CHAPTER 4

State Implications of the IRS Centralized Partnership Audit Regime

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§ 4.01 INTRODUCTION

As our readers are no doubt aware, the Bipartisan Budget Act of 2015, Public Law 114-74 ("BBA"), totally revamped Internal Revenue Service ("the Service" or "IRS") audit procedures for certain partnerships (including multi-member LLCs) effective for taxable years beginning after December 31, 2017.[1] Those rules displaced the rules enacted under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"),[2] the application of which is still being hashed out in the courts today. The BBA rules were intended to resolve a number of issues and difficulties that were encountered in

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the Paul J. Hartman State and Local Tax Forum Advisory Board, and the Bloomberg State Tax Advisory Board.

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[1] Bipartisan Budget Act of 2015, Pub. L. No 114-74, 129 Stat. 620 (2015) (partners could opt-in to the BBA audit procedures for taxable years beginning after November 2, 2015 and before January 1, 2018).

[2] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

partnership audits under TEFRA. Only now, however, are we actually witnessing the rollout of BBA partnership audits and the impact of those audits, from both a federal and state perspective, on the partners or former partners of the targeted partnerships. In the authors' view, the original BBA budget estimate of almost $1 billion in new revenue over the first 10 years is probably too rosy, and the impact on the states with net income taxes is unquantifiable at this relatively early date.

Since the enactment of the BBA and issuance of lengthy Treasury Regulations,[3] several new partnership-related developments have occurred. Because of several published reports indicating that partnership audits were few and far between, as compared to C corporation audits, and because of the infusion of new enforcement funding from the Inflation Reduction Act of 2022, Public Law 117-169 ("IRA"),[4] the pressure is on the Service to ramp up its audit activity, including training a cadre of new, specialized revenue agents.[5]

In the first review of the IRS efforts, the Treasury Inspector General for Tax Administration issued a report in May 2022, criticizing the Service and complaining that approximately 78 percent of the partnership audits for 2016 through 2019 tax returns under the new regime were closed without any changes.[6] Partly as a result of this report and because of the infusion of approximately $80 billion in funding from the IRA, the IRS had made multiple promises to add enforcement capacity for reviewing the returns of complex partnerships as well as high net worth individuals and large corporations. The IRS predicted a massive increase in the number of partnership audits compared with the past few years: 8,852 would be opened in 2023 and 5,253 would be opened in 2024. Whether the IRS achieved its 2023 goal has yet to be reported as of this writing.

As a corollary, the IRS announced it has begun more vigorously applying a rarely used anti-abuse rule, Treas. Reg. § 1.701-2,[7] which discourages the formation of partnerships for the primary purpose of reducing partners' federal income tax liability. Senior counsel to the Associate Chief Counsel in the Pass-Through and Special Industries Group at the IRS, Clifford M. Warren, so warned the audience at a PLI tax conference, lamenting that "some of the murkiest, most loophole-ridden parts of America's broken tax code deal with partnership income."[8]

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[3] *See, generally*, 26 C.F.R. §§ 301.6221(a)-1–301.6227-3 (2019); *see also* Am. Bar Ass'n Section of Taxation Comments on Proposed Regulations Implementing the Partnership Audit Procedures Enacted as Part of the Bipartisan Budget Act of 2015 (Sept. 11, 2017), 71 Tax Law. 219 (2018).

[4] Inflation Reduction Act of 2022, Pub. L. No. 117-169, Part 3, 136 Stat. 1818 (2022).

[5] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-23-106020, IRS AUDIT PROCESSES CAN BE STRENGTHENED TO ADDRESS A GROWING NUMBER OF LARGE, COMPLEX PARTNERSHIPS (2023); I.R.S. News Release IR-2023-166 (Sept. 8, 2023).

[6] TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, Report No. 2022-30-020, CENTRALIZED PARTNERSHIP AUDIT REGIME RULES HAVE BEEN IMPLEMENTED; HOWEVER, INITIAL NO-CHANGE RATES ARE HIGH AND MEASURABLE GOALS HAVE NOT BEEN ESTABLISHED (2022).

[7] Treas. Reg. § 1.701-2 (1995).

[8] K. Lucero, *IRS Ramps Up Policing of Abusive Partnerships, Official Says*, Law360 Tax Authority

Most recently, the IRS announced that it will target partnerships owning professional sports franchises.[9] And as will be discussed below, the states imposing net income taxes are monitoring these developments closely. A number of states came together under the auspices of the Multistate Tax Commission ("MTC") to craft a model state statute that would, in essence, wrap-around the BBA rules. Three of the co-authors of this article played a role in that effort, either on behalf of the MTC (Chris Barber) or the ABA Section of Taxation's Task Force on the State Implications of the New Federal Partnership Audit Rules (Bruce Ely and Kelvin Lawrence).

§ 4.02 OVERVIEW OF THE BBA AND ADMINISTRATIVE ADJUSTMENT REQUESTS

The BBA generally applies to partnership tax years beginning on or after January 1, 2018,[10] and applies to all partnerships unless a valid election out of the BBA rules is made for a particular tax year.[11] Partnerships subject to the BBA (hereinafter referred to as "BBA partnerships") must designate a partnership representative to act on behalf of the partnership with respect to BBA matters.[12] Under TEFRA, the IRS had the burden of assessing and collecting taxes due under federal partnership audit examination directly from each of the partners in the affected tax year (hereinafter referred to as the "reviewed year").[13] The enactment of the BBA repealed TEFRA and created a centralized audit proceeding at the partnership level with many new procedural and administrative changes affecting the party responsible for payment of tax, how much tax is paid, and reporting procedures for partnership audit adjustments.[14] The audit of a BBA partnership takes place at the partnership level and adjustments to items of income, gain, loss, deduction, or credit are determined at the partnership level.[15] As a default rule, the BBA provides that an audited partnership, rather than the partners, must either (i) pay an "imputed underpayment," equivalent to the tax calculated at the highest applicable rate associated with certain adjustments,[16] or (ii) report adjustments that do not result in an imputed underpayment under a "true-up" rule, generally resulting in the partnership making offsetting "true-up adjustments" in the partnership's

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(Apr. 25, 2023), https://www.law360.com/tax-authority/articles/1600511/irs-ramps-up-policing-of-abusive-partnerships-official-says.

[9] *See* C. Harshburger, *IRS Aims at Sports Teams in Latest Push on Wealthy Taxpayers*, BLOOMBERG DAILY TAX REPORT, (Jan. 25, 2024), https://news.bloombergtax.com/daily-tax-report/irs-aims-at-sports-teams-in-latest-push-on-wealthy-taxpayers.

[10] Certain partnerships, however, may elect into BBA for tax years beginning after November 2, 2015 and before January 1, 2018. Treas. Reg. § 301.9100-22(d)(2018).

[11] I.R.C. § 6221(b) provides an annual opt-out election for partnerships with 100 or fewer partners with each such partner qualifying as an individual, corporation, or estate taxpayer.

[12] I.R.C. § 6223(a) (2024).

[13] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

[14] *See generally* Bipartisan Budget Act of 2015, Pub. L. No 114-74, § 1101, 129 Stat. 620 (2015), replacing I.R.C. §§ 6221 through 6225 and §§ 771 through 777 with new I.R.C. §§ 6221 through 6241.

[15] I.R.C. § 6221(a) (2024); Treas. Reg. § 301.6221(a)-1(a).

[16] I.R.C. § 6225(a)(1) (2024).

tax year in which the adjustment is finally determined (i.e., the "adjustment year").[17] Imputed underpayment costs are effectively borne by current partners in the adjustment year without any effect on historic reviewed year partners as the underpayment of tax is imputed to the adjustment year rather than the reviewed year. As a hybrid option to the default rule, a partnership may request certain modifications to the imputed underpayment amount with partner-level attribute information (e.g., by reducing the tax rate to reflect certain attributes of partners).[18]

As an alternative to the default rule, a BBA partnership may choose to make a "push-out" election to furnish to each reviewed year partner a statement of the partner's share of adjustments to income, gain, loss, deduction and credit, instead of paying an imputed underpayment at the partnership level and affecting adjustment year partners.[19] There must be imputed underpayment in order for the partnership to make such push-out an election (i.e., push-out election is not available for audit adjustments that do not result in an imputed underpayment).[20] A partnership makes the push-out election by filing Form 8988, *Election to Alternative to Payment of the Imputed Underpayment;* Form 8986, *Partner's Share of Adjustment(s) to Partnership-Related Item(s);* and Form 8985, *Pass-through Statement—Transmittal/Partnership Adjustment Tracking Report*. Each reviewed year partner would generally report the associated tax on their tax return for the partner's tax year in which the partnership furnishes the push-out statement to the partner (i.e., Form 8986).

Since much of the focus of BBA has been the effect on audited partnerships (i.e., partnerships subject to IRS audit examination), insufficient attention has been paid to the significant reporting changes made under the BBA with respect to modifying a prior year partnership information return. A BBA partnership generally cannot file an amended return,[21] and can only revise its tax return items by filing an administrative adjustment request ("AAR").[22] An AAR may be filed either with (i) Form 1065-X, *Amended Return or Administrative Adjustment Request*, or (ii) electronically filed with Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request*, along with revised Form 1065. If a partnership was required to file its federal Form

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[17] I.R.C. § 6225(d)(2) (2024). If the adjustment is appealed, the "adjustment year" is the partnership's tax year in which the appeal becomes final; if the adjustment is not appealed, the adjustment year is the partnership's tax year in which the final adjustment is mailed; if the adjustment is a result of an administrative adjustment request, it is the partnership's tax year in which the administrative adjustment request is made.

