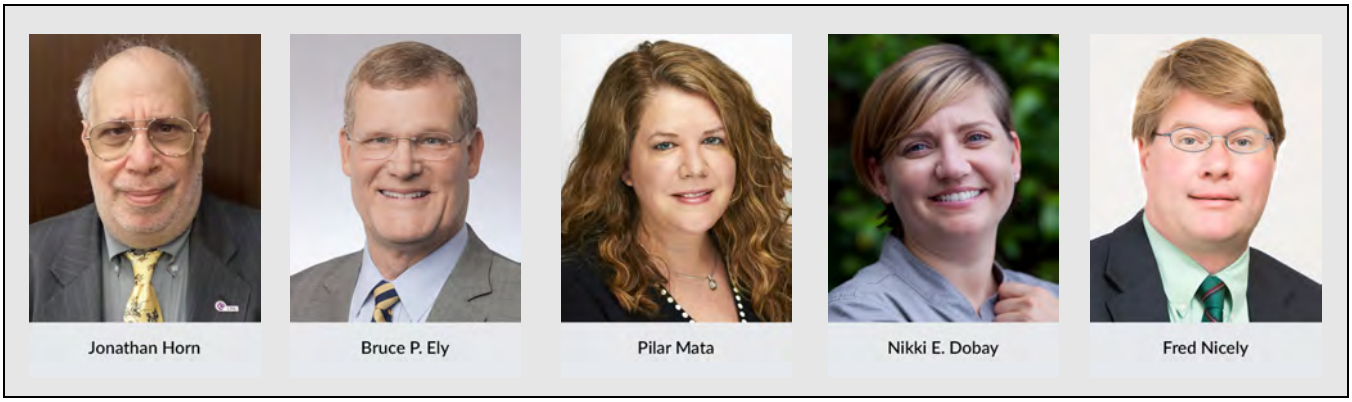
For the Greater Good

by Jéanne Rauch-Zender



The federal partnership audit rules are scheduled to take effect January 1, 2018. The rules will have an important and substantial impact on the state and local taxation of partnerships and their partners. The rules, referred to as the centralized federal partnership audit regime (CPAR), have presented state legislatures with the need to "consider legislation to ideally conform to the federal regime while making the state reporting of the anticipated federal partnership audit adjustments more streamlined for multistate taxpayers."[1] The CPAR was established by the Bipartisan Budget Act of 2015, as amended by the Protecting Americans From Tax Hikes Act of 2015, and the repeal of the partnership audit rules created under the Tax Equity and Fiscal Responsibility Act of 1982. Many states impose a net-income-based tax in accordance with the federal definition of taxable income; however, because the federal procedural rules are not substantive tax law, they are not adopted per se by definition, even if a state generally conforms to the Internal Revenue Code. Knowing that every state will have to amend its IRS revenue agent report (RAR) statutes to address the new federal partnership audit rules, a joint industry task force developed a more comprehensive model RAR statute. The task force created the draft model bill, the Uniform Statute and Regulations for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments. This task force, referred to by the Multistate Tax Commission as the Interested Parties, is composed of Nikki E. Dobay and Fred Nicely of the Council On State Taxation, Pilar Mata of Tax Executives Institute, Jonathan Horn of the American Institute of CPAs, and Bruce P. Ely and Will Thistle of Bradley Arant Boult Cummings LLP. I was excited to sit down with the team to discuss the group's efforts and goals thus far.

Jéanne Rauch-Zender: What is the purpose behind the Interested Parties?

Jonathan Horn: The purpose is twofold. First, it is to address the state-level issues caused by the CPAR and exactly how the states will go along with those rules, especially with the states that do not have a pure federal conformity statute. And even if they do, most states don't have a conformity statute that picks up procedural types of issues that we see here. Second, it is to assist the MTC in updating their current model statute for

[1] Bruce P. Ely and William T. Thistle II, "Update on States' Responses to Federal Partnership Audit Rules," *State Tax Notes*, Oct. 30, 2017, p. 405; Bruce Ely and William Thistle, "MTC, Business Groups Respond to Federal Partnership Audit Rules," *State Tax Notes*, Jan. 9, 2017, p. 215. Messrs. Ely and Thistle are transitioning their roles to fellow ABA SALT committee members, Alysse McLoughlin and Dan DeJong, who are with McDermott Will & Emery LLP (NY) and KPMG LLP (DC), respectively.

reporting RAR adjustments, and to have something that's uniform among states.

