

Guidelines for Reporting Federal Tax Adjustments

During the 2020 Session, the Virginia General Assembly enacted House Bill 1417 (2020 *Acts of Assembly*, Chapter 1030) which provided updated procedures for reporting certain adjustments, including partnership adjustments, that result from federal tax changes and other changes to federal taxable income to the Department of Taxation (“the Department”). This legislation updated Virginia’s law regarding reporting tax adjustments to make it match with new federal procedures set forth in the federal Bipartisan Budget Act of 2015 (“BBA”). In addition, this legislation specified when other Virginia income taxpayers such as individuals, estates, trusts, and corporations must report federal tax changes to the Department.

These guidelines are published by the Department of Taxation (“the Department”) to provide guidance to taxpayers regarding the updated procedures for reporting federal tax changes to the Department, as required by the second enactment clause of 2020 House Bill 1417. These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner’s general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information regarding these procedures will be published and posted on the Department’s website, www.tax.virginia.gov.

These guidelines complement the Department’s existing General Provisions Applicable to All Taxes Administered by the Department of Taxation Regulation (23 *Virginia Administrative Code* (“VAC”) 23 VAC 10-20-10 et seq.), Individual Income Tax Regulation (23 VAC 10-110-20 et seq.), and Corporation Income Tax Regulation (23 VAC 10-120-10 et seq.). To the extent that there is a conflict between the Department’s existing guidance and 2020 *Acts of Assembly*, Chapter 1030, the provisions of that law, as interpreted by these guidelines, supersede existing guidance.

These guidelines represent the Department’s interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845.

Definitions

As used in these guidelines, unless the context requires otherwise:

"Administrative adjustment request" means an administrative adjustment request filed by a partnership pursuant to Internal Revenue Code (“IRC”) § 6227.

"Direct" means, with respect to a partner, that such partner holds a direct interest in a partnership or a pass-through entity and that such interest is not held indirectly through another partnership or pass-through entity.

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"Federal adjustment" means a change to an item or amount determined under the IRC that is used by a taxpayer to compute Virginia tax owed, regardless of whether that change results from an action by the Internal Revenue Service ("IRS") including a partnership-level audit, or the filing of an amended federal return, federal refund claim, or administrative adjustment request by the taxpayer. A federal adjustment is positive to the extent that it increases Virginia taxable income and is negative to the extent that it decreases Virginia taxable income.

"Partner" means a person that holds an interest directly or indirectly in a partnership or pass-through entity.

"Partnership" means an entity subject to taxation under Subchapter K, 26 U.S.C. § 701 et seq., of Chapter 1 of Subtitle A of the IRC.

"Partnership-level audit" means an examination by the IRS at the partnership level pursuant to Subchapter C, 26 U.S.C. § 6221 et seq., of Chapter 63 of Subtitle F of the IRC that results in federal adjustments.

"Pass-through entity" means any pass-through entity as defined in *Va. Code* § 58.1-390.1, other than a partnership as defined in this section.

"Reviewed taxable year" means the taxable year of a partnership that is subject to a partnership-level audit from which federal adjustments arise.

General Requirements for the Reporting of Federal Tax Adjustments

If an adjustment is made to the federal taxable income of an individual, estate, trust or corporate taxpayer, taxpayers are required to report federal adjustments to the Department ("general reporting requirement"). 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.

Effective July 1, 2020 and after, 2020 House Bill 1417 requires that federal adjustments be reported to the Department within one year after a "final determination date" rather than one year after a "final determination," the term used under prior law. This new definition of "final determination date" will apply throughout these guidelines, unless context requires otherwise, including the sections regarding partnerships. In addition, the application will depend on whether the federal adjustment arises from IRS action or from taxpayer action.

Prior to July 1, 2020, federal adjustments were required to be reported to the Department within one year after the "final determination" of such adjustment. 23 VAC 10-20-

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180(B)(2)-(5) provides guidance regarding the final determination of a federal adjustment.

