The 2020 National Multistate Tax Symposium
Mastering the Art (and Articulation) of State Tax—Distilling the Complex

January 29-31, 2020
Point/counterpoint – multistate tax and passthrough entity structures
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Agenda

• Federal Partnership Audit Rules
• State Legislation
• MTC Model Statute
• Other Recent Developments
Federal Partnership Audit Rules
Major Partnership Changes in the Bipartisan Budget Act (BBA) of 2015

- **Key Terms and Shorthand References**
  - *Election In* - early application of the BBA to electing partnerships
  - *Election Out for Small Partnerships* - annual option for qualifying partnerships
  - *Adjustment Year* - the year in which the adjustment is made or becomes final
  - *Reviewed Year* - the partnership tax year under examination
  - *Imputed Underpayment* - net adjustments x highest tax rate
  - *6225 Payment* - the default rule where the partnership pays the imputed underpayment
  - *6226 Payment* - partnership election to push out the imputed underpayment to reviewed-year partners
  - *Partnership Representative* - binds the partnership and the partners
**BBA Audit Timeline**

- **P/S Files Tax Return**
  - **Notice of Administrative Proceeding**
  - **IRS Issues NOPPA**
  - **IRS Issues Notice of FPA**

**Section 6225: No Push-Out Election**
- Push-out election must be made no later than 45 days after date of the notice of FPA. Section 6226(a)(1).
- Within 10 days, each partner is required to pay their share of the adjustments to their tax imposed in the reporting year.

**Section 6226: Push-Out Election***
- Reviewed year partners are required to pay assessment of tax, interest, and penalties upon partners within 10 days.

**Assessment of tax, interest, and penalties upon partners**
- Each partner’s share of the adjustments will affect its tax imposed in the reporting year.

1. **Within 10 days**
   - Partnership required to pay

2. **Section 6226: Push-Out Election***
   - Reviewed year partners required to pay

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*Partnership has 90 days after the date the notice of FPA is mailed to file a petition for readjustment with the Tax Court, the appropriate district court of the United States, or the Court of Federal Claims under section 6234. Otherwise the FPA become final and assessment and collection is due. Section 6232(b).*

**If any amount of the imputed underpayment is not paid within the 10 day period, an overpayment rate of interest shall be applied to the amount due and the Secretary may assess upon each partner a tax equal to the partner’s proportionate share of the remaining amount due, including any other interest or penalties determined. See section 6232(f).**

***Partnership must furnish statements to its reviewed year partners within 60 days after the date the FPA becomes final. Prop. Treas. Reg. § 301.6226–2(b). Each reviewed year partner’s tax imposed for the reporting year will be adjusted under section 6226(b)(2) to take into account its share of the adjustments to partnership-related items for the reviewed year and tax attributes from intervening years.*
Overview of the BBA Regime

• The Centralized Partnership Audit Regime (the “BBA Regime”) repealed TEFRA effective for tax years beginning after 12/31/2017

• Under the BBA Regime, the IRS generally determines, assesses, and collects tax from the partnership, rather than the partners, based on appropriately netted adjustments (determined at the partnership level) multiplied by the highest applicable tax rate in effect for the reviewed year (an “imputed underpayment”)

• “Adjustment year partners” (i.e., partners during the adjustment year), rather than the “reviewed year partners” (i.e., the partners during the partnership taxable year to which a partnership adjustment relates), indirectly bear the cost of the tax assessed, unless the partnership
  – Has elected out of the BBA Regime (if eligible) on a timely filed return,
  – Requests, and is granted, any modifications to the imputed underpayment under section 6225, or
  – Makes a valid “push-out” election under section 6226
BBA Rules – Partnership Representative

• A partnership may appoint any person to be the partnership representative (PR), provided that person has a “substantial presence in the United States”.
  
  - Various considerations of appointing someone other than a partner: Access to information/knowledge of the business.

• The PR can be an entity (e.g., a partnership, limited liability company or corporation) rather than an individual, but if so, partnership must identify a “designated individual”

• PR Designation is made for each taxable year on the partnership’s income tax return.

• If partnership fails to timely appoint a PR, then the IRS may appoint one.

• The partnership representative has the sole authority to act on behalf of the partnership in connection with IRS matters including:
  
  ◦ Accepting a notice of final partnership adjustment or seeking an appeal.
  
  ◦ Electing to push out IRS-imposed adjustments under section 6226.
  
  ◦ Agreeing to an extended period of limitations for adjustments.
  
  ◦ Determining whether to assert partner level defenses to adjustments or penalties.

• Partnership Agreement considerations
MTC Model Statute
Multistate Tax Commission (MTC) Model for Partnership Audit Rules

• Multistate Tax Commission (MTC) created a model statute for reporting adjustments to federal taxable income and federal partnership adjustments
  – MTC Model also covers non-partnership audits
• The MTC received comments on the proposed model from multiple organizations.
• One of key differences in MTC Model versus federal rules is default payment method (notwithstanding any applicable elections) for exam adjustments:
  – MTC Model = partners pay the adjustment
  – BBA (federal) = partnership pays the adjustment
• MTC model adopts concept of partnership representative for state purposes
  – The state partnership representative will default to the federal partnership representative, unless otherwise specified.
MTC Model Statute vs. Federal Partnership Audit Rules

