NEW FEDERAL PARTNERSHIP AUDIT PROCEDURES—ISSUES TO CONSIDER AND WHEN TO ACT[1]

Nikki E. Dobay
Senior Tax Counsel
Council On State Taxation (COST)
1033 SW Yamhill Street, #202
Portland, Oregon 97205
503-956-6146

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EXECUTIVE SUMMARY

In 2015, with the passage of Bipartisan Budget Act of 2015 (H.R. 1314, "BBA"), the federal partnership audit procedures currently in effect were changed significantly. These changes, however, will not take effect until tax years beginning on or after January 1, 2018. Because the BBA changes related to audit procedures, they will not practically take effect until several years after that date. To illustrate, a partnership subject to these rules will not file its 2018 tax year return until 2019; therefore, any such audit of that return would not take place until at least 2020, if not later. In addition to these rules going into effect for several years, the Internal Revenue Service ("IRS") has significant rulemaking authority to determine many of the specific procedures for how these rules will work. At this time, and for the foreseeable future, there remains considerable uncertainty regarding the IRS's rulemaking; thus, we do not expect to see draft regulations until later this year.

Considering the timing of the effective date and the significant uncertainty surrounding these changes, we do not recommend that California attempt to conform to the new BBA partnership audit rules at this time. Rather, as explained in the paper, we urge California to wait until the new procedures have been finalized and fleshed-out at the federal level prior to making legislative changes that may have to be undone later.

With this underlying premise in mind, this paper presents the following information:

- Section I explains the current federal partnership audit procedures and the changes that will take pursuant to the BBA;
- Section II explains California partnership reporting/filing requirements and partnership audit requirements;
- Section III provides an overview of several issues to consider as California contemplates conformity with the new federal partnership audit procedures, including certain recommendations related to conformity of specific provisions of the BBA and U.S. Constitutional provisions that must be considered for purposes of conformity; and
- Section IV asks the State to consider improving its reporting of federal changes procedures as part of this exercise.

DISCUSSION

I. FEDERAL PARTNERSHIP AUDIT PROCEDURES

A. TEFRA Audit Procedures

On November 2, 2015, President Obama signed the Bipartisan Budget Act of 2015 (H.R. 1314, "BBA"). New partnership[2] audit rules were included as part of the BBA. These new partnership audit rules replace the ones established in Internal Revenue Code ("IRC") §§ 6221 through 6234 by the Tax Equity and Fiscal Responsibility Act of 1982, commonly referred to as "TEFRA." The BBA amendments will take effect for tax years beginning after December 31, 2017.[3]

Before the BBA, TEFRA established unified procedures for audits of certain types of partnerships. Pursuant to TEFRA, the tax treatment of partnership items is determined at the partnership level. TEFRA established three categories of partnerships that are subject to these different audit procedures: (1) small partnerships with 10 or fewer partners; (2) partnerships with more than 10 partners following TEFRA rules; and (3) partnerships owned by 100 or more partners that elect to apply the Electing Large Partnership ("ELP") rules. Partnerships with 10 or fewer partners are not subject to TEFRA's audit procedures so long as all partners were individuals. [4]

Small Partnership Audits. For partnerships with 10 or fewer partners, each partner and the partnership were audited separately, and each partner acted independently of the other partners and the partnership. Accordingly, the IRS provided every partner with a separate audit report. Each partner could then separately dispute any tax deficiency through the administrative process for deficiencies that applied to individual income tax disputes. If it so elected, a small partnership could opt to use the TEFRA rules. Without an affirmative election, however, a small partnership and its partners automatically fell outside of TEFRA's rules.

ELP Partnership Audits. As indicated above, partnerships with 100 or more partners could elect to be treated as an ELP.[5] This election requires ELP partners to adjust in the current year the partners' shares of partnership income, gains, losses

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[2] The new BBA partnership audit regime only applies to partnerships (general and limited) and limited liability companies that are taxed as partnerships. The BBA rules do not apply to certain types of pass-through entities, such as S corporations. For purposes of this paper, the term "partnership" only refers to entities covered by the new partnership audit rules under the BBA (unless otherwise provided).

[3] Partnerships can elect into the new BBA regime prior to the effective date of 1/1/18. P.L. 114-74, sec. 1101(g).

[4] Existing IRC § 6231(a)(1)(B).

[5] *See* IRC §§ 771-777.

and deductions to reflect audit changes from prior tax years. Under the ELP regime, a partner does not file an amended tax return for the prior year that was under audit. Additionally, partners of an ELP do not participate in the audit or litigation process and cannot report adjustments on their tax returns that are inconsistent with the partnership return. A partnership's use of these ELP rules was purely elective, and few qualifying partnerships chose to make this election.[6] Thus, until tax years beginning after December 31, 2017, TEFRA rules apply to most partnerships with more than 10 partners.[7]

TEFRA Partnership Audits. A partnership subject to the unified TEFRA audit regime is audited by the Internal Revenue Service ("IRS") using a single investigation of the partnership's tax return, as opposed to individual audits of the partners' tax returns.[8] Taxes, penalties, and interest on adjustments of partnership items are determined at the partnership level.[9] During the audit and any appeal, the partnership designates a party to be the liaison between the IRS and the partnership. This person is referred to as the tax matters partner ("TMP"). Under the TEFRA rules, the TMP may request the notice of adjustment to be issued to the partnership, in which case the partners are not required to file individual amended tax returns.[10] Although the TMP is: (1) the partnership's contact person with the IRS, (2) able to request the notice of adjustment to be issued to the partnership, and (3) able to initiative a suit on behalf of the partnership in Tax Court or a federal district court, the IRS may still elect to issue notices to the partners.[11] Further, partners can individually elect to settle separately with the IRS, regardless whether the partnership or other partners join the settlement. A partner can even file its own suit in Tax Court or a federal district court, if the TMP does not.[12] In all cases, the IRS is required to calculate each partner's share of the overall adjustment and provide each partner with notice of the amount.[13]

