Adopt or adapt? New IRS partnership audit rules affect states

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I. Bipartisan Budget Act of 2015

Each state has its own system of tax audit procedures that present challenges for taxpayers and tax authorities alike, with a multitude of additional potential complexities arising out of the recent federal changes applicable to the tax audit of partnerships. The federal changes, adopted in the Bipartisan Budget Act of 2015 (Budget Act) — effective for returns filed for partnership tax years beginning after December 31, 2017 — will significantly affect taxpayers and state tax authorities, regardless of whether the states adopt the new federal audit rules.

The Budget Act was enacted on November 2, 2015, and it includes significant rule changes for partnership tax audits and adjustments. The Budget Act completely replaces the current Tax Equity and Fiscal Responsibility Act procedural rules for partnership audits and adjustments. It provides for one set of partnership-level audit rules that will apply to all partnerships, subject to an opt-out election available to some partnerships with 100 or fewer partners. Under these streamlined audit rules contained in the Budget Act, the IRS will examine partnership items for a particular year (the reviewed year), and any adjustments will be taken into account by the partnership at the partnership level in the year the audit or judicial review is completed (the adjustment year). This is a significant change from the current TEFRA provisions because it shifts the cost of any adjustment to the partners in the adjustment year rather than flowing the adjustments through to the partners who benefited from the underpayment of tax in the reviewed years.

Under the Budget Act, the partnership will pay the tax, interest, and penalties on underpayments. The tax due is calculated by multiplying the net of the adjustments by the highest statutory corporate or individual rate. Any adjustments not causing underpayments will then flow through to the partners in the year of the adjustment. The amount of the underpayment at the partnership level could be reduced by (i) the tax reported on the underpayment by partners filing amended returns; (ii) the tax attributable to tax-exempt partners; and (iii) the tax rate differential due to a lower corporate tax rate or lower capital gain and dividend rate.

Alternatively, under the Budget Act, partnerships may elect to issue adjusted information returns to the reviewed-year partners, who would then take the adjustments into

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account on their individual returns in the adjustment year through a simplified amended return process.11 Those partners would calculate the additional tax owed for the reviewed year and then pay the tax (and interest and penalties) from that prior year with the tax return for the year when they receive the statement of adjustments.12 The partnership is not required to ensure that each of its reviewed-year partners actually take the adjustments into account and pay any tax due. Once this election is made, it may only be revoked with the consent of the U.S. Treasury secretary.13

The statute of limitations for assessments is determined based on when the partnership’s return was filed and considers extensions between the IRS and the partnership, rather than taking into account partners’ individual assessment statutes of limitations.14 The statute of limitations for filing partnership refund claims is based solely on when the partnership return was filed and cannot be extended by agreement.

Small partnerships with 100 or fewer qualifying partners are allowed to elect out of the new rules, and those partnerships and partners are subject to the general rules that apply to auditing individual taxpayers.15 To elect out, the partners must all be individuals, C corporations, foreign entities that would be treated as C corporations if domestic, S corporations, estates of deceased partners, or others if the Treasury secretary prescribes in guidance.16 Thus, partnerships with partners that are themselves partnerships or trusts are unable to elect out absent further guidance. The provision also contains several consent and election rules, with special rules for specific partners, such as C corporations.17 The election to opt out is made for a particular year with a timely filed return for that tax year.18

Audits will be handled by a designated partnership representative, who can be a partner or non-partner with substantial presence in the U.S.19 The partnership representative is granted broad authority to resolve any partnership audit, and the resolution would be binding on all partners.20

II. Current State Laws
In some respects, states may already be better situated than the IRS for collecting additional tax directly from partnerships as a result of an audit. For instance, many states already have in place mechanisms such as withholding and composite returns through which they could collect assessed taxes directly from the partnership.

A majority of states require partnerships to withhold taxes for some nonresident partners and directly remit those taxes to the state. Under many of these withholding rules, state auditors can force partnerships to collect the additional assessed taxes from their partners via withholding rules and remit the taxes to the state. Typically, the withholding rules do not apply to partners who are residents of the state, and most states allow exemptions for at least some types of partners. For states such as California, Illinois, and New York, all of which already have mandatory withholding requirements,21 a simple modification to the withholding rules could potentially allow auditors to collect the tax for all partners.