Federal

Federal Partnership Representative

Default assessment on partnership

Push-Out Election
Partners report on future return

MTC

State Partnership Representative

Default assessment on partners
Partners report on amended returns

Partnership-Pays Election
MTC Model – Default Rules for Audit Adjustments

• **Default Reporting/Payment Method:**
  - Within **90 days** of final partnership determination:
    - Partnership files a partnership adjustment report
    - Partnership notifies the direct partners
    - Partnership files amended composite/withholding tax return (if required) and pays applicable tax
  - Within **180 days** of final partnership determination
    - Direct partners file adjustment report reporting distributive share of adjustments
    - Direct partners pay any applicable tax, which is calculated as if properly reported.
  - Special reporting provisions for tiered partnerships
MTC Model – Partnership Pays Election for Audit Adjustments

**Partnership Pays Election – affirmative election**

Within **90 days** – partnership files adjustment report and notifies state that it is making the election

- Within **180 days** – partnership pays the amount of the adjustment

- Computing partnership-level adjustment:
  - Exclude amounts attributable to direct exempt partners
  - Distributive shares to direct corporate partners: apportion and allocate adjustments and multiply by highest corporate tax rate
  - Distributive shares to non-resident direct partners: state-sourced income and multiply by highest applicable tax rate
  - Distributive share to resident direct partners: multiply amount by highest applicable tax rate
  - Distributive share to tiered partners: three step process
Partnership Audit Rules State Legislation
State Legislative Responses to BBA

• As of 12/1/19, the following states have adopted specific rules relating to reporting federal adjustments pursuant to a BBA partnership audit:

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• Some state legislation primarily follows the MTC model statute (e.g., Georgia, Oregon and West Virginia)
  – Note: these state provisions may be slightly different from the MTC model statute.
  – For example, Oregon has a different time frame for reporting/paying of federal adjustments although it is similar to the MTC method

• California
  – Adopts many of the BBA provisions and partnerships generally bound by federal election (e.g., push-out)
  – Mechanics are different as partners must file amended returns to report pushed-out amounts
State Legislative Responses to BBA (cont’d)

• Maine
  – Adopts many of the principles but does not appear to allow a push-out election
  – Statute provides that partners must pay and report any additional tax when filing a federal amended return (*e.g.*, modification) or claim for refund

• Rhode Island
  – Partnerships/partners are required to report adjustments from partnership exam or AAR and make payments by filing applicable supplemental return.
  – Rhode Island DOR Advisory 2019-13 – partners must file required supplemental Rhode Island returns and make payments within 180 days

• Some states (*e.g.*, Arizona and Hawaii) have adopted parts of the federal provisions, but have limited guidance:
  – Arizona has issued forms to report the federal partnership adjustment, which provides clarity on Arizona administrative rules – Form 165PA
  – Note: adjustment based on Arizona sourced income at 4.4% tax rate
Procedures under BBA – Voluntarily Correcting Prior Year Return (Administrative Adjustment Request (AAR))

• Does the state conform to BBA rules for AARs?
  − Under the MTC model, the partnership does not appear to be able to elect to pay an amount stemming from an AAR (in contrast to adjustments stemming from a federal examination).
    ◦ Example: Arizona Form 165PA, which allows the partnership to pay, specifically only applies to adjustments from a federal exam.
  − Possible that a state may follow a federal election with different mechanics (e.g., California generally adopts the federal elections under BBA so would follow any push-out election but requires amended returns, but not clear if these procedures apply for AARs).
• States that do not conform to BBA – follow prior rules (e.g., amended partner returns)?
• Potential for timing issues
  − Future return (federal) vs. amended state returns
  − Partners may be required or permitted to report additional state income tax prior to reporting/paying additional tax for federal purposes (due to current year inclusion)
Other Recent Developments
IRC Section 163(j) – Interest Expense Limitation

• **Limitation** applied **at partnership level**, so it may increase partnership’s income for purposes of:
  - Entity level taxes
  - Nonresident withholding
  - Composite returns

• **Carryforward** of Excess Business Interest **applied at the partner level** which may create issues for state taxes, especially **nonresident withholding and composite tax returns**.

• Nonresident carryforward rules and tracking of state sourced disallowed interest expense:
  - Currently, few state administrative rules exist
  - Rules may be similar to Passive Loss Rules and NOL rules
  - Cost of compliance vs. impact on credit for taxes paid to other states
IRC Section 163(j) – Interest Expense Limitation

- Iowa (for taxable years beginning in 2019)
  - Did not conform in 2018, so deductions exceeding federal may be reported on an adjustment worksheet.
  - For 2019 and beyond, partners must make adjustments to Iowa deduction calculation to account for partnership’s federally-disallowed Iowa deduction in 2018.

- Other non-conforming states

- Tiered partnerships
Pass-through Entity Level Taxes

• Since the Tax Cuts and Jobs Act of 2017 (TCJA), certain states have adopted pass-through entity (PTE) taxes:
  - Connecticut
  - Louisiana (elective)
  - New Jersey (elective)
  - Oklahoma (elective)
  - Rhode Island (elective)
  - Wisconsin (elective)

• Additional states, such as Arkansas and Michigan, have proposed PTE level tax legislation.

• Other potential considerations for elective PTE taxes
Oregon Corporate Activity (CAT) Tax

• Effective for tax years beginning on or after 1/1/2020

• Oregon CAT legislation does not repeal Oregon’s corporate income or excise tax, but includes slight personal income tax reduction

• In addition to a flat $250 tax, CAT imposed at rate of 0.57% on taxpayer’s “taxable commercial activity” in excess of $1 million
  − Taxpayer with less than $1 million in taxable commercial activity is exempt from tax

• Tax imposed on single taxpayers and unitary groups of taxpayers (unitary group treated as a single taxpayer)

• Taxpayers entitled to one subtraction – 35% of the greater of either cost inputs or compensation (apportioned)
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