

# Changes in Federal Tax Treatment of Partnerships

1

**NEED FOR STATE CONFORMING LEGISLATION**

**PRESENTED TO  
THE NCSL STATE TAX TASK FORCE  
AUGUST 7, 2016  
HELEN HECHT, GENERAL COUNSEL, MTC**

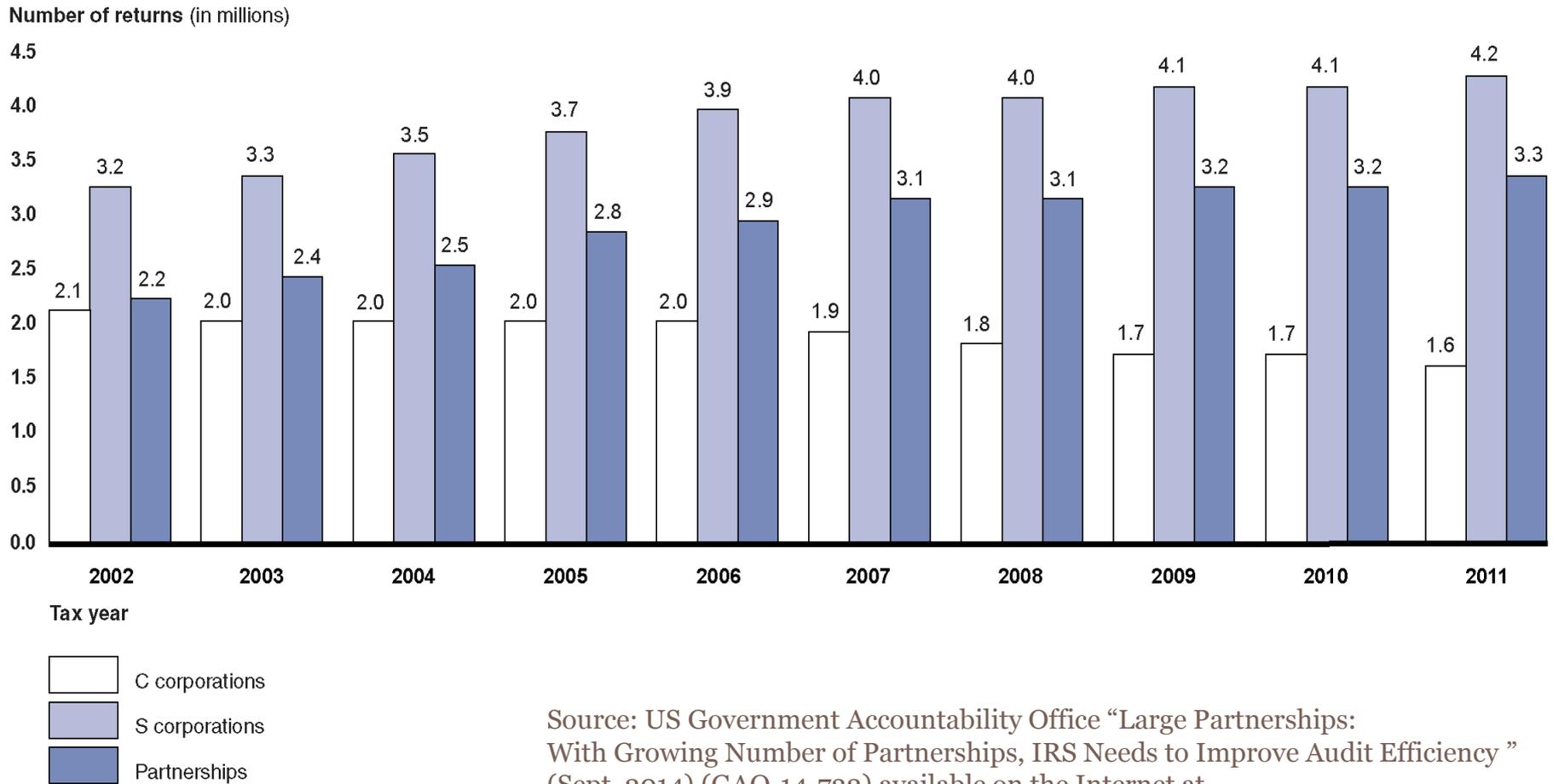
# Federal IRC Subchapter K

2

- One level of tax
  - Imposed on the owners
  - For their share of current income items
- So
  - 1065 – Partnership determines tax treatment
  - Schedule K – Partnership determines tax items
  - Schedule K-1 Partnership allocates items (distributive share) to partners
  - 1040/1120 – Partners report items

