taxnotes® state

Volume 115, Number 8 ■ February 24, 2025

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Reprinted from *Tax Notes State*, February 24, 2025, p. 513

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In this installment of Noonan's Notes, Noonan and Bourg provide an overview of New York's proposed new reporting requirements for federal audit changes and compare them with the federal reporting regime, as well as the Multistate Tax Commission's relevant model legislation.

It's February, which means the Buffalo Bills are preparing for the Super Bowl and New York is preparing to drop its executive budget for the next fiscal year, right? Well, almost. Though the former ended in heartbreak (again), Gov. Kathy Hochul (D) did recently unveil the state's proposed fiscal 2026 budget. And while it contains no new taxes or tax increases, the budget calls for changes to tax administration, most notably regarding the reporting of federal partnership audit adjustments, which could cause more pain and hardship than an NFL referee blowing an obvious first-down call at a critical juncture in an AFC championship game.[1]

Here, we outline why New York's proposed legislation misses the mark and recommend a different approach.

Federal Reporting Regime

To understand the impact of New York's reporting changes at the state level, it's helpful to have some familiarity with the federal scheme.

As part of the Bipartisan Budget Act of 2015, Congress established a centralized partnership audit regime that replaced the audit and tax collection procedures for partnerships under the 1982 Tax Equity and Fiscal Responsibility Act. The procedural and administrative changes enacted by the BBA apply to partnership tax years beginning on or after January 1, 2018.[2] The BBA overhauled the reporting procedures for partnership audit adjustments and administrative adjustment requests (AARs) to streamline federal audits of complex partnerships.

Specifically, the BBA transformed the procedures by which the IRS or the partnership itself can adjust a previously filed Form 1065, either by a federal audit or the filing of an AAR. Under the BBA framework, when the IRS audits a partnership, any adjustments to items of income, gain, loss, deduction, or credit are determined at the partnership level.[3] At the end of an examination, the IRS may assess an imputed underpayment, which is determined based on the net positive adjustments multiplied by the highest

[1] Amos Morale III, "Chiefs Turn Controversial Fourth-Down Call Into Go-Ahead TD in AFC Championship Game," *The Athletic*, Jan. 26, 2025.

[2] Bipartisan Budget Act of 2015, P.L. 114-74.

[3] *Id.*

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applicable individual or corporate tax rate. As a default rule, imputed underpayments are treated as additions to tax and are payable by the partnership on behalf of its partners in the year that adjustments are made (the adjustment year) — as opposed to the tax year to which the adjustments relate (the reviewed year).[4]

Alternatively, partnerships subject to the BBA can make a push-out election under IRC section 6226, which relieves the partnership from the requirement to pay the imputed underpayment for the adjustment year.[5] In effect, a push-out election shifts the liability from the partnership to the reviewed-year partners. Each partner is furnished with a statement of its share of the adjustments to income, gain, loss, deduction, and credit for the year under review — as opposed to the year the federal adjustment is determined. The benefit of a push-out election is that it allows partners to report and pay the adjustments based on their specific and individual tax scenarios. It also — and perhaps more properly — imposes tax on the partnership as it existed during the tax year under review, rather than imposing the tax on a potential different set of partners that might exist in the year the adjustments are made.

The federal centralized partnership audit regime has arguably done what it was designed to do: simplify the process for auditing partners and partnerships. But it's created a mess at the state level. For instance, if the partnership pays the tax at the federal level in the adjustment year, who pays the tax at the state level without a special mechanism to do so? Does that adjustment relate to the reviewed year or the adjustment year? And how is a partnership to report that change to states whose procedures are tied to the old way of doing things?

Not to worry, though. We can always count on states to be quick to conform to a changing legal landscape in a uniform, consistent way.

Just kidding! As is often the case in state taxation, states are all over the place. Some have followed a Multistate Tax Commission model that largely conforms to what the IRS is doing, others have done their own thing, and half of the states have done nothing.

The MTC Model

To promote uniformity and consistent tax policy across the states, the MTC adopted a model statute in 2019 addressing the reporting and payment of state tax on federal partnership audit adjustments. Further technical corrections to this model legislation were adopted in November 2020.[6] The model statute serves as a uniform recommendation for states to examine when drafting their own legislation.

The MTC's model legislation differs from the BBA's centralized partnership regime in a few key aspects. Most notably, the MTC's rules default to using a push-out election for the adjustments, rather than assessing an imputed underpayment against the partnership. Under the MTC's model, the partnership would file a federal adjustments report with the state, as well as an amended composite or withholding return for partners, and issue notices of each partner's share of the adjustments. The partners must also file a federal adjustments report in accordance with their distributive share of the adjustments and pay any additional tax due as if the partners themselves properly reported the adjustments.