[18] I.R.C. § 6225(c) (2024).

[19] I.R.C. § 6226(a) (2024); I.R.C. § 6226(b) (2024); Treas. Reg. § 301.6226-1.

[20] I.R.C. § 6226(a)(1) (2024).

[21] I.R.C. § 6031(b) (2024). For example, I.R.C. § 6031(b)(1) provides that only non-BBA partnerships are excluded from the prohibition of amended returns and therefore non-BBA partnerships may continue to file amended Forms 1065 and Schedules K-1 rather than an administrative adjustment request.

[22] I.R.C. § 6227 (2024). Note that for the 2018 and 2019 tax years, I.R.S. Rev. Proc. 2020-23, 2020-18 I.R.B. 749, granted an exception to the general prohibition on filing amended partnership returns for BBA partnerships to account for certain benefits included in the Coronavirus Aid, Relief, and Economic Security ("CARES") Act, Pub. L. No. 116-136, 134 Stat. 281 (2020).

1065 electronically, then it must file its AAR electronically. It does this by filing an electronic Form 1065, checking the box "(G)(5)" for an "amended return," and attaching Form 8082.[23] While this procedure refers to the Form 1065 as an "amended return," as mentioned above, BBA partnerships are generally prohibited from filing amended returns.[24] The Code provides some exceptions, and the IRS has provided a few more administratively.[25] However, even the AAR instructions on the IRS website make clear that the "amended return" box is checked because it is "required for transmission purposes."[26] In similar fashion, a taxpayer that paper-filed Form 1065 may file a Form 1065-X, titled "*Amended Return or Administrative Adjustment Request (AAR)*." This title is necessary because partnerships that opted out of the BBA can still file amended returns and would use this form to do so. However, for BBA partnerships, this form is not an amended return, but is rather an AAR. An AAR must be filed within three years of the due date of the partnership information return or the actual date the return was filed, whichever is later.[27] The filing of an AAR by a BBA partnership will reset the statute of limitations period for all items in the tax year affected by the AAR.[28]

The manner in which items of adjustment are reflected under the AAR parallels the same treatment for such adjustments under the imputed underpayment calculation as if the default rule for reporting audit adjustments under BBA were applied.[29] Consistent with such reporting requirements summarized above with respect to IRS audit adjustments, if an imputed underpayment results from the adjustments to the original return made under an AAR, the partnership must either pay the imputed underpayment when it files the AAR[30] or make the push-out election to report the adjustment to the reviewed year partners.[31] Also consistent with BBA reporting requirements in the IRS audit context, the partnership may request certain modifications to the imputed underpayment amount with partner-level attribute information.[32] If an AAR results in an imputed underpayment and the partnership pays the imputed underpayment itself, it need not file anything further than the electronic Form 1065 and Form 8082, or paper Form 1065-X. However, if an AAR results in an imputed underpayment *and* the BBA partnership elects to push out that imputed underpayment to its reviewed year partners, then it must file two additional forms. First, it must notify each of its reviewed year

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[23] *See* I.R.S., https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request-under-bipartisan-budget-act-of-2015-bba (last visited Feb. 15, 2024).

[24] I.R.C. § 6031(b) (2024).

[25] *See* I.R.C. § 6031(b)(1) through (4) (2024); Rev. Proc. 2020-23, 2020-18 I.R.B. 749; Rev. Proc. 2021-29, 2021-27 I.R.B. 12.

[26] I.R.S., https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request-under-bipartisan-budget-act-of-2015-bba (last visited Feb. 15, 2024).

[27] I.R.C. § 6227(c) (2024); Treas. Reg. § 301.6227-1(b) (as amended in 2021).

[28] I.R.C. § 6235(a)(1)(C) (2024); Treas. Reg. § 301.6235-1(a)(1)(iii)(2019).

[29] Treas. Reg. § 301.6227-2(a)(1) (2019).

[30] Treas. Reg. § 301.6227-2(b)(1) (2019).

[31] Treas. Reg. § 301.6227-2(c) (2019).

[32] Treas. Reg. § 301.6227-2(a)(2) (2019).

partners using the Form 8986 to provide each partner's respective share of adjustments. Second, it must file copies of such Forms 8986 with the IRS and file Form 8985 to show the total amount of the imputed underpayment allocated to each partner.

If the adjustments to the original return made under AAR do not result in an imputed underpayment, the partnership is *required* to push out the adjustments to the reviewed year partners. Notably, this requirement for AARs differs significantly from reporting IRS audit adjustments that do not result in imputed underpayment, as audit adjustments that do not result in imputed underpayment result in the partnership making "true-up adjustments" in the adjustment year and thereby impacting adjustment year partners only.[33] Similar to the IRS audit context, however, adjustments that are pushed out under AAR must be reported on a Form 8986 issued to each reviewed year partner. This procedure allows the reviewed year partners to claim their share of tax benefit associated with the adjustments on their federal tax returns in the "reporting year"[34] (i.e., the year in which the partner is furnished Form 8986). As is the case when there is an imputed underpayment, the partnership must also use Form 8985 to report to the IRS the total amount of tax benefit allocated to its partners.

A partner, other than a pass-through entity partner, who receives a Form 8986 must then file the partner's reporting year federal income tax return, attaching a Form 8978 which converts the adjustments from the Form 8986 to information regarding the amount of income and tax for the reviewed year that should be added or reduced. Among other things, the Form 8978 reflects the changes to the taxpayer's taxable income, deductions, credits, tax, interest, and penalties for each reviewed year.

As mentioned above, a BBA partnership can generally make prior year changes only through an AAR and may either pay the imputed underpayment at the partnership level when it files the AAR or make a push-out election to report the adjustment to its reviewed year partners. In the latter case, the BBA rules governing push-out elections dictate the amount of additional tax a partner must pay pursuant to the AAR and the additional tax amount is reported as additional tax liability in the reporting year.[35] Alternatively, a BBA partnership with AAR adjustments that do not result in an imputed underpayment must push out those adjustments to the reviewed year partners, and the tax effect of such adjustments would be available as a reduction to such partners' tax liability in the reporting year.[36] As such, the tax-effected adjustment amount serves as an offset to the partner's reporting year tax liability in similar fashion to a tax credit, but any excess "tax credit" amount beyond the partner's reporting year tax liability cannot be refunded or carried forward.[37]

In summary, in the case of either (i) push-out of adjustments under AARs or (ii) push-out of imputed underpayments resulting from IRS audits, there will never be an

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[33] Treas. Reg. § 301.6227-3 (2019); Treas. Reg. § 301.6227-2(d) (2019).

[34] Treas. Reg. § 301.6227-3(a) (2019).

[35] Treas. Reg. § 301.6227-3(a) (2019).

[36] I.R.C. § 6226 (2024); Treas. Reg. § 301.6226-3(a) (2019).

[37] Treas. Reg. § 301.6226-3(a) (2019); Treas. Reg. § 301.6226-3(b)(1) (2019).

adjustment resulting in a reviewed year change to federal taxable income and/or adjusted gross income of a reviewed year partner or a BBA partnership. Thus, there are no federal amended returns involved at all—not with respect to the BBA partnership (as amended returns are prohibited) and not with respect to reviewed year partners (as such partners account for only the tax-effect of those pushed-out adjustments, either as additional tax liability or as non-refundable credits in the reporting year only). Because mandates to report the impact of these federal income tax changes at the state and local levels are generally premised on a reported change in federal taxable income or adjusted gross income and/or the filing of an amended federal income tax return, the lack of any such triggering mechanism in the context of reporting adjustments pursuant to an AAR raises significant questions as to how states and localities can lay claim to their share of adjustments reported under AARs. To that end, we now turn attention to the Multistate Tax Commission's efforts to craft a model state statute to conform to BBA partnership audit adjustments as well as prior year changes made by partnerships under AARs.

§ 4.03 MTC MODEL STATUTE PROCESS AND COMPARISONS WITH/ CONTRASTS TO FEDERAL AND STATE APPROACHES

[1] Partnership Representative

In an effort to promote multistate uniformity in conforming to adjustments to federal taxable income resulting from IRS audits or taxpayer amendments, in 2003 the MTC adopted a Model Uniform Statute for Reporting Federal Tax Adjustments, but no state fully conformed to that model. Following enactment of the BBA, the MTC Uniformity Committee convened an informational project to help its members understand the new federal partnership audit process and participated in meetings with representatives of the IRS to discuss planned implementation.

Anticipating that the BBA would produce significant federal tax adjustments, the MTC Uniformity Committee formed a work group to draft a model law addressing the reporting and payment of state tax on federal partnership audit adjustments. The work group received a proposal from interested parties, including the Council On State Taxation (COST), the Tax Executives Institute (TEI), the ABA Section of Taxation (ABA), the AICPA SALT Committee (AICPA), and the Institute for Professionals in Taxation (IPT), to incorporate the new provisions into the 2003 model.

