

FEDERAL ADJUSTMENTS DUE TO PARTNERSHIP LEVEL AUDITS

Phone: (517) 373-8080
<http://www.house.mi.gov/hfa>

Senate Bill 248 (S-1) as passed by the Senate
Sponsor: Sen. Jim Runestad
House Committee: Tax Policy
Senate Committee: Finance
Complete to 5-11-21

Analysis available at
<http://www.legislature.mi.gov>

SUMMARY:

Senate Bill 248 would add to Part 3 of the Income Tax Act a new chapter 18 that would create a process for reporting a final federal adjustment arising from a partnership level audit. That is, if an audit of a partnership by the Internal Revenue Service (IRS) resulted in changes to reported income or tax liability, those adjustments (and any payments) would have to be made under the framework provided by the bill (rather than, for example, by filing an amended return under other provisions of the act). Among other things, the bill would require a partnership to have a representative to act on its behalf, allow partnerships to elect specified alternative methods of reporting and payment, hold taxpayers harmless for penalties and interest if the requirements of the reporting and payment process were met, and allow the Department of Treasury to promulgate rules to implement the bill. The bill would make related changes to other parts of the act. The bill states that its provisions would be retroactive and effective beginning January 1, 2018.

Reporting final federal adjustments

Senate Bill 248 would require *partnerships* and *partners* to report *final federal adjustments* arising from a *partnership level audit* or an *administrative adjustment request* and make payments as required under the new chapter 18—except for adjustments required to be reported for federal purposes by taking those adjustments into account in the partnership return for the year of adjustment.

Partner would mean a person that holds an interest directly or indirectly in a partnership or *pass-through entity*.

Partnership would mean an entity subject to taxation under subchapter K of the Internal Revenue Code.¹

Pass-through entity would mean an S corporation, partnership, limited partnership, limited liability partnership, or limited liability company. (An “S corporation” is a corporation electing taxation under subchapter S of chapter 1 of subtitle A of the Internal Revenue Code.²)

¹ <https://www.govinfo.gov/content/pkg/USCODE-2010-title26/pdf/USCODE-2010-title26-subtitleA-chap1-subchapK.pdf>

² <https://www.govinfo.gov/content/pkg/USCODE-2009-title26/pdf/USCODE-2009-title26-subtitleA-chap1-subchapS.pdf>

See also <https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations>

Partnership level audit would mean an examination by the federal Internal Revenue Service (IRS) at the partnership level under sections 6221 to 6241 of the Internal Revenue Code that results in federal adjustments.³

Administrative adjustment request would mean an administrative adjustment request filed by a partnership under section 6227 of the Internal Revenue Code.⁴

Final federal adjustment would mean a **federal adjustment** after the **final determination date** for that federal adjustment has passed.

Federal adjustment would mean a change to an item or amount determined under the Internal Revenue Code that is used by a taxpayer to compute tax liability under the Income Tax Act, whether that change results from action by the IRS (including a partnership level audit) or from the filing by the taxpayer of an amended federal return, a federal refund claim, or an administrative adjustment request.

Final determination date would mean the following:

- Except as provided below, for a federal adjustment arising from a IRS audit or other action by the IRS, the first day on which no federal adjustments arising from that audit or action remain to be finally determined—whether by IRS 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 that must be signed by the IRS and the taxpayer, the final determination date would be the date the last party signed.
- For a federal adjustment arising from a IRS audit or other action by the IRS, if the taxpayer filed as a person included in a **unitary business group** and required to file a combined return, the final determination date is the first day on which no related federal adjustments arising from that audit or action remain to be finally determined, as described above, for the entire unitary business group.
- For a federal adjustment resulting from filing an amended federal return, a federal refund claim, or an administrative adjustment request or if the federal adjustment was reported on an amended federal return or similar report, the final determination date is the day the report was filed.