[6] Of the current partnership audit rules, the ELP procedures are the most like the new BBA rules, in that a prior-year adjustment is made to/paid in a later year. The fact that very few partnerships elected into the ELP rules is illustrative of the challenges that partnerships are likely to face under the new BBA rules.
[7] Jeffrey J. Bryant, *A New Law Changes the Way the IRS Will Handle Partnership Audits*, 33 J. Tax'n Inv. 45, 46 (2016).
[8] Existing Treas. Reg. § 301.6221-1.
[9] IRC § 6227.
[10] *Id.*
[11] *Id.*
[12] IRC § 6226.
[13] As part of the IRS's closing agreement, the IRS is required to include an amended Form 1065 showing the partnership changes as well as amended Schedule K-1s to show individual partner changes. *See* IRS Audit Manual, Partnership – Audit Technique Guide – Chapter 13 – TEFRA (Oct. 2007), https://www.irs.gov/businesses/partnerships/partnership-audit-technique-guide-chapter-13-tefra-revised-10-2007.

B. **BBA Changes to the Federal Partnership Audit Procedures**

BBA Sections 1101(a) and (b) repeal the TEFRA partnership audit and the ELP rules, effective for tax returns filed for partnership taxable years beginning after December 31, 2017. Pursuant to the new rules, all partners are bound by a final resolution in the partnership audit. In general, the new default BBA audit procedures do not give a partnership's owners any direct right to participate in, or be notified of, an IRS audit of the partnership. Additionally, penalties are determined at the partnership level, and there are no partner-level defenses to the assertion of those penalties. Rather than having a "tax matters partner," as currently provided for under TEFRA,[14] each partnership must designate a "partnership representative" ("PR"). The PR must be a "person"[15] with a substantial U.S. presence. The PR, however, is not required to be a partner in the partnership. Unlike TEFRA, the BBA allows a non-partner manager to serve as the PR.[16]

If all the partners qualify, any partnership that has 100 or less partners can opt out of the BBA audit rules.[17] To qualify for this opt-out provision, however, all partners must be either individuals, C corporations, foreign entities that are treated as C corporations, S corporations or estates of deceased partners.[18] Thus, partnerships with partners that are single member limited liability companies ("LLC") or partnerships (including LLCs treated as a partnership) will not be able to opt out of the BBA's audit provisions. A qualifying partnership that wishes to elect out of the BBA's audit procedures must do so annually on a timely filed return.

Under the new law, partnerships and partners have a continued duty of consistency in reporting. All partnership items of income, gain, loss and deduction must be reported on a partner's return consistent with the treatment of those items on the partnership return.[19]

The new BBA audit procedures differ greatly from TEFRA in that they allow the IRS to directly assess and collect additional tax, interest, and penalties from the partnership itself, unless the partnership has elected otherwise.[20] In other

[14] Bryant, *A New Law Changes the Way the IRS Will Handle Partnership Audits*, 33 J. Tax'n Inv. at 46.
[15] IRC § 6223(a).
[16] This will be helpful to LLCs with non-member managers.
[17] IRC § 6221(b).
[18] IRC § 6221(b)(1)(C).
[19] IRC § 6222(a).
[20] IRC § 6225(a).

words, the IRS will examine all items of partnership income, gain, loss, deduction and credit at the partnership level. The overall adjustments to the partners' distributive shares are used to calculate an imputed underpayment that the partnership itself owes. Regardless of the extent to which the imputed underpayment consists of additional tax, penalties, or interest, no part of the imputed underpayment amount is deductible by the partnership.[21] The partnership will only be able to pass the tax liability to its partners if it makes a special election (discussed below).

During an audit under the new rules, the imputed underpayment of tax is determined by netting all audit adjustments to items of partnership income, gain, loss or deduction and then multiplying that net amount by the highest tax rate in effect for either individuals or corporations in the year to which the adjusted items relate. Usually, positive and negative audit adjustments are netted to derive the imputed underpayment. This imputed underpayment may be reduced based on certain partner-level information.

The BBA also incorporates new terminology that is somewhat confusing. It is important to note that the tax year subject to audit is referred to as the "reviewed year." In contrast, the year in which the notice of final partnership adjustment is mailed by the IRS to the PR is referred to as the "adjustment year." Under the general rules, the partnership will pay any imputed underpayment in the adjustment year, unless it timely appeals.

Although the new rules generally instruct the IRS to directly audit and assess the partnership, the PR is provided with some flexibility to report and pay the partnership's imputed underpayment. For instance, as explained in more detail below, a PR may elect (1) to "push-out"[22] the imputed underpayment or (2) to have the partners "pay-up"[23] their portion of the tax assessed to the partnership.