In July 2017, after several drafting sessions in person and by conference call, the interested parties presented the Uniformity Committee with a draft model statute, and the committee voted to consider that draft and make any changes the work group might deem necessary. The partnership work group held periodic calls to discuss issues affecting state assessment of tax. Substantial changes were made to the draft model statute, and a final version was presented to the Uniformity Committee at its July 2018 meeting. That version of the model was approved for referral to the Executive Committee, and it was officially adopted by the MTC in early 2019. In 2020, in response to questions about how the model would apply to AARs and the interim issuance of guidance on these AARs by the IRS, there were certain technical corrections made to the model, which the MTC adopted in November 2020. The

following sections summarize the key elements of this model, known as the Model Uniform Statute for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments (the "MTC Model Statute").

Similar to the BBA regime, the MTC Model Statute calls for the partnership to appoint a state partnership representative who will handle matters involving state reporting of federal centralized partnership audit adjustments.[38] If the partnership does not appoint anyone for this role, the federal partnership representative will also serve as the state partnership representative.[39]

[2] Reporting Adjustments to Federal Taxable Income—General Rule

The MTC Model Statute provides a "general rule" requiring a partnership subject to a BBA partnership level audit or which filed an AAR to report the resulting adjustments, notify its partners of their share of those adjustments, and pay any state composite or withholding tax due as a result. The partners must then report their share of the adjustments to the state and pay any remaining tax, interest, and penalties due after accounting for composite or withholding tax paid by the partnership.[40]

[3] Reporting Federal Adjustments—Partnership Level Audit and Administrative Adjustment Request (AAR)

With the exception of federal adjustments that do not result in an imputed underpayment (i.e., taxpayer-favorable adjustments) and that are required under the BBA to be taken into account by the partnership under the "true-up" rule in the adjustment year, partnerships and partners are required to report to the state final federal adjustments arising from a BBA partnership audit or an AAR and to make tax payments no later than 90 days after the "Final Determination Date" as follows: (i) filing a completed "Federal Adjustments Report" (i.e., a method or form to be prescribed by the relevant state tax agency to report final federal adjustments), (ii) notifying each of its direct partners of their distributive share of adjustments, and (iii) in instances where composite tax returns or withholding returns are authorized, filing an amended composite tax return and/or amended withholding return for direct partners and corollary payment of additional tax amounts that would have been due if the federal adjustments had been reported properly.[41] In addition, no later than 180 days after the "Final Determination Date," each taxable direct partner (e.g., individuals, trusts, estates, corporations) is required to (i) file a "Federal Adjustments Report" reporting their distributive share of federal adjustments, and (ii) pay additional income tax due as if the federal adjustments had been properly reported, plus penalties and interest, and less any credit for amounts paid or withheld and remitted on behalf of the direct

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[38] MODEL UNIF. STATUTE FOR REPORTING ADJUSTMENTS TO FED. TAXABLE INCOME AND FED. P'SHIP AUDIT ADJUSTMENTS § C(1)(Official Draft with Technical Correction as of November 2020 and Additional Note for States Adopting the Model), www.mtc.gov/wp-content/uploads/2023/06/Proposed-Model-RAR-Statute-Technical-Corrections-FINAL.pdf.

[39] *Id.* at § C(1)(b).

[40] *Id.* at § C(2)(b).

[41] *Id.* at § C(2)(a).

partner.[42] In this regard, it appears that the MTC Model Statute deviates from the BBA by requiring pass-through treatment of federal adjustments along with payment of required composite and/or withholding taxes, and requiring partners to file their own reports, make their own tax determinations related to such federal adjustments, and claim credit for composite and/or withholding taxes paid at the partnership level. In contrast, the BBA generally requires the partnership itself to pay the imputed underpayment amount, without any effect on the partners.

Notwithstanding the foregoing, a BBA partnership that is subject to an IRS partnership level audit may instead make an election to (i) file a completed "Federal Adjustments Report," along with notification to the relevant state(s) that it's making the election discussed herein, no later than 90 days after the IRS audit "Final Determination Date," and (ii) no later than 180 days after the "Final Determination Date," pay an amount of tax at the partnership level, in lieu of taxes being paid by any partners, calculated by taking into account various factors.[43] Those factors may include: (a) exclusion of federal adjustment amounts attributable to tax-exempt partners; (b) allocation and apportionment of the federal adjustment amounts attributable to corporate partners in accordance with the relevant state's corporate income tax apportionment methodology multiplied by the state's highest corporate income tax rate; (c) allocation and apportionment of the federal adjustments attributable to nonresident personal income taxpayer partners based on the relevant state's personal income tax income sourcing methodologies multiplied by the highest personal income tax rate; (d) piercing through upper-tier partnerships to determine the proper sourcing of federal tax adjustments and applying the appropriate tax rate to such adjustments attributable to the ultimate partners in such upper-tier partnerships; and (e) multiplying the share of federal tax adjustments attributable to resident individuals, estates, and trusts by the highest personal income tax rate.[44] Accordingly, the MTC Model Statute deviates from the BBA by providing a <u>state-level</u> election to BBA partnerships (specifically those reporting adjustments resulting from an IRS partnership level audit)[45] to pay the state tax at the partnership level. In contrast, the BBA provides an election generally to push-out federal adjustments to the reviewed year partners.

[4] Administrative Adjustment Requests (AARs)

Under the MTC Model Statute, the date that a partnership files an administrative adjustment request in accordance with IRC § 6227 is the "Final Determination Date."[46] The partnership will then have 90 days from that date to file a completed federal

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[42] *Id.* at § C(2)(b).

[43] *Id.* at § C(3)(a).

[44] *Id.* at § C(3)(b).

[45] *Id.* at § C(3)(c). Indeed, partnerships reporting federal adjustments arising from an AAR are specifically excluded from the state-level election to pay state tax at the partnership level described in §§ C(3)(a), C(3)(b). In addition, the share of federal adjustments attributable to unitary corporate partners is also excludible from the state-level election to pay state tax at the partnership level.

[46] *Id.* at § A(9).

adjustment request with the state, notify each of its direct partners of their distributive share of the final federal adjustments, and file, where authorized or required, an amended composite and/or withholding tax return for its direct partners.[47] As previously noted, AAR adjustments are excluded from the election to pay state tax at the partnership level.[48] Instead, each direct partner will have 180 days from the date the administrative adjustment report is filed to file a federal adjustments report (which may take the form of an amended return for the reviewed year) and pay any tax due net of credits for previously-paid composite and/or withholding taxes.[49]

§ 4.04 STATE APPROACHES TO THE CENTRALIZED PARTNERSHIP AUDIT RULES

[1] Overview of State Approaches to Date

As described above, the federal centralized partnership audit regime or CPAR adopted under the BBA was intended to simplify the process of auditing complex partnerships by allowing for entity-level audits and assessments.[50] For as much simplicity as this may add at the federal level, it tends to create complexity at the state level. This is because most states that impose an income tax usually rely on either federal taxable income or adjusted gross income as a starting point. States generally require taxpayers to amend their state returns when there is a change in federal taxable income or adjusted gross income, or when amendments are made to the federal income tax return. However, so far only about half of the states have updated their audit or return amendment procedures to address conformity to the BBA or the MTC Model Statute.

As a result, this creates state-level challenges—particularly with respect to an AAR. Whether an AAR results in a partnership paying an imputed underpayment at the entity level, electing to push out the imputed underpayment to its reviewed year partners, or mandatorily allocating out a non-refundable tax credit (i.e., related to an adjustment that does not result in an imputed underpayment) to reviewed year partners, the partnership does not file an amended federal return or issue amended Schedules K-1 to the reviewed year partners.[51] If a state has not adopted a law to specifically address these issues, a partnership that files an AAR—and its partners—must determine whether there has been a triggering event that requires amending the partnership's or the partners' state returns. Some states may consider a federal AAR as a triggering event, requiring the partnership to amend its state return for the audited year and to issue corrected state Schedule K-1 equivalents showing a change to the partners' income from the partnership for that year. However, because a BBA partnership is prohibited from

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[47] *Id.* at § C(2)(a).

[48] *Id.* at § C(3)(c)(ii).

[49] *Id.* at § C(2)(b).

[50] Bipartisan Budget Act of 2015, Pub. L. No. 114-74, 129 Stat. 620 (2015).

[51] I.R.C. § 6031(b) (2024).

issuing amended federal Schedules K-1,[52] the affected partners in this scenario could have a mismatch between the income reported on their federal and state returns for the reviewed year.

The remainder of this Chapter provides a summary as of February 2024 of several approaches different states have taken—or failed to take—to address this issue, to see whether anything can be learned by the comparison. It may be that some states have developed practices that are particularly efficient and should be adopted elsewhere. Conversely, certain state procedures should be avoided, while others are in dire need of clarification. For reasons that will become clear, the authors believe the MTC Model Statute reflects years of work and compromise to develop practices that are beneficial for states and taxpayers alike and should be adopted more widely, with careful attention to integrating it into each state's tax scheme.

