

DEPARTMENT OF TAXATION

2020 Fiscal Impact Statement

1. **Patron** Vivian E. Watts

3. **Committee** Senate Finance and Appropriations

4. **Title** Updated Procedures for Reporting Federal
Adjustments to Partnership Taxable Income

2. **Bill Number** HB 1417

House of Origin:

 Introduced

 Substitute

 Engrossed

Second House:

 X **In Committee**

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would provide updated procedures for reporting certain partnership adjustments that result from federal tax changes and other changes to federal taxable income to the Department. During 2015, Congress enacted federal legislation that generally shifted the burden of paying tax resulting from federal tax adjustments from owners and investors in a partnership ("partners") to the partnership itself. As a result, partnerships are no longer required to provide their partners with information regarding federal tax adjustments.

Under current law, Virginia's reporting requirement for reporting federal tax adjustments remains based on the old federal methodology. Therefore, this legislation is intended to update Virginia's law regarding reporting tax adjustments to make it match with the new federal procedures. This portion of the bill would only apply to those partnership with 100 or fewer partners that elect to opt-out of the new federal rules.

This bill would also specify when Virginia income taxpayers must report federal tax changes and other changes to federal taxable income to the Department. This would be accomplished by linking the taxpayer requirement to report federal audit and other changes to federal taxable income to a final determination date.

If enacted during the 2020 Regular Session of the General Assembly, this bill would become effective July 1, 2020.

This is a Department of Taxation bill.

6. **Budget amendment necessary:** No.

7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

8. Fiscal implications:

Administrative Costs

The Department considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have an unknown positive revenue impact beginning in Fiscal Year 2021. Because this bill would set forth new procedures for reporting partnership tax adjustments that work with the updated federal procedures, it would make doing so simpler for partners and partnerships to properly report such adjustments to the Department. This would help avoid a negative General Fund revenue impact that may result from difficulties regarding how to apply the updated federal procedures to current, unaltered Virginia procedures. Based on historical data, this bill would preserve an estimated \$1.1 million annually. In addition, this bill would increase revenues to the extent that it increases taxpayer compliance.

The portion of the bill relating to the final determination date would have no impact on General Fund revenues.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Bipartisan Budget Act of 2015

On November 2, 2015, Congress enacted the federal Bipartisan Budget Act of 2015, which created new procedural rules governing certain business entities known as “partnerships” for federal income tax purposes. The new rules are mandatory for partnerships for taxable years beginning on or after January 1, 2018. These rules completely replace the Tax Equity and Fiscal Responsibility Act rules and the Electing Large Partnership rules for partnership adjustments with one set of rules that will apply to all partnerships, subject to an opt-out election available to certain partnerships with 100 or fewer partners.

The essential concept of partnership taxation is that all profits and losses flow through to the owners of the business, referred to as “partners.” Partners are therefore responsible for paying tax owed, not the entity.

Under the old rules, a partnership was required to provide its partners with information regarding federal tax adjustments made by the Internal Revenue Service (“IRS”) during the course of an audit. This enabled the partners the ability to compute and pay any tax due themselves. By contrast, under the new rules, Congress generally shifted the burden

of the tax on partnership adjustments from partners to the partnership itself. As a result, Congress no longer requires partnerships to provide their partners with information regarding partnership adjustments.

The new rules provide that adjustment to items of a partnership and any partner's distributive share of such adjustments will be determined at the partnership level. For any such adjustment, the partnership itself is now required to pay tax on the understated income on behalf of its partners at each partner's top tax rate, which may vary depending on whether the partners are individuals, corporations or tax-exempt entities. Alternatively, a partnership may elect to push out adjustments to its historical partners for the audited year rather than paying tax at the partnership level. This election will trigger an obligation on such partners for the audited year to pay additional taxes in the current year.

On December 21, 2018, the Treasury Department published final regulations regarding the implementation of these new procedural and administrative rules governing partnerships.

Virginia and the Reporting of Federal Tax Adjustments

If an adjustment is made to the federal taxable income of an individual, estate, trust or corporate taxpayer, Virginia law requires the taxpayer to report the federal adjustment to the Department within one year after the final determination of such adjustment. If the adjustment results in an increase in the taxpayer's Virginia income tax liability, additional tax may be due at the time when the change is reported. If the adjustment results in a decrease, the taxpayer may be entitled to a refund. These adjustments are most commonly the result of either an audit by the IRS or the filing of an amended federal income tax return by the taxpayer.

Virginia's requirement to report federal tax adjustments to the Department does not generally apply directly to partnerships. Prior to the BBA, the lack of a reporting requirement on partnerships was not an issue because federal law required partnerships to provide information about partnership adjustments to their partners. These partners include individuals, estates, trusts and corporation that are subject to Virginia's reporting requirement. Under the BBA, federal law no longer required partnerships to provide this information, instead allowing them to account for any adjustments themselves. As a result, certain partners are currently subject to a Virginia requirement to report information that no longer receive.