Another mechanism already established in many states is the use of composite returns. A composite return is a return that a partnership files for its electing nonresident partners. The partnership computes and reports the income and tax attributable to the electing nonresident partners on a single return. Generally, the filing of a composite return satisfies the participating partners’ required filing of an individual return with the applicable state, resulting in administrative ease for both the partners and state taxing authorities. Participation by nonresident partners in a composite return is typically voluntary. However, there are several states where composite returns are mandatory, including Alabama and Connecticut.22 As with the withholding rules, the composite return allows state auditors to collect additional assessed tax directly from the partnership.

Some states have rules that resemble aspects of the Budget Act. In Illinois, for example, a partnership that errs in its computation of any item of income, deduction, addition, subtraction, or credit is permitted to pay any resulting underpayment, or collect any resulting refund, directly for its partners.23 The statute is applicable to tax years ending on or after December 31, 2008; however, it has not been heavily used by partnerships or the Illinois Department of Revenue. The recent changes to the federal rules may generate greater interest in this generally underutilized statute.

III. Complexities for States Adopting Rules Similar to the Budget Act
Under the federal rules, the IRS will examine the partnership’s items of income, gain, loss, deduction, or credit for a reviewed year and calculate any resulting adjustments.24 These adjustments will be taken into account by the partnership at the partnership level in the adjustment year.25 Under the federal rules, if the partnership uses the method

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1126 U.S.C. section 6226.
1226 U.S.C. section 6226(b)(1).
1526 U.S.C. section 6221(b).
1926 U.S.C. section 6223(a).
2026 U.S.C. section 6223(b).
2426 U.S.C. section 6221(a).

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in which the partnership directly pays the tax adjustments, it has several options for reducing its tax obligation. First, it may exclude the adjustments for those partners who file amended returns that take the reviewed-year adjustments into account, or for those partners that the partnership can demonstrate are tax exempt. Second, subject to some limitations, the partnership may lower the applicable tax rate for partners that are either C corporations or who are individuals. In the case of corporate partners, the partnership tax obligation will be calculated by taking into account a lower rate of tax to the extent the partnership can demonstrate that a portion of the underpayment obligation is allocable to the income of a corporate partner. Further, a lower rate of tax will also be applied to the portion of the underpayment that the partnership can demonstrate is allocable to the capital gains or qualified divided income of an individual partner.

At the state level, however, calculating this tax liability and potential adjustments for different partner types may be significantly more complicated than at the federal level. If states try to adopt similar procedures in which the partnership can pay tax for the partners, various considerations will need to be examined, specifically regarding resident individual, trust, corporate, and tax-exempt partners. Also, administrative and procedural difficulties may need to be considered.

A. Resident Partners

A state will tax resident individuals on the entirety of their income but tax nonresidents on the portion of their income sourced to that state. Therefore, a state that chooses to adopt the federal rules may want the partnership to compute the tax for the resident individuals on the entire adjustment and not just the portion sourced to that state. However, what happens when the partnership is not doing business in the state where the individual partner is a resident? Many states do not require partnerships to file a return with that state solely on the basis of the partnership having a resident partner. Approximately a dozen states, including Missouri, New Jersey, New York, and Pennsylvania, require partnerships to file a return even if the only reason for filing is that a partner resides in the state. If states adopt rules similar to the Budget Act, they may also change their partnership filing requirements to require all partnerships with resident partners to file. If so, this will dramatically increase the number of partnerships required to file and the corresponding compliance costs. If states that choose to adopt the Budget Act do not require all partnerships with resident partners to file, how will the state collect tax on the resident partners?