One can broadly categorize state approaches to AARs into three groups: (1) states with an income tax that have not adopted any specific BBA guidance; (2) states with an income tax that have enacted or adopted specific BBA guidance that differs significantly from the MTC Model Statute; and (3) states with an income tax that have enacted the MTC Model Statute, with varying degrees of modification. States without a personal income tax are not a part of this review. While this Chapter is intended to be informative, it is not intended to be a comprehensive review of state approaches. Rather, it highlights one state from each of these broad categories to see what differences, similarities, strengths, and weaknesses can be discerned among the categories, as well as highlighting the shortcomings within each approach.

In the first category, about 24 states have not enacted a specific statute to address the BBA.[53] Their approach has been to default to generally applicable rules that require the filing of amended returns by either or both the partnership and the partners when there is an amended federal return, a change to a federal return by the Internal Revenue Service, or a change to the amounts shown on the state's return as a result of a change to another return (whether federal or, in some cases, state). Because the BBA was intended to make federal audits easier by avoiding numerous amended returns if partnership-level adjustments were made, one feature of statutes of this type, discussed in more detail below, is that the state's requirement for a taxpayer to file an amended return may not be triggered by a BBA proceeding.

Other states, such as Arizona, Hawaii, and Maine, form a second category of states that have enacted statutes to address BBA procedures but are vastly different from one another, and from the MTC Model Statute. Because it is a state with a large population and was the first to enact a statute following enactment of the BBA, this Chapter will

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[52] *Id.*

[53] AK, AL, AR, CT, DC, DE, FL, ID, IL, KS, MD, MS, NC, ND, NE, NH, NY, OK, PA, SC, SD, TN, TX, and UT. *See generally*, COUNCIL ON STATE TAXATION, STATES THAT ENACTED OR NEED TO ENACT MTC CONSENSUS MODEL FOR FEDERAL AUDIT CHANGE REPORTING AND PARTNERSHIP AUDITS (Aug. 8, 2023) (listing 26 states; Rhode Island and New Jersey adopted portions of the MTC Model Statute), https://us.aicpa.org/content/dam/aicpa/advocacy/state/downloadabledocuments/map-of-states-adopting-mtc-model.pdf (last visited Feb. 15, 2024).

consider Arizona's act as the exemplar for this category. Arizona has also had more time to make amendments to its statute since its enactment, and since the adoption of the MTC Model Statute.

A third category is composed of the approximately 21 states that have enacted a law that follows the MTC Model Statute in whole or in substantial part.[54] Some of these states have made some material changes to the Model Statute, such as California.[55] Others have largely preserved its provisions, such as Georgia.[56] Several states incorporated the revised Model Statute only for partnerships, leaving their existing statutes largely unchanged with respect to the reporting of corporate and individual federal adjustments. Because Ohio is a relatively large-population state that has made a modest number of revisions to the Model Statute, and because of the authors' familiarity with its existing pass-through entity taxation framework, the authors have selected it for comparison in this review.

[2] States with No Specific Enactment

[a] Summary of New York's Approach

One would hope that states would be eager to adopt their own processes to handle BBA audits and AARs. However, this has proven not to be the case. Approximately half the states have not adopted any specific guidance addressing how to handle a BBA audit or AAR. In the authors' experience, these states typically rely on a general statute requiring the filing of an amended state return when the taxpayer files an amended federal return or refund application, when a federal audit is concluded and a federal "revenue agent report" ("RAR") is generated, or in connection with other federal tax changes such as a change in federal taxable income or adjusted gross income. Statutes that require state-level amendments in these situations are colloquially referred to as state "RAR" statutes, and that terminology will be used in this article.

New York is a state with a large population, a mature, complex, developed economy, and a sophisticated governmental agency enforcing its taxes. Thus, it seems like a natural place to begin a review of state responses to the BBA. Although New York is an early adopter in many fields of tax policy and procedure, it has been slow to enact a specific provision addressing state management of AARs, and thus far has failed to enact the MTC Model Statute.

The process of notifying the New York Department of Taxation and Finance of changes to a taxpayer's federal income tax liability is generally governed by the state's

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[54] CA, CO, GA, OH, IA, IN, KY, LA, MA, MI, MN, MO, MT, NJ, NM, OR, RI, VA, VT, WI, and WV. *See generally*, COUNCIL ON STATE TAXATION, STATES THAT ENACTED OR NEED TO ENACT MTC CONSENSUS MODEL FOR FEDERAL AUDIT CHANGE REPORTING AND PARTNERSHIP AUDITS (Aug. 8, 2023) (listing 20 states; Rhode Island has only enacted a few parts of the MTC Model Statute), https://us.aicpa.org/content/dam/aicpa/advocacy/state/downloadabledocuments/map-of-states-adopting-mtc-model.pdf (last visited Feb. 15, 2024).

[55] CAL. REV. & TAX. CD. § 18622.5 (2023).

[56] GA. CODE ANN. § 48-7-53 (2023).

statute regarding the reporting of federal income tax changes, N.Y. Tax Law § 659.[57] The statute generally requires that when certain amounts represented on the taxpayer's state return or report, including federal taxable income, are adjusted by the IRS or other competent authority, the taxpayer so affected must report such change or correction or disallowance within 90 days after the final determination, and state whether the taxpayer concedes or objects to the accuracy of the IRS's determination.[58]

With respect to amended federal returns, New York's statute provides that "[a]ny taxpayer filing an amended federal income tax return . . . shall also file within ninety days thereafter an amended return under this Article, and shall give such information as the commissioner may require."[59] For purposes of this statute, a "taxpayer" includes a partnership having a New York resident partner, or having income derived from New York sources, and a "federal income tax return" includes a federal partnership return required under IRC § 6031.[60] Amended returns filed by partnerships under this provision must "indicate the portion of the change in each item of income, gain, loss or deduction . . . allocable to each partner[,] and shall set forth such identifying information with respect to such partner . . . as may be prescribed by the commissioner."[61]

On reading the flush language of the statute, it appears most provisions of N.Y. Tax Law § 659 do not require a BBA partnership, or its partners, to file amended New York state returns when an AAR is filed. When filing an AAR, a partnership's federal taxable income for the reviewed year is not "changed or corrected" by the IRS or any other taxing authority; the partnership itself is the cause of the change or correction. Despite superficial appearances to the contrary, a partnership filing an AAR is also not "filing an amended federal income tax return." The federal procedure for filing an AAR electronically requires filing an electronic Form 1065 with the box checked indicating an "amended return."[62] Likewise, a partnership that files paper returns must complete a Form 1065-X, which is titled "Amended Return or Administrative Adjustment Request (AAR)" in connection with filing an AAR. Despite this nomenclature and programming, the Internal Revenue Code generally prohibits BBA partnerships from filing amended returns, and the IRS's instructions make it clear that the electronic 1065 and 1065-X are not considered "amended returns" when filed as an AAR for a BBA partnership.[63]

There is further ambiguity surrounding whether a New York amended return is required when an AAR is filed that would reduce the partnership's income or a partner's

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[57] N.Y. TAX LAW § 659 (2024).

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] *See, e.g.*, I.R.S., https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request-under-bipartisan-budget-act-of-2015-bba (last visited Feb. 15, 2024).

[63] *See, e.g.*, I.R.S., https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request-under-bipartisan-budget-act-of-2015-bba (last visited Feb. 15, 2024); I.R.S., Instructions for Form 1065-X, at 3 (2023).

tax liability, and the IRS denies the AAR. N.Y. Tax Law § 659 requires a taxpayer to report the disallowance, in whole or in part, of a claim for credit or refund of federal income tax. The report must be filed on the prescribed form and must be filed within 90 days after the final determination of the disallowance. The report must state whether the taxpayer concedes to the accuracy of the disallowance or must state how the disallowance is erroneous.[64]

Because of how partners must take into account AARs that reduce federal income tax liability, an AAR can be considered a partnership's request for credit against the federal income tax of its partners. Viewed in this light, if an AAR is denied, there is a credible argument that the AAR was a partnership's "claim for credit or refund" that was "disallowed." However, there are several problems with this reading of the statute.

First, the statute appears intended to address only refund claims filed in the form of amended returns. When an amended federal return is filed for a taxable year, and a state imposes its tax on a measure based on federal taxable income or adjusted gross income, it seems natural that the state would need to know the nature of the claim (through a parallel amended state return), and whether the claimed federal credit or refund is denied, so the state could parallel the income tax effect of that denial. However, when a federal claim could not change the partner's or the partnership's income for the taxable year with the change, a parallel state refund claim and reporting the disallowance of that claim to the state seem unnecessary.

New York's statute is also concerned with any taxpayer's claim for credit or refund of federal income tax, presumably even those outside an amended return. Implicit is the understanding that such a claim is one for a credit against or refund of a taxpayer's *own* federal income tax liability, not a claim for the amounts reported by a pass-through entity where any tax is paid or credit claimed by its partners. This is particularly the case where the claim for credit does not affect the income that would be reported on the state income tax return of either the partnership or the partner for the reviewed year. Indeed, the partnership is generally *prohibited* from filing amended federal Schedules K-1 that would have that effect.

Finally, the applicable regulations require the report be filed on the "prescribed" form, but no such form appears to exist for New York state income tax purposes.[65] It appears that a Form IT-115 did exist at one point in time for reporting the disallowance of a federal credit, but the form does not appear to have been updated in nearly 40 years.[66] If one were to construe this statute as requiring a report to be filed upon the disallowance of an AAR, compliance with the letter of the law seems impossible.

