When Is a Partner's Taxable Income Too Small to Report?, Journal of Taxation, Sep 2020

Journal of Taxation (WG&L)

SHOP TALK

When Is a Partner's Taxable Income Too Small to Report?

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com; Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com; and Adam M. Cohen , 555 17th Street, Suite 3200, Denver, Colorado 80202, ACohen@hollandhart.com.

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When it comes to partnerships and partners, your Shop Talk editors think small. As many of our readers know, we have long and often wondered, "How *small* can a partner's interest be, while still being recognized as a partner's interest for federal and state tax purposes?" See, e.g., Shop Talk, "How Small Can a Partner's Interest Be?," 83 JTAX 126 (August 1995); "How Small Can a Partner's Interest Be: Is 0.1% (or 0.01%) the 'New' 1%?," 114 JTAX 186 (March 2011), and "Revisiting the 1% Minimum Ownership Interest in Safe Harbors," 132 JTAX 38 (May 2020). Until recently, however, we have not given thought to another, related "small" issue: how small must a partner's taxable income or tax liability be for state income tax purposes so as to be ignored as de minimis, in the context of adjustments arising from a completed federal tax audit?

On July 14, 2020, a telephonic public hearing-in California they call it an IPM (Interested Parties Meeting)-on that question was held by the Franchise Tax Board (FTB) to discuss "De Minimis Partner Reporting and Payment Requirements" under section 18622.5 of the California Revenue and Taxation Code (CRTC). This IPM reportedly was the first in response to a statutory directive; all previous IPMs were with respect to FTB regulations projects.

As described in an FTB online handout "intended only for purposes of facilitating discussion at the IPM," the purpose of the meeting was "to receive input from the taxpayer community regarding a potential de minimis rule, as it may apply to the partner reporting and payment requirements resulting from a Partnership Level Audit concluded by the (IRS)" under the Centralized Partnership Audit Regime.

Some background is useful here. Pursuant to CRTC section 18622.5, if any item required to be shown on a federal partnership return is changed or corrected by the IRS, and the partnership is issued an adjustment under Section 6225 of the Internal Revenue Code or makes a federal election for alternative payment with the IRS as the result of a Partnership Level Audit conducted by the IRS, the partnership

must report to the FTB each change or correction for the reviewed year within six months after the date of each final federal determination. Pursuant to CRTC section 18622.5(j), in order to reduce the administrative burden on taxpayers that may be imposed by additional filings and payments that do not contribute materially to revenue, the FTB is directed to convene a meeting or meetings of interested parties for the purpose of determining appropriate de minimis partner reporting and payment requirements as the result of a partnership level audit.

On June 25, the FTB issued a Notice of Interested Parties Meeting, to be held telephonically on July 14. The Notice included a link to a "Discussion Topics" handout, intended solely for purposes of facilitating that discussion. A discussion topic suggested by the FTB was: "What should California's de minimis exception to the partner reporting and/or payment requirements under CRTC section 18622.5 be?"

Section 18622.5 was added to the CRTC in 2018 by California S.B. No. 274. The Legislative Counsel's Digest accompanying that statute makes no mention of section 18622.5(j) or its de minimis exception.

There is no similar de minimis exception in IRC Section 6225, and your Shop Talk editors have not previously encountered a de minimis exception of this nature with respect to any state or local income tax system. As the IPM appeared to be a hearing of first impression, one of your editors dialed in to find out if a line of demarcation would (or even could) be identified, and exactly where that line would be. Would the FTB throw out for discussion some benchmarks for response from the call's participants? As to the reporting requirement, would the demarcation line be based on some quantified amount of change in

