/withholding filers still subject to partnership paying the tax)	Default – Partnership is required to follow partnership’s federal treatment (<i>i.e.</i> , if partnership paid at the federal level, default for California is partnership pays)
Partners that filed amended returns (or simply pay (“pull-in”)) at the federal level are required to report under the general reporting requirements at the state level (<i>i.e.</i> , file separate amended state return). Those partners are <u>not</u> be included in any partnership pays tax calculation	California legislation also requires such partners to report and pay under general reporting requirements
Separate state partnership pays election allowed	California legislation also provides allows for a separate state election to be made so long as the election does not impede the FTB’s ability to collect the tax
Allows for an alternative reporting and payment methodology to be used by mutual agreement	California legislation also allows for an alternative reporting and payment methodology to be used by mutual agreement

Comparison of Draft State Model to California Legislation

Draft MTC State Model Process	California Legislation Process
Partnership pays calculation – unitary partners elected, distributions to tax exempt partners excluded and presumption that indirect partners are treated as resident partners	California legislation also excludes unitary and tax exempt partners from the partnership pays calculation, but does <u>not</u> presume indirect partners are treated as resident partners
“Push-out” option requires reporting and payment on an amended return for original (“reviewed”) year. Ability to report/pay tax on current year tax return unavailable (likely an administrative systems issue w/most states)	California’s treatment of the “push out” option also requires reporting and payment on an amended return for the original (“reviewed”) year and current year reporting and payment is unavailable
Allows the designation of a state partnership representative	California legislation also allows for the designation of a state partnership representative
Subject to extension, Tiered Partners must complete all reporting and payments 90 days after the extended due date of the Audited Partnership's return for the adjustment year	California legislation subjects Tired Partners to the same reporting requirements and time lines

Comparison of Federal Process to Draft State Model

Federal Audit Reporting Process	Georgia Legislation (2018)—based on earlier version of the MTC Model
Default – Partnership pays the tax using highest individual/corporate income tax rates	Default – Partnership notifies partners and partners pay the tax (composite/withholding filers still subject to partnership paying the tax)
Has option for partners to file amended returns (or simply pay (“pull-in”)) to remit tax	Such partners required to report under the general reporting requirements at the state level (<i>i.e.</i> , file separate amended state return). Those partners are <u>not</u> be included in any partnership pays tax calculation.
Has option for partnership to “push-out” tax to review year partners to remit the tax when they file their tax return for the year IRS completes the audit (adjustment year)	“Push-out” option requires reporting and payment on an amended return for original (“reviewed”) year. Ability to report/pay tax on current year tax return unavailable (likely an administrative systems issue w/most states)
Tiered Partners – must complete all filings by the extended due date of the Audited Partnership's return for the adjustment year	Subject to extension, Tiered Partners must complete all reporting and payments 90 days after the extended due date of the Audited Partnership's return for the adjustment year

▶ Questions?

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**Draft as of July 18, 2018 with minor edits (redlined) discussed at the Uniformity
Committee Meeting on July 24, 2018
and approved for referral to the Executive Committee.**

(WITHOUT SUGGESTED REGULATIONS)

**Model Uniform Statute and Regulation for Reporting Adjustments to Federal
Taxable Income and Federal Partnership Audit Adjustments**

This draft was produced by a working group consisting of representatives of the Council On State Taxation (COST), Tax Executives Institute (TEI), the ABA Section of Taxation's SALT Committee, the American Institute of CPAs (AICPA), the Institute for Professionals in Taxation (IPT) and the Master Limited Partnership Association (MLPA) as well as a work group set up by the MTC uniformity committee. As of this date, this draft has not been officially endorsed by these organizations.

This draft has been reformatted with line numbering as well as internal citations simplified and underlined to aid in the final review.

1 **SECTION A. Definitions**

2 The following definitions apply for the purposes of [this subdivision of the State Code]:

3 **(1) "Administrative Adjustment Request"** means an administrative adjustment request
4 filed by a Partnership under IRC section 6227.

5 **(2) "Audited Partnership"** means a Partnership subject to a Partnership Level Audit
6 resulting in a Federal Adjustment.

7 **(3) "Corporate Partner"** means a Partner that is subject to tax under [reference to State
8 law].

9 **(4) "Direct Partner"** means a Partner that holds an interest directly in a Partnership or
10 Pass-Through Entity.

11 **(5) "Exempt Partner"** means a Partner that is exempt from taxation under [reference to
12 State law] [except on Unrelated Business Taxable Income¹].