Unitary business group would mean a group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, one of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other members, and that has business activities or operations which result in a flow of value between or among members included in the unitary business group or has business activities or operations that are integrated

³ <https://www.govinfo.gov/content/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleF-chap63-subchapC.pdf>

and <https://www.govinfo.gov/content/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleF-chap63-subchapD-partI.pdf>

⁴ <https://www.govinfo.gov/content/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleF-chap63-subchapC-sec6227.pdf>

with, are dependent upon, or contribute to each other. Unitary business group includes an affiliated group that makes the election to be treated, and to file, as a unitary business group under section 691(2) of the Income Tax Act.⁵

State partnership representative

For an action by a partnership that is allowed or required under the bill, and for any other proceeding or action allowed under the bill or under 1941 PA 122, the state partnership representative for the *reviewed year* would have the sole authority to act on behalf of the partnership, and the partnership's *direct partners* and *indirect partners* would be bound by those actions. The state partnership representative would be the partnership's *federal partnership representative* unless the partnership designated another person in writing. The Department of Treasury could establish reasonable qualifications and procedures for such a designation.

Federal partnership representative would mean the person the partnership designates for the reviewed year as the partnership's representative, or the person the IRS has appointed to act as the federal partnership representative, under section 6223 of the Internal Revenue Code.⁶

Direct partner would mean a partner that holds an interest directly in a partnership or pass-through entity.

Indirect partner would mean a partner in a partnership or pass-through entity that itself holds an interest directly, or through another indirect partner, in a partnership or other pass-through entity.

Reviewed year would mean the tax year of a partnership that is subject to a partnership level audit from which a federal adjustment arises.

Reporting adjustments

Except for those subject to a properly made election described under "Election," below, final federal adjustments would have to be reported as follows:

- No later than 90 days after the final determination date, the partnership would have to do all of the following:
 - File a completed *federal adjustments report*, including information as required by the Department of Treasury.
 - Report to each of its direct partners for the reviewed year their distributive share of the final federal adjustments, including information as required by the Department of Treasury.
 - Submit a payment on behalf of any *nonresident partner* previously included on a composite return for the reviewed year for the additional amount of tax that would have been due had the final federal adjustments been reported properly as required.

⁵ See <https://www.legislature.mi.gov/documents/mcl/pdf/mcl-281-1967-2-10.pdf>, which also defines terms used in the definition of *unitary business group*, such as "affiliated group," "business activity," "corporation," "foreign operating entity," "insurance company," and "person."

⁶ <https://www.govinfo.gov/content/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleF-chap63-subchapC-sec6223.pdf>

- If the partner’s increase in the amount of tax due resulting from the final federal adjustment was \$25 or more, no later than 180 days after the final determination date, each direct partner for that reviewed year that is a **corporate partner**, **resident partner**, or nonresident partner whose payment was not included in the composite return payment described above would have to file a federal adjustments report reporting that partner’s share of the adjustments reported as described above and pay any additional amount of tax due as if final federal adjustments had been properly reported, plus any penalty and interest as provided under 1941 PA 122. If the Department of Treasury determined that the taxpayer overpaid the tax imposed by the Income Tax Act, a credit or refund of the overpayment would have to be issued immediately.

Federal adjustments report would include methods or forms required by the Department of Treasury for use by a taxpayer to report final federal adjustments, including an amended tax return or information return.

Corporate partner would mean a partner, other than a unitary business group, that is subject to tax under chapter 11 of the Income Tax Act, including a partner that has **unrelated business activity**.

Unrelated business activity would mean, for a tax-exempt person, business activity directly connected with an unrelated trade or business as defined in section 513 of the Internal Revenue Code.⁷

Resident partner would mean an individual, estate, or trust that is a resident⁸ for the relevant tax year.

Nonresident partner would mean an individual, estate, or trust partner that is not a resident partner.

