STATE OF CALIFORNIA
Franchise Tax Board

BILL ANALYSIS

Author: Glazer and Berryhill Bill Number: SB 274

Subject: Reporting Federal Changes Imputed to a Partnership under the New Federal Audit Rules

Summary

This bill would, under the Administration of Franchise and Income Tax Law, provide for the California assessment and reporting requirements for federal audit adjustments under the new federal partnership audit rules.

Reason for the Bill

The reason for the bill is to allow the Franchise Tax Board (FTB), partnerships, and their partners to take advantage of the efficiencies resulting from a single partnership-level adjustment, by conforming to the new federal partnership-level audit assessment process for final federal determinations.

Effective/Operative Date

As an urgency measure, this bill would be effective immediately upon enactment and would be operative for final federal determinations assessed pursuant to Subchapter C of Chapter 63 of the Internal Revenue Code (IRC) as in effect January 1, 2018.

Federal/State Law

Federal Partnership Audit Rules under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

TEFRA provided a set of consolidated examination, processing, and judicial procedures which determine the tax treatment of partnership items at the partnership level for partnerships and limited liability companies that file as partnerships. TEFRA created the unified partnership audit and litigation procedures of IRC sections 6221 through 6234 and generally applies to partnership taxable years that began after the September 3, 1982, enactment date through partnership returns filed for taxable years that begin on or before December 31, 2017.

Federal Partnership Audit Rules under the Bipartisan Budget Act of 2015 (BBA of 2015)

The BBA of 2015 replaced the TEFRA partnership audit rules with new rules generally effective for partnership years beginning on or after January 1, 2018, with the option for partnerships to elect to adopt the new rules as early as tax years beginning after November 2, 2015, the date the BBA of 2015 was enacted. Generally, the new rules require adjustment of all items of income, gain, loss, deduction, or credit at the partnership level, with the partnership being liable for any resulting underpayment of tax. The following is a summary of the new rules, additional detail is included as Exhibit A.

Under the rules, a partnership's net adjustments for the reviewed year will be taxed at the highest individual or corporate tax rate and the result will be considered a partnership imputed underpayment. The Internal Revenue Service (IRS) is authorized to promulgate rules adjusting or allocating imputed underpayments to take into account several modifications including allowing partners to report the adjustment amounts and changes based on the taxation of each partner.

Additional taxes, as well as penalties and interest, arising from an audit are payable by the partnership. However, the partnership may elect to pass through to its partners their respective shares of the adjustment, with the partners paying tax, penalties, and interest on their adjusted distributive shares.

Partnerships generally may elect out of the new rules if their only partners are individuals, estates of a deceased partner, or S or C corporations (or foreign entities treated as a C corporation); they issue no more than 100 Schedules K-1, *Partners Share of Income, Deductions, Credits, etc.*; and they follow certain requirements as to the time and manner of making the election.

As under TEFRA, partners that fail to treat all items of income, etc., consistent with the treatment on the partnership return, may be subject to an underpayment that the IRS may collect under its math or clerical error authority without resorting to traditional audit procedures, including issuance of a deficiency notice.

Partnership Taxation in General

California generally conforms to federal laws that govern the taxation of partnerships as of the "specified date" of January 1, 2015.[1]

Partnership Audit Rules

California does not conform to the partnership audit rules under TEFRA or the BBA of 2015.

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[1] Revenue and Taxation Code section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015, except as otherwise provided.

Under California law, the audit rules generally applicable to taxpayers subject to the state's personal income tax apply to partnership audits. The California tax treatment of an adjustment to a partnership's items of income, gain, loss, deduction, or credit is determined for each partner in separate proceedings, both administrative and judicial. Adjustments to items of income, gains, losses, deductions, or credits of the partnership generally are made in separate actions for each partner, and each partner has its own separate statute of limitations.

This Bill

This bill would amend existing law to prescribe the method for determining the California tax based on a federal partnership-level adjustment; specify that unless the FTB approves a separate election, a partnership's federal election regarding audit rules is binding for state purposes; clarify the partnership's and partners' requirements for reporting federal adjustments to the state; add provisions specifically relating to publicly traded partnerships (PTP), and make other technical changes.

Legislative History

A review of the last five legislative sessions found no similar bills which would impose California reporting requirements for federal changes imputed to a partnership.

Other States' Information

Review of *Florida*, *Illinois*, *Massachusetts*, *Michigan*, and *New York* laws found no statutes addressing comparable federal conformity to the new partnership audit rules. These states were selected and reviewed due to their similarities to California's economy, business entity types, and tax laws.

Arizona has enacted and the *Georgia* legislature has passed comparable federal conformity, while *Minnesota*, *Missouri*, and *Montana* are considering similar legislation.

