State RAR Reporting — Simplifying Unnecessary Complexities

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Introduction

Changes to federal taxable income associated with previously filed state income tax returns trigger an involved and arduous reporting process for multistate taxpayers. In this installment of A Pinch of SALT, we explore the complex world of state tax reporting associated with federal tax changes and review the various considerations facing taxpayers when attempting to accurately and timely report federal adjustments. We suggest some ideas for simplification and clarification associated with reporting federal tax changes, including clarity as to when reporting obligations arise and the effect on otherwise closed state statutes of limitations.

Background

Overview of the Federal Audit Procedures

Having an understanding of the disposition of the audit at the federal level is important to the reporting of federal adjustments at the state level.

Generally, after an Internal Revenue Service examination is completed, proposed changes to the taxpayer's return are reflected in a revenue agent's report (RAR) is written. If the taxpayer agrees with the proposed adjustments, the IRS will request that the taxpayer sign a Form 870, "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment."[1] Without the Form 870, the IRS is precluded from making an assessment or refund without first following deficiency procedures.[2]

If a taxpayer disagrees with the RAR, there are several options available. A conventional course would be for the IRS to issue a 30-day letter, which allows the taxpayer to file a protest and seek an administrative appeal with the IRS Appeals Division. If the taxpayer and the IRS reach an agreement on the disposition of the proposed RAR adjustments at the Appeals Division, the case is closed either with a Form 870-AD or a Form 906, "Closing Agreement."[3] Otherwise, the taxpayer may decide to litigate the issue in one of the three available forums.[4] If, after meeting with Appeals, the case is unagreed, a statutory notice of deficiency (also known as a 90-day letter) is issued.[5]

As discussed above, there are several possible points in a traditional process at which a federal change may have to be reported. For example, at the conclusion of the examination when the RAR is issued and agreed; at the conclusion of the administrative appeals conference when the disposition of

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[1]Signing the Form 870 precludes the taxpayer from bringing an action in the nonpay Tax Court, since there has been a waiver of the assessment provisions. However, a taxpayer could file a refund claim and then bring a refund suit in one of the two refund forums.

[2]*See* Internal Revenue Code section 6213(a).

[3]A Form 870-AD is similar to a Form 870, except that it usually includes language precluding the subsequent filing of any suit, including refund actions for the matters settled. A closing agreement is essentially a contract providing for finality and is governed by IRC section 7121.

[4]There are some requirements that must be met to bring suit in each of the three forums. Generally, the taxpayer can litigate the case in the U.S. Tax Court, without first paying the deficiency, or in either of the two refund courts, the appropriate federal district court or the Court of Federal Claims. If after litigating the case in one of the three courts, the taxpayer disagrees with the decision, an appeal to the appropriate U.S. court of appeals may be filed. Any further appeal would be on writ to the U.S. Supreme Court.

[5]*See* IRC section 6213(a) for deficiency notices.

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the RAR is agreed; after the issuance of a decision of a trial court if an appeal is not timely filed; or on issuance of a decision of the appeals court, if further appeal is not pursued or is denied.

The conventional course described above is not the course of many taxpayers. Instead, there may be multiple times at which a taxpayer may have to report federal changes regarding a single year or even uncertainty of when the reporting should take place. For example, at the conclusion of an examination, there may be several issues raised by the examiner in the RAR, some of which the taxpayer agrees with and others for which there is disagreement. In that instance, the taxpayer and IRS may enter into a partial agreed case with a Form 870 and a related RAR for the agreed issues. Then the unagreed issues would be reflected in a 30-day letter and be protested to Appeals or be litigated. Later, when there is a disposition of those unagreed issues, another reporting cycle of the federal changes for the same tax year(s) would be required. Also, uncertainty may exist when a taxpayer receives an RAR and does nothing — in which case, the IRS will issue either a 30- or 90-day letter. If the taxpayer does not respond, eventually the IRS will issue an assessment. In that situation, the taxpayer still has the ability to pay the amounts, file a claim for refund, and later file a suit for refund. Thus, there is question of if and when any federal change should be reported.

If a taxpayer does not make a timely report of an RAR, the statute of limitations is often tolled for that reporting year.

To confuse the issue further, the IRS has programs in which a taxpayer may participate, including early referral to Appeals and fast-track mediation, which occur before an examination is completed. In those instances, an issue may be settled resulting in a federal change that has to be reported even before the examination is completed. Determining the finality of tax-year reporting and changes also presents issues. The only federal changes that are final with certainty are final decisions of a court or closing agreements. In most matters resolved by agreement with an examiner or Appeals, a Form 870 or 870-AD is executed. However, even in those instances, the IRS continues to have the ability to reopen the year and make additional adjustments and assessments if the statute of limitation is open.[6]

[6]*See* IRC section 7605(b).