Bruce P. Ely: Yes, the goal is to address the CPAR regime and resolve the state-specific issues, and to create a uniform RAR statute for all the states to adopt.

Rauch-Zender: What does the proposal do? How did the Interested Parties integrate the proposal work provisions for reporting federal partnership audit adjustments?

Horn: The proposal's got a two-pronged approach in that it, number one, attempts to conform the state requirements for partnership audits, but more importantly, it creates a uniform framework for the reporting of all changes at a federal level, regardless of the type of taxpayer. That's a key part that brought the Interested Parties together and what we're trying to accomplish here. Right now there's the mishmash of things, ideas out there in terms of when you have to report, how long you have to report, what format you use to report. A multistate taxpayer could be faced with 10, 20, 30 different separate filings at different times just for a small federal change. So let's try to consolidate all of that. Take the best of the best in terms of what the MTC model from 2003 is, what folks have learned since then, what the states have shown works. Get some uniform definitions, both from a partnership audit side and also in terms of general RAR, and make the reporting so that it's a set date when a final determination is made at the federal level, whether it's a taxpayer voluntary determination by an amended return or a government determination by IRS audit, and when all the changes to a tax year are done, at that point, and only at that point, does it trigger the reporting requirements to the state.

Rauch-Zender: Why develop a more comprehensive model RAR statute? How will a uniform provision affect the states?

Pilar Mata: As Bruce and Jonathan noted, we came together to address the partnership questions and how to best deal with the federal rules at the state level. As we began talking about reporting federal adjustments generally, we realized that all of our organizations have been approaching the reporting of RARs independently, with some success, but not a lot, because states are generally comfortable with where they are. But reporting federal adjustments is such a big compliance issue, as Jonathan noted, that we really saw an opportunity to not just address the partnership issues, but to address reporting RARs generally. And when we start thinking about how we might draft model provisions for the partnership rules, we had to draw upon pieces from the general reporting rules. So we decided to start with overhauling the MTC's 2003 model statute, making it what we would recommend from a taxpayer perspective and then integrated the partnership provisions into that. Our hope is that, as states are considering how to amend their rules to deal with these federal provisions for partnerships, they'll take a closer look at their general reporting rules as well, and use our model to overhaul it.

Nikki E. Dobay: I would just add to that we really do think that it serves to further uniformity, which will improve overall compliance. That is the message that we've taken to the MTC and other tax administrators and legislatures: that this will help the process and should get them more dollars in the door.

Rauch-Zender: The MTC's Uniformity Committee on August 1 agreed to a motion to use the Interested Parties' RAR proposal as the starting point for its own drafting. What does this mean?

Fred Nicely: What I think is really important with the MTC Uniformity Committee is that they agreed to take on the Interested Parties' federal adjustment proposal. Not only for the federal partnership adjustments that have to be made, but, very importantly, for all types of federal adjustments that have to be made. What we're really trying to do is provide clarity there on making sure when a taxpayer has to report, whether it's a partnership partner, a C corporation, or an individual. That said reporting to the state should not occur until all issues for the tax year are finalized by the IRS. We're also pushing for taxpayers to have at least 180 days to file amended returns to the state.

Dobay: I would add that one of things that we did not want to see happen, and that we worked very hard to stop, is that the MTC started its working group right around the time our group came together and started analyzing these issues as well, and we did not want to be in a situation

where would have dueling models. When we were able to get the Uniformity Committee to agree to use our model as a starting point, we saw that as a very positive step toward all of us working together on one document. We are eager to develop that document with them so that when we do go and take this to the states, we will have everybody on the same side on this and supporting the same model.

Horn: I think it's evidence that we've been successful in conveying the message to the MTC, the states, and all the stakeholders that there's a need to do something because of the partnership audit changes. This is a perfect opportunity; they're going to need to look at their RAR provisions in order to make those changes, and while they're doing that, rationalize them to see if they even make sense in an overall scheme makes sense, we may see a little more acceptance of a uniform overall RAR statute than what happened after the 2003 MTC model.

Rauch-Zender: Must the model statutory language the MTC develops be designed in a way that a state could drop portions? Why or why not?