Federal Adjustment From IRS-Initiated Action

If the federal adjustment arises from an IRS audit or other action by the IRS, "final determination date" means:

1. The first day on which no federal adjustments arising from that audit or other 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 required to be signed by the IRS and the taxpayer, the final determination date is the date on which the last party signed the agreement.
2. If the taxpayer filed as a member of a combined or consolidated return, the final determination date means the first day on which no related federal adjustments arising from that audit remain to be finally determined, as determined in Paragraph 1 above, for the entire group.

Because 23 VAC 10-20-180(B)(2)-(5) is generally consistent with the "final determination date" definition in 2020 House Bill 1417, the Department will follow such regulations in interpreting this legislation. As a result, the date when any one of the following events occur will be considered to be a final determination date:

- The signing of federal Form 870 or other IRS form consenting to the deficiencies, accepting any overassessment shown on the form, or both. However, where the signature of an authorized representative of the IRS is also required, the final determination date is the date on which the taxpayer receives notice of the signing by the IRS.
- The expiration of the 90-day time period (150-day period in the case of notice addressed to a person outside the states of the union and the District of Columbia) within which a petition for redetermination may be filed with the United States Tax Court with respect to a statutory notice of deficiency issued by the IRS, if a petition is not filed with that court within such time.
- A closing agreement entered into with the IRS under IRC § 7121. The final determination shall occur when the taxpayer receives notice of the signing by the Commissioner of Internal Revenue.
- A decision by the United States Tax Court, a United States district court, the U.S. Claims Court, a United States court of appeals, or the United States Supreme

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Court that has become final, or the date the court approves a voluntary agreement stipulating disposition of the case.

Federal Adjustment From Taxpayer-Initiated Action

If the federal adjustment does not arise from an IRS audit or other action by the IRS, the “final determination date” means the day on which the amended return, refund claim, administrative adjustment request, or other similar report was filed (“the filing rule”). Because the filing rule is inconsistent with the payment and refund rule in 23 VAC 10-20-180(B)(1), the Department considers the filing rule in House Bill 1417 to supersede this portion of the regulation.

Requirements for Reporting Certain Partnership-Level Federal Tax Adjustments

Under the federal Bipartisan Budget Act of 2015 (“BBA”), Congress enacted a new regime for auditing partnerships referred to as “the centralized partnership audit regime.” Under this regime, tax is generally determined, assessed, and collected at the partnership level. This has the effect of generally shifting the burden of paying tax resulting from federal audits from the taxpaying partners to the partnership itself. As a result, partnerships are no longer required for federal purposes to provide their partners with information regarding federal tax adjustments.

Federal Centralized Partnership Audit Regime

Under the BBA, a federal centralized audit is conducted entirely at the partnership level through its partnership representative. A partnership representative is the person designated by the partnership who makes all audit-related decisions. For more information, please see the BBA Centralized Partnership Audit Regime webpage maintained by the IRS.

Virginia Partnership Reporting Requirement

For Virginia income tax purposes, the general requirement to report federal adjustments is imposed on the partners, not the partnership itself. However, under the new federal centralized partnership audit regime, partnerships are not generally required to provide information regarding federal adjustments to their partners. In addition, under prior Virginia law, there was nothing requiring the partnership to provide such information to their partners. Therefore, partners in a partnership subject to the centralized partnership audit regime may have difficulties reporting federal adjustments to the Department due to a lack of necessary information from the partnership.

To address this issue, the General Assembly enacted House Bill 1417 during the 2020 Session. Effective July 1, 2020 and after, this legislation requires that a partnership must report final federal adjustments arising from a partnership-level audit or an administrative adjustment request both to the Department and to its partners (“the partnership reporting

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requirement”). All partnerships are subject to the partnership reporting requirement for taxable years beginning on or after January 1, 2018, unless the partnership has made a valid federal election out of the centralized partnership audit regime. Partnerships are subject to the partnership reporting requirement for taxable years beginning before January 1, 2018 if the partnership has made a valid federal election into the centralized partnership audit regime.