Another issue affecting resident partners that may arise if states adopt rules similar to the Budget Act concerns the timing of changes in residency. For example, it is not uncommon for a partner’s state of residence to change between the reviewed year and the adjustment year. Questions may arise on which state of residence should be used in calculating the tax — should it be based on the partner’s state of residence in the reviewed year or in the adjustment year? On the one hand, the reviewed-year residence was the partner’s home in the year the income was earned; on the other hand, the adjustment-year residence is where the partner resides in the year the tax is being paid under audit. States that adopt rules similar to the Budget Act, which allow the partnership to elect to have the partners pay their own tax in the adjustment year, may want the tax calculation to work the same way under either option to avoid creating planning opportunities potentially arising from the election. In other words, the state may want to compute the tax the same way regardless of whether the partnership elects to have the partners pay the tax directly — with the tax computed based on the partner’s state of residence in the adjustment year — or if the partnership does not make that election. There are valid arguments for either approach. Additional issues regarding double taxation may arise if the original residence state and the new residence state enact conflicting approaches.

As discussed above, a state will tax resident individuals on all of their income but will tax nonresidents only on the portion of their income sourced to that state. To avoid double taxation, resident individuals usually receive a credit for taxes paid to nonresident states.

For states that adopt rules similar to the Budget Act, the partnership may have to compute these credits when calculating the tax on resident individual partners. There are a number of complex issues regarding the calculation of these credits for taxes paid to other jurisdictions. For instance, questions arise whether states must include city and local taxes in the calculation. In Comptroller of the Treasury of Maryland v. Wynne, the U.S. Supreme Court held that part of Maryland’s personal income tax regime violated the dormant commerce clause because it only provided a credit for taxes paid to other jurisdictions against the state income tax and not the county income tax. At issue was Maryland’s failure to provide a credit for taxes paid to other states when calculating a Maryland resident’s county-level tax, resulting in a higher tax on income earned outside Maryland compared with income earned in state.
A separate consideration is whether states permit a credit for entity-level taxes, such as the Illinois replacement tax. Several states allow the credit only for taxes imposed on the partner (that is, they do not allow a credit for entity-level taxes). How will these states differentiate between entity-level taxes and audit adjustments imposed on the partnership? This might not be a problem for states such as California that permit a credit for the resident individual’s share of entity-level taxes. However, there are other forms of tax that, while not true income taxes, are treated as such for some purposes. The Texas franchise tax, for example, is a tax on gross margin and is often considered an income tax. Under the holding of Rosenberg v. Riley, Georgia permits a resident that is a partner in a partnership to make an “adjustment to federal adjusted gross income for the entity’s income taxed in another state that imposes on the entity a tax on or measured by income.” In Rosenberg, Georgia determined that the Texas franchise tax is a tax “measured by income,” and thus permitted the taxpayers to adjust their federal AGI by subtracting income received from a flow-through entity that was subject to an entity-level tax in Texas. If states adopt rules similar to the Budget Act that require the partnership to pay an assessed tax after audit, the tax calculation needs to be adjusted for resident partners, and the credits for taxes paid to other states need to be part of this calculation.

The facts in Rosenberg also suggest another complexity that could arise when these rules become effective. Georgia allows a credit for taxes imposed on a partner but also allows an adjustment to income for taxes on the entity. If other states adopt rules similar to the Budget Act, how will Georgia treat the additional tax paid by the partnership to those states?

Also, under the Budget Act, the primary method by which adjustments are addressed is through payment of the assessed tax by the partnership for its partners. Timing issues between the reviewed year and the adjustment year can result in significant inequities and complex considerations for credits for taxes paid to other jurisdictions among affected partners. Consider the following scenario: Firm A is in operation from 2010 through the present. In 2010, Firm A has three partners, Partners B, C, and D. In 2012, Partner B leaves the firm and is replaced in 2013 by Partner E. In 2015 an audit is concluded for year 2011, resulting in an assessment for underpayment.

In the above scenario, under the Budget Act, in situations in which the entity pays the tax, the adjustment year partners — Partners C, D, and E — will be liable for the underpayment obligation because the partnership is required to pay the tax in the adjustment year, and they are the partners during the adjustment year. Consider Partner B, who received a benefit through the underpayment of his or her tax obligation during the reviewed year. As a result, Partner B receives a windfall and Partner E is liable for a tax obligation that was incurred before Partner E was even a partner. If some states adopt rules similar to the Budget Act and the partnership pays additional state tax, should Partner B or Partner E be allowed to claim a credit for taxes paid to other states?