# IRS returns by entity type

Figure 4: Number of Returns by Form of Business, Tax Years 2002 to 2011



Source: US Government Accountability Office “Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency” (Sept. 2014) (GAO-14-732) available on the Internet at <http://www.gao.gov/assets/670/665886.pdf> (last accessed Mar. 22, 2016))

Source: GAO analysis of IRS data. | GAO-14-732

# State – Federal Relationship

4

- Conformity
  - To IRS Subchapter K and other income tax provisions
  - Tax on partners, not the entity
  - With IRS reporting requirements (1065, K-1, 1040, etc.)
- Apportionment and residency treatment
  - Credits for taxes paid
- Affect of later adjustments on states –
  - RAR Statutes
  - Triggering events –
    - ✦ Revenue agent report, proposed adjustment, final adjustment, etc.
    - ✦ Taxpayer amended return.

# State Specific Partnership Rules

5

- Withholding or composite return rules
  - The partnership is required to withhold tax (generally at the highest marginal rate) on the distributive share of income made to nonresident partners. Those partners may file nonresident personal returns and claim a refund of amounts overpaid.
  - Alternatively, states may allow partnerships to file composite returns in lieu of having partners file separately.

# Growth of large partnerships

**Table 16: Number of Large Partnerships by Industry Group, Tax Years 2002 to 2011**

Industry Group	Tax Year									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Mining	18	32	35	44	76	99	131	129	127	170
Manufacturing Transportation and Warehousing	23	25	27	39	56	85	105	108	116	142
Transportation and Warehousing	43	43	51	40	56	61	92	87	96	114
<b>Finance and insurance</b>	<b>1,799</b>	<b>2,195</b>	<b>2,715</b>	<b>3,190</b>	<b>4,731</b>	<b>5,707</b>	<b>5,530</b>	<b>6,124</b>	<b>5,955</b>	<b>7,333</b>
Real Estate, Rental and Leasing	695	685	782	870	1,081	1,275	1,486	1,401	1,287	1,507
Professional, Scientific, and Technical Services	55	57	69	74	85	86	108	109	98	129
Holding companies	56	53	72	89	113	157	186	200	193	233
Other	143	152	198	256	320	403	446	442	387	471

Source: GAO analysis of IRS data from the Enhanced Large Partnership Indicator (ELPI) File and Business Returns Transaction File, Compliance Data Warehouse. I GAO-14-732

# Partnership

7

- “An AGREEMENT to do business jointly” –
  - implicit, explicit, written or unwritten,
  - exists in the context of a particular state’s law
- Why is this important?
  - Because how partners share tax items (income, expense, gain, loss and credits) is governed by the agreement.
  - Because the decision-making that will be required with respect to the new federal audit and adjustment rules will be affected by the partnership’s AGREEMENT as to how to handle such matters.