However, if either the push-out or pull-in process established by the IRS in order to report federal adjustments is used or if there are adjustments that do not result in an imputed underpayment, the partnership reporting requirement does not apply to such adjustments. These adjustments will flow through to the affected partners, and they will therefore be included in income for Virginia tax purposes. This treatment is also given to reallocation adjustments. However, because the IRS accounts for these adjustments as a nonrefundable credit or as additional tax in the adjustment year, additions and subtractions may be necessary on the partner’s amended Virginia income tax return for the reviewed taxable year. The Department will publish more information regarding this process in its form instructions, including any additions and subtractions that may be necessary.

90-Day Rule for Partnerships to Report and Notify

Under the partnership reporting requirement, a partnership must file with the Department a completed Form 502FED-1 no later than 90 days after the final determination date. On the Form 502FED-1, the partnership is required to report the details of the effect of federal adjustments on amounts reported on the original partnership return for the reviewed taxable year. Along with the Form 502FED-1, the partnership must file an amended Form 502 with all associated forms and schedules.

In addition to making filings with the Department, a partnership must notify each direct partner of its distributive share of the federal adjustments no later than 90 days after the final determination date. In order to comply with this requirement, the partnership must provide to each direct partner a copy of:

- Form 502FED-1,
- An amended federal Schedule K-1, and
- An amended Schedule VK-1.

Nonresident Withholding Tax

If the partnership paid nonresident withholding tax with respect to its nonresident owners, the partnership must include with its amended Form 502 a payment for any additional withholding tax that may be due as a result of the federal adjustments. “Nonresident owner” means any person who is treated as a partner, member, or shareholder of the partnership for federal income tax purposes and, in the case of an individual, is not a

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domiciliary or actual resident of Virginia, or, in the case of any other entity, does not have its commercial domicile in Virginia

Composite Return

If the partnership previously filed a composite return ("Form 765") on behalf of its qualified nonresident owners, the partnership must file an amended Form 765 no later than 90 days after the final determination date. This amended Form 765 is required in addition to the filing of a Form 502FED-1 and an amended Form 502. The partnership must include with its amended Form 765 a payment for any income tax that may be due as a result of the federal adjustments. Please see the Department's Guidelines for Pass-Through Entity Withholding ("Public Document 15-240) for additional details, including the definition of a "qualified nonresident owner."

One-Year Rule for Partners to Report and Pay

If the partnership reporting requirement applies to a partnership, any direct partner of such partnership must file a federal adjustments report no later than one year after the final determination date ("the one-year rule"). In the case of the one-year rule, the federal adjustments report will take the form of an amended Virginia income tax return for the reviewed taxable year. In addition, the partner must include a payment for any additional amount of income tax due as if federal adjustments had been properly reported, including any applicable penalty and interest. The payment may be reduced by any credit for related amounts paid or withheld and remitted on behalf of the direct partner. However, the one-year rule does not apply to the following:

- Partners whose income for the reviewed taxable year after any federal adjustments places them below the filing threshold specified in *Va. Code* § 58.1-321; and
- Partners who are not subject to Virginia's individual, estates and trusts, or corporate income tax.

Failure of Partnership to Comply with Federal Adjustments Reporting Filing Requirements

A partnership failing to file its federal adjustments report within the 90-day period or a partner failing to file its federal adjustments report within the one-year period will be liable for a penalty of \$200 if the failure is for not more than one month, with an additional \$200 for each additional month or fraction thereof during which such failure to file continues, not exceeding six months in the aggregate. In no case, however, may the penalty be less than \$200. See *Va. Code* §§ 58.1-399.7 and 58.1-394.1(A).

In addition, if any partnership's failure to comply with the 90-day period exceeds six months, the Department will assess a penalty of six percent of the total amount of federal adjustments derived by its partners from the partnership for the taxable year. If any partner's failure to comply with the one-year period exceeds six months, the Department

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will assess a penalty of six percent of the total amount of federal adjustments attributable to that partner from the partnership for the taxable year. The Department may determine such penalty from any information in its possession. The six percent penalty may be reduced by the monthly \$200 penalty assessed. In addition, the penalty would not apply to any tax paid by the partners on their share of federal adjustments from the partnership for the taxable year.

