State Practitioners Preview Complexity of New Federal Partnership Audit Rules

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The state tax administrative issues resulting from the new federal partnership audit rules signed into law on November 2 will be extraordinarily complex, practitioners said December 17.

Speaking at the New York University Institute on State and Local Taxation, Steve Wlodychak of EY said conformity to the federal changes will not be automatic and that most states conform to the Internal Revenue Code merely for determining federal taxable income. Few states actually incorporate the federal code's administrative procedures, he said.

Under the new federal rules, enacted as part of the Bipartisan Budget Act of 2015 (H.R. 1314), the IRS will begin auditing partnerships at the entity level and imposing tax and assessments at the partnership level. To be eligible to elect out of the new regime, a partnership must have 100 or fewer partners, none of which can be partnerships in themselves, trusts, or tax-exempt organizations.

The new rules, which change the 1982 Tax Equity and Fiscal Responsibility Act reporting rules in IRC section 6231, give the designated tax matters partner sole authority to bind the partnership. Tax bills will be the responsibility of current-year partners.

Wlodychak predicted "a fire hose of work from the IRS" as changes to federal taxable income from federal audit adjustments flow into state partnership returns, and as states receive a huge increase in Revenue Agent Reports from the IRS.

The new rules allow the IRS to audit the partnership directly and assess tax at the highest marginal income tax rate. Wlodychak predicted the IRS will engage in a game of "audit ping-pong." He outlined scenarios in which the IRS assesses tax at the highest rate, and a partnership responds by arguing that half the members that audit year were exempt organizations.

Another administrative issue is that partnerships with fewer than 100 partners will be governed by the old pre-TEFRA rules, under which the audit liability will be asserted against each partner individually but will be based on the partnership return.

Wlodychak also said constitutional issues could arise from the complexity added on the state administrative side because the way states impose tax against partnerships differs from the federal approach. For example, he said a state receiving increased information from the IRS could decide to aggressively audit nonresident partners but not audit resident partners.

Wlodychak also described intergenerational audit issues that could arise in the states as a result of the new federal audit regime, which applies past-year adjustments to current-year liability. One administrative complication is that a state revenue department will be auditing an earlier year while partners from that year may have since sold their partnership interest, left the partnership, or changed states of residence.

"When I look at this, I see a tremendous amount of complexity on the state side," said Matthew Polli of Deloitte Tax LLP. "Could this be the straw that breaks the camel's back?"

Polli said complex questions — for example, whether a limited partner owning an interest in a partnership is enough to constitute jurisdiction or nexus — have already been litigated in many states. He said that in response, some states have taken those issues off the table by imposing tax at the entity level.

"Could we see more of that, just to eliminate all this complexity and the uncertainty?" Polli wondered.

Bruce Ely of Bradley Arant Boult Cummings LLP said the federal reform will raise interesting ethical issues for practitioners who draft and review partnership agreements.

"Do I represent the LLC or the members?" Ely asked. "Who's my client?"

The practitioners reported that the Multistate Tax Commission is studying the state tax implications of the newly enacted federal partnership tax audit regime, with an eye toward initiating a model uniformity project. (Related coverage: p. 877.) ✰