One potential alternative may be to require a BBA partnership that files an AAR with the IRS to file an amended New York Form IT-204, *Partnership Return*, and amended

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[64] N.Y. TAX LAW § 659 (2024); N.Y. COMP. CODES R. & REGS. tit. 20, § 159.1 (2024).

[65] N.Y. COMP. CODES R. & REGS. tit. 20, § 159.1 (2024); N.Y. COMP. CODES R. & REGS. tit. 20, § 159.2 (2024).

[66] *See* N.Y. Dep't of Taxation and Fin., Instructions for Form IT-115-I (1986), https://www.tax.ny.gov/pdf/1986/inc/it115i_1086.pdf (last visited Feb. 15, 2024).

New York Schedules IT-204-IP, *New York Partner's Schedule K-1*, and IT-204-CP, *New York Corporate Partner's Schedule K-1*, as necessary. Such an alternative, however, may create more problems than it would solve because the AAR does not (and a BBA partnership cannot) change federal taxable income reported on a Schedule K-1. As such, an amended IT-204 would create a mismatch between the partner's federal Schedule K-1 and the state Form IT-204-IP or Form IT-204-CP for the same taxable year. Unlike a partnership filing an electronic Form 1065 or a paper Form 1065-X, a partner receiving a Form 8986 indicating a credit or an amount of imputed underpayment will not file an amended federal return for the reviewed year. That partner instead will pay its share of the imputed underpayment due in the partner's reporting year. It is not clear that such a partner has actually had its federal taxable income for the reviewed year changed or corrected by the IRS or is under any obligation to amend the reviewed year New York return. Accordingly, requiring amended Forms IT-204 and Schedules IT-204-IP or IT-204-CP pursuant to a federal AAR submission would create inconsistencies in a state that otherwise largely conforms to the federal Internal Revenue Code as the starting point for computation of state taxable income. New York should take legislative action to make clearer that such an incongruous result is not intended.

[3] States with Specific Enactment that Differs Materially from the MTC Model Statute

[a] Summary of Arizona's Approach

A handful of states have enacted legislation to address BBA audits and AARs in ways that differ significantly from the MTC Model Statute. These states include Arizona, Maine, and Hawaii.[67] Some of the differences in these states may be attributed to the fact that several of these states enacted their legislation prior to the initial adoption of the MTC Model Statute by the Multistate Tax Commission on January 24, 2019 and have not amended the relevant law since.[68] As mentioned, Arizona was the first of these states to act, enacting its law, Senate Bill 1288, on May 11, 2016.[69]

Arizona's 2016 amendments to its RAR statute, Ariz. Rev. Stat. § 43-327, largely accomplish the goal of providing the state a way to respond to federal adjustments stemming from centralized partnership audits under the BBA. The amendments do this in part by enacting a specific statute, Ariz. Rev. Stat. § 43-1414, to address the federal

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67 ARIZ. REV. STAT. ANN. § 43-327 (2023) and ARIZ. REV. STAT. ANN. § 43-1414 (2023); ME. REV. STAT. ANN. tit. 36 § 5196 (2023); and HAW. REV. STAT. § 235-2.45 (2023). Rhode Island's enactment of portions of the MTC Model Statute is so limited as to effectively include it in this second category.

68 *See* Multistate Tax Comm'n, https://www.mtc.gov/mtc-new-uniformity-model-partnership-project/#:~:text=At%20a%20special%20Commission%20meeting,uniformity%20recommendation%20to%20the%20states (last visited Feb. 15, 2024). Note that Maine adopted its statute in 2019 and amended it in 2021 to address several shortcomings with the initial legislation, in part to address refunds and administrative adjustment requests. H. Paper 891, 130th Leg., 1st Reg. Sess., Pt. A, §§ A-7–A-11 (Me. 2021).

69 S.B. 1288, 52nd Legislature, 2d Reg. Sess. § 6 (Ariz. 2016); S.B. 2821, 29th Leg., § 4 (Haw. 2017) (applicable to taxable years beginning after December 31, 2017); H. Paper 1296, 129th Leg., 1st Reg. Sess., § 2 (Me. 2019).

assessment of imputed underpayments. However, these enactments do not explicitly govern how partnerships should address AAR adjustments. Despite the absence of statutory or regulatory rules requiring amended returns in the context of a federal AAR, the Arizona Department of Revenue has provided guidance to require such returns. While this is more instructive to taxpayers than not offering any guidance, the approach creates a few challenges and leaves many questions unanswered.

If the Commissioner of Internal Revenue or another federal officer changes an Arizona taxpayer's taxable income reported to the U.S. Treasury for a tax year, Ariz. Rev. Stat. § 43-327 generally requires that within 90 days the taxpayer must either: (i) file a copy of the federal final determination and concede the accuracy of the determination or state the errors in the determination, requesting the Arizona Department of Revenue to recompute the Arizona tax due; or (ii) file an amended return if required to do so by the Arizona Department of Revenue.[70] The Arizona Department of Revenue reserves the right to require a taxpayer to file an amended return if the department lacks the necessary information to recompute the tax owed.[71] All Arizona taxpayers are required to file an amended Arizona return within 90 days of the final determination of an amended federal return.[72] A determination is "final" when the appeal rights of both parties have expired or have been exhausted relative to the tax year.[73]

With regard to changes covered by the state's enactment specifically addressing BBA audits, A.R.S. § 43-1414, the applicable rules depend on whether the partnership has elected to pay the federal tax at the entity level, or to "push out" the tax to its reviewed year partners.[74] When the federal tax is paid at the entity level, the partnership must file an amended Arizona return.[75] In addition to filing an amended partnership return, the partners must file amended Arizona individual returns if the partnership has instead elected to push out the liability under IRC § 6226 and ARS § 43-1414(B)(2), described below.[76]

If a partnership doing business in Arizona is audited by the IRS and is assessed an imputed underpayment or elects to push out an imputed underpayment to its reviewed year partners under IRC § 6226, within 90 days after the IRS's determination becomes final, the partnership must file an Arizona Form 165PA showing the adjustments to income, gain, loss, or deduction on which the federal imputed underpayment is based,

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[70] ARIZ. REV. STAT. ANN. § 43-327(A) (2023).

[71] ARIZ. REV. STAT. ANN. § 43-327(C) (2023).

[72] ARIZ. REV. STAT. ANN. § 43-327(D) (2023).

[73] ARIZ. REV. STAT. ANN. § 43-1414(E)(2) (2023) and ARIZ. REV. STAT. ANN. § 43-327(H) (2023).

[74] ARIZ. REV. STAT. ANN. § 43-327(B) (2023).

[75] ARIZ. REV. STAT. ANN. § 43-327(B)(2) (2023) and ARIZ. REV. STAT ANN. § 43-1414(B)(1) (2023).

[76] ARIZ. REV. STAT. ANN. § 43-327(B)(1) (2023), ARIZ. REV. STAT ANN. § 43-1414(A) (2023) and ARIZ. REV. STAT ANN. § 43-1414 (B)(2) (2023).

as well as any adjustments required by Arizona law.[77] If the federal imputed underpayment is assessed at the partnership level, and the adjustments result in an increase in Arizona taxable income, then the increase in Arizona tax and applicable interest must also be paid at the entity level, at the highest individual income tax rate, within 90 days of the federal final determination.[78]

If the federal audit results in a change to Arizona taxable income but the partnership has elected to push out the federal liability to its reviewed year partners under IRC § 6226, then within 90 days of the final determination of the federal adjustment, the partnership must furnish to those partners (or former partners) a form showing their share of the adjustments to income, gain, loss, or deduction on which the federal imputed underpayment is based, as well as any adjustments required by Arizona law.[79] Those partners (or former partners) must then file amended Arizona returns within 150 days of the final determination of the federal adjustment.[80] In effect, the partnership generally must follow at the state level the election it made at the federal level with respect to payment of the federal imputed underpayment. One exception is that a partnership is liable for the Arizona tax if it had an increase in Arizona taxable income, pushed out the federal tax liability under IRC § 6226, but failed to timely notify its reviewed year partners as required.[81]

As is the case in New York, the state's rules generally applicable to federal adjustments and amended returns make no mention of AARs. Moreover, because the Arizona Department of Revenue permits composite tax returns, but Arizona law does not specifically address them, the statutes do not make clear whether the partnership's obligation to file the Form 165PA and pay state tax also encompasses Arizona composite returns. There are no state regulations addressing these issues, and the Department has not issued formal rulings addressing them. As a result, the most reliable source for guidance appears to be the state's income tax returns and instructions.

Partnerships doing business in Arizona are generally required to file an Arizona Form 165 to report the partnership's income.[82] The 2023 instructions to Arizona Form 165 state that partnerships that have opted out of the BBA audit rules must use an amended Arizona Form 165 to report changes to their federal returns.[83] The Form 165 instructions further advise that:

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[77] ARIZ. REV. STAT ANN. § 43-1414(A) and (B)(1)(d) (2023) (imposing penalties if return is not filed within 90 days).

[78] ARIZ. REV. STAT ANN. § 43-1414(B)(1) (2023).