The penalties will be assessed and collected by the Department in the manner provided for the assessment and collection of income taxes or in a civil action, at the instance of the Department. In addition, the partnership may be compellable by mandamus to file a complete federal adjustments report and notify its direct partners.

Partnership Pays Election

As an alternative to having partners report and pay tax on their distributive share of adjustments, an audited partnership may make an election to pay tax on their behalf ("the partnership pays election"). "Audited partnership" means a partnership subject to a partnership-level audit that results in a federal adjustment. Partnerships with final federal adjustments arising from administrative adjustment requests are not able to make the partnership pays election. To properly make such election, the audited partnership must:

- No later than 90 days after the final determination date, file a completed Form 502FED-1 and Form 502FED-2, checking the box indicating that it is making a partnership pays election to submit an elective payment on behalf of its partners; and
- No later than one year after the final determination date, make the elective payment.

The election may be made by checking the appropriate box on the Form 502FED-2. If multiple taxable years are included in the federal audit, one Form 502FED-1 and one Form 502FED-2 are required to be filed for each year. The audited partnership may make a separate election for each taxable year and is not be required to make the election for all taxable years. The partnership should ensure that the appropriate box is checked on each Form 502FED-2 that is filed. If an election to pay the tax on behalf of its partners is made for a particular taxable year, then all partners of the audited partnership must be included in the election, including those that were originally included in a composite return.

The partnership is required to issue to each direct partner a written statement regarding the amount of elective payment that has been made and that partner's pro rata share of such payment. If an elective payment is made after the Form 502FED-2 is filed, it is recommended that the elective payment be made as soon as possible and that any written statement also be provided to direct partners as soon as possible to ensure such partners have sufficient time to file amended returns for refunds if they are eligible.

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Adjustments that do not result in additional tax are not included in the elective payment computation for partnerships making a partnership pays election. Those adjustments will flow through to the affected partners, and will therefore be included in income for that year. Because the IRS accounts for these adjustments as a nonrefundable credit in the adjustment year, additions and subtractions may be necessary on the partner's amended return for the reviewed taxable year. The Department will publish more information regarding this process in its form instructions.

Allocation and Apportionment of Income

The first step in computing the elective payment is determining the allocation and apportionment of the partnership's income. If a partnership's entire business is conducted within Virginia, then all of its income is Virginia source income, and no income is allocated or apportioned to another state.

If a partnership conducts its business within Virginia and elsewhere in a manner such that its income would be subject to a tax on net income in Virginia and at least one other state, the partnership must allocate and apportion its income in the same manner that is provided in Virginia law for corporations. Dividends received are to be allocated to the state of the partnership's commercial domicile, but all other income must be apportioned. A partnership may not apportion its income based on divisional or separate accounting, or any other alternative method unless it has requested and received permission to do so in advance from the Department.

Effect of Allocation and Apportionment on the Elective Payment

The second step in computing the elective payment is determining the effect of the partnership's allocation and apportionment on the partners, which varies as described below.

Non-Tiered Partners

To the extent that the partners of the electing partnership are direct, non-tiered partners, the elective payment amount will be calculated according to this section depending upon whether the partner is a resident partner, nonresident partner, corporate partner, or tax-exempt partner.

Resident Partners

For the portion of federal adjustments that would flow through to a resident partner, the elective payment is the distributive share of the full amount of such adjustments multiplied by Virginia's highest individual income tax rate of 5.75 percent. This is because a Virginia resident individual owner is taxable on all of his or her partnership income regardless of the partnership's allocation and apportionment.

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With respect to an individual partner, a "resident partner" means that such partner is a "resident," as defined in *Va. Code* § 58.1-302, for the relevant tax period. Any individual partner who does not meet this definition is a "nonresident partner."

With respect to an estate or trust partner, "resident partner" means that such partner is a "resident estate or trust," as defined in *Va. Code* § 58.1-302, for the relevant tax period. Any estate or trust partner who does not meet this definition is a "nonresident partner."