Further, it is not clear that partnerships have sufficient information to properly calculate the tax after credits. For example, not every partner files a return in each of the states in which the partnership has income. Should the partnership base its calculation on the assumption that each of its partners filed in every state? Similarly, many states require that a nonresident partner’s tax be computed based on the taxpayer’s everywhere income. Should the partnership proceed as if every partner is taxed at the highest rate in every state? The breadth of information that would be required to accurately calculate these taxes and the resulting credits could be substantial and inaccessible. Other information that might be difficult for a partnership to obtain includes itemized deductions, personal exemptions, other income and loss the partner may have in the state, and various carryovers (such as passive loss, net operating loss, capital loss, or excess charitable contributions). Some states, including Alabama and Missouri, allow taxpayers a deduction for federal income taxes. If any of these states adopt rules similar to the Budget Act, questions may arise, such as whether the partnership would be able to claim this deduction for its partners. These types of deductions also can cause circular calculations because the federal tax is affected by the state tax, and the state tax is affected by the federal. Further confusion may arise regarding the year in which the deduction would be applicable — would it apply in the adjustment year or the reviewed year?

B. Tiered Partnerships

Multitiered structures are very common. While they will create additional complexity at the federal level, issues at the state level may present even greater challenges. Because of the intricacy in computing the tax for the ultimate owners, the composite return rules in most states do not permit tiered partnerships to be included as participants in composite filings. Likewise, these complications are one reason why, in many states, withholding is not required for tiered partnerships. It is doubtful that tiered partnerships will have the information required to properly calculate the tax for the ultimate owners. For many tiered partnerships, this will require acquiring information from several tiers up the

34 Cal. Rev. & Tax. Code section 18006(a).
37 Id.
ownership chain. Also, state calculations require more information than is needed for federal. For example, state calculations require the income to be sourced to the state via apportionment or allocation. Many states have several alternative methods for tiered partnerships to compute the income sourced to the state. In Illinois, for example, unitary partnerships may flow up apportionment factors and combine them with the upper-tier entity’s apportionment factors. Further, many states treat apportioned business income differently from allocated nonbusiness income. Will a lower-tier partnership know how an upper-tier partnership has treated the income?

Similar to the issue potentially affecting resident individual partners, a lower-tier partnership might not file returns in all of the states in which the upper-tier partnership files. For states that adopt rules similar to the Budget Act, will the lower-tier partnership have to file and pay the tax in all of the states where its partners are filing returns? For example, if Partnership A only has operations in Illinois but has as a partner (Partnership U) that is filing returns in 40 states, does Partnership A have to file in all 40 states to pay the tax for Partnership U’s partners? If states adopt rules similar to the Budget Act, they may also change their partnership filing rules to require all partnerships with partners in a state to file. If so, this will dramatically increase the number of partnership filings and the corresponding compliance costs. If states adopting the Budget Act do not require all partnerships with partners in the state to file, how will these states collect tax from the lower-tier partnership?

C. Trust Partners

Including a trust as a partner in a partnership is also common and creates additional complexity for states adopting rules similar to the Budget Act. Most states follow the federal treatment of trusts, wherein the trust or its beneficiaries may be subject to tax on the resulting income. Also, trust residency rules are even more complicated than individual residency rules because it is possible for a trust to be taxed as a resident in multiple states. Further, similar to resident individual partners, most states tax resident trusts on all of their income and allow a credit for taxes paid in other states. States adopting rules similar to the Budget Act may want to tax resident trusts on all of the adjustment taxable to the trust. They also may want to tax nonresident trusts on the portion of the adjustment sourced to the state and taxable to the trust. Similar to resident individuals, the states may then need to compute the credit for taxes paid to other jurisdictions.

Trusts are also similar to tiered partnerships because income can flow through to the beneficiaries. The trust receives a deduction for distributable net income flowing to the beneficiaries. Unlike partnerships, the trust may be taxed on some of the income and the beneficiaries may be taxed on some of the income. If states adopt rules similar to the Budget Act, when the partnership pays the tax on the adjustment and the partnership has trust partners, the state may want the partnership to determine how much of the adjustment should go to the resident beneficiaries of the trust because the state may want to tax all of the adjustment that is taxable to the resident beneficiary. The state also may want to tax nonresident beneficiaries on the part of the adjustment sourced to the state and taxable to the nonresident beneficiary. The states may then need to compute the credit for taxes paid to the other jurisdictions.