partnership net income or net loss as determined for federal tax purposes? As to the payment requirement, would the demarcation line be based on an absolute dollar amount maximum of *federal* income tax liability (e.g., an adjustment for the partnership's federal taxes totaling no more than say $100,000? $10,000?)? Might it be based on an absolute dollar amount maximum for the year's *state* (California) income taxes (e.g., $10,000? $1,000?)? If the state's tax rates are to be used, what rate(s) would be applied in determining the maximum tax liability for each partner or the partnership as a whole? For ease of administration, would the computation reflect the highest California state income tax marginal bracket applicable to individuals? C corporations? If the maximum hypothetical tax rate is not used, would each partner's applicable tax rate come into play? If so, what rates should be used if any of the partners are tax exempt? If one or more partners themselves are pass-through entities, will the determination of the tax liability of the ultimate person(s) up the chain who actually pay or are subject to California income taxes be too difficult to get upstream information and/or too complex to determine? And whatever dollar amount threshold is selected, would it be subject to a further (or an alternative) threshold based on each partner's allocable share of the adjustment, e.g., involving a partner having no more than some minimum dollar amount (e.g., $1,000 or $100)? Would the size of each partner's interest in the partnership be relevant to the analysis, either directly or indirectly? And if the size of each partner's percentage interest is relevant, what is the highest percentage deemed to be de minimis?

There were over 30 participants who dialed in for the FTB's July 14 meeting-that's more than many IRS hearings on proposed regulations draw. The IPM started precisely at 10:00 am PDT. All participants were muted while the ground rules and a number of official procedural matters (the meeting's Rules of the Road, so to speak) were addressed by main presenter Michael Laisne, Tax Counsel III in the FTB's Legal Division. Also present to assist were Leah Thyberg, another Tax Counsel III in the Legal Division, and Ruby Dhaliwal, a Program Specialist III in the FTB's Audit Division. Laisne described the call as unique among IPMs in that the participants would be given the opportunity to voice their comments on the phone (requested maximum time: 5 minutes) after the preliminary introduction by the FTB (during which time they would be muted). As stated in the Notice of IPM, comments could be submitted at the meeting or be provided to the FTB via email (FTBRegulations@ftb.ca.gov). Laisne mentioned that to date no other state or the IRS has implemented such a de minimis rule.

Finally, he asked fellow FTB presenter Thyberg to read comments from the public that were received by the FTB prior to the meeting.

(Cue the imaginary drumroll.) Thyberg reported, "We received no email comments." (Can the drumroll.)

So the FTB officials opened up discussion by the participants. It was now 10:05 am PDT.

No one spoke. For the longest time. It was only 10 or 15 seconds, but it felt like eternity.

You know how awkward it is when you go to a big wedding party and the band plays their hearts out but *no one* dances? When you attend an auction and no one bids on *anything*, and the gavel is about to be slammed down on the last non-selling item, but the auctioneer really doesn't want to do it, so he holds slamming the hammer for what seems like a lifetime?

Well, that's how it felt at 10:06 am PDT on July 14 at the IPM that no one spoke at.

But just as the moderator started to wrap up the meeting, one brave soul-Nikki Dobay, Senior Tax Counsel of the Council On State Taxation (COST), a trade organization representing business taxpayers-seized the moment and saved the day by explaining that CRTC section 18622.5(j) came from model legislation recommended by the Multistate Tax Commission (MTC), which covers, among other things, partnership-level tax audit matters. (Shop Talk later determined she was referencing the Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit Adjustments (the Model Act).) She identified a number of organizations that were actively involved with the project. (The Model Act states it was produced by a group consisting of representatives of COST, the Tax Executives Institute (TEI), the ABA Section of Taxation's SALT Committee, the American Institute of CPAs (AICPA), the Institute for Professionals in Taxation (IPT) and the Master Limited Partnership Association (MLPA), as well as a work group set up by the MTC Uniformity Committee.) The work group had focused on the numbers being zero or so low as to be worthy of exemption from the reporting/tax paying requirements.

But, Ms. Dobay reported, after discussion, the MTC work group could not agree on a number to include

in the Model Act. So, they left the number blank and, so far, no state has filled it in.

Shop Talk subsequently reviewed the final version of the Model Act, which does not literally have a blank but for all purposes punts to the states adopting the provision. Section D of the Model Act, "De Minimis Exception," provides: "The [State Agency] at its discretion may promulgate regulations to establish a de minimis amount upon which a taxpayer shall not be required to comply with Sections B and C of this [Chapter]." (The title of Section B is "Reporting Adjustments to Federal Taxable Income-General Rule" and Section C is "Reporting Federal Adjustments-Partnership Level Audit and Administrative Adjustment Request.") The model statute provides that a state agency may promulgate regulations to establish a de minimis amount upon which a taxpayer shall not be required to comply with the notification, reporting, and payment requirements in the model statute. See Eileen Reichenberg Sherr, "A uniform state approach to the new federal partnership audit regime," Tax Adviser, 12/01/2018, https://www.thetaxadviser.com/issues/2018/dec/uniform-state-approach-federal-partnership-audit-regime.html.

