

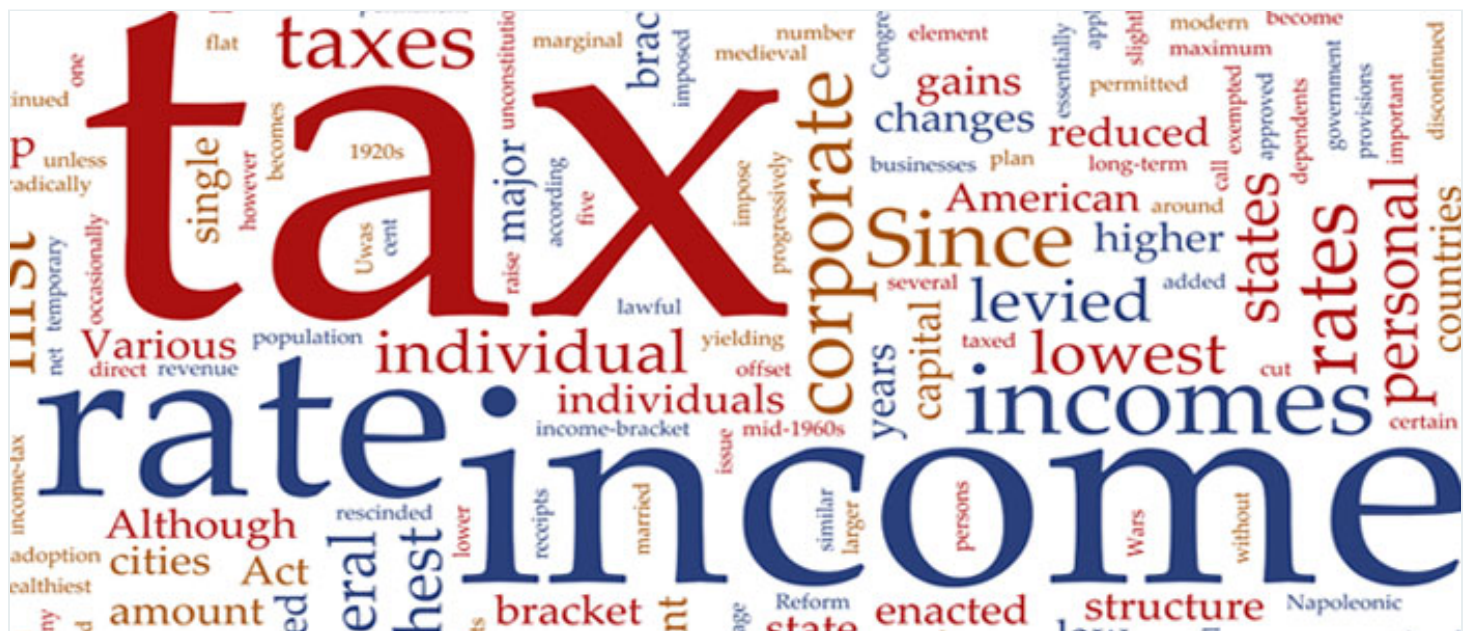
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Audit Changes

State conformity with federal rules and uniformity among state tax systems are at an all-time low. Practitioners and executives must stay informed of developments at both the federal and state levels to effectively employ pass-through entities in ...

Feb. 12, 2018



Landmark federal tax reform and recent changes to **federal partnership audit rules** make understanding the complexities of state taxation of pass-through entities a high priority for tax professionals and business leaders. While taxation of these entities and their owners has always been a complicated subject, being informed about states' responses to tax reform can better position you to help clients successfully navigate potential pitfalls and minimize confusion.

The Impact of Federal Tax Reform

Pub. L. 115-97, the 2017 tax act (officially, “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year

2018”), undoubtedly altered the landscape for all taxpayers. Pass-through entities

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upon a sale or exchange of 50 percent or more of the total interest in a partnership's capital and profits within a 12-month period, and new elections are not required or permitted.

In many ways, federal tax reform is good news for pass-through entities; however the complex interplay of state and federal tax mechanics complicates the analysis when trying to determine the impact on state budgets.

States Brace Themselves

Early state responses to the 2017 tax act cover the spectrum from the [policy message to legislators from Illinois' Governor](#), to detailed agency reports, like those out of New York and Maryland.

In the [Preliminary Report on the Federal Tax Cuts and Jobs Act](#), the New York Department of Taxation and Finance predicted that the 2017 tax act will unleash grim results on New York's tax system and economy, and presented options for state tax reform in response to the act.

“Absent changes to New York's tax code,” the report tells Gov. Cuomo, “the law's limitations on the deductibility of state and local taxes will cost New York's taxpayers an additional \$14.3 billion per year and risk undermining the progressivity of New York's tax system, the investments and services that the State provides for its residents, and the competitiveness of New York's economy over the long term.”

The report outlines options for a new statewide unincorporated business tax, offset by personal income tax credits for business owners, as well as a number of policy options for reducing income taxes and shifting to a statewide employer compensation expense tax. All of these proposals would affect pass-through entities.

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The report predicts that federal tax reform will influence how businesses organize and operate in Maryland. Specifically, some pass-through businesses may elect to reorganize as C corporations to benefit from the lower tax rate and greater certainty, which would result in an increase in state tax revenues.

2018 Partnership Audit Changes Loom for State Legislators

Changes to the way partnerships are audited at the federal level took effect Jan. 1, 2018. Previously, partners were responsible for any unpaid tax where federal audit changes resulted in an increase in the partnership's income. Under the new law, the partnership becomes liable directly for additional taxes, interest, and penalties resulting from an audit.

Though the first audits under the new regime will likely not occur until 2020, the sweeping nature of the changes has spurred concerns over the impact at the state level. The anticipated increased information reporting that is expected to result from the federal audits also means states will need to be able to handle larger volumes of tax data and improve coordination and reporting among jurisdictions.

Another concern, as pointed out in a Jan. 4, 2018, [letter](#) from the American Institute of CPAs (AICPA) to ranking members of the Senate Committee on Finance and the House Committee on Ways and Means, are the laws states must pass to establish new policies and procedures that will allow them to identify and collect additional tax on their share of any adjustment.

Both states and taxpayer groups are engaged in efforts to bring some degree of uniformity to state responses to these issues. However, the lack of a model statute from the Multistate Tax Commission (MTC) and interested parties has paused any

movement by states that want to integrate the new federal partnership audit regime

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to take strategic action for clients before the ink dries on state changes.

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