F I S C A L   I M P A C T   R E P O R T

ORIGINAL DATE 02/28/21
SPONSOR Burt **LAST UPDATED** 03/09/21 **HB**

SHORT TITLE Adjustment of Certain Taxes **SB** 410/aSTBTC

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	FY22	FY23	FY24	FY25		
	See Fiscal Implications					

Parenthesis ( ) indicate revenue decreases.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY21	FY22	FY23	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$25.8	--	$25.8	NR	ITD – staff workload costs
		$64	$64	$128	R	RPD - FTE

* In thousands of dollars. Parentheses ( ) indicate a cost saving. ** Recurring (R) or Non-Recurring (NR).

SOURCES OF INFORMATION
LFC Files

Responses Received from
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of STBTC amendment

The Senate Tax, Business and Transportation Committee amendment to Senate Bill 410 corrects a technical reference in the applicability sections, from section 5 dealing with composite returns pursuant to the Withholding Tax Act, to section 4 dealing with the authority to make refunds or credits. The amendment extends the start date for the three-year rule for claiming refunds from "the date the assessment was made" to "the date the tax was paid." The third provision of the amendment delays the effective date of sections 3 and 5 from July 1, 2021 to July 1, 2022.

Synopsis of Original Bill

Senate Bill 410 proposes that New Mexico adopt the Multistate Tax Commission's uniform model statute for federal partnership audits. This model legislation amends Section 7-1-13 NMSA 1978, Taxpayer Returns; Section 7-1-18 NMSA 1978, limitation On Assessment By The Department; Section 7-1-26 NMSA 1978, Claim For Refund; and Section 7-1-29 NMSA 1978, – Authority To Make Refund.

The main purpose of the bill is to address issues arising from a federal partnership audit or adjustment request that requires a corresponding adjustment to state taxes. The changes to state treatment are required by a change in procedures and law applicable to federal auditing and assessment of certain large partnerships that became effective on January 1, 2018. The bill also adds a new section of the Withholding Tax Act to allow a pass-through entity to file a composite income tax return on behalf of electing nonresident members that will result in reporting and paying income tax at the highest marginal rate provided in Section 7-2A-5. The federal law changes are complex and states throughout the country have been studying how to respond to these changes. The Multistate Tax Commission has adopted a model statute for that purpose and the provisions in this bill are based on that model statute.

The effective date of this bill is July 1, 2021. The provisions of Section 1 – requiring partners to report and pay the state if the partnership return is audited with a federal amount due – and Section 5 – allowing a composite return to be filed – are applicable for "federal adjustments with a final determination date occurring on and after January 1, 2021. (See "Technical Issues."). [Note: the technical issues identified for the original bill have been rectified with the STBTC amendments.]

FISCAL IMPLICATIONS

The substantial procedural changes imposed by the provisions of this Uniform Partnership Audit Act will probably have no immediate revenue effect.

However, a number of provisions may need to be regulated or require the issuance of letter rulings. TRD asserts additional budget authority may be needed. See "Administrative Issues."

SIGNIFICANT ISSUES

TRD notes the following policy issues:

The bill is intended as a response to the federal partnership auditing rule changes enacted by the federal Bipartisan Budget Act of 2015, which became effective on January 1, 2018. For most taxpayers, an adjustment to federal taxes is the result of an audit or the filing of an amended return. In such cases, because New Mexico taxes conform in large part to federal taxes, a New Mexico taxpayer will have to then file an amended state tax return. Section 7-1-13(C) NMSA, as currently enacted, provides for this situation, and requires a New Mexico taxpayer to file an amended state return, and to pay any taxes due, within 180 days of the final determination of the federal adjustment.

The Bipartisan Budget Act of 2015 changed the way that certain large partnerships (generally defined as partnerships with more than 100 partners, or certain other "tiered" partnerships, where partnerships are partners in a larger partnership) are audited and assessed. This method is commonly referred to as the centralized partnership audit regime. See Section 6225 of the Internal Revenue Code. It also changes how these large partnerships may amend their own returns to pay additional tax or claim refunds. This new method is called an "administrative adjustment request" and is created by Section 6227 of the Internal Revenue Code. These changes mean that there may be adjustments to the taxes on large partnership income that do not result from an assessment, or from the filing of an amended return, by the partners themselves, but rather from a partnership-level assessment or an administrative adjustment request. New Mexico's statutes, as currently enacted, will not clearly require partners whose partnerships have been audited or have filed administrative adjustment requests with respect to their federal taxes to file amended state tax returns. This bill will fix that gap in enforcement.