[79] ARIZ. REV. STAT ANN. § 43-1414(B)(2) (2023); this is Form 165PA Schedule K-1 for Arizona residents and Form 165PA Schedule K-1(NR) for Arizona nonresidents; *see* Ariz. Dep't of Revenue, Instructions for Ariz. P'ship Adjustment—Fed. Imputed Underpayment Assessment Form 165PA at 1 (2023).

[80] ARIZ. REV. STAT ANN. § 43-327(B)(1) (2023).

[81] ARIZ. REV. STAT ANN. § 43-1414(B)(2) (2023).

[82] ARIZ. REV. STAT. ANN. § 43-306 (2023); *see* Ariz. Dep't of Revenue, Instructions for Ariz. Form 165 (2023), Ariz. Dep't of Revenue, Ariz. P'ship Income Tax Return (2022).

[83] Ariz. Dep't of Revenue, Instructions for Ariz. Form 165 at 3 (2023).

> Partnerships that are subject to the BBA centralized partnership regime (BBA) must submit Arizona Form 165PA to report changes to their federal return either as the result of a federal imputed underpayment assessment **and (amended) returns for which an administrative adjustment request (AAR) was filed by the partnership**.[84]

The instructions also provide the following caveat:

> "**NOTE:** Do not use this form to report changes from the filing of an amended federal Form 1065 if the partnership is subject to the BBA centralized audit regime. Report any federal imputed underpayment assessment resulting from an audit or from filing an administrative adjustment request (AAR) on Arizona Form 165PA."[85]

There is no statutory or regulatory citation in the instructions for the requirement to file a return when reporting changes as a result of an AAR. These two statements are also unclear about whether the Form 165PA must be filed for any AAR, or only for those AARs resulting in an imputed underpayment.

Also missing is a time frame within which the Form 165PA must be filed and the tax paid if an imputed underpayment arises from an AAR and leads to an increase in Arizona tax. The sole clue comes from the instructions to Part 1, Line A, which instruct the taxpayer to "[e]nter the date the IRS made its final determination or the date the AAR was filed with the IRS."[86] Because it is clear penalties can be imposed if a Form 165PA is not filed within 90 days after an imputed underpayment is finally determined by the IRS, this instruction implies that a Form 165PA could be due within 90 days of a partnership filing a federal AAR.[87]

In addition to lacking any reference to AARs, as mentioned above, Arizona law does not specifically provide for the filing of composite tax returns. However, by administrative fiat, qualifying partnerships (and other specified entities treated as pass-through entities for federal income tax purposes, such as certain Subchapter S corporations and limited liability companies taxed as partnerships) doing business in Arizona with eligible nonresident individual partners may file composite returns on behalf of those eligible nonresident partners.[88] To file a composite return, a partnership must complete a nonresident individual return, Form 140NR, using the information about its participating nonresident individual partners, and checking the appropriate box on the return to identify it as a "composite return."[89]

Assuming the nonresident individual partners satisfy the requirements to participate—including by having no other Arizona-source income—the Arizona Department of

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[84] *Id.* (emphasis added).

[85] *Id.* at 4.

[86] Ariz. Dep't of Revenue, Instructions for Ariz. P'ship Adjustment—Fed. Imputed Underpayment Assessment Form 165PA at 2 (2023).

[87] ARIZ. REV. STAT. ANN. § 43-1414(B)(1)(d) (2023).

[88] Ariz. Dep't of Revenue, Ariz. Individual Income Tax Ruling No. 16-2 (Sept. 13, 2016); *see also* Ariz. Dep't of Revenue, Ariz. Form 140NR Nonresident Personal Income Tax Return (2022).

[89] Ariz. Dep't of Revenue Instructions for Ariz. Form 140NR at 1 (2023).

Revenue considers the composite return to be the income tax return filing of the nonresident partners included in the return.[90] However, the partnership is still required to file a Form 165. Importantly, the tax paid using the composite return must be borne by the partners themselves: either remitted by the partners, remitted by the partnership on behalf of the partners, or treated as a charge against the partners' loan account.[91] The tax remains an obligation of the partners, and not of the partnership.

The Department's administrative policy allowing Arizona composite returns states that a composite return "may not be changed or corrected except by an amended composite return filed by the entity."[92] Presumably, this is to prevent numerous individual taxpayers from changing amounts indicated on the composite return by filing individual returns. However, this requirement implies that an increase in a nonresident individual partner's Arizona tax as a result of an AAR can only be changed by an amended Form 140NR—and not by a Form 165PA—when the partner participated in the composite return. Because the Department requires payment with the Form 165PA when the partnership has not elected to push the tax out to its reviewed year partners,[93] it raises serious doubts whether partnerships filing a federal AAR and a Form 165PA that have an increase in Arizona tax should file an amended individual Form 140X on behalf of the nonresident partners who participated in the Form 140NR composite return. This is far from clear, but if a Form 140X is not required, it may be in part a result of the Arizona Administrative Procedure Act.

The 2016 ruling authorizing composite returns states that it is a "[s]ubstantive policy statement," generally defined in the Arizona Administrative Procedure Act as a "a written expression which informs the general public of an agency's current approach to, or opinion of, the requirements of" applicable law.[94] This is in contrast to a "Rule," which is an "agency statement of general applicability that implements, interprets or prescribes law or policy, or describes the procedure or practice requirements of an agency."[95] The ruling states that it is not permitted to impose additional restrictions or penalties on a taxpayer.[96]

This limitation on agency authority is imposed by the Arizona Administrative Procedure Act and prevents the Department of Revenue from imposing a rule of general application without following the public notice and comments procedures required by that Act. This is a possible source of the requirement that composite tax remains an

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[90] Ariz. Dep't of Revenue, Ariz. Individual Income Tax Ruling No. 16-2 (Sept. 13, 2016).

[91] Ariz. Dep't of Revenue, Ariz. Individual Income Tax Ruling No. 16-2 (Sept. 13, 2016).

[92] Ariz. Dep't of Revenue, Ariz. Individual Income Tax Ruling No. 16-2 (Sept. 13, 2016).

[93] Ariz. Dep't of Revenue, Instructions for Ariz. P'ship Adjustment—Federal Imputed Underpayment Assessment Form 165PA at 2 (2023).

[94] *See* ARIZ. REV. STAT. ANN. § 41-1001 (2023) (defining "substantive policy statement"); Ariz. Dep't of Revenue, Ariz. Individual Income Tax Ruling No. 16-2 (Sept. 13, 2016).

[95] *See* ARIZ. REV. STAT. ANN. § 41-1001 (2023) (defining "Rule" for purposes of the Arizona Administrative Procedure Act).

[96] *See* ARIZ. REV. STAT. ANN. § 41-1001 (2023) (defining "substantive policy statement").

obligation of the partners, and not of the partnership. Furthermore, to the extent a partner's own taxable income is not changed as a result of an AAR, this limitation raises the question whether a partner who participated in a composite return can be subjected to penalties if the partnership files Form 165PA and itself pays an increase in Arizona tax, but the partner fails to file an amended Form 140NR or Form 140X following the filing of an AAR that results in an increase in Arizona tax.

Because there is no explicit requirement in Ariz. Rev. Stat. § 43-1414 or Ariz. Rev. Stat. § 43-327 for a partnership to file an amended return when it files an AAR, rather than an amended return for the reviewed year, and because an AAR is not considered an amended return under federal income tax law, there is also a valid question whether the Arizona Department of Revenue can lawfully require a BBA partnership to file a Form 165PA and furnish statements to its partners after filing an AAR, or can lawfully assess a penalty for failure to do so, even if the changes in the AAR would result in an increase in Arizona tax *had they been* included on an amended return for the reviewed year.

While the Arizona Department of Revenue seems to have put forth a solution for partnerships filing AARs when additional tax is due, the legal basis for that solution is questionable, and it is not at all clear what BBA partnerships should do when they file an AAR that results in a reduction in federal or Arizona tax. Under the federal rules, an AAR that does not result in an imputed underpayment must be "pushed out" under rules similar to those applicable to IRC § 6226.[97] The closest analogue under the Arizona law currently in effect seems to be the rule applicable to IRS audits that result in a net reduction in Arizona taxable income: the partnership should furnish to the partners a statement of each partner's share of the required adjustments to items of income, gain, loss, or deduction, and associated Arizona adjustments, and file copies with the Department of Revenue.[98] Unfortunately, until the Arizona legislature takes action to clarify the rule applicable in this scenario, taxpayers are left to muddle through, and the Department of Revenue is left with questionable mechanisms to enforce the law. It is a situation that begs to be rectified and is emblematic of states that acted quickly to respond to the possibility of lost revenue as a result of the BBA, but failed to fully consider the implications that might be of benefit to taxpayers.

[4] States that Have Enacted the MTC Model Statute

[a] Summary of Ohio's Approach

Ohio enacted the MTC Model Statute, in substance, as part of its biennial budget bill in 2019.[99] The enactment amended the state's existing statute relating to the filing of amended income tax and pass-through entity tax returns, Ohio Rev. Code § 5747.10, and made the changes applicable to federal adjustments with a final determination date

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[97] I.R.C. § 6227(b) (2024).

[98] *See* ARIZ. REV. STAT. ANN. § 43-1414(B)(2) (2023).