Fiscal Impact

Staff estimates approximate costs to develop and administer a partnership-level assessment process, program systems, and test revisions to existing systems for this proposal of $51,000 for the 2018-2019 fiscal year with absorbable costs through the 2020-2021 fiscal year. As volumes increase during the 2021-2022 and later fiscal years, processing costs would increase to approximately $82,000.

The department will pursue a budget change proposal if necessary.

Economic Impact

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of SB 274 as Amended June 28, 2018
For Revenue Agent Reports (RAR) Received On or After January 1, 2018
Assumed Enactment after June 30, 2018

($ in Millions)

Fiscal Year	Revenue
2017-2018	$3.3
2018-2019	$6.3
2019-2020	$11.0

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

Using 2014 federal and California partnership audit data, it is estimated that RARs for large partnerships with 100 or more partners would result in an estimated $100 million revenue gain in partnership assessments to California. This amount was adjusted to reflect changes in the economy over time. The ability to follow a partnership's federal treatment would allow the state to issue assessments following federal partnership-level determinations. The FTB estimates the department will begin receiving partnership-level RARs two years after the federal tax returns are filed. It is further assumed that the 2018 partnership-level RARs would be received over the next six years, with the majority expected to begin arriving in 2020. However, it is assumed that a few partnerships will adopt the new federal partnership audit rules early, resulting in a small number of partnership-level RARs being sent to the FTB beginning in 2018.

It is assumed that 48 percent of these assessments would be collected over a six-year period. This collection rate is adjusted to account for the FTB's inability to collect from the partnership if the taxpayer elects to be assessed at the partner level. It is estimated that 75 percent would be corporate assessments and the remaining 25 percent would be personal income tax assessments. The ability to issue adjustments following a federal partnership-level RAR would result in an estimated revenue gain of $40,000 in fiscal year 2018-2019, increasing to $50 million in fiscal year 2025-2026.

In addition to the above gain, the revenue from the department's current RAR workload would gradually increase due to the ability to assess at the partnership-level based on the change in the federal partnership audit rules. This would result in a revenue gain increasing from $3.3 million in fiscal year 2018-2019 to $32 million in fiscal year 2025-2026.

The combined estimated revenue gain for this proposal would increase from $3.3 million in fiscal year 2018-2019 to $80 million in fiscal year 2025-2026.

The taxable-year estimates are converted to fiscal-year estimates, accrued back one year and then rounded to arrive at the estimates shown in the above table.

Appointments

None.

Support/Opposition[2]

Support: California Taxpayers Association (Co-Sponsor), Counsel on State Taxation (Co-Sponsor), Board of Equalization Member, District 1, California Society of Enrolled Agents, Spidell Publishing, Inc.

Opposition: None provided.

Votes

Location	Date	Yes Votes	No Votes
Concurrence	August 31, 2018	39	0
Assembly Floor	August 27, 2018	80	0
Senate Floor	April 24, 2018	36	0

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[2] As presented in the Assembly Revenue and Taxation Committee analysis, dated June 22, 2018.

Exhibit A[3]

New Federal Partnership Audit Rules

Generally for returns filed for partnership taxable years beginning after 2017,[4] the tax reporting provisions and voluntary centralized audit procedures under The Tax Equity and Fiscal Responsibility Act of 1982[5] partnership audit and adjustment rules were repealed and replaced with the provisions of the Bipartisan Budget Act of 2015[6] (BBA of 2015). The BBA of 2015 was modified by the Consolidated Appropriations Acts of 2016[7] and 2018[8] which made various technical corrections. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves applicable the prior rules.

Determination at Partnership Level

Under the centralized system, the audit of a partnership takes place at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally are determined at the partnership level.[9] Any tax attributable to these items is generally assessed and collected at the partnership level. The applicability of any penalty, addition to tax, or additional amount that relates to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year or to any partner's distributive share thereof is determined at the partnership level. The centralized system is applicable to any partnership unless it meets eligibility requirements and has made a valid election out for a taxable year.[10]

100 or Fewer Statements

A partnership may elect out of the centralized system (and it and its partners would be governed by the deficiency proceedings discussed above) for a partnership taxable year if it meets eligibility requirements. One of the eligibility requirements is that for the taxable year, the partnership is

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[3] From the Summary of Federal Income Tax Changes - 2015.
[4] Beginning on or after November 2, 2015, an election is available to apply the new centralized audit procedures prior to January 1, 2018.
[5] Public Law 97-404.
[6] Public Law 114-74.
[7] Public Law 114-113.
[8] Public Law 115-141.
[9] IRC section 6221(a).
[10] IRC section 6221(b).

required to furnish 100 or fewer statements under Internal Revenue Code (IRC) section 6031(b) (Schedules K–1) with respect to its partners.