Subsection 1(E) of the bill retains the 180-day amended return filing requirement for federal adjustments that are the result of an audit or the filing of an amended return. The taxpayer is also required to file a "federal adjustments report", which is a form created by the Taxation and Revenue Department, (the "Department"), for the taxpayer to report the federal adjustment to New Mexico. The federal adjustment report may be an amended return or may accompany the amended return. Subsections 1(F) and 1(G) of the bill address the new administrative adjustment requests that may be made to the federal tax liabilities of large partnerships and their partners. The bill offers two ways for affected taxpayers to report this new federal method of adjustment. The default method is set out in Subsection 1(F); it applies only to adjustments not covered by Subsection 1(E). In other words, adjustments, even of large partnerships and their partners, that are the result of a federal audit assessment of the taxpayer (including a partner) or the filing of an amended federal tax return by a taxpayer, will still be subject to the requirements of Subsection 1(E). This section only changes tax liabilities that are the result of federal partnership-level audits or administrative adjustment requests for large partnerships and partners that are covered by Subsections 1(F) and 1(G).

Under Subsection 1(F), a partnership must file a completed federal adjustment report with the Department, and also notify each partner of their distributive share of that final adjustment. The notification to the partners must include information necessary for reporting that partner's resulting state tax due, if any. Each partner must then file their own federal adjustment report (which may simply be an amended return) reflecting their distributive share of the federal tax adjustment, and must also pay the additional tax due, if any, plus penalty and interest.

Subsection 1(G) allows a partnership to elect to make the adjustment differently. Instead of adjusting each partner's income and requiring each partner to file an amended return, the partnership can elect to pay the tax deficiency at the partnership level, and then allocate that payment among its partners. This election is irrevocable, unless a change is approved by the Department.

The bill therefore will allow New Mexico to capture all changes in state tax liability that will arise as a result of federal tax adjustments. If the bill is not passed, large partnerships and their partners may escape reporting and paying increased state tax liability resulting from adjustments to their federal tax liability.

The bill also provides that partnerships and other pass-through entities may file a "composite" return on behalf of non-resident partners or members who elect to allow that method of filing. Only nonresident partners or members whose only source of income within New Mexico or other states where the composite return is to be filed consists of pass-through income may make this election.

A very useful article in *The Tax Adviser*[1] explains the stakes for the states to adopt this Multistate Tax Commission's (MTC's) model uniform statute and regulation for reporting adjustments to federal taxable income and federal partnership audit adjustments. Uniformity among the states is always advantageous because it ensures even-handed treatment of in-state and out-of-state taxpayers so there are no "gotchas." *The Tax Adviser* article explains the background and useful features of the MTC model legislation.

Background
Important changes in the federal income tax treatment of partnership audits began to apply for tax years beginning Jan 1, 2018, for many partnerships (enacted as part of the Bipartisan Budget Act of 2015, P.L 114-74) With extended 2018 partnership returns timely filed by Sept 15, 2019; the IRS is expected to begin to conduct audits using the new partnership audit regime in 2020 In anticipation of increased partnership audit activity by the IRS, states are starting to react and enact (or at least consider) legislation regarding the new federal partnership audit process.

Why states need to enact the MTC model statute in 2020.
States incorporate the Internal Revenue Code (IRC) "tax base" into their tax laws in various ways However, states' conformity to the IRC's assessment and refund laws varies widely, with most states adopting their own independent assessment and refund laws that are distinctly separate from those in the IRC Therefore, almost every state that imposes an individual and/or corporate income tax needs to amend its federal adjustment reporting laws to account for the new federal partnership audit regime procedures for the process to work fairly, both for the state and for taxpayers who hold interests in impacted partnerships.

For example, the laws of many states do not allow for the direct assessment of partnerships, as these entities are not taxpayers upon which the state may assess, collect, or levy a tax In other states, the partnership itself is the taxpayer; thus, the impact is less significant because individual assessment against a partner is not permitted, as the state may not subject its partners (e.g., individuals) to state income taxation on the income earned by a partnership However, most states assess partners directly; therefore, many states will need to enact legislation that allows them to also assess the partnership, following the new federal regime State tax authorities will need to issue guidance to explain how the states will implement any changes.