It goes (and at the IPM went) unsaid that a de minimis exception should fall

in a range where it is not so low as to emasculate its goal of avoiding undue administrative burden on taxpayers and not so high as to encourage gamesmanship that improperly avoids payment of state income taxes. As to the latter, the "Discussion Topics" handout for the IPM indicates that "filings and payments of taxes that do not contribute materially to revenue" are within the realm of the de minimis exception.

Ms. Dobay stated the MTC work group thought a lower number would be right for some states (e.g., North Dakota), while a higher number might be appropriate for others (e.g., California).

Thank goodness for Ms. Dobay! The ice was broken! Something more than the FTB's procedural Rules of the Road would be reported on this meeting's transcript after all! Your Shop Talk correspondent was relieved! And the FTB moderator seemed beyond happy and thankful, noting these comments would be taken into consideration and were very helpful!

But a post-mortem leaves us less than fully satisfied and has gotten your Shop Talk editors thinking. Exactly where are we, after this first public opportunity to discuss the de minimis partner exception in connection with the nation's most populous state (and which, among the states, may have the most tax partnerships and K-1 partners)? CRTC section 18622.5(j) requires the FTB to convene a meeting or meetings of interested parties for the purpose of determining appropriate de minimis partner reporting and payment requirements as the result of a partnership level audit-which it did on July 14. It does not literally require the FTB to adopt rules pertaining to a de minimis rule; only to hold a meeting. Indeed, the FTB stated in the "Discussion Topics" write-up that the purpose of the IPM was to receive input from the taxpayer community regarding "a *potential* 'de minimis' rule," and the FTB wished to "promote a robust examination of the issue." (emphasis added.) As a strategic matter, is the burden on the taxpayer community to come up with guidance and/or one or more viable alternatives for the FTB to select? Or

(should the FTB receive no meaningful guidance), will the FTB move forward with its own proposed de minimis exception because the FTB has an interest parallel to taxpayers and their professionals in avoiding additional filings and payments that do not contribute materially to revenue? This article was submitted for publication prior to the FTB's (August 11, 2020) deadline for submission of written public comments; perhaps some of the IPM participants or others have submitted or will submit helpful comments to identify a de minimis exception that in principle moves the ball for both taxpayers and the FTB. (Heck, anything is better than zero or a lack of a de minimis rule.)

Well, $1 may be better than zero, but not by much. It is understood that a number of states provide that if the partnership tax audit adjustments arising from the IRS's audit are $1/less than $1, the partnership has no reporting or tax payment obligations with respect to those states. That de minimis level of a "de minimis" exception doesn't give us much comfort that the administrative burdens on taxpayers (and the state taxing authorities) will be much lessened, at least with respect to small amounts of partners' taxable income.

So when does it become an administrative burden for partnerships and taxpayers to have to comply with reporting tax adjustments? How low is "too low to bother"? How minimal is de minimis? Stated affirmatively, how large can small be? If ten thousand angels (a/k/a the angel investors) invested in Dancing On A Pinhead Partnership, and in 2020 the IRS successfully audited the partnership (disallowing its deductions of $X claimed for angels' dancing shoes, resulting in an increased federal income tax of say $0.31X), must the partnership send new California K-1 reporting and tax liability/tax payment information to the FTB splitting the adjustment among all 10,000 angels? What if, after splitting the adjustment, each angel only owes a buck or two for California taxes? Well, nobody on the IPM call said anything about that, either.