This added complexity is one reason why many states do not allow trust partners to participate in a composite return. Normally, partnerships do not have the information detailing how much of the partnership income was taxed at the trust level and how much was taxed at the beneficiary level. Also, partnerships lack information about the beneficiaries of the trusts that are partners. It may be nearly impossible for partnerships to gather the information necessary to calculate all of the state taxes for the trust and its beneficiaries.

Similar to the problem with the resident individual partners, a partnership might not file returns in all of the states where the trust and its beneficiaries file. For states that adopt rules similar to the Budget Act, will the partnership have to file and pay the tax in all of the states where its trust partners and their beneficiaries file returns? If so, this will dramatically increase the number of partnership filings and the corresponding compliance costs. If states adopting the Budget Act do not require all partnerships with trust partners filing in the state to file, how will these states collect tax for the trust partners and their beneficiaries?

D. Corporate Partners

As with tiered partnerships and trust partners, there are similar complications regarding corporate partners. Because of these complexities, corporate partners are usually not permitted to be included in composite returns. Likewise, several states also do not require withholding on corporations. Corporate partners are taxed on income sourced to the state. Many states have several alternative methods for corporate partners to compute the partnership income sourced to the state. For example, if the corporate partner is unitary with the partnership, many states flow-up apportionment factors and combine them with the corporation’s own apportionment data. Depending on the facts, the determination of income sourced to the state can be different for each corporate partner. Further, many states treat apportioned business income differently than allocated nonbusiness income. The partnership normally does not know what tax positions the corporate partners are taking, nor does the partnership normally have enough information to determine income sourced to the state by the corporate partner.


41Id.
As discussed in the context of partners that are trusts and resident individual partners, a partnership might not file returns in all of the states where the corporate partners file. For states that adopt rules similar to the Budget Act, will the partnership have to file and pay the tax in all of the states where its corporate partners are filing returns? If so, this will dramatically increase the number of partnership filings and the corresponding compliance costs. If states adopting the Budget Act do not require all partnerships with corporate partners filing in the state to file, how will these states collect tax for the corporate partners?

E. Tax-Exempt Partners

Finally, tax-exempt partners create their own distinct complications. Although many states follow the federal rules for unrelated business taxable income, which remains subject to tax, some states have their own definition or requirements for an entity to be exempt from tax. These complications are a major factor as to why many states do not allow tax-exempt partners to participate in composite returns or require partnerships to withhold state taxes on tax-exempt organizations. Similar to other types of taxpayers, will the partnership have enough information to properly compute the tax for the tax-exempt partner?

IV. Complexities for States Adopting Rules Similar to The Budget Act — Election for Partners to Pay Tax

Under the Budget Act, one alternative to the partnership directly paying the assessed tax is for the partnership to elect to provide each reviewed-year partner with a statement of that partner’s share of any adjustments. On receipt of these statements, each partner would be obligated to take the adjustments into account on their individual returns in the adjustment year through a simplified amended return process. Those partners would calculate the additional tax owed for the reviewed year and pay the tax (including interest and penalties) from that year with the tax return for the year when they receive the statement of adjustments. The partnership, however, is not required to ensure that each of its reviewed-year partners actually takes the adjustments into account and pay any tax due. Lastly, once the partnership makes the federal election, it may only be revoked with Treasury’s consent.

A. Election

Will a federal election be binding on a state, or will a state allow a different election? Partnerships may want the ability to make a different election for state purposes than that made at the federal level, especially in light of the complexities described above in calculating the tax at the state level. As explained above, partnerships might not have enough information to properly calculate the tax for all the partners. Allowing partnerships to make a separate state election may be an acceptable solution to some of these issues.

However, allowing partnerships to make a different election at the state level than at the federal level could also create more problems. For example, communicating to the partners the information that they need so that they can calculate the tax in the states will be more complicated if a different election is allowed. Differing elections could also create confusion for the partners. Additionally, information sharing between the IRS and the states may be more complicated if different elections are allowed. Further, in states that allow a deduction for federal income tax, what would be the effect if the partnership paid the tax for federal, but the partner paid the tax for the states, or vice versa?