Under the "push-out" election, those who were partners during the reviewed year may pay their portion of the partnership's assessment on their adjustment year tax return.[24] It is important to note that for purposes of this election, each partner who was a partner during the reviewed year(s) must participate. With this election, each reviewed-year partner must calculate the tax due from the reviewed year and

[21] IRC § 6225(a).
[22] IRC § 6226.
[23] IRC § 6225.
[24] IRC § 6226, as clarified by the proposals contained in the Tax Technical Corrections Act of 2016, H.R. 6439, S-3506.

add that to their tax due on their return filed for the adjustment year.[25] With this election, the partnership is relieved of the liability and the partners are not required to amend their prior year returns (*i.e.*, reviewed year returns).[26]

In addition to the push-out election, a partnership may also elect to notify the reviewed-year partners of their duty to file amended reviewed-year returns and pay their share of tax with that amended return.[27] Under this "pay-up" election procedure, not all the reviewed year partners are required to file amended returns. Thus, the partnership is relieved only of the liability of those partners who elect to and actually file amended returns and pay their share of the assessment.[28] The IRS may also allow for a reduction of the imputed underpayment for partners who are tax-exempt or where the partnership can show that a partner's highest tax rate is lower than the general rate imposed upon the partnership pursuant to the general rules.[29] Unlike the push-out election, this pay-up option is not practical if the reviewed-year partners (and/or percentage of ownership) are not the same as the adjustment-year partners.

The IRS has been given broad rule-making authority with respect to enforcing both the push-out and pay-up election provisions and is required to create forms and instructions to enable the PR to make these elections. To date, the IRS has only published regulations which provide instruction to partnerships that wish to opt into these rules early (*i.e.*, prior to the effective date of 1/1/2018).[30]

II. CALIFORNIA LAW

A. Summary of California Partnership Filing, Withholding and Composite Return Rules

In California, like most states, each partnership is required to file an annual informational return.[31] The partnership's informational returns indicate the income or loss earned by the partnership as well as the partners who would be entitled to share in the net income or loss, including the amount of the distributive share received by each partner.[32] The partners in the partnership ultimately report their

[25] IRC § 6226(b)(1).
[26] IRC § 6226(a)(2).
[27] IRC § 6226.
[28] IRC § 6225(c)(2).
[29] IRC § 6225(c)(3) and (4).
[30] P.L. 114-74, sec. 1101(g).
[31] Cal. Rev. & Tax. Cd. §§ 18633 and 18633.5.
[32] Cal. Rev. & Tax. Cd. § 18633.

distributive share of partnership income and pay the California income tax on their respective income.[33]

Although a partnership does not pay California income tax, a partnership may be required to make withholding payments on behalf of its nonresident partners or the partnership may elect to pay the tax on behalf of its nonresident individual partners.[34] California imposes a withholding tax obligation on payments and distributions made to nonresidents partners on California source income.[35] Tax withheld on California source income is reported to the Franchise Tax Board ("FTB") using Form 592.[36] The items of income that are subject to withholding include distributions to domestic as well as foreign nonresident partners in a partnership.[37] The amount of nonresident withholding tax to be withheld is computed by applying a rate of seven percent or such lesser amount as authorized by the FTB. Partnerships are not required to withhold when: (1) the partner is an individual California resident or a business entity with a permanent place of business in the state,[38] (2) the payments are less than $1,500, or (3) the distributions are derived from certain intangible personal property, such as interest or dividends, that is not sitused to California. Income subject to withholding requirements includes income derived from personal services, rents and royalties from assets located in California, and distributions of California source income.[39] The tax withheld follows the income and flow through to the partners, and partnerships are not entitled to receive refunds of withholding credits.[40]

B. Partnership Audit Procedure and Requirement to Report Federal Changes

[33] We recognize that California imposes an entity-level tax on LLCs (including those taxed as partnerships) and limited partnerships. Those entity-level taxes, however, are beyond the purview of this paper and our recommendations.

[34] A partnership may elect to file a group nonresident return on behalf of its individual nonresident partners or members. The partnership electing to file a group return, also known as a composite return, is required to use California Group Form 540NR, and the partnership pays tax at a rate of 12.3 percent (13.3 percent if an individual owner's California total taxable income from all sources exceeds $1 million). *See* FTB Publication 1067 (2015), https://www.ftb.ca.gov/forms/2015/15_1067.pdf.

[35] Cal. Rev. & Tax. Cd. § 18662.

[36] If the entity is exempt from the withholding requirement, it should complete Form 590 and submit it to the withholding agent before payment is made. The withholding agent is then relieved of the withholding requirements unless otherwise notified by the FTB.

[37] *See* FTB Form 592.

[38] Corporations registered with the California Secretary of State are also exempt from withholding. FTB Pub. 1017 (Rev. 12-2015).

[39] FTB Pub. 1017 (Rev. 12-2015).

[40] California's robust partnership withholding regime could potentially be used to address the collection issue under the new partnership audit procedures.

Turning to California's audit procedures for partnerships, California tax law differs from TEFRA in that adjustments are not made at the partnership level and then assessed to the partners individually.[41] Rather, when there is a change at the federal level such as those resulting from an IRS audit, California law requires the individual California partners to report the federal change to the FTB.[42] Each partner must file an amended California return. The correction must be mailed to the FTB within six months (or 180 days) after the federal determination becomes final.[43] In the case of a TEFRA audit at the federal level, the final determination for purposes of California's statute of limitations is the date that individual partners are assessed by the IRS.[44]

For purposes of California's general statute of limitations, if the taxpayer reports a federal change within six months of the final federal determination, then the FTB has two years to issue a notice of deficiency assessing additional tax.[45] If a taxpayer fails to report a federal change within six months of the final federal determination, then the FTB has four years to issue a notice of deficiency assessing additional tax.[46] The FTB's assessment is generally not limited to the federal changes because any federal waiver, plus six months, extends California's general statute of limitations for the FTB to issue an assessment. However, if a taxpayer's return under California's statute of limitations is not open, then the FTB's assessment is limited to changes that relate to the federal adjustment.[47]

III. STATE TAX IMPLICATIONS OF NEW FEDERAL PARTNERSHIP AUDIT PROCEDURES

A. Current Legislative Action is Premature

We do not recommend that California attempt to conform to the new BBA partnership audit rules at this time.[48] Although there is considerable ambiguity