Which got your Shop Talk editors thinking some more. If there is a floor to tax liability that the IRS has pursued in court-throwing all of the resources of the United States Government against a taxpayer-then any tax liability below that amount *de facto* must be a floor below which taxpayers (who are not blessed with the authority to legally print money, unlike Uncle Sam) should not be held to a standard of reporting and payment in any state. So, Shop Talk set out to find the lowest amounts of income tax liability ever litigated by the federal revenuers and decided by the courts. (Spoiler alert: there are some embarrassingly low numbers.)

Our deep dive started (and ended) with our prior Shop Talk articles on (you guessed it) very small federal income tax cases.

We have long been fascinated by the IRS's willingness to put taxpayers through the litigation wringer, and by taxpayers' willingness to fight the long and burdensome fight, for what appears to be peanuts. See, e.g., Shop Talk, "Searching for Cents: IRS's Smallest Cases," 80 JTAX 320 (May 1994) and "Searching for Cents: IRS's Smallest Cases, Take Two," 81 JTAX 191 (September 1994).

As we observed back then, we are always stumped as to why the IRS would waste personnel, time, and expense to pursue cases involving very small amounts. This in turn got us to thinking about the smallest

deficiency ever requested by the IRS. We also invited our readers' submissions.

Shortly before his death, our mentor and colleague, Professor Walter J. Blum of the University of Chicago Law School sent us his entry, which-at least on a pre-inflationary basis-is closest to the lowest deficiency mathematically possible. Professor Blum sent us a copy of a 1936 letter from Carter H. Harrison, Collector of Internal Revenue, written to a taxpayer whose name was sanitized from the copy sent to us. Collector Harrison's entire letter follows:

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> Dear Sir: A recomputation of the figures on the face of the income tax return filed by you for 1935, discloses errors which results in an increase in tax of $0.58.
>
> Section 25(a)(4) of the Revenue Act of 1934 provides an earned income credit of ten per cent of the amount of the earned net income, but not in excess of ten per cent of the amount of the net income. Therefore, your earned income credit computed on the basis of $9,220.00 net income has been decreased from $936.12 to $922.00. Normal tax at 4% is therefore, $196.81 instead of $196.24.
>
> Original surtax was understated $0.01.
>
> It will be appreciated if you will return with this letter, your remittance in the amount indicated hereon. Otherwise, the amount of the additional tax will be included in the formal notice and demand, which will be forwarded to you prior to June 15, 1936.
>
> Yours very truly, Carter H. Harrison, Collector."

Certainly Professor Blum's submission was laudable, but deserves to be in the "old-timer" category, since (1) Collector Harrison was employed by the Bureau of Internal Revenue, (2) the tax at issue predated even the 1939 Code, and (3) in those days 58 cents bought a lot more than what a postage stamp costs today. But clearly 58 cents (which, in 2020, taking into account 85 years' inflation, would still be less than $11) should still not have been enough to justify litigation from an administrative viewpoint (notwithstanding the Collector's threatened notice and demand).

L. Howard Adams, then a senior attorney (now senior counsel) at Cahill Gordon & Reindel LLP, New York City, alerted us (as described in greater detail in our September 1994 Shop Talk article) to a modern-era entry for cases involving small amounts in controversy, albeit one technically not involving a deficiency. In *Acord,* 532 F. Supp. 22 , 50 AFTR2d 82-5210 (DC Mo., 1981), the taxpayer sought (and received after a trial) a refund of $14 in tax.

More recently, in *Liljeberg*, 148 TC 83 (2017), *aff'd* 122 AFTR2d 2018-6561, 907 F.3d 623 (CA-DC,

2018), the court ruled on an income tax deficiency of $54 for the named petitioner (Richard Liljeberg). Along with two other individuals whose cases were consolidated with his by the Tax Court, the three cases' total income tax deficiency ballooned to $616. In *Liljeberg*, the court ruled entirely in favor of the IRS.

But (to misquote our favorite, perennial pitchman Ron Popeil) wait, there's less! In *Dees*, 148 TC 1 (2017), another Tax Court regular opinion issued one month prior to *Liljeberg*, the court was faced with a case involving a zero deficiency. (Friends, you can't go lower than that!) Dees claimed a refundable credit under Section 36B on his 2014 income tax return. The IRS determined Dees to be unentitled to the refundable credit and slapped him with a notice of deficiency. That notice showed a deficiency of zero on the first page. The attached computation pages stated that there was a decrease to refundable credits but erroneously computed a tax deficiency of ".00." Dees timely filed a petition to challenge the IRS's disallowance of his refundable credit. The Tax Court ordered the Commissioner to show cause why this case should not be dismissed for lack of jurisdiction, questioning the validity of the notice of deficiency. As we will see, ultimately the full Tax Court weighed in, with five opinions.