Allowing different elections may also cause statute of limitations issues. For example, when the partnership elects to have the partners report the adjustments on the partners’ returns in the adjustment year, the statute of limitations for reporting the adjustment is based on the adjustment year. When the partnership pays the tax itself, the statute of limitations is based on when the partnership’s return was filed and factors in extensions between the IRS and the partnership, rather than taking into account partners’ individual assessment statutes of limitations. The statute of limitations for filing partnership refund claims is based solely on when the partnership return was filed and cannot be extended by agreement.

Partnerships may also want the ability to make different elections in some states but not others, or to pay tax in states where the sourced income is small and the tax due is minimal. However, in states where the sourced income and tax liability are large, partnerships may prefer the partners to pay the tax. In situations when partnerships do not have enough information about the partners to properly compute the tax in some states, this may be an acceptable approach.

However, allowing the partnership to elect different methods in different states creates potential problems. For example, calculating a resident partner’s credit for taxes paid to others states will become much more complicated if the partnership pays the tax in some states, while the partners pay the tax in other states with their adjustment year returns. An additional level of complexity is added when the partners pay the tax on amended reviewed-year returns in the states that do not adopt the Budget Act.

B. State Audits

For states that adopt rules similar to the Budget Act, state tax authorities would have to contemplate situations in which taxpayers have not been audited by the IRS. What is the outcome if a state conducts an audit and makes adjustments that were not made by the IRS? There are many state issues, such as apportionment, state modifications, and state credits, that do not present federal tax issues. Can the partnership make a different election for these state-only

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42 26 U.S.C. section 6226(a).
43 26 U.S.C. section 6226(b).
44 Id.
adjustments? What changes to the federal rules for state purposes will states need to make as a result of these state-specific issues?

What happens when a state examines a partnership that the IRS has not examined? What if after the state audit is completed and the tax assessments paid, the IRS conducts an audit and makes an adjustment? It is unlikely that the IRS rules will defer to the election made by the partnership as a result of the state audit.

C. Changes in a Partner’s Facts

In the time between the reviewed year and the adjustment year, facts affecting the state tax calculations may change for many of the partners. As we have explained above, individual and trust partner state tax calculations depend on the taxpayer’s state of residence. If the taxpayer is no longer a resident of the state in the adjustment year, how does that affect the procedures for states adopting these rules? What if the taxpayer has no filing requirement in the state? Most taxpayers do not continue to file returns in a state after they have moved away and are no longer residents. Nonresident individual, corporate, and partnership partners may not be filing returns in the same states in the reviewed year as the adjustment year. If a partner has no filing requirement in the adjustment year, how does that affect the procedures for states adopting rules similar to the Budget Act? For partners that apportion the income from the partnership, should they use the apportionment factor from the reviewed year or the adjustment year? Many states have throwback rules in computing the apportionment factor. Are these rules applied on the facts in the reviewed year or the adjustment year?

D. Other Adjustments

If a partner has other adjustments to the tax calculation for the reviewed year, may that partner use those adjustments to reduce the assessment? For example, may a partner use a NOL carryback to reduce the assessment? What about unused tax credits? What about items that the taxpayer did not originally report in the reviewed year, but because of a later adjustment, they would like to later report? For example, what if a taxpayer had passive losses that were suspended in a state, but as a result of the adjustment, those passive losses become available for use? What about a change in the apportionment factor? For example, what if a partner’s apportionment factor in the reviewed year is reduced because of a change in the throwback calculation caused by an audit in another state? What about mistakes that a taxpayer made in the reviewed year that were not corrected because there was no tax impact, but, because of a later adjustment, they want to correct? There are any number of items in the reviewed year that may affect the tax calculation.

E. Statute of Limitations Issues

If the statute of limitations for the partner’s reviewed-year return has closed, how does that affect the answers to questions regarding other adjustments? Under the Budget Act, the statute of limitations for assessments can be extended by agreement between the IRS and the partnership. The statute of limitations for refunds cannot be extended by agreement between the IRS and the partnership. If the partnership elects to have the partners pay the tax on the adjustments, the partners pay the tax in the adjustment year.