# Federal Partnership audits

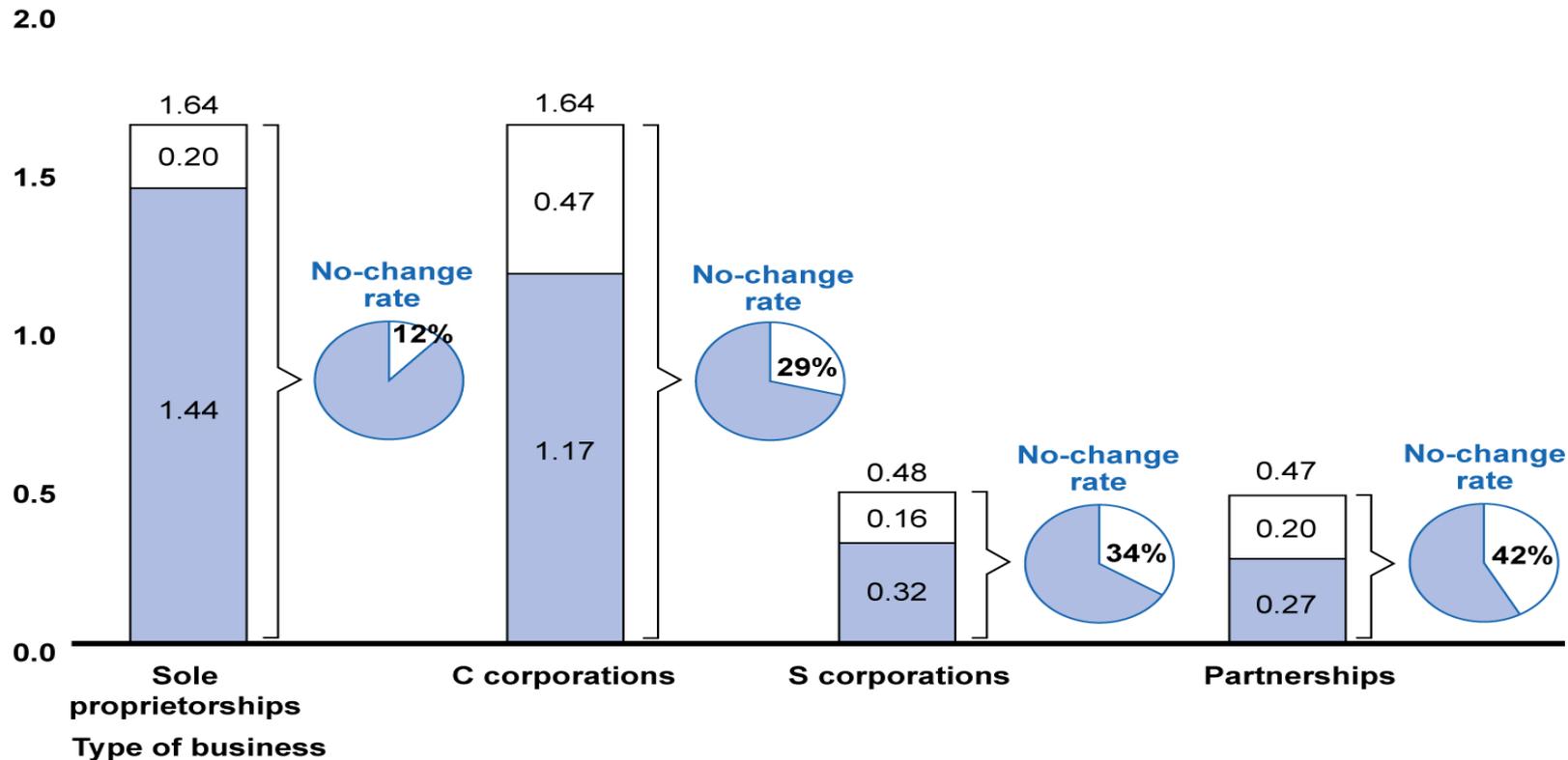
8

- Possibilities –
  - Partner Level – audit all issues at individual partner level
  - Hybrid – audit some issues at partner level, some at partnership level
  - Partnership Level – audit all issues at partnership level

# IRS audit/adjustment rates by entity type

Figure 5: Fiscal Year 2012 Examination and Adjustment Rates for Different Types of Tax Returns

