Income Tax Topics: Partnership Audit Adjustments

COLORADO
Department of Revenue
Taxation Division

House Bill 23-1277 imposes several state requirements relating to final federal adjustments resulting from an Internal Revenue Service ("IRS") audit of a partnership. The partnership must file a Partnership Federal Adjustments Report with the Department and may elect to determine and pay any resulting Colorado income tax at the partnership level. A partnership that does not make this election must comply with various notification, filing, and payment requirements with respect to its partners.

This publication is designed to provide general guidance regarding Colorado income tax requirements relating to federal adjustments for partnerships. Nothing in this publication modifies or is intended to modify the requirements of Colorado's statutes and regulations. Taxpayers are encouraged to consult their tax advisors for guidance regarding specific situations.

This publication does not provide guidance regarding administrative adjustments requests that partnerships file with the IRS. Please see Department publication Income Tax Topics: Administrative Adjustment Requests for Colorado requirements relating to administrative adjustment requests.

Federal centralized audit & adjustment

A federal centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Under the centralized system, the audit of a partnership takes place, and any adjustment is determined, at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally are determined at the partnership level. Any tax attributable to these items is assessed and generally is collected at the partnership level as an imputed underpayment paid by the partnership (under section 6225 of the Internal Revenue Code).

As an alternative to partnership payment of the imputed underpayment, the audited partnership may elect to furnish to the IRS and to each partner of the partnership for the reviewed year a statement of the partner's share of any adjustments to income, gain, loss, deduction, and credit as determined in the notice of final partnership adjustment. In this case, each such partner takes these adjustments into account and pays the tax as provided under section 6226 of the Internal Revenue Code (the "push out" process under section 6226 of the Internal Revenue Code).

Modification for partners' amended returns

Payments made by reviewed year partners with amended returns filed to report the partner's distributive share of the adjustments can reduce the amount of an imputed underpayment determined in an audit. Alternatively, a partnership may submit on behalf of a relevant partner all information and payment of any tax, penalties, additions to tax, additional amounts, and interest that would be required to be provided if the relevant partner were filing an amended return (the "pull-in" process). Procedures for modification provide that the amount of an imputed underpayment is determined without regard to the portion of the underpayment taken into account by payment of tax included with amended returns of the reviewed year partners.

Adjustments that do not result in imputed underpayment

Any IRS audit adjustment in the amount of any partnership item, or any partner's distributive share, that does not result in an imputed underpayment is taken into account by the partnership in the adjustment year. In general, the amount of the adjustment is treated as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate). However, in the case of a partnership adjustment to a partnership-related item that is required to be separately stated, the adjustment is taken into account by the partnership in the adjustment year as a reduction in such separately stated item or as an increase in such separately stated item (whichever is appropriate).

Additional information

Additional information about the federal centralized audit and adjustment regime can be found online at IRS.gov/businesses/partnerships/bba-centralized-partnership-audit-regime.

Colorado requirements

Section 39-22-601.5(3), C.R.S., imposes several state requirements relating to final federal adjustments. These requirements apply to every partnership that is audited by the IRS, regardless of whether the partnership elects to pay any additional federal tax at the partnership level or "push out" the adjustments to the partners. The requirements of section 39-22-601.5(3), C.R.S., also apply to tiered partners that are direct and indirect partners in an audited partnership. A tiered partner is any partner that is a partnership or S corporation.

These reporting requirements do not apply to adjustments required to be reported for federal purposes by taking those adjustments into account in the partnership return for the year of adjustment (generally overpayments determined through an IRS audit of the partnership).

Partnerships generally must report final federal adjustments to the Department and notify each direct partner of their distributive share of the final federal adjustments. Partnerships may elect to determine and pay Colorado income tax on federal adjustments in lieu of taxes otherwise owed by its direct and indirect partners.

If a partnership or tiered partner fails to make any required report or payment in a timely manner, the Department may assess direct partners and indirect partners for taxes they owe, using the best information available.

State partnership representative

With respect to any action required or permitted to be taken by a partnership under section 39-22-601.5, C.R.S., the state partnership representative for the reviewed year has the sole authority to act on behalf of the partnership. The state partnership representative's sole authority includes protests, hearings, and appeals under sections 39-21-103 and 39-21-105, C.R.S. The partnership's direct partners and indirect partners are bound by those actions.