13 **(6) "Federal Adjustment"** means a change to an item or amount determined under the
14 Internal Revenue Code that is used by a Taxpayer to compute [State tax] owed whether that
15 change results from action by the IRS, including a Partnership Level Audit, or the filing of an
16 amended federal return, federal refund claim, or an Administrative Adjustment Request by the
17 Taxpayer. A Federal Adjustment is positive to the extent that it increases state taxable income as
18 determined under [reference to State laws] and is negative to the extent that it decreases state

¹ Drafting note: This portion of definition should only be used by the [State] if it taxes unrelated business income.

1 taxable income as determined under [reference to State laws].

2 **(7) “Federal Adjustments Report”** includes methods or forms required by [State Tax
3 Agency] for use by a Taxpayer to report Final Federal Adjustments, including an amended [State]
4 tax return, information return, or a uniform multistate report.

5 **(8) “Federal Partnership Representative”** means the person the Partnership designates
6 for the taxable year as the Partnership’s representative, or the person the IRS has appointed to
7 act as the Federal Partnership Representative, pursuant to IRC section 6223(a).

8 **(9) “Final Determination Date”** means the following:

9 (a) Except as provided in Section A(9)(b) and (c), if the Federal Adjustment arises from
10 an IRS audit or other action by the IRS, the Final Determination Date is the first day on
11 which no Federal Adjustments arising from that audit or other action remain to be finally
12 determined, whether by IRS decision with respect to which all rights of appeal have been
13 waived or exhausted, by agreement, or, if appealed or contested, by a final decision with
14 respect to which all rights of appeal have been waived or exhausted. For agreements
15 required to be signed by the IRS and the Taxpayer, the Final Determination Date is the date
16 on which the last party signed the agreement.

17 (b) For Federal Adjustments arising from an IRS audit or other action by the IRS, if the
18 Taxpayer filed as a member of a [combined/consolidated return/report under State law],
19 the Final Determination Date means the first day on which no related Federal Adjustments
20 arising from that audit remain to be finally determined, as described in Section A(9)(a), for
21 the entire group.

22 (c) If the Federal Adjustment results from filing an amended federal return, a federal
23 refund claim, or an Administrative Adjustment Request, or if it is a Federal Adjustment
24 reported on an amended federal return or other similar report filed pursuant to IRC section
25 6225 (c), the Final Determination Date means the day on which the amended return, refund
26 claim, Administrative Adjustment Request, or other similar report was filed.

27 **(10) “Final Federal Adjustment”** means a Federal Adjustment after the Final Determina-
28 tion Date for that Federal Adjustment has passed.

29 **(11) “Indirect Partner”** means a Partner in a Partnership or Pass-Through Entity that itself
30 holds an interest directly, or through another Indirect Partner, in a Partnership or Pass-Through
31 Entity.

32 **(12) “IRC”** means the Internal Revenue Code of 1986, as codified at 26 United States Code
33 (U.S.C.) Section 1, et seq., [insert State’s current practice to incorporate IRC] and applicable

1 regulations as promulgated by the U.S. Department of the Treasury.²

2 **(13) “IRS”** means the Internal Revenue Service of the U.S. Department of the Treasury.

3 **(14) “Non-Resident Partner”** means an individual, trust, or estate Partner that is not a
4 Resident Partner.

5 **(15) “Partner”** means a person that holds an interest directly or indirectly in a Partnership
6 or other Pass-Through Entity.

7 **(16) “Partnership”** means an entity subject to taxation under Subchapter K of the IRC.

8 **(17) “Partnership Level Audit”** means an examination by the IRS at the partnership level
9 pursuant to Subchapter C of Title 26, Subtitle F, Chapter 63 of the IRC, as enacted by the
10 Bipartisan Budget Act of 2015, Public Law 114-74, which results in Federal Adjustments.

11 **(18) “Pass-Through Entity”** means an entity, other than a Partnership, that is not subject to
12 tax under [reference to State law imposing tax on C corporations or other taxable entities].

13 **(19) “Reallocation Adjustment”** means a Federal Adjustment resulting from a Partnership
14 Level Audit or an Administrative Adjustment Request that changes the shares of one or more
15 items of partnership income, gain, loss, expense, or credit allocated to Direct Partners. A positive
16 Reallocation Adjustment means the portion of a Reallocation Adjustment that would increase
17 federal income for one or more Direct Partners, and a negative Reallocation Adjustment means
18 the portion of a Reallocation Adjustment that would decrease federal income for one or more
19 Direct Partners [pursuant to Regulations under IRC section 6225].