A further eligibility requirement for a partnership to make the election is that each of its partners is an individual, a deceased partner's estate, a C corporation, a foreign entity that would be required to be treated as a C corporation if it were a domestic entity, or an S corporation (provided special rules are met).

Requirement of Consistency with Partnership Return

The centralized system imposes a consistency requirement. A partner on its return must treat each item of income, gain, loss, deduction or credit attributable to a partnership in a manner that is consistent with the treatment of such income, gain, loss, deduction, or credit on the partnership return. An underpayment that results from a failure of a partner to conform to the partnership reporting of an item is treated as a math error on the partner's return and cannot be abated under IRC section 6213(b)(2).[11]

Partners Bound by Actions of Partnership; Designation of Partnership Representative

For purposes of the centralized system, the partnership acts through its partnership representative. The partnership representative has the sole authority to act on behalf of the partnership under the centralized system. Under the centralized system, the partnership and all partners of the partnership are bound by actions taken by the partnership. Thus, for example, partners may not participate in or contest results of an examination of a partnership by the Internal Revenue Service (IRS). A partnership and all partners of the partnership are also bound by any final decision in a proceeding with respect to the partnership brought under the centralized system.

Partnership Adjustments by the IRS

The centralized system provides that any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year and any partner's distributive share thereof, are determined at the partnership level. Any tax attributable to these items is assessed and generally is collected at the partnership level as an imputed underpayment paid by the partnership.

Reviewed Year and Adjustment Year

For purposes of the centralized system, the reviewed year means the partnership taxable year of the item being adjusted relates to.[12]

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[11] This provision allows a taxpayer to file a request for abatement of a math error assessment.
[12] IRC section 6225(d)(1).

The adjustment year means: (1) in the case of an adjustment pursuant to the decision of a court (under the centralized system's judicial review provisions), the partnership taxable year in which the decision becomes final; (2) in the case of an administrative adjustment request, the partnership taxable year in which the administrative adjustment request is made; or (3) in any other case, the partnership taxable year in which the notice of final partnership adjustment is mailed.[13]

Payment of Imputed Underpayment by the Partnership

Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year—and any partner's distributive share thereof—are determined at the partnership level. In the event of any adjustment by the IRS in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share, that results in an imputed underpayment, the partnership is required to pay the imputed underpayment in the adjustment year.[14]

Interest at Partnership Level

Interest due is determined at the partnership level and accrues at the rate applicable to underpayments.[15]

Adjustment That Does Not Result in Imputed Underpayment

Any adjustment by the IRS in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share, that does not result in an imputed underpayment is taken into account by the partnership in the adjustment year. The amount of the adjustment is treated as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate). It may also be appropriate to treat the amount of an adjustment as a reduction (or increase) in a separately-stated amount of income, gain, loss, or deduction. The amount of an adjustment in a credit is taken into account as a separately-stated item.[16]

Determination of Imputed Underpayment Amount

An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of federal income tax applicable either to

[13] IRC section 6225(d)(2).
[14] IRC section 6225(a)(1).
[15] IRC section 6621(a)(2).
[16] IRC section 6225(a)(2).

individuals or to corporations that is in effect for the reviewed year.[17] Any adjustments to items of credit are taken into account as an increase or decrease, as the case may be, in the figure resulting from this multiplication. Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income. Netting is done taking into account applicable limitations, restrictions, and special rules under present law.

Determining Imputed Underpayment Amount: Adjustments to Distributive Shares

In determining an imputed underpayment, any adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any decrease in any item of income or gain and disregarding any increase in any item of deduction, loss, or credit.[18]

Modification of Imputed Underpayment Amount

When an audit of a partnership has begun, the IRS notifies the partnership and the partnership representative of the administrative proceeding initiated at the partnership level. The IRS also notifies the partnership and the partnership representative of any proposed partnership adjustment developed during the proceeding.[19] The IRS must establish procedures for modification of the amount of an imputed underpayment.[20] One or more modification procedures may be implemented by the partnership after the initiation of the administrative proceeding, including before any notice of proposed adjustment. These procedures include the filing of amended returns by reviewed-year partners, determination of the imputed underpayment without regard to any portion allocable to a tax-exempt partner, and modification of the applicable highest tax rates, including determining the portion of an imputed underpayment to which a lower rate applies.[21]