Unless the partnership designates in writing another person as its state partnership representative, the state partnership representative for the reviewed year is the person the partnership designates for the taxable year as the partnership's representative, or the person the IRS has appointed to act as the federal partnership representative. Such designation may be made by the partnership in the Partnership Federal Adjustments Report it files. A partnership may designate as its state partnership representative only a person who is eligible to serve as its federal partnership representative.

For information about federal partnership representatives and the designation thereof, please visit IRS.gov/businesses/partnerships/designate-a-partnership-representative.

Final determination date

Deadlines for Colorado requirements relating to final federal adjustments are generally determined in relation to the final determination date for the adjustments. For federal adjustments arising from an IRS audit or action, the final determination date is the date all federal adjustments arising from the IRS audit or action have been finally determined. In general, federal adjustments are finalized for Colorado income tax purposes when all rights to appeal the federal adjustment have been waived or exhausted or the taxpayer and IRS both sign an agreement with respect to the adjustment.

Extensions

The notification, filing, and payment deadlines for audited partnerships and tiered partners may be extended by written agreement between the partnership or tiered partner and the Department. An automatic 60-day extension is allowed to any audited partnership or tiered partner that has 10,000 or more direct partners.

Partnership federal adjustments report

An audited partnership or tiered partner must electronically file a completed Partnership Federal Adjustments Report with the Department. The report must be submitted as an e-filer attachment through Revenue Online within 90 days of the final determination date (see Department Rule 39-22-601.5-1(3)(g) in 1 CCR 201-2 regarding reporting of the in-lieu-of amount by a partnership making an election to pay as described later in this publication). The report must include the required information for each direct partner of the partnership for the tax year to which the item(s) being adjusted relates, including any direct partner excluded, pursuant to section 6225(c)(2) of the Internal Revenue Code, from the computation of the imputed underpayment.

Notification, filing, and payment requirements

Additional notification, filing, and payment requirements apply to any audited partnership or tiered partner that does not make an election to pay under section 39-22-601.5(3)(d), C.R.S. The partnership must satisfy each of these requirements within 90 days of the final determination date.

Partner notification

A partnership must notify each of its direct partners of their distributive share of the final federal adjustments. Partnerships may use form DR 0796, Partner Notification of Final Federal Adjustments to provide direct partners the required notification or may provide all of the information required by form DR 0796 to each of their direct partners by some other means.

Each direct partner must file an amended return for the reviewed year reporting their distributive share of the adjustments, unless either:

- they are included in an amended composite return properly filed by the partnership to report the partner's distributive share of the final federal adjustments; or
- they are included in an amended SALT Parity Act return properly filed by the partnership to report the partner's distributive share of the final federal adjustments and the resulting additional credit allowed to the partner equals or exceeds the additional tax the partner would owe as a result of the federal adjustments.

Positive adjustments must be reported as an "other addition" on the partner's amended return and negative adjustments must be reported as an "other subtraction."

Each partner must file the amended return within 180 days of the final determination date. Partners of tiered partners must file their amended return no later than 90 days after the due date for the federal return for the adjustment year of the partnership that filed the administrative adjustment request.

Each partner must also pay any additional amount of tax due as if the final federal adjustments had been properly reported, plus any penalty and interest due. In determining the additional tax due, each partner may claim credit for related amounts paid on their behalf with Department form DR 0108.

Amended partnership return

If, in its original return, the partnership filed a composite return on behalf of any of its nonresident partners or made an election under the SALT Parity Act, the partnership must file an amended return with Department form DR 0106, reflecting the final federal adjustments. The partnership must pay any additional amount due as a result of the final federal adjustments.

In the case of negative final federal adjustments for a partnership that made an election under the SALT Parity Act for the tax year to which the adjusted item relates, no refund is allowed to the partnership that made the SALT Parity Act election for those negative final federal adjustments. Instead, each partner must file an amended Colorado income tax return to claim a refund for any overpayment resulting from their distributive share of the final federal adjustments.

Remittance for nonresident partners

If the partnership previously made payment for a partner with Department form DR 0108, the partnership must remit with a new form DR 0108 any additional amount that would have been due had the final federal adjustments been reported properly as required.