20 **(20) “Resident Partner”** means an individual, trust, or estate Partner that is a resident in
21 [State] under [reference to state laws] for the relevant tax period.

22 **(21) “Reviewed Year”** means the taxable year of a Partnership that is subject to a Partner-
23 ship Level Audit from which Federal Adjustments arise.

24 **(22) “Taxpayer”** means [insert reference to State definition] and, unless the context clearly
25 indicates otherwise, includes a Partnership subject to a Partnership Level Audit or a Partnership
26 that has made an Administrative Adjustment Request, as well as a Tiered Partner of that
27 Partnership.

28 **(23) “Tiered Partner”** means any Partner that is a Partnership or Pass-Through Entity.

29 **(24) “Unrelated Business Taxable Income”** has the same meaning as defined in IRC
30 section 512.³

² Drafting note: A State may need to address undefined terms. Suggested language – “To the extent terms used in this [article] are not defined in this Section or elsewhere in [citation to chapter in which this article is contained], it is the intent of the Legislature to conform as closely as possible to the terminology used in the amendments to the IRC pertaining to the comprehensive partnership audit regime as contained in the Bipartisan Budget Act of 2015, Public Law 114-74, as amended, and this [article] shall be so interpreted.”

³ Drafting note: This term should only be used by the [State] if it taxes unrelated business income.

1 **SECTION B. Reporting Adjustments to Federal Taxable Income – General Rule**

2 Except in the case of Final Federal Adjustments that are required to be reported by a Partnership
3 and its Partners using the procedures in Section C, and Final Federal Adjustments required to be
4 reported for federal purposes under IRC section 6225(a)(2), a Taxpayer shall report and pay any
5 [State] tax due with respect to Final Federal Adjustments arising from an audit or other action by
6 the IRS or reported by the Taxpayer on a timely filed amended federal income tax return,
7 including a return or other similar report filed pursuant to IRC section 6225(c)(2), or federal
8 claim for refund by filing a Federal Adjustments Report with the [State Tax Agency] for the
9 Reviewed Year and, if applicable, paying the additional [State] tax owed by the Taxpayer no later
10 than 180 days after the Final Determination Date.

11 **Section C. Reporting Federal Adjustments – Partnership Level Audit and Administrative**
12 **Adjustment Request**

13 Except for adjustments required to reported for federal purposes pursuant to IRC section
14 6225(a)(2), and the distributive share of adjustments that have been reported as required under
15 Section B, Partnerships and Partners shall report Final Federal Adjustments arising from a
16 Partnership Level Audit or an Administrative Adjustment Request and make payments as
17 required under this Section C.

18 **(1) State Partnership Representative.**

19 (a) With respect to an action required or permitted to be taken by a Partnership under
20 this Section C and a proceeding under [reference to provisions for State administrative
21 appeal or judicial review] with respect to that action, the State Partnership Representative
22 for the Reviewed Year shall have the sole authority to act on behalf of the Partnership, and
23 the Partnership’s Direct Partners and Indirect Partners shall be bound by those actions.

24 (b) The State Partnership Representative for the Reviewed Year is the Partnership’s
25 Federal Partnership Representative unless the Partnership designates in writing another
26 person as its State Partnership Representative.

27 (c) The [State Tax Agency] may establish reasonable qualifications for and procedures
28 for designating a person, other than the Federal Partnership Representative, to be the State
29 Partnership Representative.

30 **(2) Reporting and Payment Requirements for Partnerships Subject to a Final Federal**
31 **Adjustment and their Direct Partners.** Final Federal Adjustments subject to the requirements
32 of this Section C, except for those subject to a properly made election under Section C(3), shall
33 be reported as follows:

34 (a) No later than 90 days after the Final Determination Date, the Partnership shall:

35 (i) File a completed Federal Adjustments Report, including information as re-
36 quired by [State Tax Agency ~~rule or instruction~~ regulation], with [State Tax Agency];

1 and

2 (ii) Notify each of its Direct Partners of their distributive share of the Final Federal
3 Adjustments including information as required by the [State Tax Agency ~~rule or in-~~
4 ~~struction regulation~~]; and

5 (iii) File an amended composite return for Direct Partners as required under [ref-
6 erence to State law] and/or an amended withholding return for Direct Partners as re-
7 quired under [reference to State law] and pay the additional amount under [reference
8 to State law(s)] that would have been due had the Final Federal Adjustments been re-
9 ported properly as required.