Because there are many possible problems regarding the potential number of federal changes for any given year and the finality of those changes, it is important to have an understanding of status of the federal changes to make informed decisions as to the reporting of those changes with the states.

Interplay With State Reporting Requirements

A final federal determination triggers the commencement of time-sensitive state reporting requirements — requirements often accompanied by noncompliance penalties. On the issuance of an RAR, most states require a taxpayer to amend its return within 30, 60, or 90 days of a final determination.[7]

Taxpayers who fail to comply with state requirements, including timeliness, are subject to various penalties. For example, North Carolina subjects a taxpayer who fails to report federal changes within six months from receipt of an RAR to a failure-to-file penalty of 5 percent of the total taxes due for each month of delinquency, up to a maximum of 25 percent.[8] Moreover, a North Carolina has an additional "penalty": a taxpayer may not seek a refund as a result of the federal changes outside the six-month period.[9] Massachusetts assesses a penalty of $100 or 10 percent of the additional tax due, whichever is less, on a taxpayer that fails to timely submit a report of a federal adjustment.[10] Further, if a taxpayer does not make a timely report of an RAR, the statute of limitations of most states is tolled for

[7]For example, New York, Arizona, Delaware, District of Columbia, Maine, Maryland, New Jersey, and Connecticut tax laws require a taxpayer to report changes resulting from a federal RAR within 90 days after the federal change. Florida, Idaho, Nebraska, Vermont, and Louisiana, have a 60-day requirement. However, Kentucky, Mississippi, and Pennsylvania have a 30-day requirement.

[8]N.C. Gen. Stat. section 105-236(a)(3).

[9]North Carolina Individual Income Technical Bulletin XIII, 11/01/2009.

[10]Mass. Regs. Code 62C.30.1(7)(a). Also, Massachusetts subjects the taxpayer to a penalty of $100 or 10 percent of the additional tax due, whichever is smaller, for failure to report a change in tax paid to other jurisdictions, when that is used as basis for a credit. Mass. Gen. L. Chapter 62C section 30A(c). Alabama also imposes a penalty. Taxpayers who do not comply with Alabama's reporting procedures are subject to a 5 percent negligence penalty associated with underpayments found in Ala. Code section 40-2A-11(c). Ala. Admin. Code section 810-3-40-.01(5). Texas imposes a penalty of 10 percent of additional taxes due on a taxpayer who fails to file an amended return as a result of an RAR; however, the penalty is not imposed in cases in which a refund would result. Tex. Tax Code Ann. section 171.212(d); Tex. Admin. Code 34 section 3.584(f)(6).

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that reporting year — allowing states to assess additional tax for a tax period that otherwise would be closed.[11]

State Reporting Requirements — Reporting Federal Changes

Finality — *What Triggers a Reporting Requirement?*

One of the most complex and uncertain issues of state reporting requirements of federal adjustments concerns determining when a reporting obligation arises.

Generally, state statutes contemplate that a reporting obligation is triggered when a federal adjustment is "final." However, requiring taxpayers to report adjustments when they are "final" does little to simplify state reporting requirements — not all state statutes are clear on the definition of final. Further, not all state definitions of "final" properly correlate to the federal procedure that informs whether a federal adjustment is truly final.

> ***Is a state reporting obligation triggered the day a taxpayer receives a copy of the RAR, Form 870, a 90-day letter, or a closing agreement?***

Not all federal resolutions truly are final even when a taxpayer is aware of the proposed adjustment. Depending on the type of agreement entered into by a taxpayer and the IRS, a taxpayer often preserves its right of appeal or may enter into a superseding agreement. Questions arise as to whether those appeal rights or superseding agreements prolong the time in which a federal change becomes final. By way of illustration, is a state reporting obligation triggered the day a taxpayer receives a copy of the RAR, Form 870, a 90-day letter, or a closing agreement?

Finality — *A State Review*

While most states require that a state tax reporting requirement of a federal change is required when the federal change is final, many states do not define final. For example, while Idaho defines the term "final federal determination" to mean the final resolution of all issues that were adjusted by the IRS, Idaho does not elaborate on what is meant by "final."[12]

To further complicate matters, some states do not mention the concept of finality but seem to rely on it. Louisiana law requires taxpayers to notify the state "within 60 days after the federal adjustments have been made and accepted by the taxpayer."[13] Does "accepted by the taxpayer" mean that a taxpayer is required to file a report as soon as it receives the RAR? If the purpose of the state reporting statute is to ensure that state taxable income is based on final federal taxable income, it seems inefficient at best to require state reporting the moment the taxpayer *knows* of an adjustment.