Percentage examined



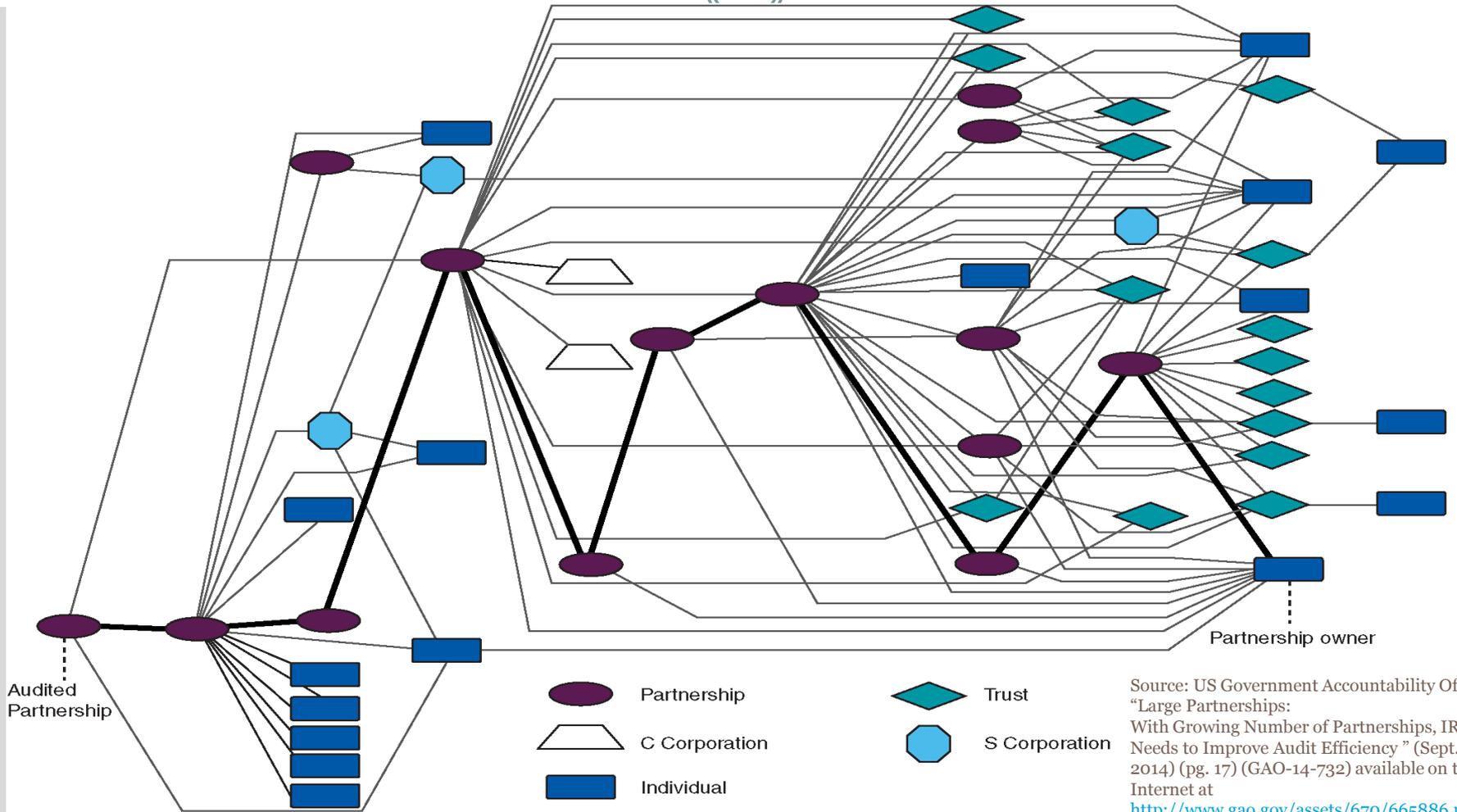
Not adjusted  
 Adjusted

Source: IRS.

Source: US Government Accountability Office “Partnerships and S corporations: IRS Needs to Improve Information to Address Tax Noncompliance” (May 2014) (available on the Internet at <http://www.gao.gov/assets/670/663185.pdf> (last accessed Mar. 22, 2016))

# Why the Need for Partnership Audits

10



Source: GAO analysis of IRS documentation. | GAO-14-732

Source: US Government Accountability Office  
 “Large Partnerships:  
 With Growing Number of Partnerships, IRS  
 Needs to Improve Audit Efficiency” (Sept.  
 2014) (pg. 17) (GAO-14-732) available on the  
 Internet at  
<http://www.gao.gov/assets/670/665886.pdf>  
 (last accessed Mar. 22, 2016))

# In a word -

11

- Tiers
- Even if there are only a few ultimate taxpayer-partners, a few partnership tiers will make it exceedingly difficult to determine whether even a substantial Subchapter K change at a lower partnership level will affect a particular taxpayer without auditing all the partnerships in between.

# Difficulties Faced by IRS

12

- Report of the Office of Tax Analysis of the U.S. Treasury Department – “Business in the United States: Who Owns It and How Much Tax Do They Pay”-
  - A recent study of partnership reporting found that about 20% of partnership income could not be traced from the partnership return to the partners.
  - Also, 15% is apparently earned in circular partnership structures.
  - Of the total partnership income – 69% accrues to the top 1% of income earners (compared with 45% of corporate income).

# Difficulties Faced by IRS

13

- Together, the income that cannot be traced and the income that appears to be flowing through circular structures (so that it does not hit a taxpayer's return) amounts to \$200 billion.
- Tax exempt and foreign entities earn roughly 15% of partnership income.
- The conclusion of one of the chief researchers in this area was that the only point of some of these complicated structures is to obscure the tax treatment.

# Now Two-Prong Regime

14

- Partnerships that are covered by the new rules will be audited at the partnership level
- Partnerships that are not covered by the new rules (because they are qualified to elect out and do elect out) will be audited at the partner level

## Sec. 6221(a) In General

15

- “Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner’s distributive share thereof) shall be determined, any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share shall be determined, at the partnership level pursuant to this subchapter.”