[99] Am. Sub. H.B. 166, 133rd Gen. Assem. § 101.01 (Ohio, 2019).

on or after October 1, 2019.[100] Ohio imposes an income tax generally applicable to individuals, trusts, and estates, as well as a pass-through entity withholding tax that effectively acts as a collection mechanism for the state's income tax.[101] Since enactment of the MTC Model Statute reporting provisions, Ohio has also enacted an elective pass-through entity tax that complies with the requirements of Internal Revenue Service Notice 2020-75.[102] However, Ohio's enactment of the MTC Model Statute does not appear to have been updated to address enactment of that tax.[103]

Ohio's enactment largely carries over the definitions in the MTC Model Statute, with a few notable revisions. One important definition that Ohio imported from the MTC Model Statute largely intact was that of "[f]ederal adjustment." Ohio's definition retains the language in the MTC Model Statute that includes changes stemming from an AAR as a "federal adjustment."[104] As a result, every provision applicable to a "federal adjustment" also applies to an adjustment resulting from an AAR. One definition that was added is the term "[a]udited partnership," which is generally defined as a partnership that is subject to an examination by the Internal Revenue Service resulting in a federal adjustment. Because many of the procedures in Ohio's enactment only apply to "audited partnerships," but AARs are included in the definition of "federal adjustments," changes resulting from an AAR are subject to Ohio's default amended return requirements.

As it relates to changes from the MTC Model Statute, definitions were not necessary for terms used in the Internal Revenue Code, because those terms have the same meanings for Ohio income tax purposes as they do in federal law, unless otherwise provided by statute or the context dictates.[105] Numerous terms in the MTC Model Statute were also unnecessary, because they were already defined elsewhere in Ohio law.[106] A handful of definitions were removed entirely,[107] while others were revised. For example, "[f]ederal partnership representative" was deleted, and "[s]tate partnership representative" was added in its place, with the definition for the latter term

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[100] Am. Sub. H.B. 166, 133rd Gen. Assem. § 757.70 (Ohio, 2019).

[101] OHIO REV. CODE ANN. § 5747.02 (2023) (income tax); OHIO REV. CODE ANN. § 5733.41 (2023) (entity tax on pass-through entities having at least one "qualifying investor" that is not an individual) and OHIO REV. CODE ANN. § 5747.41 (2023) (withholding tax on pass-through entities having at least one "qualifying investor" that is an individual, and on trusts having at least one "qualifying beneficiary" that is an individual).

[102] OHIO REV. CODE ANN. § 5747.38 (2023).

[103] OHIO REV. CODE ANN. § 5747.10(C)(2)(a)(iii) (2023); *see also*, Ohio Dep't of Taxation, Instructions for Filing: IT 4738 Electing Pass-Through Entity Income Tax Return (2023).

[104] OHIO REV. CODE ANN. § 5747.10(A)(4) (2023).

[105] OHIO REV. CODE ANN. § 5747.01 (2023).

[106] *See, e.g.*, "Internal Revenue Code" defined in OHIO REV. CODE ANN. § 5747.01(H); "Resident" defined in OHIO REV. CODE ANN. § 5747.01(I) (2023); "Nonresident" defined in OHIO REV. CODE ANN. § 5747.01(J) (2023). Note that "partnership" was not carried into OHIO REV. CODE ANN. § 5747.10 (2023) from the MTC Model Statute, and is not specifically defined for Ohio income tax purposes.

[107] *E.g.*, "Corporate partner," presumably removed because Ohio has no corporate income tax; "Partner," presumably removed because Ohio's pass-through entity tax uses the broader term "Investor."

defaulting to "[t]he person who served as the partnership's representative for federal income tax purposes, pursuant to section 6223(a) of the Internal Revenue Code, during the corresponding federal partnership audit,"[108] and offering an option to designate another person by a filing with the state tax commissioner.[109]

The MTC Model Statute's definition for "[f]inal determination date" was deleted from the Ohio enactment, replaced by a list of three dates when a federal adjustment is considered "final" or "agreed to or finally determined for federal income tax purposes."[110] The first and third dates largely parallel the first set of "Final Determination Dates" in the MTC Model Statute.[111] Because Ohio does not have a corporate income tax, the MTC Model Statute's final determination date relating to consolidated group audits was deleted.

Unfortunately, Ohio's definition does not have a final determination date specific to amended returns, refund claims, and AARs. These are specifically addressed in the third set of dates under the MTC Model Statute.[112] Ohio's definition of "final" for a federal adjustment includes the date on a refund check issued by the Internal Revenue Service.[113] However, checks would seem to be rare because a downward federal audit adjustment typically must be taken into account by the partnership in the adjustment year,[114] while a refund in connection with an AAR must be pushed out to partners as a credit in the partners' reporting year.[115]

The other two definitions for an adjustment being "final" presume either a federal tax assessment or an agreement between the Internal Revenue Service and the taxpayer or audited partnership.[116] Because the tax stemming from an imputed underpayment in connection with an AAR must be taken into account in the partnership adjustment year return or partner's reporting year return,[117] it seems as if it would rarely be the case that there is a federal tax assessment. And because the AAR is filed voluntarily, it would also seldom be the case that the Internal Revenue Service and the taxpayer or audited partnership would enter into a settlement or closing agreement. Moreover, Ohio's definition theoretically allows more than one of the listed dates to be the "final" date, as there is no temporal priority limitation in the statute. With respect to this definition, Ohio's version of the MTC Model Statute is sorely in need of revision to address the finality of amended returns, refund claims, and AARs.

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[108] OHIO REV. CODE ANN. § 5747.10(A)(6)(a) (2023).

[109] OHIO REV. CODE ANN. § 5747.10(A)(6)(b) (2023).

[110] OHIO REV. CODE ANN. § 5747.10(A)(7) (2023).

[111] OHIO REV. CODE ANN. §§ 5747.10(A)(7)(a) (2023) and (c); *cf.* MTC MODEL STATUTE § (A)(9)(a) (2020).

[112] *See* MTC MODEL STATUTE § (A)(9)(c) (2020).

[113] OHIO REV. CODE ANN. § 5747.10(A)(7)(b) (2023).

[114] I.R.C. § 6225(a)(2) (2024).

[115] I.R.C. § 6227(b) (2024); Treas. Reg. § 301.6227-3(c)(2) (2019).

[116] OHIO REV. CODE ANN. § 5747.10(A)(7)(c) (2023).

[117] I.R.C. § 6227(b)(1) (2024) and I.R.C. § 6227 (b)(2) (2024).

The default rule for partnership audit adjustments under Ohio's statute largely parallels the MTC Model Statute. It generally requires that unless an audited partnership elects to pay the state tax at the entity level, within 90 days after the federal adjustment becoming final the partnership must: (1) notify direct investors of their share of the adjustments, using the state's form; (2) file a federal adjustments return and copies of the notices sent to direct investors; and (3) file an amended return on behalf of its nonresident direct investors and pay any additional tax that would have been due under Ohio's mandatory pass-through entity taxes or composite return statute had the final federal adjustments been properly reported on the original return.[118] Within 90 days of the date the audited partnership files the federal adjustments report with the tax commissioner, the direct investors subject to Ohio's income tax are then required to file an amended income tax return and pay the tax due.[119] Pass-through entity partners of the audited partnership are subject to the same notice, filing, and payment requirements, but with a deadline for filing returns and making payments of 90 days after the deadline for filing and furnishing statements under IRC § 6226(b)(4) and applicable regulations, which is the extended deadline for filing the annual return of the audited partnership.[120]

Like the MTC Model Statute, Ohio's statute also provides an election for the partnership to pay the tax at the entity level.[121] It generally requires that within 90 days of the federal adjustments becoming final, the audited partnership must file a federal adjustment return with the tax commissioner, and pay tax calculated using the state's highest individual income tax rate.[122] The tax calculation includes the allocated and apportioned distributive share of federal adjustments attributable to nonresident investors, as well as the entire distributive share of the federal adjustments attributable to resident investors.[123]

In another parallel with the MTC Model Statute, the Ohio statute does not explicitly specify whether this calculation is intended to apply to reviewed year investors or adjustment year investors. Because Section C of the MTC Model Statute and Ohio Rev. Code § 5747.10(C) both state, in effect, that they do not apply to adjustments that must be taken into account in the adjustment year, the clear implication is that the calculation applies only to reviewed year investors.[124] Adjustments that do not result in additional tax are not included in the "partnership pays" election calculation under the MTC Model Statute, and are to be accounted for in the year the adjustments become final.[125]

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[118] OHIO REV. CODE ANN. § 5747.10(C)(2)(a) (2023).

[119] OHIO REV. CODE ANN. § 5747.10(C)(2)(b) (2023).

[120] OHIO REV. CODE ANN. § 5747.10(C)(2)(c) (2023); *see* Treas. Reg. § 301.6226-3(e)(3)(ii) (2019).

[121] OHIO REV. CODE ANN. § 5747.10(C)(3) (2023).

[122] OHIO REV. CODE ANN. § 5747.10(C)(3)(a) and (b) (2023).

[123] OHIO REV. CODE ANN. § 5747.10(C)(3)(b)(i) and (ii) (2023).