These and other issues may need to be considered by states adopting rules similar to the Budget Act, allowing a partnership to elect to have its partners pay the additional tax with the adjustment year tax return.

V. Complexities for States Adopting Rules Similar to the Budget Act — Opt-Out for Small Partnership

Under the Budget Act, subject to some limitations, small partnerships with 100 or fewer partners may opt out of the new federal partnership audit rules. For states adopting rules similar to the Budget Act, there are state issues to consider as a result of the opt-out provision. Many of these issues are similar to those described above concerning the other election under the Budget Act (in which the partners pay the tax). For example, will a partnership’s federal election to opt out be binding on a state? If not, will the state require separate opt-out elections? Will states that adopt the federal rules allow partnerships that did not opt out for federal purposes to opt out for state purposes? Will states that adopt the federal rules allow partnerships that opted out for federal purposes to elect not to opt out for state purposes (for example, allow the partnership to pay the tax or have the partners pay the tax in the adjustment year instead of the reviewed year)?

VI. State Adoption Issues

Many states conform to the Internal Revenue Code by adopting federal AGI or federal taxable income as the starting point for the state tax calculation. Unlike most federal tax law changes that affect the computation of AGI or taxable income, these partnership audit procedural changes in the Budget Act are not something that states will automatically adopt. Most states have procedural rules that are not directly tied into and do not conform to the federal procedural rules. This may account for why so few states adopted rules similar to the TEFRA rules that the Budget Act is replacing.

In 1982 Congress passed TEFRA, which established unified audit rules for partnerships with more than 10 partners, and required that the tax treatment of all partnership items be determined at the entity level for these partnerships. In 1997 Congress added rules to allow partnerships with more than 100 partners (an electing large partnership) to opt out of the federal rules.
partnership) to elect into a simplified reporting regime, which included streamlined audit and adjustment procedures.\(^ {48}\) For states, adopting the TEFRA rules may have been less complicated than adopting the rules in the Budget Act. Massachusetts, for example, has enacted a statute that directs the commissioner of revenue to promulgate regulations concerning unified audit procedures for partnerships. The legislation requires that the regulations be "modeled on federal rules."\(^ {49}\) Under the subsequently adopted regulations, which explicitly draw guidance from TEFRA, a partnership appoints a tax matters partner, but partners are permitted to elect out of the unified audit proceedings.\(^ {50}\) However, the TEFRA rules do not allow the partnership to pay the tax, interest, and penalties on underpayments. States that choose to adopt rules similar to the Budget Act may have to address all of the issues discussed above. The TEFRA rules did not have similar state complications.

However, the potential problems for states that do not adopt rules similar to the Budget Act are much more complex. States not adopting rules similar to the Budget Act may find that they need to at least adapt to the new federal audit procedures.

**VII. Issues That Arise if States Do Not Adopt Similar Rules**

**A. Entity-Level Tax**

As noted previously, under the Budget Act, the IRS will examine partnership items for a reviewed year and aggregate any resulting adjustments.\(^ {51}\) These adjustments will be taken into account by the partnership at the partnership level in the adjustment year.\(^ {52}\) This section considers issues that may arise if the states do not adopt rules similar to those in the Budget Act.

1. **Collection of tax**

In the absence of state adoption of the Budget Act rules, what methods will states use to assess and collect the tax? The current mechanism used by most states is for the taxpayer to report changes to their federal income to the state and calculate the additional state tax. How can this mechanism continue to work effectively if under the Budget Act the partnership pays the tax and the partners are not reporting AGI or taxable income adjustments to the IRS? The states may be forced to adopt their current procedures because of the new federal procedures in the Budget Act.

Another issue that the states should consider concerns notification requirements. Under the Budget Act, it is unclear if either the IRS or the partnership representative is required to report adjustments to the partners. How can the states’ current mechanism of voluntary reporting by the partners operate effectively if under the new federal procedures the partners are unaware of the changes? States that do not adopt the Budget Act may have to adapt their current procedures to provide a means for alerting partners of the potential state adjustments. Also, it may be necessary for states to adopt a mechanism to ensure partners are given all the information necessary to calculate a change in tax. This, however, may not be as easy as it sounds.