[41] FTB Chief Counsel Ruling 2002-0731.
[42] Cal. Rev. & Tax. Cd. § 18622.
[43] Cal Rev. & Tax. Cd. § 18622.
[44] Chief Counsel Ruling 2002-0731.
[45] Cal. Rev. & Tax. Cd. § 19059.
[46] Cal. Rev. & Tax. Cd. § 19060.
[47] 18 CCR § 19059. The California statute of limitations is also extended by the period covered under any federal waiver, plus six months. Cal. Rev. & Tax. Cd. § 19065. Further, the FTB has apparently taken the position that a federal waiver, whether or not limited to specific federal issues, keeps the California statute of limitations open for all assessment as to all issues. Thus, in situations where a taxpayer is required to report a federal change and there is a federal waiver in place, the FTB will take the position that the taxpayer's California statute of limitations is open for all issues.
[48] Any California conformity legislation (including any subsequent "clean up" legislation) would likely require a two-thirds vote pursuant to California Proposition 26.

regarding California's ability to impose a state-level assessment of tax following a federal partnership audit under the new BBA rules (discussed below), the BBA rules are not effective until tax years beginning after December 31, 2017.[49] Further, during a meeting with the IRS Commissioner and his staff on November 14, the IRS appeared to be struggling with the drafting of regulations; thus, it is not expected that they will issue additional regulations until sometime in mid-2017, and that may be dependent on the likely passage of legislation in the 115th Congress addressing issues raised by the Tax Technical Corrections Act of 2016, H.R. 6439, S. 3506.[50]

Considering these numerous uncertainties, we urge California to wait until the new procedures have been finalized and fleshed-out at the federal level prior to making legislative changes that may have to be undone later. While this issue is of the utmost importance for the State to analyze, the time to act is premature. In addition, the Multistate Tax Commission ("MTC") and the State Tax and Local Tax Committee of the American Bar Association are in the process of studying these issues, and both organizations are likely put forth recommendations. As a result, the MTC may create a uniform model act for the states to consider. COST, Tax Executives Institute ("TEI"), American Institute of Certified Public Accountants ("AICPA") and other state tax practitioners are working with the MTC on this project. We do not anticipate this project will be completed until late 2017 or early 2018.

Below, however, are some suggested issue for California to consider as it determines whether to conform to the new BBA audit process, assuming it remains in place as currently written.

B. Issues to Examine When Considering Conformity

1. *Taxation of a Partnership*

Absent making a push-out or pay up election, a partnership will remain responsible for the imputed underpayment at the federal level. Currently, California treats partnerships as taxpayers for some purposes.[51] California, however, does not automatically conform to changes to the IRC. Thus, California

[49] P.L. 114-74, sec. 1101(g).
[50] Jennifer McLoughlin, *New Federal Tax on Partnership Audits: A Primer*, BNA Daily Tax Reporter, 236 DTR H-1 (Dec. 7, 2016); Andrew Velarde, *New Bill May Require Reproposal of Partnership Regs*, Tax Notes (Dec. 9, 2016).
[51] Cal. Rev. & Tax. Cd. § 17004.

must enact specific conformity legislation to directly tax an imputed underpayment as determined at the federal level under the new BBA audit process.

2. *Push-out/Pay up Elections*

California must also determine whether it wishes to conform to the push-out and pay-up elections set forth under the new federal rules if a decision is made to conform to the new general procedures. With respect to these elections, California should consider conformity with these and any model legislation suggested by the MTC to simplify compliance at both the state and federal level. Specifically, it is recommended that the State automatically adopt the PR's ability at the federal level to have the option to use a push-out or a pay-up election. However, the PR should be able to make a separate election at the state level that differs from its federal election so long as the partnership remains liable for the deficiency.

Providing partnerships with the ability to make a separate state election would be mutually beneficial to California as well as to the partnerships and their owners. To illustrate, for federal purposes, a partnership may determine that making a push-out or pay-up election makes economic sense, such as where one or more partners are tax-exempt or taxed at a lower rate (in the case of the push-out election) or the partners have determined that filing amended returns is worth the increased administrative burden (in the case of the pay-up election). While one of the elections may make sense at the federal level, a partnership may decide that for state purposes it is more efficient to simply have the partnership pay any additional tax at the state level.

Allowing a state-level election relieves the administrative burden of having the partnership calculate the liability of each reviewed year partner and asking each of them to include a relatively nominal adjustment in their income (in the case of a push-out election). With respect to the pay-up election, allowing a partnership to pay would indeed be much simpler than requiring the many reviewed year partners to file multiple amended state returns (assuming the partnership files in multiple states).

In addition to the significant compliance burden imposed on the partners discussed above, the state would also face a significant administrative burden itself. If a state requires the partnership to honor its federal election for state purposes, the state would have to process and review the additional tax report on the reviewed year partners' adjustment year returns (in the case of a push-out election) or process and review numerous amended returns (in the case of a pay-up

election). In both situations, it would be in the state's best interest to simply hold the partnership, as opposed to multiple partners, responsible for the payment of the tax.

3. *Partnership Representative*

The states should also consider whether it makes sense to allow a partnership to name a separate state PR. Pursuant to the federal provisions, the partnership is required to name a PR to manage the audit and liaison with the IRS. We would encourage the State to accept the designation of the federally designated PR. To provide flexibility and administrative ease, however, we encourage California to also allow a partnership to make a separate state-PR designation. This seems particularly important for a state like California, in which the substantive state tax provisions can differ substantially from the federal tax provisions. Although the federally designated PR may be an expert at federal partnership law and procedure, that person may not have any expertise with California's tax law. Thus, it would behoove the State as well as the partnership to allow a partnership to designate someone with California experience/expertise to act as the PR in certain situations.