10 (b) [Except as provided under State law for minimal tax liabilities]⁴, no later than 180
11 days after the Final Determination Date, each Direct Partner that is taxed under [reference
12 to State law imposing tax on individuals, trusts, estates, C corporations, etc.] shall:

13 (i) File a Federal Adjustments Report reporting their distributive share of the ad-
14 justments reported to them under Section C(2)(a)(ii) as required under [reference to
15 State laws]; and

16 (ii) Pay any additional amount of tax due as if Final Federal Adjustments had been
17 properly reported, plus any penalty and interest due under [reference to State law] and
18 less any credit for related amounts paid or withheld and remitted on behalf of the Di-
19 rect Partner under Section C(2)(a)(iii).

20 **(3) Election – Partnership Pays.** Subject to the limitations in Section C(3)(c), an Audited
21 Partnership making an election under this Subsection (3) shall:

22 (a) No later than 90 days after the Final Determination Date, file a completed Federal
23 Adjustments Report, including information as required by the [State Tax Agency rule or
24 instruction], and notify the [State Tax Agency] that it is making the election under this
25 Subsection (3);

26 (b) No later than 180 days after the Final Determination Date, pay an amount, deter-
27 mined as follows, in lieu of taxes owed by its Direct and Indirect Partners:

28 (i) Exclude from Final Federal Adjustments the distributive share of these adjust-
29 ments reported to a Direct Exempt Partner not subject to tax under [reference state
30 law taxing certain income to tax-exempt entities].

31 (ii) For the total distributive shares of the remaining Final Federal Adjustments
32 reported to Direct Corporate Partners subject to tax under [reference to State law] and
33 to Direct Exempt Partners subject to tax under [reference state law taxing certain in-

⁴ DRAFTER’S NOTE: If the state adopts a de minimis rule as further set out in this model, then this section would need to be conditioned on a reference to that rule.

1 come to tax-exempt entities], apportion and allocate such adjustments as provided un-
2 der [reference to existing multi-state business activity allocation/apportion law or reg-
3 ulation] and multiply the resulting amount by the highest tax rate under [reference to
4 State law(s)];

5 (iii) For the total distributive shares of the remaining Final Federal Adjustments
6 reported to Non-Resident Direct Partners subject to tax under [reference to State law
7 applying to individuals and /or trusts], determine the amount of such adjustments
8 which is [State]-source income under [reference to existing non-resident partner
9 sourcing law or regulation], and multiply the resulting amount by the highest tax rate
10 under [reference to State law applying to individuals and/or trusts];

11 (iv) For the total distributive shares of the remaining Final Federal Adjustments
12 reported to Tiered Partners:

13 (A) Determine the amount of such adjustments which is of a type that it would
14 be subject to sourcing to the [State] under [reference to existing State rules for al-
15 locating/apportioning income of non-resident partners]; and then determine the
16 portion of this amount that would be sourced to the state applying [these rules];

17 (B) Determine the amount of such adjustments which is of a type that it would
18 not be subject to sourcing to the [State] by a Nonresident Partner under [reference
19 to existing State rules for income fully sourced based on a taxpayer's residency];

20 (C) Determine the portion of the amount determined in Section C(3)(b)(iv)(B)
21 that can be established, under regulation issued by [State Agency], to be properly
22 allocable to Nonresident Indirect Partners or other Partners not subject to tax on
23 the adjustments; or that can be excluded under procedures for Modified Reporting
24 and Payment Method allowed under Paragraph (5).

25 (v) Multiply the total of the amounts determined in Section C(3)(b)(iv)(A) and (B)
26 reduced by the amount determined in Section C(3)(b)(iv)(C) by the highest tax rate
27 under [reference to State law applying to individuals and/or trusts];

28 (vi) For the total distributive shares of the remaining Final Federal Adjustments
29 reported to Resident Direct Partners subject to tax under [reference to State law apply-
30 ing to individuals and /or trusts], multiply that amount by the highest tax rate under
31 [reference to State law applying to individuals and/or trusts];

32 (vii) Add the amounts determined in Section C(3)(b)(ii), (iii), (v), and (vi), along
33 with penalty and interest as provided in [reference to State law].

34 (c) Final Federal Adjustments subject to this election exclude:

35 DRAFTER'S NOTE: THE EXCLUSION IN (i) IS INTENDED TO ADDRESS THE PARTICU-
36 LAR STATE'S LAW WITH RESPECT TO ADJUSTMENTS THAT WOULD FLOW THROUGH

1 TO CORPORATE PARTNERS AND MIGHT BE TREATED AS PART OF THE UNITARY
2 BUSINESS OF THE CORPORATION.

3 (i) The distributive share of Final Audit Adjustments that under [reference to State
4 law] must be included in the unitary business income of any Direct or Indirect Corpo-
5 rate Partner, provided that the Audited Partnership can reasonably determine this; and

6 (ii) Any Final Federal Adjustments resulting from an Administrative Adjustment
7 Request.