New York's Approach

New York was among the states on the sidelines of this issue. Thankfully, it has since entered the fray and provided new rules and guidance for taxpayers to address the new BBA audit regime. Less thankfully, the state has at least initially proposed to take things in a different direction. And what it has proposed is, well, kind of a mess.

Part V of the budget proposes amending articles 9-A, 22, 30, and 33 of New York's Tax Law to establish new reporting requirements for federal partnership audit changes and administrative adjustments consistent with the centralized partnership audit regime established by the BBA. The legislation would add a new

[4] *See* IRC section 6225(a)(1).

[5] IRC section 6226; Treas. reg. section 301.6226-1.

[6] MTC, "Model Uniform Statute for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments" (updated Nov. 2020).

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section 659-a to the tax law to address reporting and tax payment requirements for partnerships subject to federal audit adjustments or AARs.

Here's a breakdown of the notable provisions:

- **Proposed tax law section 659-a(a):** If any item required to be shown on a federal partnership tax return is changed or corrected by the IRS, and the partnership is issued an adjustment under IRC section 6225, or makes a federal election for alternative payment (see IRC section 6226) or files an AAR, the partnership must report the change to New York in such detail to allow for the computation of New York tax for the reviewed year within 90 days. So far, so good.
- **Proposed tax law section 659-a(c)(1):** This provision requires that the tax be paid at the partnership level. Period. There's no ability for the tax liability to be pushed out to the partners.
- **Proposed tax law section 659-a(c)(2):** Notwithstanding any election made for federal tax purposes, this provision mandates that any adjustments to tax must be calculated as of the reviewed year, and that those adjustments must be paid by the partnership. So again, this means there is no push-out option available to partners and no way to treat adjustments as current-year adjustments.
- **Proposed tax law section 659-a(c)(3):** Notwithstanding those same federal elections above, if the federal change results in an overpayment of tax, this provision provides that the partners "may" request a refund of the overpayment. There does not appear to be a mechanism for the partnership itself to request the refund. Why the difference? It appears that the legislation is designed to make it easy for the state to collect any tax due resulting from federal adjustments by mandating that the entity pay the tax, and very likely that the partnership will pay the maximum amount of tax possible (more on that later). But if there's a refund, it's not so easy: There's no provision for the partnership to be paid the refund, and the law allows the option for partners to each chase down their refunds by themselves.
- **Proposed tax law section 659-a(d):** An added layer of complexity will always arise at the state level for partners, since the amount of the state tax that could apply as a result of a federal audit adjustment will differ based not only on state apportionment rules, but also the partner's individual characteristics. This section of the proposed legislation lays out how the partnership is supposed to sort through these complexities. Here's the gist: If a partner is a corporation, then the state tax due because of the federal adjustment is computed based on the partner's business apportionment factor determined under the corporate apportionment rules. If the partner is an individual and a New York resident, then its share of the tax is computed at 100 percent. And for nonresident partners, the amount of state tax due as a result of the federal adjustment is calculated based on the partnership allocation rules under the personal income tax law. So far, so good. That all makes sense.

  But subsection (d)(2)(B) is where the computation quickly becomes problematic. If the partnership lacks the necessary information to compute the partner's distributive share — which may be the case for the types of large partnerships or tiered partnerships typically subject to the federal centralized audit regime — this subsection requires that the partnership *must assume a 100 percent allocation or apportionment* for all income. In other words, if the partnership doesn't know the underlying corporate apportionment percentages of its corporate partners, it must assume a business apportionment factor of 100 percent. If the partnership doesn't know the nonresident partner's allocation percentage, same deal: It has to assume it's 100 percent. And if the partnership does not know its partners' resident status, then it must assume the partners are residents and taxable on 100 percent of any federal audit changes.

For good measure, subsection (d)(2)(C) also requires additional tax to be paid at

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the highest marginal tax rate applied to the year under audit (although underlying partners may pay tax at a lower rate based on their income level). For example, a partnership with 25 equal partners that has over $25 million in income will pay tax at New York's highest rate of 10.9 percent, even though individually each partner is likely only required to pay tax at the 6.85 percent tax rate.

More on this later, but *wow*. The proposed statute appears to ensure that on federal audit adjustments that affect the state, the partnership pays the tax at the highest possible allocation and at the highest possible rate.

- **Proposed tax law section 659-a(e):** If a partnership fails to file a report or pay the tax due, New York can assess tax, penalties, and interest against the partnership under the assessment rules in tax law section 683.
- **Proposed tax law section 659-a(f):** If the partnership fails to file a report or pay the tax due, then New York can assess individual partners for their share of the tax due.
- **What's missing?** There is no provision allowing for the push-out of the tax payment to the individual partners. Moreover, there is no provision for partners to get a refund if the tax computation under section 659-a(d) outlined earlier results in a greater tax than what would've been due if the partners were allowed to compute the amount of tax due for themselves.
- **Effective date?** These rules would take effect immediately and apply to any final partnership adjustment issued by the IRS since January 1, 2018. Any final adjustments issued prior to the effective date must be reported within one year of the effective date, and interest does not accrue on such adjustments until one year after the effective date.