[124] OHIO REV. CODE ANN. § 5747.10(C) (2023) (excepting "adjustments required to be reported for federal purposes pursuant to section 6225(a)(2) of the Internal Revenue Code"); MTC MODEL STATUTE § (C) (2020) (excepting "adjustments required to be reported for federal purposes by taking those adjustments into account in the partnership return for the year of adjustment").

[125] *See* HELEN HECHT, MULTISTATE TAX COMM'N, REPORT OF THE HEARING OFFICER TO THE

Application to the reviewed year investors under Ohio's statute maintains the integrity of the tax year at issue, and should make state-level reporting easier. However, it may create complexity for partnerships that must collect the tax from reviewed year partners that are no longer partners in the partnership's adjustment year.

If a partnership elects to pay the tax at the entity level, Ohio's statute exempts the partnership's direct investors from the obligation to file a return reporting the changes.[126] However, Ohio's statute does not prohibit the partner from filing an amended return to claim credit for the tax paid at the entity level.[127] Ohio's enactment also allows an exempt partner to file a claim for refund, if the partnership paid tax on the exempt partner's share of income in error.[128]

This approach is at odds with the MTC Model Statute, which does not allow a partner to claim a credit for payments made by the partnership. The MTC Model Statute states that with respect to a partnership electing to pay at the entity level, the amounts paid are treated as paid "**in lieu of taxes** owed by its Direct and Indirect Partners."[129] As a result, for payments made at the partnership level (or under an alternative method), "[t]he Direct Partners or Indirect Partners **may not take any deduction or credit for this amount or claim a refund** of the amount in this State."[130] This change to allow the credit in Ohio is necessary in the name of fairness, but may create challenges for partnerships accounting for amounts attributable to former partners. If this rule applies to reviewed year partners, and the partnership is unsuccessful in collecting reimbursement from them, care must be taken to prevent former partners from claiming a credit for tax they were allocated, but never paid. This issue suggests that when the partnership elects to pay at the entity level in Ohio, it may be wiser to allocate the final adjustments to the partnership's adjustment year investors, and not its reviewed year investors to the extent allowed under the partnership's governing documents.

Ohio Rev. Code § 5747.10(D) requires, among other things, a taxpayer's amended return and an audited partnership's federal adjustments return to be accompanied by payment of any combined additional tax and interest. This appears redundant for an audited partnership because Ohio Rev. Code § 5747.10(C)(2)(a)(iii) already requires filing an amended return and paying the additional tax on behalf of its nonresident direct investors. Likewise, Ohio Rev. Code § 5747.10(C)(3) requires an audited partnership that elects to pay at the entity level to file a federal adjustments return and

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MULTISTATE TAX COMM'N EXEC. COMM. ON THE PROPOSED MODEL UNIFORM STATUTE FOR REPORTING ADJUSTMENTS TO FED. TAXABLE INCOME AND FED. P'SHIP AUDIT ADJUSTMENTS 19 (2018). OHIO REV. CODE ANN. § 5747.10(D)(2) (2023) implies the federal adjustments return reopens reviewed year facts and figures that are affected by the final federal adjustment, making the reviewed year partners implicated.

[126] OHIO REV. CODE ANN. § 5747.10(C)(4)(a) (2023).

[127] OHIO REV. CODE ANN. § 5747.10(C)(4)(b)(i) (2023).

[128] OHIO REV. CODE ANN. § 5747.10(C)(4)(b)(ii) (2023).

[129] MTC MODEL STATUTE § (C)(6)(b) (2020) (emphasis added); *see also* MTC MODEL STATUTE § (C)(3)(b) (2020) (requiring an electing partnership to "pay an amount, determined as follows, in lieu of taxes owed by its Direct and Indirect Partners").

[130] MTC MODEL STATUTE § (C)(6)(b) (2020) (emphasis added).

pay the amount of combined additional tax due under Ohio Rev. Code § 5747.10(D)(2). Presumably, this duplication is intended to address timing by ensuring that the return is accompanied by the payment, and to clarify that the payment must include interest. This could be a trap for the unwary if the failure to include interest with the return (or the interest is underpaid) is construed to invalidate the election.

If a federal audit does not result in an imputed underpayment, such that the federal adjustments must be taken into account by the partnership in the adjustment year under IRC § 6225(a)(2), Ohio's statute prohibits an audited partnership from filing an application for refund.[131] Moreover, because federal adjustments that must be taken into account under IRC § 6225(a)(2) are excluded from Ohio Rev. Code § 5747.10(C), the audited partnership would not file a federal adjustment return with the Ohio Department of Taxation after this audit, either. The federal adjustments would reduce the reporting year income of the adjustment year investors. Fortunately, because the Ohio statute specifically references IRC § 6225(a)(2), this applies only to adjustments by the Internal Revenue Service and does not apply to AARs that do not result in an imputed underpayment. Presumably those AARs may still support filing refund claims under Ohio Rev. Code § 5747.10(E)(1).

§ 4.05 CONCLUSIONS

For each of these states, we have only touched the tip of the iceberg in terms of the complexity of their statutes addressing federal audit adjustments under the BBA. Moreover, this is a sampling of only one of the states in each category of approaches to the issue; even among other states within the same category, differences remain. The states are as divided in how they address these issues as they are for any issue in state taxation. Still, by comparing these states, we can see that there are several things they should revise or clarify, and which other states should pay careful attention to as they try to reconcile their own state's law with these federal rules and the MTC Model Statute.

States need to enact provisions specifically addressing AARs. Under the MTC Model Statute, a partnership that files an AAR must adhere to the familiar three-step process of filing a federal adjustments report, notifying its direct partners of their share of the final federal adjustments, and filing an amended composite or withholding return and paying the additional tax due.[132] Partnerships filing an AAR are not permitted to elect to pay at the entity level.[133] In Ohio, neither option is available to a partnership submitting an AAR, and it must file an amended return.[134] Even in this state that has adopted a version of the MTC Model Statute, it is not clear when that amended return must be filed. Must it be filed at the same time as the AAR? Or when the partnership receives confirmation the AAR has been granted? The Ohio law is not clear on this point, and neither are New York nor Arizona any clearer.

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[131] OHIO REV. CODE ANN. § 5747.10(E)(2)(b) (2023).

[132] MTC MODEL STATUTE § (C)(2) (2020).

[133] MTC MODEL STATUTE § (C)(3) (2020).

[134] OHIO REV. CODE ANN. § 5747.10(B) (2023).

States need to carefully address finality in audits or AARs when there is not an imputed underpayment. States generally do a good job of defining when an audit has concluded with a finding of additional tax due. Even outside of the audit context, if a refund is generated, there is some understanding of finality provided for in the states reviewed. However, when an AAR results in a reduction in income in the adjustment year or a credit against tax in the partner's reporting year, even where some states address AARs, they may be unclear as to when the AAR is considered "final," such that it triggers a reporting requirement or deadline. The current situation is untenable and must be avoided through future legislation as states seek to conform with the MTC Model Statute or enact other legislation to their existing amended return and refund procedures.

States should allow partnerships to elect whether to follow, at the state level, the federal election with respect to paying the imputed underpayment at the entity level. Arizona's approach of requiring taxpayers to follow their federal election in all cases is unnecessary and unduly burdensome. There is no reason to believe states would lose revenue as a result, and partnerships should have the flexibility to pay at the entity level to states in which they have minimal activity or exposure. If the reporting mechanisms are clear, there should be no additional burden on state tax administrators, either.

When the additional tax is paid at the entity level, the state's law needs to be clear whether the tax is considered a liability of the adjustment year partners, not the reviewed year partners. At the federal level, when the imputed underpayment is paid at the entity level, it affects the income of the adjustment year partners. While this is implied in Arizona and Ohio, it is not clear. Because these states tend to respect the integrity of a single tax year, it can be argued that they instead require this to be a liability of the reviewed year partners. Alternatively, for states that defer to the freedom of contract, it could be that they leave it to the partnership itself to determine whether the liability must be borne by the reviewed year partners, adjustment year partners, or both. If no additional notice is sent to partners of their share of the tax paid, then it necessarily must be a reduction to the partnership's nonseparately stated income, and effectively borne by the adjustment year partners.

Like Ohio's enactment, states should allow a taxpayer to claim a credit for the increased state tax paid at the entity level as a result of a federal adjustment. In most states, the pass-through entity tax is merely a mechanism for collecting the state's income tax. Denying the credit when tax has been paid effectively imposes this tax on the partner twice. However, special attention needs to be paid to make sure the credit is claimed at the appropriate rate, and these credits do not shift tax liability to partners from a different tax year.

From the above recommendations, it is readily apparent that adopting a uniform state statute is prudent not only for state (and certain local) taxing authorities but partnerships, partners and their tax advisers as well. That is why the MTC Model Statute is such a unique work product. It represents one of those rare moments in which the states, taxpayers, and tax practitioners came together to negotiate and draft a compromise statute that addresses the above issues in a systematic way. The authors therefore respectfully recommend that states—even the early adopter states such as

Arizona—promptly enact the Model Statute, perhaps with the Ohio modification mentioned above, and do so quickly. We are witnessing a substantial increase in IRS partnership audits across the country and soon will encounter many of the follow-on state-level issues we point out above.