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[17] IRC section 6225(b)(1). The rule for determining the imputed underpayment applies except as provided in IRC section 6225(c), which provides that the Secretary of the Treasury shall establish procedures under which the imputed underpayment amount may be modified consistent with requirements imposed thereunder.
[18] IRC section 6225(b)(2).
[19] IRC section 6231(a)(1) and (2).
[20] IRC section 6225(c).
[21] See section 411 of the Protecting Americans from Tax Hikes Act of 2015, Division Q of Public Law 114–113. Under the provision, certain IRC section 469(k) passive-activity losses can reduce the imputed underpayment of a publicly-traded partnership under the centralized system. The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to (*i.e.*, would be offset by) specified passive-activity losses attributable to a specified partner. The amount of the specified passive-activity loss is concomitantly decreased, and the partnership takes the net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which the net decrease relates. A specified passive-activity loss for any specified partner of a publicly-traded partnership means the lesser of the IRC section 469(k) passive-activity loss of that partner which is separately determined with respect to the partnership (1) for the partner's taxable year in which or with which the reviewed year of the partnership ends, or (2) for the partner's taxable year in which or with which the adjustment year of the partnership ends. A specified partner is a person who continuously meets

Modification Procedures: Amended Returns of Reviewed-Year Partners

Payments made by reviewed-year partners with amended returns can reduce the amount of an imputed underpayment.[22] Procedures for modification provide that the amount of an imputed underpayment is determined without regard to the portion of the underpayment taken into account by payment of tax included with amended returns of the reviewed-year partners. The amended return relates to the taxable year of the partner that includes the end of the reviewed year of the partnership. The amended return must take into account all adjustments in the amount of any item of income, gain, loss, deduction, or credit of the partnership (or any partner's distributive share) properly allocable to each partner, along with changes for any other taxable year with respect to which any tax attribute is affected by reason of the adjustments. Payment of any tax due is to be included with the amended return. In the case of an adjustment that reallocates the distributive share of any item from one partner to another, this modification procedure is only available if amended returns for the reviewed year are filed by all partners affected by the adjustment.

Modification Procedures: Modification of Applicable Highest Tax Rates

Procedures for modification provide for taking into account a rate of tax lower than the highest rate of federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year, for certain types of taxpayers or types of income.[23]

Alternative to Payment of Imputed Underpayment by Partnership

As an alternative to partnership payment of the imputed underpayment in the adjustment year, the audited partnership may elect to furnish to the IRS and to each partner of the partnership for the reviewed year a statement of the partner's share of any adjustments to income, gain, loss, deduction and credit as determined in the notice of final partnership adjustment.[24] In this case, each such partner takes these adjustments into account and pays the tax.[25]

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each of three requirements for the period starting with the partner's taxable year in which or with which the partnership reviewed year ends through the partner's taxable year in which or with which the partnership adjustment year ends. These three requirements are that the person is a partner of the PTP; the person is an individual, estate, trust, closely-held C corporation, or personal service corporation; and the person has a specified passive-activity loss with respect to the publicly-traded partnership.

[22] IRC section 6225(c)(2).
[23] IRC section 6225(c)(4).
[24] IRC section 6226(a).
[25] IRC section 6226(b).

Payment by Reviewed-Year Partners in Year that Includes Date of the Statement

The reviewed-year partner's tax is increased by an amount equal to the aggregate of the adjustment amounts as determined under the provision. This includes the amount by which the partner's tax would increase if the partner's distributive share of the adjustment amounts were included for the partner's taxable year that includes the end of the reviewed year, plus the amount by which the tax would increase by reason of adjustment to tax attributes in years after that year of the partner and before the year of the date of the statement. Tax attributes in any subsequent taxable year are required to be appropriately adjusted.

Time and Manner of Making Election

The partnership may make this election not later than 45 days after the notice of final partnership adjustment.[26] The election is revocable only with the consent of the IRS. The election may be made whether or not the partnership files a petition for judicial review of the notice of final partnership adjustment.

Administrative Adjustment Request by Partnership

A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for a partnership taxable year. Following the filing of the administrative adjustment request, the partnership may apply most of the procedures for modification in a manner similar to modification of an imputed underpayment under new IRC section 6225(c). Like the partnership audit, tax resulting from the adjustment may be paid by the partners in the manner in which a partnership pays an imputed underpayment in the adjustment year under new IRC section 6225. Alternatively, the adjustment may be taken into account by the partnership and partners, and the tax paid by reviewed-year partners upon receipt of statements showing the adjustments, similar to new IRC section 6226. However, in the case of an adjustment (pursuant to a partnership's administrative adjustment request) that would not result in an imputed underpayment, any refund is not paid to the partnership; rather, procedures similar to the procedure for furnishing reviewed-year partners with statements reflecting the requested adjustment apply, with appropriate adjustments.

[26] IRC section 6226(a)(1).