This proposed legislation has several critical flaws. First, the preclusion of a push-out election (allowed under the federal BBA regime and in most states) creates a massive lack of conformity with the IRS rules and with the way the state has historically taxed partners. It also places a considerable burden on the partnership to determine the correct amount of tax due. And because of the computational rules in subsection (d) of section 659-a (which default to taxing each partner's share of the income at 100 percent and at the highest possible marginal tax rate), this will inevitably result in an artificial inflation of tax liability. Allowing the liability to be assigned to the partners would result in a more accurate computation of the state tax liability, which is presumably why the MTC model legislation defaults to the push-out approach.

To be fair, the state uses a somewhat similar method to determine the tax due and payable by partnerships under its passthrough entity tax (PTET) regime, in which partnerships are required to pay the partners' state taxes. For example, similar to the earlier example, a partnership with 25 equal partners that has more than $25 million in income will pay the PTET at New York's highest rate of 10.9 percent, even though individually each partner is likely only required to pay tax at the 6.85 percent tax rate. But then when the partners file their individual tax returns, they are allowed to calculate their actual tax due on their share of the partnership's income and receive a refund of any PTET amounts overpaid by the partnership.

But under this proposed regime, that refund option is missing. If (and most likely when) a partnership pays more tax under tax law section 659-a after a federal audit adjustment, neither the partnership nor the partners have any right to seek a refund. It's almost as if the state is getting a "tip" when there's a federal audit adjustment! This lack of a refund option is arguably the most significant problem with New York's proposed regime.

The preclusion of a push-out election creates another significant problem for partnerships doing business in multiple states, specifically for tax paid on behalf of nonresident partners. If the nonresident partners were able to pay their share of the state tax resulting from the federal audit adjustment, then presumably they would be entitled to claim a credit for that tax in their home state, under the typical resident-credit schemes allowed for in most states. But if that tax is paid on their behalf by the partnership, it's likely any state

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tax credits would be lost. So, now we're not only talking about the computation of tax at the partnership level that results in too much tax; New York's proposed regime creates the very real potential for double state taxation on the same income.

And to make things more confusing, this proposed legislation has a retroactive element. Though it takes effect immediately, it applies to any final federal partnership adjustment since January 1, 2018. Entities are, therefore, required to report final adjustments handed down by the IRS since 2018 within one year of the effective date, or else interest will begin to accrue on the amount of the adjustment. This will create significant headaches for taxpayers who have concluded a prior federal audit since 2018, and already properly reported the changes under the prior regime. Plus, the retroactivity will make it difficult for partners to claim a refund of overpayment or credits in other states. As with New York's other proposed provisions, this approach differs from that suggested by the MTC model. For federal adjustments that are issued before the effective date of the law, the MTC suggests that states should consider modifying the definition of "final determination date" to account for the retroactivity issue.

Aside from being unfair, there are potential constitutional concerns. For one, it's hard to see how this regime would pass muster under the internal consistency test often used in federal dormant commerce clause cases. Namely, if every state imposed this regime, there would be obvious double taxation.[7] Also, a statutory scheme that allows the state to impose an unapportioned, income-based tax on a partnership engaged in a multistate business is clearly open to a constitutional challenge as well.

Finally, at its core, there's a somewhat "heads we win, tails you lose" aspect to this proposed legislation. The statutory scheme provides a mechanism that makes it easy for the tax department to collect any tax due resulting from a federal audit adjustment, and in a way that practically ensures that the entity will pay more tax than would've been due under the tax law had the partners paid the tax themselves. But on the flip side, if a federal audit adjustment results in a refund, it's not so easy. In that situation, the partnership itself has no right to any refund, nor the ability to compute a refund that might be higher than what the individual partners might get. Instead, the legislation provides that if there is an overpayment resulting from a federal adjustment, the partners may claim the refund if they want, forcing each individual partner to chase after the refund themselves.

Next Steps?

It's not all bad news. New York should be commended for taking this step and for working to conform the state law to the BBA federal audit regime. But this is not the way — there has to be a better approach. And from what we've heard, the tax department and the state Legislature are open to other suggestions or approaches, which is also commendable.

So what should the state do? To be sure, New York is often a leader or trendsetter in the state tax arena, and mostly for the better. But this seems to be one area in which the state is better off as a follower. And while New York isn't a member of the MTC and doesn't always conform with its recommendations or model legislation, it would be prudent to do so here, given the complications in different approaches and the fact that other states have been using the MTC model for a number of years without any apparent fanfare or controversy. ■

[7] *See Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542 (2015).

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