Nicely: I think it is important that everyone understands the states all have the nuances in their tax codes with how they do certain things. Some of the states are real big on using composite terms, where other states have withholding requirements for payments made to partners. So inherently, there has to be some flexibility there.

Horn: We've tried in drafting the model to leave enough flexibility within it, recognizing that states in many cases are going to need to fill in the gaps with regulations, which will be state-specific.

Rauch-Zender: How do the new federal partnership audit rules affect the states? What is the first step the states must do?

Dobay: What got most states' attention on this issue is that many states have the definition of a taxpayer, and a partnership is generally not included in that definition. So for many states, they are stuck in a situation where under the new federal regime, when the partnership becomes a taxpayer, the states won't be able to impose tax on the partnership because those entities aren't taxpayers in their states. And so they need to conform to these new audit rules. Another issue: You may think that many states have conformity statutes that link them to the Internal Revenue Code, so wouldn't these rules just get picked up with one of those statutes? And the answer is generally no because states' conformity statutes usually provide a link to the substance rules but not procedural rules. So states really do need to act. We saw this in Arizona. They acted very quickly. We quickly realized, we need to make sure they're doing the right thing instead of just doing something. The hope now is that, with the model, states will have a tool that they can use to address the issues and that allows them to conform to these new rules in a way that works for taxpayers and complies with the constitutional limitations on the states, which are not present at the federal level.

Horn: The states should make sure that they understand what their current process is for dealing with partnership audit changes that come down from the federal level because they need to know what the current system is before they can change to accommodate the new one.

Mata: This has been an unusual situation: we have the federal legislation, we have a technical corrections bill that was introduced but not passed, and we have regulations that have been proposed but not passed. So we have an idea of what the law will be at the federal level, where it might change, and where they might fill in gaps, but Treasury and the IRS are still figuring out how these federal provisions are going to work. And it's going to come into effect for tax years after the first of next year. At the same time, we are trying to draft state provisions that basically work off of those federal rules, without really knowing what those final rules and procedures will be because we're trying to give the states something they can get on their books so that they can handle these adjustments as they come through.

Horn: The idea of normal state conformity wouldn't apply here because normally state conformity statutes only relate to tax law per se, not administrative, and that's what has made this such a challenging exercise. Here, the states can't just say, "We conform to what the federal laws say," because administrative procedures aren't conformed. They're state-specific. And we're trying to get something that's going to conform and going to match with what the IRS is doing without knowing what the IRS is doing.

Rauch-Zender: Why did the Interested Parties ask the Uniformity Committee to expand the scope of the partnership audit work group to include a comprehensive revision of the MTC's 2003 model RAR statute?

Nicely: When the MTC model statute came out in 2003, there was not a huge push by business and business associations on getting states to adopt the MTC model. I think that's a learning lesson that we've had. We're going to need to work with state legislators and have support from the business community, pushing for the states to take uniform action.

Dobay: This is one of the biggest hurdles, I would say, to getting the Uniformity Committee to take up the RAR provisions as well as the partnership provisions because I think they were so taken aback by the fact that they did a lot of work in 2003, created their model, and then it was not adopted by any of the states. This is very important to our members at COST and the other groups' members as well. We know our members want uniformity so it's easier for the taxpayers to comply.

Rauch-Zender: What is the checklist the Interested Parties prepared for states that are developing legislative responses? Why the checklist?

Horn: The checklist was just a quick and easy way to lay out what are the concerns and issues, and make sure that, for us, the MTC, and the states, as you develop a model, we are checking all of the boxes. Have we missed anything? Because when you're dealing with something this complicated, it's easy to leave something out.

Ely: Jonathan is right. Will Thistle and I have put together our own checklist as we are proposing to amend the Alabama statute, and it became somewhat of a paradigm to look at, from a ground zero level. What does a particular state statute need, in terms of amendments? So I thought the checklist was a great way for the states, the MTC, and others, to realize how complex these rules are and how they have such a trickle-down effect on the states.

Rauch-Zender: It has been recommended that states accept uniform forms similar to those used for federal amended tax returns (Form 1040X or Form 1120X) to report federal income tax changes to a state revenue department. How will this be helpful?