C. State Constitutional Limitations

1. *Overview of Due Process Clause and the Commerce Clause Protections*

The U.S. Constitution places limits on the states' taxation of income derived from multistate businesses. Of direct concern with the states' taxation of income derived from partnerships are the Due Process and the Commerce Clauses of the United States Constitution. "The Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,' and that the 'income attributed to the State for tax purposes must be rationally related to the 'values connected with the taxing state.'"[52]

The Commerce Clause prevents state laws from impeding interstate commerce, which is left to the purview of the federal government.[53] It ensures that states do not enact laws that might unduly burden or inhibit the flow of commerce between states. To determine whether a law violates the Commerce Clause, the

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[52] *Quill Corp. v. North Dakota* 504 U.S. 298 (1992), *citing Miller Bros. Co. v. Maryland,* 347 U.S. 340, 344-45 (1954) and *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).
[53] U.S. Const. Art. I, §8, cl.3.

U.S. Supreme Court in *Complete Auto*[54] developed a four-prong test. The four-prong test requires: (1) substantial nexus, *i.e.,* there a connection between the state and the income a partner receives for the state to impose a tax on that partner; (2) no unfound discrimination, *i.e.*, the state treats interstate and intrastate companies consistently and fairly; (3) fair apportionment, *i.e.*, the activity that transpires within the taxing jurisdiction is taxed proportionately; and (4) there is a fair relationship to services provided by the state, *i.e.*, the taxpayer receive benefits from the state. [55]

2. *Nexus Considerations*

When considering the effects of the federal partnership audit changes on a state's ability to impose a net income-based tax, the constraints of the Due Process and Commerce Clauses must be considered. Because these limitations do not exist at the federal level, the states are required to engage in an additional level of analysis not required for taxes imposed at the federal level.

Partnerships have not historically been directly subject to tax at the state level; thus, the threshold issue is whether a partner in a partnership is subject to a state's income tax. To make this determination, the partner and the income the partner receives from the partnership must have sufficient minimum contacts pursuant to the Due Process Clause and substantial nexus pursuant to the Commerce Clause. Determining what connections are needed, however, can be a challenging issue. For example, while most states, including California, do not impose an income tax[56] directly on a partnership as a legal entity, most do require the partnership to withhold and remit estimated payments otherwise due from partners that are not residents of the state. In turn, the partners are required to file tax returns with the state (some have an option to file a composite income tax return) and, as applicable, pay an income tax. States have struggled with whether the nonresident partners are directly subject to their states' income tax.

As discussed above, the nebulous relationship of nexus as it relates to nonresident partners is the driver for states imposing withholding and/or composite filing requirements. California's position is that nonresident partners are subject to California's income tax on the income they received from their ownership in a partnership doing business in California. On the individual income tax side,

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[54] *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977).
[55] *Id.* at 279.
[56] Again, we recognize that California does impose an entity-level tax upon LLCs and limited partnerships; however, we are limiting our analysis to California's income tax.

California taxes all the income earned from partners who are residents of the State, while providing credit for tax paid to other states.[57] As California considers whether to conform to the federal partnership audit changes, it should consider how constitutional protections may limit its ability to impose tax on nonresident partners following an IRS assessment of an imputed underpayment pursuant to the BBA rules.

Adding to this complexity, a resident partner during the reviewed year may move and have become a nonresident partner during the adjustment year (or vice-a-versa). As discussed above, pursuant to the new federal partnership audit procedures, generally the IRS will determine a partnership's imputed underpayment for a prior year (*i.e.*, reviewed year) but the partnership will pay that assessment in the year that the assessment is issued (*i.e.*, adjustment year). For purposes of the federal adjustment, the partnership itself may need to have certain provisions regarding how it will handle changes with respect to partners during the reviewed and adjustment year. These issues, however, are exacerbated at the state level because changes in partners between a reviewed year and the adjustment year will likely trigger constitutional nexus issues.

Although it is likely that California can create rules to allow it to conform to these federal changes without impinging on the constitutional protections of taxpayers, until there is a clear understanding of how the federal rules will work and exactly what those rules will be, we would encourage the State to delay acting legislatively on this issue until the dust has settled.

3. *Apportionment Considerations*

In addition to the nexus considerations summarized above, states must also ensure that any imputed underpayment is properly apportioned to the state (per the fair-apportionment prong of the *Complete Auto* test). For multijurisdictional businesses, this generally requires that any imputed underpayment be multiplied by the apportionment factor used by California to determine a multijurisdictional partnership's income earned (or loss derived) in California.[58] For individuals, typically the resident state taxes all an individual's income and provides a credit

[57] *See* Cal. Rev. & Tax. Cd. § 18006. The U.S. Supreme Court recently held states imposing this type of taxing scheme to satisfy the internal consistency test of the fair apportionment prong were required to provide such a credit for income taxes its residents are required to pay to other states. *See Comptroller of the Treasury of Maryland v. Wynne*, 135 S.Ct. 1787 (2015). This issue would need to be taken into consideration if states allow payments of tax to be made by partnerships. In that situation, a payments of tax made by a partnership should be considered a tax paid to another state with respect to individual partners to determine his or her credit for taxes paid to another state.
[58] Cal. Rev. & Tax. Cd. § 25128.7.

for income tax properly paid to another state.[59] For C Corporations, California requires the corporate partner to include the apportionment information of the partnership if it is unitary.[60]