Judge Buch, writing the lead (but not majority) opinion, stated that the notice of deficiency of zero is ambiguous as to whether the Commissioner determined a deficiency. The court agreed with the Commissioner that the (zero) deficiency notice was sufficient because it identified the adjustment (the disallowance of a claim to refundable credit) and because Dees made clear in his petition that he was not misled by the ambiguous notice. Accordingly, the majority held the notice of deficiency to be valid and the Tax Court had jurisdiction over the case.

As stated in the opinion, the Commissioner determined that Dees was not entitled to the premium tax credit, issuing Dees a notice of deficiency for the 2014 tax year and withholding his refundable credit. The first text sentence of the notice stated, "We determined that there is a deficiency in your income tax which is listed above." Above that sentence, the notice stated: "Deficiency: $.00." The Commissioner included with the notice a tax deficiency computation that decreased refundable credits but erroneously computed a bottom-line deficiency of ".00." Elsewhere, the document states: "A decrease to refundable credit results in a tax increase."

Six of the 16 other Tax Court judges agreed with Judge Buch's opinion. In addition, Chief Judge Marvel wrote a concurring opinion, joined by Judge Paris. Judge Ashford concurred in the result only. (That adds up to 10 judges in favor.) Judge Foley wrote a dissenting opinion, and six other judges agreed with his dissent. Judge Gustafson also wrote a separate dissenting opinion, joined by five other judges. (Judges are permitted to agree with more than one opinion, as evidenced by this case.) We list the numerous opinions as explanation in part for the 52 pages of opinions issued by the Tax Court in a case involving a stated tax deficiency of zero.

We do not mean to make light of the issue in *Dees*, or the serious nature in which the Tax Court judges attempted to discharge their duties on this procedural matter. At first glance, it looks like much ado about nothing-well, zero-but as it turned out, a zero deficiency does not mean nothing, at least when it comes

to the Tax Court's determination of its jurisdiction to hear a case. See Shop Talk, "Tax Court Issues Regular Opinions on Gargantuan, Miniscule, and Zero Deficiency Cases Just Weeks Apart," 126 JTAX 284 (June 2017).

In summary, taking *Acord, Liljeberg* and *Dees* together, the IRS has litigated cases involving claims for a $14 refund, a $54 liability, and a zero deficiency, respectively. So, we cannot take any solace that there is a de minimis number below which the IRS would not bother to pursue. Perhaps the overarching administrative view of those cases is to put taxpayers on notice that no issue is too small, and that they had better get it right or be ready to litigate-the deterrent aspect. Or perhaps they were test cases for large numbers of taxpayers with much more tax hanging in the balance. Or perhaps they prove that the government does not always think in purely economic ways, if the cost of litigating these cases and expending judicial resources swamped the potential recoveries. And in turn we cannot look to the most

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insignificant cases (in absolute dollar amounts) litigated by the IRS to suggest a number that represents a threshold below which partnerships should not have to report to states (like California) their tax liability adjustments arising from those partnerships' IRS centralized partnership audits.

Readers, we welcome your comments and suggestions as to what the lines of demarcation are and where they should be drawn by the state taxing agencies to qualify for the exception under the de minimis partner reporting and payment requirements arising from a partnership's completed federal tax audit. We applaud the FTB for holding a call-in meeting with virtually (in both senses) unlimited access in a format dictated by COVID-19, and we look forward to future guidance from the FTB on how large (in terms of tax liability) small can be, and still be de minimis, in the context of the exception contained in CRTC section 18622.5(j), and thereby the Model Act. (Shop Talk thanks Gregory Bergmann, Deloitte Tax LLP, Chicago, and Ms. Dobay for the insight they respectively shared with us on this topic of no small interest.)

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