8 (d) {OPTIONAL PROVISIONS}

9 Option A - An Audited Partnership not otherwise subject to any reporting or payment
10 obligation to [State] that makes an election under this Subsection (3) consents to be
11 subject to [State] laws related to reporting, assessment, payment, and collection of
12 [State] tax calculated under the election.

13 Option B - An Audited Partnership not otherwise subject to any reporting or payment
14 obligation to [State] may not make an election under this Subsection (3).

15 (4) **Tiered Partners.** The Direct and Indirect Partners of an Audited Partnership that are
16 Tiered Partners, and all of the Partners of those Tiered Partners that are subject to tax under
17 [reference to State laws imposing tax on individuals, trusts, corporations, etc.] are subject to the
18 reporting and payment requirements of Section C(2) and the Tiered Partners are entitled to
19 make the elections provided in Section C(3) and (5). The Tiered Partners or their Partners shall
20 make required reports and payments no later than 90 days after the time for filing and
21 furnishing statements to Tiered Partners and their Partners as established under IRC section
22 6226 and the regulations thereunder. The [State Agency] may promulgate regulations to
23 establish procedures and interim time periods for the reports and payments required by Tiered
24 Partners and their Partners and for making the elections under this Section C.

25 (5) **Modified Reporting and Payment Method.** Under procedures adopted by and subject
26 to the approval of the [State Agency], an Audited Partnership or Tiered Partner may enter into
27 an agreement with the [State Agency] to utilize an alternative reporting and payment method,
28 including applicable time requirements or any other provision of this Section C, if the Audited
29 Partnership or Tiered Partner demonstrates that the requested method will reasonably provide
30 for the reporting and payment of taxes, penalties, and interest due under the provisions of this
31 Section C. Application for approval of an alternative reporting and payment method must be
32 made by the Audited Partnership or Tiered Partner within the time for election as provided in
33 Section C(3) or (4), as appropriate.

34 (6) **Effect of Election by Audited Partnership or Tiered Partner and Payment of**
35 **Amount Due.**

36 (a) The election made pursuant to Section C(3) or (5) is irrevocable, unless [State

1 Agency], in its discretion, determines otherwise.

2 (b) If properly reported and paid by the Audited Partnership or Tiered Partner, the
3 amount determined in Section C(3)(b), or similarly under an optional election under Section
4 C(5), will be treated as paid in lieu of taxes owed by its Direct and Indirect Partners, to the
5 extent applicable, on the same Final Federal Adjustments. The Direct Partners or Indirect
6 Partners may not take any deduction or credit for this amount or claim a refund of the
7 amount in this State. Nothing in this Subsection(C)(6) shall preclude a Direct Resident
8 Partner from claiming a credit against taxes paid to this State pursuant to [reference to
9 State law], any amounts paid by the Audited Partnership or Tiered Partner on the Resident
10 Partner's behalf to another state or local tax jurisdiction in accordance with the provisions
11 of [State law or regulation allowing credit for taxes paid to another state or locality].

12 (7) **Failure of Audited Partnership or Tiered Partner to Report or Pay.** Nothing in this
13 Section C prevents the [State Agency] from assessing Direct Partners or Indirect Partners for
14 taxes they owe, using the best information available, in the event that a Partnership or Tiered
15 Partner fails to timely make any report or payment required by this Section C for any reason.

16 **SECTION D. De Minimis Exception**

17 The [State Agency] at its discretion may promulgate regulations to establish a de minimis
18 amount upon which a taxpayer shall not be required to comply with Sections B and C of this
19 [Chapter].

20 **SECTION E. Assessments of Additional [State] Tax, Interest, and Penalties Arising from**
21 **Adjustments to Federal Taxable Income – Statute of Limitations**

22 The [State Agency] will assess additional tax, interest, and penalties arising from Final Federal
23 Adjustments arising from an audit by the IRS, including a Partnership Level Audit, or reported by
24 the Taxpayer on an amended federal income tax return or as part of an Administrative
25 Adjustment Request by the following dates:

26 (1) **Timely Reported Federal Adjustments.** If a Taxpayer files with the [State Agency] a
27 Federal Adjustments Report or an amended [State] tax return as required within the period
28 specified in Sections B or C, the [State Agency] may assess any amounts, including in-lieu-of
29 amounts, taxes, interest, and penalties arising from those Federal Adjustments if [State Agency]
30 issues a notice of the assessment to the Taxpayer no later than:

31 (a) The expiration of the limitations period specified in [citation to State statute setting
32 forth normal limitations period]; or

33 (b) The expiration of the one (1) year period following the date of filing with the [State
34 Agency] of the Federal Adjustments Report.