Mata: States vary widely on what they require to report federal adjustments. Some states are going to require an amended return. Other states will allow you to provide a copy of the RAR through an audit or just mail it in. And some allow spreadsheets or a streamlined report. What we've heard from taxpayers is that filing an amended return is time-consuming and cumbersome, and very often unnecessary. If it's a simple change that affects one line item for one entity and it doesn't have a huge impact on the return, it's not necessary to go through that exercise. Something that was important to all of our organizations was to allow some type of streamlined reporting that gives the state notice there has been a change, this is what it is, and this is what the impact on the state's tax liability is, quickly and efficiently. And so it's designed to be more efficient and get the information states need without creating a lot of work for taxpayers trying to report these changes.

Nicely: I think you want to make sure you have extensions by mutual agreement. There could be situations that arise where both the tax agency and the taxpayer realize that they're going to get a much more accurate filing if they allow additional time. And there can be unique relationships, especially when you're dealing with certain types of partnerships that have thousands of partners, where there needs to be additional time granted. But I don't think anyone is suggesting that this should be an automatic extension in all situations. It needs to be something that's looked at and, for the most part, done on a case-by-case basis.

Ely: We want to remind [everyone] that there may be a different point to talk about this, but we were careful not to expand the scope of the statute of limitations or the scope of the audit. Our model limits it to the issues raised in the federal RAR. Some states are using an RAR as carte blanche authority to reopen the state return for all the issues, and we are very cognizant of that risk, so we reiterate the limitations on the scope of the statute extension in a couple of places in the model statute.

Rauch-Zender: Should the states have a standard minimum threshold before an amended return is required?

Horn: Certainly, at some point states have to do their own cost-benefit analysis in terms of is it worth tracking down and processing a $10 payment for the de minimis change on a final return, on an amended return. That's one of the reasons why, in our model, we put in the de minimis threshold for all taxpayers except those subject to the partnership audit regime. Because we were cognizant of the fact that there was a possibility of that being used in a way to, I don't want to say game the system, but in order to avoid having to pay it. If you have a large partnership that pushes it down to their thousands of partners, they would all be eligible for de minimis and we recognized that the states would not be happy about that.

Dobay: The de minimis provision is important for taxpayers because it's not really about the amount of tax at issue that they owe. This goes to the fundamental cost of preparing a large number of amended state returns. If there's a situation where a taxpayer owes $50 in tax to a particular state, they are likely to spend several hundred dollars to get that filing prepared. So if there's a process through which they can just send a letter, say we've had an adjustment, they're signing under penalty of perjury that it's de minimis, they would be more than happy to pay that de minimis amount of $250 to the state as opposed to having to pay for all of those amended returns to be prepared and filed. And, as Jonathan said, on some level at the state side, it just doesn't make sense for the states to process all of these amended returns as well. I think if states are to adopt this provision, it will likely be fairly heavily audited in the first several years that it's in effect. However, once the states get comfortable that it's being used in the right situations, it will become a tool that both sides find very valuable.

Rauch-Zender: How are provisions from the Interested Parties' proposed statute different from the MTC model? What changes are needed?

Ely: One thing I'll point out from the 2003 model to what we're working on present-day, is the 180 day deadline has not changed. That's still the focus in that taxpayers would have to do something within 180 days from the final determination date. What we are trying to clarify is what is the "final determination," and I think the model does that fairly well. We're also trying to make it clear that the taxpayer should be eligible to make estimated payments. And component two of this is the de minimis provision; you shouldn't have to file an amended return on something that is de minimis.

Rauch-Zender: Why is this an opportune time to amend each state's federal audit adjustment reporting rules (RAR statutes)?

Dobay: We think that this is an opportune time to address these RAR issues because of the partnership changes that are happening at the federal level and the states needing to do something to conform to those. Through our working together we realized the states are going to have to address their RAR statutes as a part of that. And we realized that this would be a unique opportunity to have the space to try to provide some greater uniformity. We worked hard last year to tell the states to slow down on the partnership issue to give us some time to draft something, and we were successful on that.

Rauch-Zender: Are there any due process concerns?

Nicely: There's always going to be some lingering due process concerns with whether or not a partnership or a partner of a partnership has the requisite minimum connections with the state. However, one of the things that we really focused in on with the states, and I think that the states and the MTC get it, is the commerce clause issue. What Congress can do in requiring taxpayers filing at the federal level [isn't] necessarily the same at the state [level]. States have to make sure their tax is fairly apportioned, and states are trying to use an apportionment based off of a year other than the tax year at issue that's been adjusted by the IRS; that's going to be a problem. So, we really focused in on the review year as that is something that the states have to use — they can't use the adjustment year, which is when the IRS completes the audit.