Direct Nonresident Partners

For the portion of federal adjustments that would flow through to a nonresident partner, the elective payment amount is the distributive share of such adjustments that are sourced to Virginia and multiplied by Virginia's highest individual tax rate of 5.75 percent.

A "nonresident partner" is any individual, estate, or trust partner that is not a resident partner. The allocation and apportionment is a partnership-level computation. In determining the distributive share of adjustments that are sourced to Virginia, the electing partnership adds:

- The direct nonresident partner's distributive share of federal adjustments to income other than dividend income ("apportionable income") multiplied by the partnership's post-audit apportionment percentage; and
- The direct nonresident partner's distributive share of federal adjustments to dividend income if the partnership is commercially domiciled in Virginia.

Example 1. Partner A is a nonresident individual who is a direct partner with a 40% ownership interest in Partnership Z. Partnership Z's apportionable income reported on its original return was \$100,000. The partnership has a \$10,000 federal adjustment to apportionable income, making its apportionable income \$110,000. Its apportionment percentage is 20 percent.

As a result of the audit, Partnership Z's post-apportionment income increased from \$20,000 (\$100,000 income reported on original return X 20 percent) to \$22,000 (\$110,000 income determined by IRS X 20 percent). In this case, the difference between these two amounts is the federal adjustment, which is \$2,000 (\$22,000 post-apportionment income after audit - \$20,000 post-apportionment income before audit). Because Partner A is a 40 percent owner of the partnership, Partner A's distributive share of that adjustment is \$800 (\$2,000 X 40 percent), and the elective payment on such distributive share is \$46 (\$800 X 5.75 percent).

Example 2. Same as Example 2, except that Partnership Z's apportionment percentage was 10 percent prior to the federal audit but is now 20 percent as a result of the federal audit.

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As a result of the audit and its effect on its apportionment percentage, Partnership Z's post-apportionment income increased from \$10,000 (\$100,000 income reported on original return X 10 percent) to \$22,000 (\$110,000 income determined by IRS X 20 percent). In this case, the difference between these two amounts is the federal adjustment, which is \$12,000 (\$22,000 post-apportionment income after audit - \$10,000 post-apportionment income before audit). Because Partner A is a 40 percent owner of the partnership, Partner A's distributive share of that adjustment is \$4,800 (\$12,000 X 40 percent), and the elective payment on such distributive share is \$276 (\$4,800 X 5.75 percent).

Corporate Partner

For the portion of federal adjustments that would flow through to a corporate partner, the elective payment amount is the distributive share of such adjustments that are apportioned or allocated to Virginia and multiplied by Virginia's 6 percent corporate income tax rate. "Corporate partner" means a partner that is subject to the Virginia corporate income tax.

The allocation and apportionment is a partnership-level computation. In determining the distributive share of adjustments that are apportioned and allocated to Virginia, the electing partnership adds:

- The corporate partner's distributive share of federal adjustments to income other than dividend income ("apportionable income") multiplied by the partnership's post-audit apportionment percentage; and
- The corporate partner's distributive share of federal adjustments to dividend income if the partnership is commercially domiciled in Virginia.

Tax-Exempt Partners

For the portion of federal adjustments that are to unrelated business income or other taxable income to which a tax-exempt partner would be subject to tax under *Va. Code* § 58.1-400, the elective payment amount is the distributive share of such adjustments that are apportioned or allocated to Virginia and multiplied by Virginia's 6 percent corporate tax rate. In determining the distributive share of such adjustments that are allocated and apportioned to Virginia, the same principles apply to tax-exempt partners that apply to corporate partners.

"Tax-exempt partner" means a partner exempt from Virginia income taxation. If such partner has unrelated business taxable income but otherwise is exempt from Virginia income taxation, such partner shall be considered a "tax-exempt partner." "Unrelated business taxable income" has the same meaning as such term is defined in IRC § 512.

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For the portion of federal adjustments that are to income other than unrelated business income or other taxable income to which the a tax-exempt partner would not be subject to tax under *Va. Code* § 58.1-400, the elective payment amount is zero.