Partnership election to pay

A partnership may elect to determine and pay at the partnership level any additional Colorado tax resulting from the federal adjustments made in an IRS audit. The election is irrevocable, unless the executive director of the Department, in their discretion, determines otherwise. A partnership not otherwise subject to any Colorado income tax reporting or payment obligations that makes the election consents to be subject to Colorado laws related to reporting, assessment, payment, and collection of Colorado tax calculated under the election.

Except for any distributive share of the final audit adjustments that must be included in the unitary business income of any direct or indirect corporate partner, the “in-lieu-of amount” properly reported and paid by a partnership or tiered partner that makes the election will be treated as 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 and indirect partners do not need to file amended returns to report the same federal adjustments and may not take any deduction or credit with respect to the in-lieu-of amount.

If a corporate partner’s distributive share of a final federal adjustments is excluded from the partnership election to pay, the partnership must notify the corporate partner of their distributive share of the final federal adjustments, as described earlier in this publication, either using form DR 0796, Partner Notification of Final Federal Adjustments or by providing the corporate partner all of the information required by form DR 0796 by some other means.

Deadlines

The election may be made no later than 90 days after the final determination date. The electing partnership must pay the in-lieu-of amount due, along with any applicable penalty and interest, no later than 180 days after the final determination date.

Calculation of the in-lieu-of amount

The in-lieu-of amount is determined with respect to the reviewed year partners, not partners for the adjustment year. It is calculated as an aggregation of the amounts calculated for each of the following five classes of partners:

1) Direct partners that are tax-exempt but for whom the federal adjustments are unrelated business taxable income;

2) Direct corporate partners subject to Colorado income tax;

3) Direct nonresident partners that are individuals, estates, or trusts;

4) Tiered partners; and

5) Direct resident partners that are individuals, estates, or trusts.

Using the tax rate in effect for the reviewed year, the in-lieu-of amount is calculated within the Partnership Federal Adjustments Report the partnership must file with the Department.

The calculation does not include either of the following types of partners:

- direct partners that are tax-exempt for whom the federal adjustments are not unrelated business taxable income; or

- direct partners that are excluded, pursuant to section 6225(c)(2) of the Internal Revenue Code, from the computation of the imputed underpayment for federal income tax purposes.

Additionally, the calculation of tax should exclude the distributive share of the adjustments that must be included for Colorado corporate income tax purposes in the unitary business income of any direct or indirect corporate partner, if the audited partnership can reasonably determine this.

Direct tax-exempt partners

If a direct partner is exempt from Colorado taxation under section 39-22-112(1), C.R.S., their inclusion in, or exclusion from, the calculation of the in-lieu-of amount depends on whether their distributive share of the federal adjustment is unrelated business taxable income.

If the direct tax-exempt partner's distributive share is not unrelated business taxable income, it is excluded from the calculation of the in-lieu-of amount.

If the direct tax-exempt partner's distributive share is unrelated business taxable income, it is included in the calculation of the in-lieu-of amount. Each such partner's distributive share of the federal adjustment is apportioned and allocated to Colorado as provided under section 39-22-303.6, C.R.S., using the apportionment factors determined for the partnership for the reviewed year. The character of final federal adjustments, as apportionable income or nonapportionable income, is determined with respect to the electing partnership and not with respect to each partner. The amounts of the federal adjustments apportioned and allocated to Colorado for these partners are then aggregated and the sum is multiplied by the tax rate in effect for the reviewed year.

Direct corporate partners

Each direct corporate partner's distributive share of the federal adjustment is apportioned and allocated to Colorado as provided under section 39-22-303.6, C.R.S., using the apportionment factors determined for the partnership for the reviewed year. The character of final federal adjustments, as apportionable income or nonapportionable income, is determined with respect to the electing partnership and not with respect to each partner. The amounts of the federal adjustments apportioned and allocated to Colorado for these partners are then aggregated and the sum is multiplied by the tax rate in effect for the reviewed year.

Direct nonresident partners

For direct nonresident partners that are individuals, estates, or trusts, the Colorado-source portion of their distributive shares of the federal adjustments is determined under section 39-22-203, C.R.S. The Colorado-source portions of these partners' distributive shares of the federal adjustments are then aggregated and the sum is multiplied by the tax rate in effect for the reviewed year.