As described above, under the new federal partnership audit procedures a partnership will generally be assessed tax based on the prior "reviewed year" in a later or "adjustment" year. At the federal level, there may be some Due Process Clause concerns; however, there are no Commerce Clause limitations on Congress' ability to impose a tax owed in a prior year on the partnership in a subsequent year. Assuming California eventually conforms to the BBA regime, which would allow a partnership to pay a California assessment as opposed to the partners being required to file amended returns, the imputed underpayment of a multijurisdictional business must also be fairly apportioned.[61]

Pursuant to *Complete Auto*, a taxpayer's activity within a taxing jurisdiction must have some relationship to the amount of the tax paid. Thus, when considering how to apportion a federal adjustment under the new federal partnership procedures, the apportionment information (or factor) applicable to the reviewed year should be used.[62] Use of apportionment information from the adjustment year would likely lack a sufficient relationship to the partnership's activity within the state for purposes of the adjustment. And, while California may require the taxpayer (either the partnership or the partner/member) to make a payment of tax in an adjustment year in accordance with the federal changes, for multijurisdictional non-individual partners, it should nonetheless be required to apportion that adjustment, pursuant to the Constitutional limitations. Thus, for apportionment purposes, the reviewed year apportionment factor and not the apportionment factor for the adjustment year should be used.

Accordingly, if California does ultimately determine to conform to the new federal partnership changes, we would encourage the State to specify that any adjustment is subject to apportionment using the partnership's apportionment factor for the reviewed year and not the adjustment year. We would, however,

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[59] For the states using this type of tax regime, the states are required to provide such credit for the tax to be fairly apportioned. *See Comptroller of the Treasury of Maryland v. Wynne*, 135 S.Ct. 1787 (2015).
[60] Cal. Cd. Reg. 18 § 25137-1.
[61] Even if the push-out or pay-up elections are allowed for California purposes and elected by the partnership, a multijurisdictional partnership's income would still be required to be fairly apportioned prior to each partners' distributive share of California source income being determined. Thus, this analysis is applicable regardless of whether the partnership or partners pay the California tax.
[62] *See Tenneco West v. FTB*, 234 Cal. App. 3d 1510 (1991) (use of apportionment information from a different year than the relevant tax year determined to be distortive).

encourage California to consider allowing taxpayers to make an election to either recalculate their reviewed year factor or use the factor as provided on their originally filed return.

Lastly, not all income earned by a multijurisdictional partnership is apportionable income to all the states where the partnership conducts its business. The income a state seeks to tax on an apportioned basis must be derived from a unitary business operated within and outside the taxing state.[63] If the income derived from a partnership is not unitary with the state, the state does not constitutionally have a right to tax that income.[64] The same also applies to a partner that derives income from the sale of a partnership interest which it does not have a unitary relationship. The Ohio Supreme Court recently addressed a nonresident partner's sale of his ownership interest; the gain was held not to be unitary with the partnership's business so as to subject the nonresident partner's gain to Ohio's income tax.[65]

IV. CALIFORNIA SHOULD CONSIDER IMPROVING ITS REPORTING OF FEDERAL AUDIT CHANGES

As California considers whether to conform to the new partnership audit procedures, it will be required to analyze multiple provisions of the California tax code. As part of that process, we would encourage the State to take this opportunity to also review and consider whether to make certain other changes to its statutes that set forth the reporting procedures that taxpayers are required to comply with following a federal audit (hereinafter referred to as "federal audit reporting provisions"). In addition, COST, TEI, AICPA and other state tax practitioners are working on a model federal audit reporting statute that they will be presenting to the MTC for its consideration. As with the federal partnership audit changes, although it may be premature for California to take any specific action at this time, we would recommend that California start to analyze these issues and determine whether it should consider being part of the broader conformity conversation that is currently underway.

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[63] *See MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 553 U.S. 16 (2008); *Allied-Signal, Inc. v. Div. of Taxation*, 504 U.S. 768 (1992); *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 169 (1983); and *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980).

[64] *See also* 18 CCR § 25137-1 and FTB Publication 1061, which provide rules for determining how to apportion and allocate partnership income. Pursuant to those rules, the specific method for apportioning or allocating such income for corporate partners depends on whether the partnership is unitary with its corporate partner(s). In addition to this "unitary partnership" issue, partnership item adjustments may impact partners differently. For example, income from a partnership may be nonbusiness income to some partners, and business income to other partners and the relevance of the partnership apportionment factors will likely vary by industry (*see e.g.*, 18 CCR § 25128).

[65] *See Corrigan v. Testa*, Case No. 2014-1836 (Ohio 2016).

Essentially, large multistate businesses are often required to file hundreds, if not thousands, of amended returns/reports at the state and local level when a federal tax change is made by the IRS. Compliance with these reporting requirements is best achieved by state and local governments adopting uniform and even-handed rules for reporting federal tax changes that are consistent regardless of whether a refund or deficiency results from the change. Filing interim reports of changes is not an efficient use of resources for either the state or taxpayers (which will now include partnerships and their partners). Key elements of a fair and efficient state reporting procedure for federal tax changes include:[66]

- *Final Determination*: All states that require a taxpayer to report federal tax changes, including any applicable local taxes, should link the filing requirement to a "final determination" made regarding a taxpayer's federal income tax liability. The absence of clear, consistent rules creates compliance problems and wrongfully subject taxpayers to penalties and interest for noncompliance. Moreover, some states require "interim" notification prior to a final determination of federal tax liability or refund – a practice that needlessly creates additional confusion over a taxpayer's compliance responsibilities, *e.g.*, traps for the unwary.