Tiered Partners

For the portion of federal adjustments that would flow through to a direct tiered partner, the elective payment amount is the distributive share of Virginia source adjustments multiplied by Virginia's highest individual tax rate of 5.75 percent. In determining the distributive share of such adjustments that are Virginia source adjustments, the same principles apply to direct tiered partners that apply to direct nonresident partners. See *Va. Code* § 58.1-399.1(B)(4)(ii).

An exception to this general rule provides that adjustments that are of a type that would not be subject to sourcing in Virginia are required to be included in their entirety in the elective payment. See *Va. Code* § 58.1-399.1(B)(4)(ii). Because Virginia requires sourcing of all income through either allocation or apportionment under its statutory method, this exception will not typically apply to an electing partnership's adjustments. However, this exception may apply to certain partnerships that are properly using an alternative method of apportionment or are considered an investment pass-through entity under Public Document 15-240. In such cases, if the partnership has adjustments that are of a type that would not be subject to sourcing in Virginia, then they must be included in the elective payment amount computation in their entirety as an initial matter. If the partnership seeks, instead, to exclude any portion of these adjustments, it may do so to the extent that it can establish that the amount is properly allocable to an indirect nonresident partner. While not dispositive, helpful factors in proving non-residency for this purpose may include a copy of a resident tax return filed by the nonresident indirect partner in another state and, if filed, a copy of a nonresident tax return filed by the nonresident indirect partner in Virginia. Adjustments may also be excluded to the extent an electing partnership can establish the amount is properly allocable to a partner that is not subject to tax on such amount or excludable under procedures for alternative reporting and payment.

Assessment and Collection of Elective Payment

If any partner or partnership makes a partnership pays election, the Department must assess and collect elective payments, interest, and penalties arising from final federal adjustments as if the elective payments are a corporate income tax. Penalties and interest imposed on a partner or partnership will be determined based on the date the Form 502 for the reviewed taxable year originally was due. Therefore, the provisions of Chapter 3 and Chapter 18 of Title 58.1 relating to the assessment and collection of corporate income tax apply, making such changes necessary after considering the differences between the corporate income tax and the elective payment. The effect of some of these provisions on audited partnerships is detailed below.

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Failure to Pay Penalty and Interest

The failure to pay penalty for electing partnerships will be based upon the corporate penalty in *Va. Code* § 58.1-455. The amount of such penalty will be equal six percent of the elective payment amount for each month or fraction thereof from the date the Form 502 for the reviewed taxable year originally was due until paid, not exceeding thirty percent in the aggregate.

Interest upon such elective payment, and on the accrued penalty, will be added at a rate determined in accordance with *Va. Code* § 58.1-15, from the date the Form 502 for the reviewed taxable year originally was due until paid. In the case of an elective payment assessed by the Department, if the Form 502 was made in good faith and the understatement of the amount in the return was not due to any fault of the electing partnership, there will be no penalty on the elective payment because of such understatement. However, interest will be added to the amount of the deficiency at a rate determined in accordance with *Va. Code* § 58.1-15, from the date the Form 502 for the reviewed taxable year originally was due until paid.

If the understatement is false or fraudulent with intent to evade the tax, a penalty of 100 percent of the elective payment will be added together with interest on the payment at a rate determined in accordance with *Va. Code* § 58.1-15, from the date the Form 502 for the reviewed taxable year originally was due until paid.

Failure of Partnership to File a Federal Adjustments Report

Any partnership that fails to file a Form 502FED-1 and Form 502FED-2 within 90 days after the final determination date or any partnership that files such forms but fails to check the appropriate box on the Form 502FED-2 indicating that it is making a partnership pays election will be considered to have not made a partnership pays election for the reviewed taxable year or taxable years included in the federal audit. Such partnership will be subject to the penalty applicable to non-electing partnerships described under Failure of Partnership to Comply with the 90-Day Requirement Penalty above.