Some states provide a definition of what is considered final for purposes of triggering a reporting requirement. Texas requires notification by the 120th day "after the revenue agent's report or other adjustment is final." Under Texas law, "final" means the date on which "all administrative appeals with the Internal Revenue Service or other competent authority have been exhausted or waived."[14] Massachusetts, which has one of the most comprehensive statutes regarding filing notification stemming from an RAR, provides that a taxpayer must report the federal adjustment "within 3 months of receipt of notice of the final determination." Final determination is defined to mean when there is "no right of administrative or judicial appeal," when no appeal is taken, or when on the date of decision "in the court of last resort."[15]

Effect on State Taxes — *What's Open for Adjustment?*

State statutes provide state departments of revenue time to review a taxpayer's report of a federal change to determine whether the state agrees with the taxpayer's claimed state tax ramifications of the federal adjustment. Even a tax year that is otherwise closed because the statute of limitations has expired is reopened to allow the state time to evaluate the affect of the federal change.[16]

Under that extension for assessment, a question arises whether the extension of the normal statute of limitations is unlimited (that is, opens the entire state tax return) or confined to the particular adjustments made at the federal level (that is, is limited to only the state tax changes emanating from the federal change). For instance, a federal adjustment

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[11]*See*, *e.g.*, Md. Code Ann. Tax-Gen. section 13-303; Kan. Stat. Ann. section 79-3230(f).

[12]Idaho Code section 63-3068(f).

[13]La. Rev. Stat. Ann. section 47:103.C.

[14]Tex. Tax Code Ann. section 171.212(a); Tex. Tax Code Ann. section 171.212(b); Tex. Admin. Code 34 section 3.584(f)(2); Tex. Admin. Code 34 section 3.584(f)(5).

[15]Mass. Code Regs 62C.30.1.

[16]For example, the Indiana law provides that "if a taxpayer's federal income tax liability for a taxable year is modified due to the assessment of a federal deficiency or the filing of an amended federal income tax return, then the date by which the department must issue a proposed assessment . . . is extended to six (6) months after the date on which the notice of modification is filed with the department by the taxpayer." Indiana Code section 6-8.1-5-2(g).

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on federal taxable income typically will reopen the state's calculation of state taxable income. However, it is much less clear whether a federal adjustment on federal taxable income will allow a state (or a taxpayer) to revisit whether the taxpayer qualified for an unrelated state credit.

The issue of whether the extension of the normal statute of limitations is unlimited or confined to the particular federal adjustments has important ramifications for multistate taxpayers, including whether they are entitled to a refund and how any future assessment may affect their financial statements because of an uncertain tax position.

Some states do not mention the concept of finality but nevertheless rely on it.

This issue has been addressed by a few courts. In *Kelly-Springfield Tire Co. v. Iowa State Bd. of Tax Review*,[17] the taxpayers reported federal adjustments to the Iowa Department of Revenue and the department issued additional assessments that were unrelated to the federal adjustments.

The relevant Iowa statute in effect at the time stated: "The department shall have six months to make an examination and determination from the date of receipt by the department of notice from the taxpayer of the final disposition of any matter between the taxpayer and the internal revenue service with respect to the particular tax year."[18] The department maintained that "an examination and determination" was without limitation. The taxpayer argued that the statute should be read to limit the state examination to only those state changes that were adjusted at the federal level.

In finding for the taxpayers, the Iowa Supreme Court considered the literal words of the statute and concluded that "the object sought to be accomplished or the problems sought to be remedied and arrive at a construction that will best effect its purpose."[19] The court held that the extension of the statute of limitations was available to the department "only if adjustments made by the Internal Revenue Service create a change of circumstances affecting the taxpayer's Iowa tax liability."[20]

Some states provide express statutory language limiting (or not limiting) the permissible state adjustments. For example, Maryland's RAR reporting provision provides for a limited extension of the statute of limitations. The law provides: "if a report of federal adjustment is filed. . . . An assessment . . . shall be related to changes made by the amended items in the return."[21] Similarly, California provides that if there is no state or federal waiver, the Franchise Tax Board is limited to changes "based on" or "resulting from" the federal adjustments.[22]