- *Time for Reporting and Auditing*: Taxpayers need adequate time to report federal tax changes to the states. The necessary adjustments relating to federal tax changes, especially when taking into consideration the states' decoupling from certain IRC provisions such as bonus/accelerated depreciation, require sufficient time for analysis and accurate reporting. It is recommended that a state's law provide at least 180 days (or six months) to report IRS adjustments to states. California already provides six months to report those changes. (Cal. Rev. & Tax. Cd. Sec. 18622(a)) States should also be flexible regarding the method of reporting the changes to avoid overly restrictive and inefficient filing requirements. For instance, a federal tax change that does not affect the taxable income reported to the state should have a simplified method to report the close of the federal audit. In addition, the time provided for a state to audit a taxpayer's adjusted liability

[66] These key elements are derived from one of the Council On State Taxation's policy statements, "State Reporting Requirements for Federal Tax Changes," available at: http://www.cost.org/uploadedFiles/About_COST/Policy_Statement/COST%20Federal%20Tax%20Changes%20(RAR)%20POLICY%20%20FINAL%204.%2016.15.pdf. Tax Executives Institute has a similar policy position available at: https://www.tei.org/Documents/2015-11-17-SALT-Policy-Reporting-Federal-Changes-and-Template-FINAL.pdf.

relating to a federal change should not be greater than a taxpayer's right to claim a refund relating to a federal change.

- *Prepayment Process:* Taxpayers should be allowed to submit advance payments relating to partial (agreed upon) federal tax changes without the filing of an amended state return. This would permit taxpayers, if they so choose, to make tax payments to a state after a portion of the known federal issues are agreed to (prior to the final federal determination date). This change would allow taxpayers to reduce interest costs associated with reporting the federal tax change while the rest of the IRS audit process is being completed. Currently, many states have statutes that prohibit (either intentionally or unintentionally) these types of advance payments.[67]

- *State Statutes of Limitation Waived Only for Federal Tax Changes:* When the normal time period for the state to assess additional tax and for a taxpayer to claim a refund has passed, a state should provide that only those items that are the subject of the federal tax change should be open for adjustment (tax due or refund). The statute of limitations should not remain open for any other issues, including items that are related to amended returns or audits in other states.

Upon review of California's federal audit reporting provisions, California appears to generally conform with these recommendations. We would, nevertheless, recommend California review the model federal audit reporting statute attached as Exhibit A when it performs its review and analysis of whether California should conform to the new partnership audit procedures.

The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Taxation Section.

[67] It is our understanding that the FTB currently allows taxpayers to make "tax deposits" similar to the federal procedures. While this practice complies with COST's recommendation "prepayment process," we would recommend the State formalize this procedure by statute or by rule.

Exhibit A

Model Uniform Statute for Reporting Adjustments to Federal Taxable Income

*Draft Submitted to the MTC Uniformity Committee for Initial Consideration at its 12/14/2016 Meeting **

SECTION A. Definitions

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

(1) "Final determination" shall mean and be deemed to occur when the last of any of the following events has occurred with respect to a taxpayer's federal taxable year, except for entities filing unitary or other types of combined or consolidated returns with the [State Agency], "final determination" shall be based upon the occurrence of the last of such events for all members of the group:

(a) The taxpayer: (i) has final adjustments to its federal taxable income resulting from an examination by the IRS pursuant to Section 7601 of the IRC, including any requisite review by the Joint Committee on Taxation pursuant to Section 6405 of the IRC; and (ii) has not filed a petition for redetermination with the United States Tax Court pursuant to Sections 6213 or 6226 of the IRC or a claim for refund with a district court or the United States Court of Federal Claims pursuant to Sections 6226 or 7422 of the IRC, and the time for the taxpayer to timely file such a petition for redetermination or such a claim for refund has lapsed under the applicable statute;

(b) The taxpayer and the IRS have executed the forms necessary for the relevant tax period so as to establish finality under Section 7121(b) the IRC;

(c) The time for the IRS to make an assessment for the relevant tax period has expired pursuant to Section 6501 of the IRC; or

(d) A judgment from a United States court, or any other court of original jurisdiction to which the United States has submitted to personal jurisdiction regarding a taxpayer's tax issues, has become final under Section 2412(d)(2)(G) of Title 28 of the United States Code.

(2) "Report of federal adjustments" shall mean (1) an amended [State] tax return, (2) the Multistate Tax Commission's model report of federal adjustments**, or (3) any other method authorized by the [State Agency]. The report of federal adjustments shall contain information reasonably necessary to provide the [State Agency] with an understanding of the adjustments to the taxpayer's federal taxable income and their impact on the taxpayer's [State] tax liability. The report of federal adjustments shall serve as the taxpayer's means to report additional [State] tax due, report a claim for refund or credit of

[State] tax, and make other adjustments (including net operating losses) as a result of the taxpayer's federal taxable income.

(3) "Taxpayer" shall mean [insert State definition].

(4) "[State] tax" shall mean the [applicable State (or local) tax levied at XXX of the State Code].

(5) "IRC" shall mean the Internal Revenue Code of 1986, as codified at 26 United States Code (U.S.C.) Section 1, *et seq*., [insert state's current practice to incorporate IRC]

(6) "IRS" shall mean the Internal Revenue Service of the U.S. Department of the Treasury.

SECTION B. Reporting of IRS Adjustments to Federal Taxable Income

A taxpayer shall notify the [State Agency] of adjustments by the IRS to its federal taxable income as follows:

(1) Except as provided in subsection (2), a taxpayer whose federal taxable income has been adjusted shall file a report of federal adjustments with the [State Agency] within one hundred eighty (180) days following the date of the final determination.

(2) In the event the adjustments to the taxpayer's federal taxable income result in a [State] tax liability of less than $250 (excluding penalties and interest) or a refund of less than $250 (excluding interest), the taxpayer may, in lieu of filing a report of federal adjustments, notify the [State Agency] in writing or on a form prescribed by the [State Agency] that the federal adjustments are *de minimis*. The taxpayer shall provide the [State Agency] with such notice within one hundred eighty (180) days following the date of the final determination. The taxpayer's notice shall contain information reasonably necessary to provide the [State Agency] with an understanding of the federal changes and their impact on the taxpayer's [State] tax liability.