Authority to Consolidate Accounts and to Challenge Certain Transactions

In assessing and collecting the elective payment against an electing partnership, the Department has the authority to require a consolidated federal adjustment report or a consolidation of accounts and to challenge certain transactions. This authority is based upon the corporate provisions in *Va. Code* §§ 58.1-445 and 58.1-446, which will be applied as if the electing partnership is a corporation and all direct and indirect partners are stockholders of that corporation. In particular, the Department will exercise such authority where the partnership pays election is used to shift income or avoid Virginia income taxes through tiered partnership structures.

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State Partnership Representative

The state partnership representative for a reviewed taxable year is the partnership's federal partnership representative unless the partnership designates in writing another person as its state partnership representative.

The state partnership representative has the sole authority to act on behalf of a partnership with respect to an action required or permitted to be taken under Article 9.1 of Chapter 3 of the Title 58.1 of the Code of Virginia, and with respect to any administrative or judicial appeal of such action pursuant to Chapter 18 of the Code of Virginia. The actions of the state partnership representative will be binding on the direct partners and indirect partners of the partnership.

If a partnership desires to designate a person other than their federal partnership representative for Virginia tax purposes, please see the Form 502FED-1 Instructions regarding the process by which such person may be designated. The qualifications for a person to be a state representative are the same as provided by the Internal Revenue Service for a federal partnership representative.

Alternative Payment Election

An audited partnership may enter into an agreement with the Department to use an alternative reporting and payment method ("alternative payment election"). The Department will enter into such agreement only if such audited 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 due by the partners in aggregate. Application for approval of an alternative reporting and payment method must be made by the audited partnership no later than 90 days after the final determination date. The audited partnership must also submit the Form 502FED-1 to the Department no later than 90 days after the final determination date.

The partnership should indicate in its application whether, in the event its application is denied, it would like to make a partnership pays election. If the partnership would like to make a partnership pays election in the event that its application is denied but does not indicate so in its application, the partnership must submit a letter in writing to the Department within 90 days of the final determination date indicating this desire.

Effect of the Partnership Pays Election and the Alternative Reporting Election

Revoking the Election

If a partnership or partner makes a partnership pays election or an alternative payment election, such election is irrevocable by such partnership or partner. However, pursuant to *Va. Code* § 58.1-399.4, such election is revocable by the Department in its discretion.

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Paid-in-Lieu of Partner's Taxes

If properly reported and paid by the electing partnership, amounts paid pursuant to a partnership pays or alternative payment election will be treated as paid in lieu of taxes owed by a direct or indirect partner, to the extent applicable, on the final federal adjustments. As a result, the partners of such partnership may exclude the income on which such tax was paid when filing any subsequent amended returns. Since the income is excluded, no tax attributes of the affected partners will be reduced.

However, if an electing partnership fails to timely make any report or payment, the Department may assess the direct and indirect partners of such partnership for any taxes owed. Each partner is required to provide information requested by the electing partnership so that such partnership can properly calculate the amount due under the partnership pays election or the alternative payment election.

Treatment of Tax Preferences on Partners' Taxes

General Rule

Direct and indirect partners are not allowed to claim subtractions, deductions, credits, or refunds of amounts paid by the partnership. In addition, no net operating losses of any type may be eligible to reduce the total additional Virginia taxable income or distributive share of such income when the audited partnership makes a partnership pays election or an alternative payment election.

Exception for Credit for Taxes Paid

The amount of tax paid by the electing partnership pursuant to *Va. Code* §§ 58.1-399.1 and 58.1-399.3 is considered to have been paid by its direct partners in proportion to their ownership of such partnership. Accordingly, resident direct partners who would be eligible for a credit under *Va. Code* § 58.1-332(A) if they paid the tax themselves will be eligible for a credit for their distributive share of amounts paid by the electing partnership. Nonresident direct partners who would be eligible for a credit under *Va. Code* § 58.1-332(B) if they paid the tax themselves will also be eligible for a credit for their distributive share of amounts paid by the electing partnership.