# Flow Chart of New Rules

16

IRS audits the partnership 1065 and K-1s and computes imputed underpayment

Partnership (through representative) determines response - modifications

Partners may agree that they can or must file amended returns for the adjustments.

IRS reviews the information provided and modifies the imputed underpayment and issues final adjustment

Partnership takes amended returns and other information and provides it to IRS.

Partners will report additional tax due on current year returns.

Partnership makes choice as to how to treat final adjustment.

Payment

Form 14421 Response to Proposed Adjustment(s)

Form 1040 Partnership Income Tax Return

Information Returns

Form 1040 Partnership Income Tax Return

# Role of Partnership Representative

17

- The partnership representative will make binding decisions for all the partners with respect to a federal audit.
- Question – will states adopt the same approach when it comes to state tax decisions affecting the partnership?

# Complications

18

- Some adjustments may be made in the year of the audit adjustment rather than in the audit year (“review” year)
- “Cascading push-out”:
  - It does not appear that the statutes anticipate allowing push-out where there are tiers—but the IRS is considering whether that may be allowable provided that all the partnerships agree to cooperate and the audited partnership agrees to provide information.
- Use of administrative adjustment requests in conjunction with audits – Sec. 6227

# Summary of State Considerations

- General
  - Will states follow the federal election (out of the rules)
    - ✦ Seems like this will be necessary.
  - For covered partnerships, will the partnership representative have the same authority to handle matters for the partnership and the partners in state tax issues that are related to the federal audit?
    - ✦ What if the partnership is not doing business in the state where a partner resides?
  - Does there need to be statutory imposition of duties on the partnership representative for state level filing

# Summary of State Considerations

20

- If partnership acts to modify proposed adjustment by having partners file amended returns
  - Do state RAR rules impose related filing obligations, SOLs, refund claim rules, etc.?
  - Should the partnership be required to file amended or information returns?
  - Treatment of subsequent years.

# Summary of State Considerations

- If the partnership pushes down the imputed underpayment
  - Will states allow similar push down of related state tax?
  - Will partnership have to provide computation of the state tax?
    - ✦ How will interest and penalties be computed?
    - ✦ What about affects on apportionment?
  - Will partnership have to provide state-level information returns?
  - Can partners report and pay tax in the current year (as they do for federal)?
  - Will partners be allowed/required to file amended returns for the review year (audit year)?

# Summary of Considerations

22

- If the partnership pays the imputed underpayment-plus:
  - Will a state where the partnership does business impose a partnership level tax in that event (apportioned)?
  - Is that tax attributed to the partners (so that they would not owe additional tax)?
  - Will a state where a partner resides (but the partnership does not do business) separately impose tax?
    - ✦ What credits would be required and how will they be computed?
  - Other apportionment resident/nonresident issues to be addressed.
  - Treatment of subsequent years (should there be a filing requirement if the change affects subsequent years).

# Arizona – The First Adopter

23

- Faced a “minor” problem: No statutory authority to even audit a partnership
- Largely adopts federal procedures, with some revisions
  - New law amended RAR statute and added new statute. Ariz. Laws 2016, ch. 155 (S.B. 1288) (signed May 11, 2016)
- If partnership is assessed by IRS :
  - For increases to AZ taxable income, **partnership** must file AZ return and pay tax within 90 days after final IRS determination
  - For decreases to AZ taxable income, or if partnership makes federal “push out” election:
    - ✦ Partnership must provide “reviewed year” partners (and DOR) an adjusted K-1 within 90 days after final IRS determination
      - Partnership must pay tax if it fails to timely issue adjusted K-1s
      - Partnership must pay tax on any RAR adjustments that it does not properly include on the adjusted K-1s
- **Partners** receiving adjusted K-1 must file an amended AZ return and pay tax within 150 days after final IRS determination reporting the changes

# The MTC Uniformity Committee

24

- While we are waiting for the IRS to issue proposed regulations – the MTC has been conducting an informational project helping states get up to speed on the issues.
- The Committee has now taken up a project to help states – working on a model statute or model language to address the issues states will have.

# Questions?

25

- Contact Info:
  - Helen Hecht, General Counsel, Multistate Tax Commission,
    - ✦ [hhecht@mtc.gov](mailto:hhecht@mtc.gov)
  - MTC Partnership Project Page –
    - ✦ <http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project>