(a) In the event the taxpayer provides the [State Agency] with notice that the adjustments are *de minimis* pursuant to Section B(2), the [State Agency] may request, in writing, that the taxpayer file a report of federal adjustments pursuant to Section B(1). The [State Agency] shall issue that request to the taxpayer within the later of: (i) one hundred eighty (180) days following the date on which the taxpayer provided such notice, or (ii) the expiration of the limitations period specified in [citation to State statute setting forth normal limitations period].

(b) In the event the [State Agency] requests a report of federal adjustments within the time prescribed in Section B(2)(a), the taxpayer shall have one hundred eighty (180) days from the date the [State Agency's] request is postmarked in which to file a report of federal adjustments.

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(c) [*[Option 1]*] If the [State Agency] does not request that the taxpayer file a report of federal adjustment within the time prescribed in Section B(2)(a), the taxpayer's notice that the adjustments are *de minimis* will be deemed accepted by the [State Agency]. *[Option 2]* If the [State Agency] does not request that the taxpayer file a report of federal adjustments within the time prescribed in Section B(2)(a), the taxpayer's notice that the adjustments are *de minimis* will be deemed accepted and the [State Agency] may assess and bill the taxpayer the fixed sum of $250 if the taxpayer reported that it would have owed the State a *de minimis* [State] tax liability.

(d) Absent fraud, the taxpayer shall not be subject to additional assessment nor allowed to file a claim for refund or credit of [State] taxes pursuant to [citation to State statute setting forth claim for refund requirements] based on adjustments to the taxpayer's federal taxable income unless the statute of limitations for issuing assessments of [State] tax, interest, and penalties has not expired.

SECTION C. Assessments of Additional [State] Tax, Interest, and Penalties Arising from Adjustments to Federal Taxable Income.

The [State Agency] shall be required to issue any assessment of additional [State] tax, interest, and penalties arising directly from IRS adjustments to a taxpayer's federal taxable income as follows:

(1) If the taxpayer files a report of federal adjustments within the period specified in Section B, the [State Agency] may assess any additional [State] tax, interest, and penalties arising directly from the adjustments to the taxpayer's federal taxable income and issue a notice of assessment to the taxpayer within the later of:

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

(b) The expiration of the one (1) year period following the date of filing of the report of federal adjustments.

(2) If the taxpayer fails to file the report of federal adjustments within the period specified in Section B, the [State Agency] may assess any additional [State] tax, interest, and penalties arising directly from the adjustments to federal taxable income and issue a notice of assessment to the taxpayer within the later of:

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

(b) The expiration of the one (1) year period following the date of filing of the report of federal adjustments;

(c) The expiration of the one (1) year period following the date on which the Internal Revenue Service, another state, or an organization representing and/or conducting audits for the states' tax agencies, notifies the [State Agency], in writing or by

electronic means, that a final determination has been made with respect to the taxpayer's federal taxable income for a specified tax year; or

(d) Absent fraud, the expiration of the six (6) year period following the date of the final determination.

SECTION D. Estimated [State] Tax Payments During Federal Audit.

A taxpayer may make estimated payments to the [State Agency] of the [State] tax that it determines may ultimately be owed to [State] as a result of a pending IRS audit, prior to a final determination for a tax year, without filing a report of federal adjustments with the [State Agency]. The estimated [State] tax payments shall be credited against any tax liability ultimately found to be due to [State] ("final tax liability") and limit the accrual of further statutory interest on that amount. If the estimated [State] tax payments exceed the final [State] tax liability and statutory interest ultimately determined to be due on that amount, or the IRS ultimately does not make any adjustments to the taxpayer's federal taxable income, the taxpayer shall be entitled to a refund or credit for the excess, provided the taxpayer files a report of federal adjustments or claim for refund or credit of [State] tax pursuant to [citation to State statute setting forth claim for refund requirements] within one (1) year following the final determination date.

SECTION E. Claims for Refund or Credits of [State] Tax Arising from Federal Adjustments.

A taxpayer may file a claim for refund or credit of [State] tax arising directly from federal adjustments based on the later date of: (1) [citation to State statute setting forth claim for refund requirements], including any extensions; or (2) one (1) year from the due date of report of federal adjustments prescribed in Section B, including any extensions pursuant to Section F.

SECTION F. Scope of Adjustments and Extensions of Time.

(1) Unless otherwise agreed to by the taxpayer and the [State Agency], any adjustments by the [State Agency] or by the taxpayer made after the expiration of the [State's normal statute of limitations for assessment and refund] shall be limited to changes to the taxpayer's [State] tax liability arising directly from adjustments to the taxpayer's federal taxable income for that tax year.

(2) The time periods provided for in [this subdivision of the State Code] may be extended, in writing, by agreement between the taxpayer and the [State Agency]. Any extension granted for filing the report of federal adjustments shall extend the last day prescribed by law for assessing any additional [State] tax arising directly from the adjustments to federal taxable income and the period for filing a claim for refund or credit of [State] taxes pursuant to [citation to State statute setting forth claim for refund requirements] arising directly from adjustments to the taxpayer's federal taxable income.

SECTION G. Effective Date

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The amendments to this [section/chapter] apply to final determinations made on and after X [date].

**Prepared 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, and the AICPA. As of this date, this draft has not been officially endorsed by these organizations.*

***See attached cover letter to the Uniformity Committee explaining the background of this model report.*

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