In order to allow its direct partners to claim a credit under *Va. Code* § 58.1-332 for payments made by an electing partnership pursuant to *Va. Code* §§ 58.1-399.1 and 58.1-399.3, the electing partnership is required to provide written statements to each direct partner. For each direct partner, the written statement is required to indicate the amount of tax that has been paid by the partnership on his or her behalf, the direct partner's proportion of ownership of such partnership, and the direct partner's distributive share of amounts paid by such partnership. It is recommended that any written statement be provided to direct partners as soon as possible to ensure such partners have sufficient time to file amended returns for refunds if they are eligible. Failure of the electing

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partnership to provide a written statement to a direct partner will not extend the partner's applicable statute of limitations for refunds.

Tiered Partners

The following categories of partners are subject to the partnership reporting requirement and are entitled to make a partnership pays election or apply to use an alternative reporting and payment method:

1. Any direct tiered partner of an audited partnership;
2. Any indirect tiered partner of an audited partnership; and
3. Any partner of a partner specified in 1 or 2 above.

Any of the three categories of partners described above must make any required reports and payments no later than 90 days after the time for filing and providing statements to tiered partners and their partners pursuant to the provisions of IRC § 6226 and any regulations promulgated thereunder.

Limitations Periods

Assessments Arising From Federal Adjustments

A one-year statute of limitations period applies to assessments arising from federal adjustments. Where no partnership pays election or alternative payment election has been made:

- The Department may assess taxes, interest, and penalties against each partner within one year of the date on which each partner filed an amended Virginia income tax return; and
- The Department may assess the failure to file penalty against a partnership within one year of the date on which it filed Form 502FED-1.

If a partner or partnership fails to file an amended Virginia income tax return or Form 502FED-1 within the time period specified, the statute of limitations on assessments will remain open indefinitely until such return or form is filed. Similar treatment applies if a Virginia amended return or form is filed within the time period specified but the partner or partnership omits final federal adjustments or understates the correct amount of tax owed.

Where a partnership pays election or alternative payment election has been made, the Department may assess in-lieu-of-amounts, interest, and penalties against the partnership within one year of the date on which it was required to file a Form 502FED-1 and, if applicable, a Form 502FED-2. If the partnership fails to pay the full amount of

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payment required under such election, the Department may assess taxes, interest, and penalties against each partner of the partnership within one year of the date on which each partner would have been required to file an amended Virginia income tax return had no partnership pays election been made.

This one-year limitations is in addition to and not in place of any other limitations period that may apply. Unless otherwise agreed to in writing by the partner and the Department, any adjustments by the Department or by the partner or partnership that are made pursuant to this one-year statute of limitations are limited to adjustments to the partner's or partnership's tax liability that arise from federal adjustments.

Refunds Arising from Federal Adjustments

A one-year statute of limitations period applies to refunds arising from federal adjustments. Where no partnership pays election or alternative payment election has been made:

- Each partner may claim a refund of taxes, interest, and penalties within one year of the date on which each partner was required to file an amended Virginia income tax return; and
- The partnership may claim a refund of the failure to file penalty within one year of the date on which it was required to file Form 502FED-1.

Where a partnership pays election or alternative payment election has been made, the partnership may claim a refund of in-lieu-of-amounts, interest, and penalties if such claim for refund is made within one year of the date on which it was required to file Form 502FED-1.

This one-year limitations is in addition to and not in place of any other limitations period that may apply. Unless otherwise agreed to in writing by the partner and the Department, any adjustments by the Department or by the partner or partnership that are made pursuant to this one-year statute of limitations are limited to adjustments to the partner's or partnership's tax liability that arise from federal adjustments.

Extensions of the Limitations Periods

This one-year limitation period for assessments and refunds may 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.

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Any extension granted extends 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.

Additional Information

These guidelines are available online on the Virginia Regulatory Town Hall website, located at <https://townhall.virginia.gov>, and on the Guidance Documents section of the Department's website, located at <http://tax.virginia.gov/guidance-documents>. For additional information, please contact the Department at (804) 367-8037.

Approved:



Craig M. Burns
Tax Commissioner