2. **Credit for taxes paid to other jurisdictions**

As discussed above, a state will tax resident individuals on all of their income but tax nonresidents only on the portion of their income sourced to that state. To avoid double taxation, residents typically receive a credit for taxes paid to nonresident states. States not adopting the Budget Act may need to adapt their rules for computing these credits for the tax paid to states that adopt the Budget Act. In other words, in the states that choose to adopt the Budget Act, partnerships may be paying state tax in the adjustment year. This would create two potential problems.

First is the difference in who is taxed. States not adopting the Budget Act assess the tax on the partners. Some states allow the credit only for taxes imposed on the partner and do not allow a credit for entity-level taxes. These states may need to adopt their rules to allow a partner to claim a credit for his share of the tax paid by the partnership in those states that adopted rules similar to the Budget Act.

The second potential problem involves timing. For states adopting the Budget Act, the tax is borne in the adjustment year. However, for states not adopting the Budget Act, the additional tax is assessed against the reviewed year. States may need to amend existing credit rules to allow a matching of the credits under either scenario. Double taxation can easily occur if states do not adapt their credit rules to account for the added complexities caused by the Budget Act. If partners are double taxed on the same income, might that create additional Wynne-type constitutional issues?

3. **Enforcement**

Many states rely on information from the IRS alerting the state to federal adjustments. States not adopting rules similar to the Budget Act may need to adapt their procedures. As a result of the Budget Act, the information the IRS provides to states is likely to change. These changes may make it more difficult for the states that do not adopt rules similar to the Budget Act to identify and assess the partners to collect state tax arising from the federal tax adjustments.

4. **Statute of limitations**

Most state statutory regimes include rules that cause federal changes to extend or reopen the state statute of limitations to enable a state to collect its share of tax. If, however, it is the partnership that pays the tax, the partners would be unaffected by changes at the federal level. States

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\(^ {48}\) The Taxpayer Relief Act of 1997, PL. 105-34, 111 Stat. 788, section 1222.


\(^ {50}\) 830 CMR 62C.24A.1.

\(^ {51}\) 26 U.S.C. section 6221(a).

\(^ {52}\) Id.
that do not adopt the federal rules may need to change their rules for assessment to permissibly collect the tax.

B. Election for Partners to Pay Tax

As discussed above, the Budget Act provides a primary method of tax collection as well as an alternative. Under the primary method, the tax is paid by the partnership for its partners. If the partnership elects the alternative method, the reviewed-year partners will be required to pay the tax on receipt of adjusted statements in the adjustment year for the years under review. Partners then account for these adjustments on their individual returns in the adjustment year. However, under the Budget Act, it is unclear if the federal adjustments will end up affecting AGI or taxable income. If the adjustment is a separate calculation and it never ends up changing the partners’ AGI or taxable income, questions arise as to how states not adopting the Budget Act will collect the tax due to them.

Similarly, the above-discussed issues regarding the calculation of credits for taxes paid, the statute of limitations, and the effect of the opt-out rule apply. States that do not adopt similar rules to the Budget Act will need to consider these issues.

VIII. Conclusion

The implementation of the Budget Act will have significant ramifications at both the federal and state levels. The Budget Act will likely result in increased complexity when considering state tax issues regardless of whether states choose to adopt the new Budget Act rules.

Call for Entries:

Tax Analysts’ Annual Student Writing Competition

Tax Analysts is pleased to announce the opening of its annual student writing competition for 2016. This global competition enables students who win to publish a paper in Tax Notes, State Tax Notes, or Tax Notes International and receive a 12-month online subscription to all three weekly magazines after graduation. Submissions are judged on originality of argument, content, grammar, and overall quality.

- Students must be enrolled in a law, business, or public policy program.
- Papers should be between 2,500 and 12,000 words and focus on an unsettled question in federal, international, or U.S. state tax law policy.
- Papers must not have been published elsewhere.
- Deadline for entries is May 31, 2016.

Submissions should be sent to: studentwritingcomp@taxanalysts.org

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54 26 U.S.C. section 6226(b)(1).
55 Id.