Election

An **audited partnership** making the election described below would be subject to the laws related to reporting, assessment, payment, and collection of the tax calculated under the Income Tax Act and under 1941 PA 122. An audited partnership making an election under these provisions would have to do all of the following:

- No later than 90 days after the final determination date, file a completed federal adjustments report, including information as required by the Department of Treasury, and notify the department that it is making the election under these provisions.
- Subject to the limitation described below, no later than 180 days after the final determination date, exclude from final federal adjustments the distributive share of those adjustments attributed to direct **exempt partners** not subject to the tax under the Income Tax Act and pay an amount equal to the sum of the following along with any penalty and interest as provided in 1941 PA 122, in lieu of taxes owed by its direct partners and indirect partners:
 - For the distributive shares of the remaining final federal adjustments that are attributed to direct corporate partners, determine the amount allocated or

⁷ <https://www.govinfo.gov/content/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleA-chap1-subchapF-partIII-sec513.pdf>

⁸ “Resident” is defined here: <https://www.legislature.mi.gov/documents/mcl/pdf/mcl-206-18.pdf>

apportioned to this state under Part 2 of the act and multiply that share amount by the tax rate imposed under section 623 of the act for the reviewed year.

- For the distributive shares of the remaining final federal adjustments that are attributed to direct *tiered partners* determine, as prescribed by the Department of Treasury, as follows:
 - The distributive shares that are attributed to indirect corporate partners and that are allocated or apportioned to this state under Part 2 and multiply that amount by the tax rate imposed under section 623 for the reviewed year.
 - The distributive shares that are attributed to indirect resident or nonresident partners and that are allocated or apportioned to this state under Part 1 of the act and multiply that amount by the tax rate imposed under section 51 of the act for the reviewed year.
 - For the remaining distributive shares of the final federal adjustments that are not attributed under the above two provisions, determine the amount allocated or apportioned to this state under Part 2 and multiply that amount by the tax rate imposed under section 623 for the reviewed year.
- For the distributive shares of the remaining final federal adjustments that are attributed to direct partners subject to the tax under Part 1, determine the amount allocated and apportioned to this state under Part 1 and multiply that amount by the tax rate imposed under section 51 for the reviewed year.

Audited partnership would mean a partnership subject to a partnership level audit resulting in a federal adjustment.

Exempt partner would mean a partner that is exempt from taxation under the Income Tax Act and that does not have unrelated business activity.

Tiered partner would mean a partner that is a partnership or other pass-through entity.

In determining the amount of the tax above, if reasonably identified by the audited partnership, final federal adjustments could not include the distributive share of final federal adjustments attributed to any direct or indirect corporate partner that was unitary with the audited partnership for apportionment purposes as provided under section 663 of the Income Tax Act.

Alternative method

In accordance with procedures adopted by the Department of Treasury, an audited partnership or tiered partner could submit an application to the department, in a form and manner as prescribed by the department, for an alternative reporting and payment method within the time allowed for an election as described above. Upon approval of the application by the department, an audited partnership or tiered partner would have to enter into an agreement with the department to utilize an alternative reporting and payment method, including applicable time requirements or any other provision of the bill, if the audited partnership or tiered partner demonstrated that the requested method would reasonably provide for the reporting and payments of taxes, penalties, and interest due under the bill.

Irrevocability of elections

An election made under the provisions described above in “Election” or “Alternative method” would be irrevocable, unless the Department of Treasury, in its discretion, determined otherwise. If properly reported and paid by the audited partnership or tiered partner, the amount determined as described under “Election” or alternatively under “Alternative method” would

be considered paid in lieu of taxes owed by its direct and indirect partners, to the extent applicable, on the same final federal adjustments. The direct partners or indirect partners could not take any deduction or credit under the act for that amount or claim a refund of it. This provision would not preclude a direct resident partner from claiming a credit under section 255 of the Income Tax Act against taxes paid to the state under the act, for any amounts paid by the audited partnership or tiered partner on the resident partner's behalf to another state or local tax jurisdiction. If a partnership or tiered partner failed to timely make any report or payment as required under this provision, the Department of Treasury could assess direct partners or indirect partners for taxes owed as determined based on the best information available.