Compare Maryland's and California's limited approach with Oklahoma's statute, which provides a relatively broad extension of the statute of limitation on tax assessments for any aspect of a taxpayer's state return. Oklahoma law provides that the:

> Tax Commission shall have the authority to audit each and every item of income, deduction, credit or any other matter related to the return where such items or matters relate to allocation or apportionment between the State of Oklahoma and some other state or the federal government even if such items or matters were not affected by revisions made in such final determination. Where such items or matters do not relate to allocation or apportionment between the State of Oklahoma and some other state or the federal government, the Tax Commission shall be bound by the revisions made in such final determination.[23]

More Administrative Burdens — *Multiple RARs and Endless Reporting?*

To further complicate the RAR reporting process, states often have specific procedures for reporting federal adjustments. The multistate taxpayer that may be issued multiple federal RARs for a given tax year may be inundated with sequential reporting obligations for a given tax year. Making matters worse, changes to federal consolidated income could lead to hundreds of reporting obligations in separate return states.

The chances of reporting correctly in every state are slim.

For example, Alabama requires any increase or decrease in a taxpayer's liability or any other changes based on a federal return to be reported to the Department of Revenue in the following way:

- the taxpayer must file a completed amended return for each year indicating the additional tax due or refund requested;

[17]414 N.W. 2d 113, 115 (Iowa 1987). *See also Montgomery Ward & Co. v. Franchise Tax Bd.*, 6 Cal. App. 3d 149 (1st Dist. 1970) (state adjustments are limited to the federal adjustments).

[18]Iowa Code section 422.25(1).

[19]414 N.W. 2d 113, 115 (Iowa 1987).

[20]*Id.* at 116.

[21]Md. Code section 13-1101(c).

[22]Calif. Revenue and Taxation Code sections 19059, 19060.

[23]Okla. Stat. section 2375H.4.

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- a copy of the RAR or other itemized explanation of the federal changes must be attached to each amended return filed; and
- individuals must file a Form 40X to report changes and partnerships and fiduciaries must check the "Amended Return" box on the forms.[24]

Connecticut requires undefined documentation to be attached to the report of the RAR. The corporation must give the commissioner "any information, schedules, records, documents, or papers relating to such change, adjustment, or correction as the commissioner requires."[25] The chances of reporting correctly in every state are slim, resulting not only in the potential for the imposition of penalties but also an increased administrative burden for the states as they struggle to work with taxpayers outside established guidelines.

Conclusion — Simplification

Providing clear and simplified guidance on RAR reporting would benefit both the states and taxpayers. Simplified RAR reporting rules would help clarify a complicated process. That simplification would lead to more accurate reporting and, as a result, would lessen the administrative burden on the states. We provide our proposal for states to simplify RAR reporting:

- States should make clear whether an entire tax return is "opened" for assessment, refund, or both as a result of a federal change or whether the statute is opened for only those state tax return items that are directly affected by the federal change.
- States should provide taxpayers with at least six months to report a federal change.
- States should allow a taxpayer the option to report all federal changes for a given tax period in one report (even though the changes may be issued over a period). That "consolidated" reporting would minimize the amount of time a taxpayer must spend to report changes and the amount of a time a state must expend to review changes.
- States should simplify the procedure for reporting RARs. For example, a standardized spreadsheet reporting form that includes all the relevant information for the state and that the taxpayer can access on the department's Web site would facilitate the taxpayers' compliance.
- Finally, and perhaps most importantly, states should provide clear guidance on the meaning of "final determination." That is an area that calls for special attention because it is especially unclear and it is a critical step in the compliance process.

These suggestions would go a long way toward reducing the compliance ordeal associated with reporting federal tax changes to states. ✰

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Sutherland's SALT Practice is composed of 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, unclaimed property, and property tax matters. Sutherland's SALT Practice also monitors and comments on state tax legislative and policy efforts.

[24]Ala. Admin. Code section 810-3-40-.01; Calif. Revenue and Taxation Code section 18622(b); California FTB Information Publication (July 1, 2006). California taxpayers may either use Form 100X to make any changes to their already filed California income tax return resulting from the RAR, or they may send copies of the federal changes to a designated address. Regardless of the method used to notify the Franchise Tax Board, taxpayers must include a copy of the final federal determination or audit report, along with all data and schedules on which the federal adjustment was based. Taxpayers must report IRS adjustments made, regardless of whether the IRS change would result in additional California taxes due.

[25]Conn. Gen. Stat. section 12-22-6(a)(1).

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