Rauch-Zender: What are the thoughts on states like Arizona and Montana that have tried to revise their laws for reporting adjustments under the new IRS partnership audit regime? What problems could develop from states drafting conformity rules?

Dobay: Arizona was the first state that proposed legislation and actually got it passed. Arizona's law wasn't a bad starting point, but it was by no means comprehensive enough and doesn't cover many of the issues that the model covers. It's rough conformity that doesn't address many of the due process concerns that Fred raised. After that legislation was enacted, we quickly realized we needed to make sure that other states didn't start going down that path. And because we didn't want to find ourselves in another situation like we have on the general RAR side, which is where all the states have different rules and they're all over the board, this was something that we really needed to mobilize on and start working to stop these types of things from moving forward in states that proposed some legislation. There were a few other states, in addition to Montana, that proposed bills this year, and our group, working with other organizations and associations on this issue, was very effective in conveying the message that yes, we understand you need to do something and we want to help you, but please don't do it now, you've got time. Let us develop something that is actually workable.

Mata: I think what's become apparent through this process is there is no simple answer, there is no straightforward answer. It's taken us a year, working with different groups, studying the issues, talking it through, both from a taxpayer side and a state side, to get to what we think is the best approach for this. So while states like Arizona have gone forward, every state that has looked at this has really taken a different approach about how they would apply these federal rules at the state level. I think it's wonderful that, with the exception of Arizona, [the states] have held off to see what everyone has come up with as a best practice.

Rauch-Zender: What would you like to see the states do in response to the federal partnership audit rules? Why?

Horn: Uniformity will make collection and assessment of audited amounts from a partnership easier and simpler for both the state and the taxpayer.

Rauch-Zender: Are states using the new rules to drop the federal conformity concept, and if so what should those states be aware of?

Nicely: As Jonathan mentioned, when you're dealing with federal conformity, you're not normally dealing with the administrative issue of the states issuing the assessment. I don't think this is related to the states, you know, not wanting to have federal conformity; it's just that they've never had it when it comes to assessing taxpayers additional tax. The states have always used their own laws and not the federal assessment provisions that are changing under the new procedures used by the IRS in their partnership audits.

Rauch-Zender: What should practitioners be doing to prepare for the federal developments?

Ely: What we've been doing as tax lawyers and CPAs is educating the populous — educating the business community and the tax practitioner community — of the complexity of these new laws and how they will impact the states as well. Whether the states like it or not, or understand the new rules or not, they're coming. We've got to remind people, these rules are effective January 1, unless Congress surprises us at the last minute and postpones the effective date. We've been reminding everyone, particularly CPAs and lawyers, that when you can opt out of these rules, you probably should. That means you have to check for eligible partners, and if you have even one ineligible partner, the classic case being a single-member limited liability company or any sort of a trust or IRA, you're blown. You're under these new rules whether you have two members or 200.

So we're reminding our members and clients that they've got to review their ownership structures before December 31. They can't wait until the tax return is due next year. They've got to get the ownership structure revised in one form or another by the end of this year. And only now am I seeing clients coming in the door realizing that they can't put this off any longer, and of course asking how much is it going to cost. We talk about ethical issues and warn our lawyers that they've got to decide who their client is and to be prepared. This collaboration will continue because we've got to have CPA societies, COST and TEI, state bar tax sections, and so forth, coordinated at the state level. That's our next operational phase — the grass-roots level. Unfortunately, our work has just begun.

Dobay: I echo Bruce's comments. Practitioners are going to be very busy because these partnership agreements have to be amended. The goal of the legislation was to essentially take the IRS out of the middle of the fighting partners and just grab money; and if the partners want to fight about who was supposed to pay it, the partners are going to have to deal with that through commercial litigation. On the state side, we are trying to provide partners and partnerships with a lot of flexibility while also creating a system where there is hopefully less litigation.

Horn: I was reviewing a PowerPoint done by some outside folks for a presentation on these rules the other day, and one of their slides was, "What should we do now, or what should we do next?" And the next slide was the word "PANIC" in giant red letters. More seriously, the important thing that a practitioner can be doing is making sure they're aware that these rules are coming, and it's not just your partnership clients who are affected. ■