Tiered partners

A tiered partner is any partner that is a partnership or S corporation. The in-lieu-of amount on the distributive shares of tiered partners is determined in multiple steps.

First, the partnership must divide the tiered partners' distributive shares of the federal adjustments into two categories:

1) Adjustments which are of a type that would be subject to sourcing by a nonresident partner under section 39-22-109, C.R.S.; and

2) Adjustments which are of a type that would not be subject to sourcing by a nonresident partner under section 39-22-109.

Second, the partnership must determine the portion of the amount in the first category that would be sourced to Colorado applying the rules of section 39-22-109, C.R.S.

Third, the partnership must determine the portion of the amount in the second category that can be established to be properly allocable to nonresident partners that are indirect partners or other partners not subject to tax on the adjustments. Such portions are so established if and only to the extent that the tiered partner certifies to the electing partnership such proper allocation in accordance with the requirements of Department Rule 39-22-601.5-1(6)(f) in 1 CCR 201-2.

Finally, the amount sourced to Colorado in the first category is added to the amount remaining in the second category after deducting the portion properly allocable to nonresident partners that are indirect partners or other partners not subject to tax on the adjustments. The sum is then multiplied by the tax rate in effect for the reviewed year.

Direct resident partners

For direct resident partners that are individuals, estates, or trusts, their total distributive shares of the federal adjustments are multiplied by the tax rate in effect for the reviewed year.

Estimated payments

Prior to due date for the Partnership Federal Adjustments Report, a partnership or tiered partner may make estimated payments to pay the in-lieu-of amount. The estimated payments will be credited against any in-lieu-of amount and will limit the accrual of further statutory interest on that amount. If the estimated payments exceed the final in-lieu-of amount, penalty, and statutory interest ultimately determined to be due, the partnership or tiered partner taxpayer may claim a refund or credit for the excess no later than one year following the final determination date.

Estimated payments made by an audited partnership cannot be claimed by any direct or indirect partners or applied toward any tax that partners may owe with the partner's amended Colorado return.

Any direct or indirect partner of an audited partnership may make estimated payments for application toward additional tax they may owe with the partner's amended Colorado return. An audited partnership may not claim or apply toward any in-lieu-of amount any estimated payments made by any direct or indirect partner.

Penalty and interest

The in-lieu-of amount calculated as described above is subject to penalty and interest as prescribed by section 39-22-621, C.R.S. The penalty and interest are computed from the due date of the partnership's original return for the reviewed year, not including any extensions, without regard to the due dates for any partners' returns.

Alternative reporting and payment methods

An audited partnership or tiered partner may apply to the executive director of the Department for permission to utilize an alternative reporting and payment method, including applicable time requirements or any other requirements under section 39-22-601.5(3), C.R.S. The audited partnership or tiered partner must demonstrate that the requested method will reasonably provide for the reporting and payment of taxes, penalties, and interest due.

Any audited partnership requesting permission to use an alternative reporting and payment method must do so no later than 90 days after the final determination date. A tiered partner requesting permission to use an alternative reporting and payment method must do so 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 and the regulations thereunder.

Assessments

The in-lieu-of-amount reported by an electing partnership is an assessment. If a partnership fails to pay the in-lieu-of amount, along with any applicable penalty and interest within the time provided, the Department may collect the amounts due as provided by law.

The Department may assess any additional tax, penalties, and interest resulting from final federal adjustments if it issues a notice of deficiency within the time provided in section 39-22-601.5(5), C.R.S. In the case of fraud, the tax may be assessed and collected at any time.

Additional resources

The following is a list of statutes, regulations, forms, and guidance pertaining to Colorado income tax requirements relating to federal adjustments for partnerships. This list is not, and is not intended to be, an exhaustive list of authorities that govern the tax treatment of every situation. Individuals and businesses with specific questions should consult their tax advisors.

Statutes and regulations

- § 39-22-601.5, C.R.S. Reporting federal adjustments - definitions.
- Rule 39-22-601.5–1. Federal Partnership Adjustments.

Forms and guidance

- Tax.Colorado.gov
- Partnership Federal Adjustments Report
- Partner Notification of Final Federal Adjustments (DR 0796)
- Income Tax Topics: Administrative Adjustment Requests