35 (2) **Untimely Reported Federal Adjustments.** If the Taxpayer fails to file the Federal
36 Adjustments Report within the period specified in Sections B or C, as appropriate, or the Federal

1 Adjustments Report filed by the Taxpayer omits Final Federal Adjustments or understates the
2 correct amount of tax owed, the [State Agency] may assess amounts or additional amounts
3 including in-lieu-of amounts, taxes, interest, and penalties arising from the Final Federal
4 Adjustments, if it mails a notice of the assessment to the Taxpayer by a date which is the latest of
5 the following:

6 (a) The expiration of the limitations period specified in [citation to State statute setting
7 forth normal limitations period]; or

8 (b) The expiration of the one (1) year period following the date the Federal Adjust-
9 ments Report was filed with [State Agency]; or

10 (c) Absent fraud, the expiration of the six (6) year period following the Final Determi-
11 nation Date.

12 **SECTION F. Estimated [State] Tax Payments During the Course of a Federal Audit**

13 A Taxpayer may make estimated payments to the [State Agency], following the process
14 prescribed by the [State Agency], of the [State] tax expected to result from a pending IRS audit,
15 prior to the due date of the Federal Adjustments Report, without having to file the report with
16 the [State Agency]. The estimated tax payments shall be credited against any tax liability
17 ultimately found to be due to [State] (“Final [State] Tax Liability”) and will limit the accrual of
18 further statutory interest on that amount. If the estimated tax payments exceed the final tax
19 liability and statutory interest ultimately determined to be due, the Taxpayer is entitled to a
20 refund or credit for the excess, provided the Taxpayer files a Federal Adjustments Report or
21 claim for refund or credit of tax pursuant to [citation to State statute setting forth claim for
22 refund requirements] no later than one year following the Final Determination Date.

23 **SECTION G. Claims for Refund or Credits of Tax Arising from Final Federal Adjustments**
24 **Made by the IRS**

25 Except for Final Federal Adjustments required to be reported for federal purposes under IRC
26 section 6225(a)(2), a Taxpayer may file a claim for refund or credit of tax arising from Federal
27 Adjustments made by the IRS on or before the later of:

28 (1) The expiration of the last day for filing a claim for refund or credit of [State] tax pursuant
29 to [citation to State statute setting forth claim for refund requirements], including any
30 extensions; or

31 (2) One year from the date a Federal Adjustments Report prescribed in Sections B or C, as
32 applicable, was due to the [State Agency], including any extensions pursuant to Section G.

33 The Federal Adjustments Report shall serve as the means for the Taxpayer to report additional
34 tax due, report a claim for refund or credit of tax, and make other adjustments (including to its
35 net operating losses) resulting from adjustments to the Taxpayer’s federal taxable income.

36 **SECTION H. Scope of Adjustments and Extensions of Time.**

1 (1) Unless otherwise agreed in writing by the Taxpayer and the [State Agency], any adjust-
2 ments by the [State Agency] or by the Taxpayer made after the expiration of the [State's normal
3 statute of limitations for assessment and refund] is limited to changes to the Taxpayer's tax
4 liability arising from Federal Adjustments.

5 (2) The time periods provided for in [this subdivision of the State Code] may be extended:

6 (a) Automatically, upon written notice to [State agency], by 60 days for an Audited
7 Partnership or Tiered Partner which has [10,000] or more Direct Partners; or

8 (b) By written agreement between the Taxpayer and the [State Agency] [pursuant to
9 any regulation issued under this Section].

10 (3) Any extension granted under this Section G for filing the Federal Adjustments Report
11 extends the last day prescribed by law for assessing any additional tax arising from the
12 adjustments to federal taxable income and the period for filing a claim for refund or credit of
13 taxes pursuant to [citation to State statute setting forth claim for refund requirements].

14 **SECTION I. Effective Date**

15 The amendments to this [section/chapter] applies to any adjustments to a Taxpayer's federal
16 taxable income with a Final Determination Date occurring on and after [date].