Tiered partners

The direct and indirect partners of an audited partnership that were tiered partners, and all of the partners of those tiered partners that were subject to tax under the Income Tax Act, would be subject to the reporting and payment requirements described above in "Reporting adjustments," and the tiered partners would be entitled to make the elections described in "Election" and "Alternative method." The tiered partners or their partners would have to make required reports and payments no later than 90 days after the time for filing and furnishing statements to tiered partners and their partners as established under section 6226 of the Internal Revenue Code.⁹

Filing within time periods

If a *taxpayer* filed a federal adjustments report or an amended return as required and within the time period specified in the bill, the Department of Treasury could not assess additional tax, interest, and penalties arising from final federal adjustments after the expiration of the limitations period specified in section 27a of 1941 PA 122.¹⁰ If a taxpayer failed to file the federal adjustments report within the time period specified in the bill or filed a federal adjustments report that omitted adjustments or understated the correct amount of tax owed, the Department of Treasury could assess additional tax, interest, and penalties arising from those federal adjustments if the department issued a notice of assessment to the taxpayer within six years after the final determination date.

Taxpayer would mean all of the following:

- Any person subject to the taxes imposed by Part 1 of the act.
- A *corporation* or unitary business group that is liable for a tax, interest, or penalty under Part 2 of the act. (As used in this provision, *corporation* would mean that term as defined in Part 2.)
- A partnership subject to a partnership level audit or a partnership that has made an administrative adjustment request, as well as a tiered partner of that partnership.

Pending partnership level audits

A taxpayer expecting to owe additional tax due to a pending partnership level audit could make payments, as prescribed by the Department of Treasury, before the due date of the federal adjustments report. The department would have to credit any payments against any tax liability ultimately found to be due under the federal adjustments report, and any payments made would limit the accrual of further statutory interest on that amount.

⁹ <https://www.govinfo.gov/content/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleF-chap63-subchapC-sec6226.pdf>

¹⁰ <https://www.legislature.mi.gov/documents/mcl/pdf/mcl-205-27a.pdf>

Claim of refund or credit

Except for final federal adjustments required to be reported for federal purposes under section 6225(a)(2) of the Internal Revenue Code,¹¹ a taxpayer could file a claim for a refund or credit of the overpayment of the tax arising from federal adjustments made by the IRS before the expiration of the statute of limitations established under section 27a of 1941 PA 122. For a taxpayer that is a partnership, any claim for a refund or credit under this provision would have to be made within two years of the final determination date of the federal adjustment.

Extension of time periods

The time periods provided for in the bill could be extended as provided under either of the following:

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

Rules

The Department of Treasury could promulgate rules to implement the bill and to establish procedures and interim time periods for the reports and payments required by tiered partners and their partners and for making the elections under the bill. To the extent practicable, the Department of Treasury would have to establish rules and regulations that conform as closely as possible to the relevant federal rules and procedures.

Other amendments

Senate Bill 248 would also amend section 325 of Part 1 of the act (which generally applies to individuals) and section 687 of Part 2 (which generally applies to corporations) to provide that provisions in those sections that deal with filing amended returns do not apply to reporting a final federal adjustment arising from a partnership level audit or an administrative adjustment request required to be reported under the new chapter 18.

In addition, under each of those sections, for tax years beginning on and after January 1, 2018, if a partnership not subject to chapter 18 determined that the share of income, deductions, and credits previously reported to its partners and included in a return filed under the act required adjustment, the partnership could, at the discretion of the Department of Treasury, file a report with the department and pay the tax due or claim a refund on behalf of its partners in a manner similar to the process set forth in chapter 18.

Any refund issued to the partnership under these provisions would be in lieu of any overpayment of taxes that could be claimed by the partners.

Finally, the bill would move the deadline for an amended return for individuals and corporations from 120 days after the determination date for taxes owed to 180 days after the final determination date.

MCL 206.325 et seq.

¹¹ <https://www.govinfo.gov/content/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleF-chap63-subchapC-sec6225.pdf>

FISCAL IMPACT:

As written, the bill would have an insignificant impact on state revenue and no impact on local revenue, although the Department of Treasury will incur administrative costs to implement the various provisions.

Legislative Analysts: Jenny McInerney
Rick Yuille
Fiscal Analyst: Jim Stansell

■ This analysis was prepared by nonpartisan House Fiscal Agency staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.