Multistate Tax Commission's Model Statute

On January 24, 2019, the Multistate Tax Commission ("MTC") adopted a model statute containing procedures for the reporting of federal adjustments to state tax agencies. The model statute provides uniform rules for reporting adjustments to partnership taxable income and affected partners, and also provides for an election to pay any resulting income tax liability at the partnership level. The updated Virginia procedures that would be set forth in this bill are largely based on the MTC model statute.

Other States

Five states (California, Georgia, Ohio, Oregon, and West Virginia) have enacted legislation for reporting federal partnership adjustments that generally follows the MTC model. Four states (Arizona, Hawaii, Maine, and Rhode Island) have enacted legislation that does not follow the MTC model.

Proposed Legislation

This bill would provide updated procedures for reporting certain partnership adjustments that result from federal tax changes and other changes to federal taxable income to the Department. During 2015, Congress enacted federal legislation that generally shifted the burden of paying tax resulting from federal tax adjustments from the partners to a partnership itself. As a result, partnerships are no longer required to provide their partners with information regarding federal tax adjustments. Under current law, Virginia's reporting requirement for reporting federal tax adjustments remains based on the old federal methodology. Therefore, this legislation is intended to update Virginia's law regarding reporting tax adjustments to make it match with the new federal procedures. This portion of the bill would not apply to those partnership with 100 or fewer partners that elect to opt-out of the new federal rules.

In addition, this bill would specify with greater detail when Virginia income taxpayers must report federal tax changes and other changes to federal taxable income to the Department. This portion of the bill would apply to individuals, corporations, estates, trusts, and partnerships.

Reporting of Partnership Adjustments Generally

Under this bill, the default method of reporting partnership-level adjustments to Virginia would be a submission of report by the partnership to both the Department and the partnership's partners. The partners would then be required to report such adjustments to the Department and pay any tax due. As an alternative to this default method, an election would be permitted where the partnership would be required to pay the resulting tax attributable to any partnership-level adjustments. In addition, a partnership would be allowed to elect to enter into an agreement with the Department to use a modified reporting and payment method if necessary to reasonably report and pay taxes, penalty and interest. Both of these elections would generally be irrevocable.

Default Method

No later than 90 days after the final determination of a partnership-level federal adjustment, this bill would generally require a partnership to:

- File with the Department a completed federal adjustments report, which must include any information required by the Department;
- Notify each direct partner of its distributive share of the final federal adjustments and provide to each direct partner any other information required by the Department;

- File an amended composite return if such return previously was filed on behalf of nonresident partners;
- File an amended return; and
- Pay any additional amount that may be required as either withholding tax or as income tax required to be paid on a nonresident composite return.

Each direct partner subject to Virginia income tax would be required to:

- File a federal adjustments report that identifies the distributive share of adjustments reported to such direct partner by the partnership; and
- Pay any additional amount of tax due as if final federal adjustments had been properly reported, including any penalty and interest due. Such payment would be permitted to be reduced by any credit for related amounts paid or withheld and remitted on behalf of the direct partner.

Partnership Pays Election

As an alternative to the default method, the bill would allow an audited partnership to report information about federal adjustments directly to the Department and pay any tax that may be due on behalf of its partners. To properly make this election, the bill would provide that, no later than 90 days after the final determination of a partnership-level federal adjustment, a partnership is required to:

- File a completed federal adjustments report, which shall include any information required by the Department; and
- Notify the Department that it is making an elective payment.

After this election is made the partnership would be required to pay the elective payment amount no later than one year after the final determination date. Such amount would be in lieu of taxes owed by the direct and indirect partners.

The elective payment amount would be calculated as follows:

- **Corporate and tax-exempt partners:** The distributive share of any federal adjustments and unrelated business taxable income would be apportioned or allocated, as appropriate, to Virginia and multiplied by Virginia 6 percent corporate tax rate.
- **Non-resident partners who are individuals, trusts, and estates:** The distributive share of any federal adjustments would be sourced to Virginia and multiplied by Virginia's highest individual tax rate of 5.75 percent.

- **Resident partners who are individuals, trusts, and estates:** The distributive share of any federal adjustments would be multiplied by Virginia's highest individual tax rate of 5.75 percent.
- **Partnerships that are partners:** The distributive share of any federal adjustments would be multiplied by Virginia's highest individual tax rate of 5.75 percent. However, for this purpose, the distributive share of any federal adjustments would not include those adjustments that are of a type that would not be sourced to Virginia and can be established, under guidelines issued by the Department, to be properly:
 - Allocable to a nonresident indirect partner;
 - Allocable to a partner that is not subject to tax on such amount; or
 - Excludable under procedures for alternative reporting and payment.