The MTC model statute provides states with a reasonable method to collect revenue for their share of liabilities flowing from an IRS audit of a partnership or multimember limited liability company (LLC) under the new federal partnership audit regime and not face substantial legal and administrative concerns.
Overview of the many helpful provisions in the MTC model statute

[1] https://www.thetaxadviser.com/issues/2020/mar/multistate-tax-commission-federal-partnerships.html

The MTC model statute makes the following general improvements over current state tax procedural laws for all taxpayers:

- Provides a clear definition of "final determination" based on all issues for a tax year being final at the federal level, including taxpayers that are members of a combined/consolidated filing group;
- Establishes that taxpayers have at least 180 days to report changes (interest still accrues until paid);
- Absent a waiver, imposes a limitation on changes after the state's general statute of limitation expires for both the state and the taxpayer to the federal audit changes; and
- Introduces equal and clearly stated assessment and refund periods.

The MTC model statute provides uniformity and:

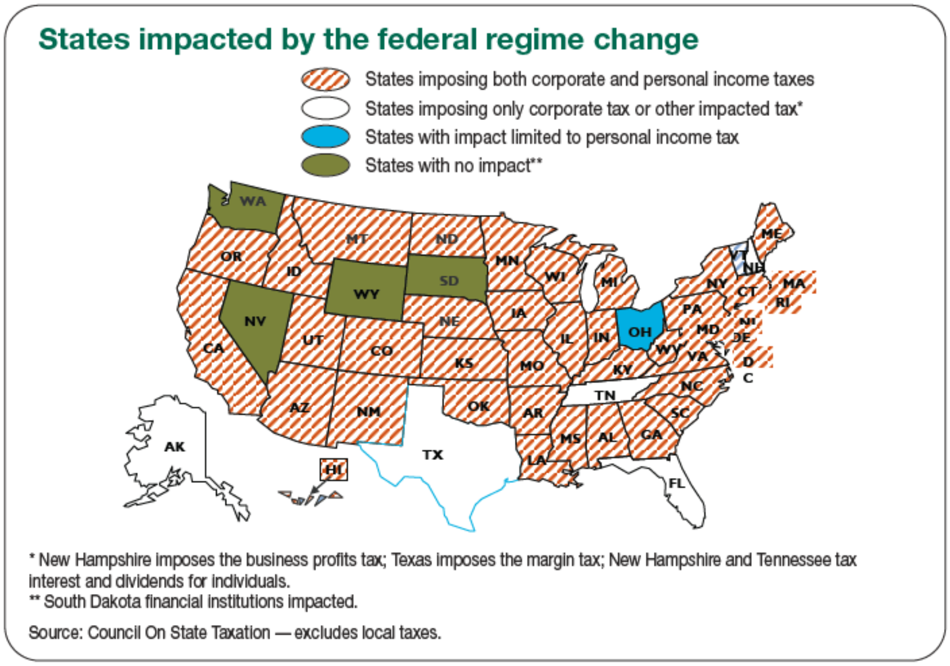
- Incorporates changes needed for states to conform in a manner that considers state tax issues and best approaches;
- Establishes more uniform standards across all the states for reporting all federal audit adjustments for all taxpayers to state-level tax authorities;
- Addresses significant changes made to federal audit procedures by the new federal partnership audit regime that affect state-specific issues; and
- Addresses taxpayer, practitioner, and state tax authority concerns.

The MTC model statute also:

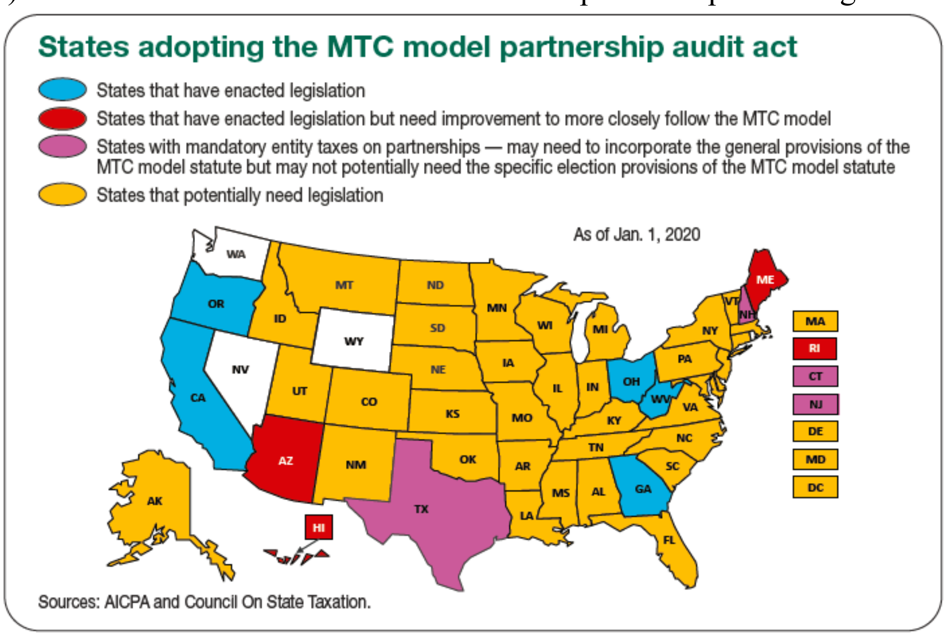
- Covers the role and authority of the partnership representative, adopting the federal partnership representative procedure, while also allowing for a partnership to choose a state partnership representative that is different from the representative chosen for the federal (or another state's) partnership audit regime reporting process;
- Allows a state-level partnership election that can differ from the election made for federal purposes (e.g., to "push out" the assessment to the partners or to let the partnership pay the adjustment directly);
- Provides modifications of imputed underpayments;
- Addresses unique state tax issues, such as apportionment/allocation or nexus and residency issues, that Congress did not need to consider in enacting the new federal partnership audit regime;
- Covers tiered partnership structures (where partnerships own other partnerships) — tiered partners, if applicable, can make a different state election and file 90 days after the federal due date for tiered partner returns at the federal level;
- Provides a clear definition of final determination — the trigger for reporting changes;
- Considers timing of reporting obligations, providing 180 days to report after the final determination;
- Allows estimated payments to reduce interest with a refund if estimated tax is overpaid;
- By mutual agreement of the partnership representative and the state, allows different reporting and payment of tax by a partnership and its partners;
- Grants partnerships with over 10,000 partners at least a 60-day automatic filing extension;
- Provides that past the normal state statute of limitation, changes are limited solely to federal tax changes; and
- Provides an equal statute of limitation for assessment/refund and absent fraud, a six-year maximum period for tax assessment (even if no return is filed, absent fraud).

With IRS audits under the new regime likely to start in 2020, states need to enact legislation conforming to the MTC model statute.

Map of Impacted States. The map "States Impacted by the Federal Regime Change" (below) shows the state-by-state effect of the federal audit changes.



Map and Status of State Action. The map "States Adopting the MTC Model Partnership Audit Act" (below) illustrates the status of states' enactment of partnership audits legislation.



ADMINISTRATIVE IMPLICATIONS

As noted in "Fiscal Implications," TRD will have to review existing rules and promulgate new regulations in as timely a manner as possible. In addition, TRD expects additional systems and processing efforts.

TRD elaborates on this point:

> Implementation of the bill will have a moderate impact on TRD's Information Technology Division (ITD), approximately 500 hours or approximately 3 months and $25,820 of staff workload costs. Implementation will require updates to GenTax, the tax system of record, the Taxpayer Access Point, and other sub-systems. Associated forms and instructions for taxpayers will require updating. In the Audit and Compliance Division (ACD), training and procedures will need to be revised to reflect the changes regarding these taxpayers. These updates would be incorporated with the annual tax year changes for tax year 2021.
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> The Revenue Processing Division (RPD) of will require an additional tax auditor position to review CIT and PTE return adjustment based on IRS RARs and AARs.

TECHNICAL ISSUES

Section 5 allows a pass-through entity (partnerships, tiered partnerships, LLCs, LLPs and Subchapter S corporations) to file a composite withholding tax return on behalf of electing non-resident members. In Section 6, Section 5 is made applicable to federal adjustments with a final determination date occurring on and after January 1, 2021. This applicability is appropriate for Section 1, but for Section 5, which does not invoke any final determinations, Section 6 should be amended to have different specifications for Sections 1 and 5. [Note: this technical issue has been resolved by STBTC amendment.]

TRD has provided notes on technical issues and alternatives:

> **[Section 1]** This section modifies the Income Tax Act and makes cross references to the Corporate Income and Franchise Tax Act, and the Oil and Gas Proceeds and Pass-Through Entity Withholding Tax In so doing, the changes provide definitions that conflict with the definitions under 7-2A-2 NMSA 1978 and 7-3A-2 NMSA 1978, including the definitions for "partnership" and "pass-through entity".
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> **[Section 3]** On page 20, line 14, the Department recommends that the reference be to "the date that the taxes were paid," and not "the date the assessment was made." [Note: this issue has been resolved by STBTC amendment.]

OTHER SUBSTANTIVE ISSUES

Because New Mexico is a small and relatively poor state with a somewhat unique tax system (including our unique gross receipts tax), it must make every effort to minimize barriers to entry into the state's economy for multistate and multi-national businesses.

LG/al/sb/rl