Any resulting elective payment amount determined above would be subject to any applicable penalties and interest under Virginia law.

Modified Reporting and Payment Method

In addition to the default method and the partnership pays election, the bill would allow a partnership to elect to enter into an agreement with the Department to use a modified reporting and payment method. However, the Department would be allowed to enter into such agreement only if it such partnership demonstrates, to the satisfaction of the Department, that the alternative method is reasonably expected to provide for the reporting and payment of taxes, penalties, and interest otherwise due. Application for approval of a modified reporting and payment method would be required to be made by the partnership within the 90 day time period required for file with the Department a completed federal adjustments report.

Other Procedural Provisions

The remaining sections of the bill would address administrative procedures. The bill would allow the Department to establish a de minimis amount upon which a taxpayer is not required to comply with the bill's reporting and payment procedures.

The responsibility to file, take any action required or permitted to be taken under this bill, and with respect to any administrative or judicial appeal of such action, would be imposed on the partnership's "state partnership representative." The state partnership representative for a reviewed year would be defined as the partnership's federal partnership representative unless the partnership designates in writing another person as its state partnership representative. Such representative would have the sole authority to act on behalf of a partnership. The actions of the state partnership representative would be binding on the direct partners and indirect partners of the partnership. The Department would be required to establish reasonable qualifications and procedures for designating a person, other than a federal partnership representative, to be the state partnership representative.

The bill would address the applicable statute of limitations for assessments and refunds. If a taxpayer timely reports a federal adjustment, the Department would be allowed to assess amounts within the Virginia's normal statutory limitation period or one year of filing the federal adjustments report with the Department. If the taxpayer does not file federal adjustments on a timely basis, the state would be permitted to assess amounts by the latest of the expiration of Virginia's normal limitations period or the expiration of the one-year period following the filing of the federal adjustments report with the Department. This bill would also provide procedures for taxpayers to claim a refund or credits of tax arising from federal adjustments. Generally, an amended return for refund arising from federal adjustments made by the Internal Revenue Service could be filed within the Virginia's normal statutory limitation period or one year from the date a federal adjustments report was due to the Department.

The bill would also address the scope of assessments and extensions of time. Unless otherwise agreed to in writing by the partnership or partner and the Department, any adjustments by the Department or by the partner or partnership that are made pursuant to the one-year statute of limitations for assessments and refunds would be limited to adjustments to the partner's or partnership's tax liability that arise from federal adjustments. The bill would allow for the one-year statute of limitations to be extended:

- Automatically, upon written notice to the Department, by 60 days for an audited partnership or a tiered partner that has 10,000 or more direct partners; or
- By written agreement between the partnership or partner and the Department.

Any extension granted would extend by an equal time period the last day for the Department to assess any additional amounts arising from the adjustments to federal taxable income and the period for filing a claim for refund or credit of taxes. The bill would provide the one-year statute of limitations would not affect the time within which or the amount for which an assessment may otherwise be made or a refund sought.

Final Determination Date

This bill would specify when Virginia income taxpayers must report federal tax changes and other changes to federal taxable income to the Department. This would be accomplished by linking the taxpayer requirement to report federal audit and other changes to federal taxable income to a final determination date. The final determination date would be defined as one of the following:

- If the federal adjustment arises from an Internal Revenue Service audit or other action by the Internal Revenue Service, the final determination date would be defined as the first day on which no federal adjustments arising from that audit or other action remain to be finally determined, whether by Internal Revenue Service decision with respect to which all rights of appeal have been waived or exhausted, by agreement, or, if appealed or contested, by a final decision with respect to which all rights of appeal have been waived or exhausted. For agreements required to be signed by the Internal Revenue Service and the taxpayer, the final determination date would be defined as the date on which the last party signed the agreement.

- For federal adjustments arising from an Internal Revenue Service audit or other action by the Internal Revenue Service, if the taxpayer filed as a member of a Virginia combined or consolidated return, the final determination date would be defined as the first day on which no related federal adjustments arising from that audit remain to be finally determined for the entire group.
- If the federal adjustment results from filing an amended federal return, a federal refund claim, or an administrative adjustment request or if it is a federal adjustment reported on an amended federal return or other similar report, the final determination date would be defined as the day on which the amended return, refund claim, administrative adjustment request, or other similar report was filed.

This portion of the bill relating to the final determination date would apply to individuals, corporations, estates, trusts, and partnerships.

This bill would provide that the Department of Taxation is required to develop guidelines. Such guidelines would be exempt from the provisions of the Administrative Process Act.

If enacted during the 2020 Regular Session of the General Assembly, this bill would become effective July 1, 2020.

cc : Secretary of Finance

Date: 02/17/2020 JJS
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