How RARs, Federal Waivers, and Competent Authority Agreements Trigger and Complicate State Tax Compliance

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Procedure

The final resolution of issues raised during a federal tax audit can trigger consequences at the state level. In this article, authors Michelle Gallagher, Matthew Laney, Colette Karam, and Sheldon Michaelson, of Deloitte Tax LLP, encourage corporate taxpayers expecting to settle federal tax issues to begin preparing for the state consequences immediately because the final resolution of a federal audit normally triggers an extensive and often costly state tax compliance process with narrow time frames. In this article, the authors discuss some of the potential state tax implications that can arise.

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BY MICHELLE GALLAGHER, MATTHEW LANEY, COLETTE KARAM, AND SHELDON MICHAELSON[1]

INTRODUCTION

Corporations that have been audited by the Internal Revenue Service desire a quick, fair resolution of their disputed tax liabilities. However, the conclusion of a federal audit does not always provide immediate relief, as this event normally triggers time-sensitive, state notification requirements for adjustments made to a taxpayer's federal return.

Corporate taxpayers are often faced with the daunting task of amending hundreds of state tax returns, many of which are due within a short time frame. This process is rarely straightforward and is often fraught with complicated issues stemming from variations in state notification rules. Additionally, it is important that

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taxpayers are aware of other circumstances, such as Competent Authority Agreements[2] and federal statute of limitation waivers, which can impact state return filings. This article seeks to identify and discuss several of these issues with the hope of raising taxpayer awareness and knowledge of this complex subject.

BACKGROUND: REVENUE AGENT'S REPORTS

IRS Audit Closing Procedures

At the conclusion of a federal audit, IRS agents will typically provide a taxpayer with a written report, commonly referred to as a ''revenue agent's report'' or ''RAR,'' which reflects proposed adjustments to the taxpayer's federal return. The date on which RAR adjustments are finalized is significant because the time frame within which states must be notified of federal adjustments normally commences on this date or at a later time when there has been a final determination of the taxpayer's federal liability. As such, it is important that taxpayers become familiar with the procedures for closing an IRS audit because state notification requirements may be triggered at different points in the closing process, depending on the particular rules of each jurisdiction.

The procedure for closing an IRS audit varies depending on whether the taxpayer agrees with some, all, or none of the auditor's proposed adjustments and whether those adjustments affect the taxpayer's liability. Unless otherwise noted, this discussion will specifically address closing procedures for ''regular agreed'' cases, which are cases where the taxpayer agrees with all of the proposed adjustments.[3]

The standard forms used to prepare an RAR for regular agreed cases are IRS Form 4549, *Income Tax Examination Changes*, for corporations, and IRS Form 4605, *Examination Changes–Partnerships, Fiduciaries, Small Business Corporations, and Domestic International Sales Corporations*, for other entities. IRS agents use these forms, which are jointly signed by both the IRS and taxpayer,[4] to list specific adjustments to income, penalties, and interest and to calculate the taxpayer's adjusted tax liability.[5] After the agent fills out the form and the taxpayer signs it, the taxpayer should receive a copy for its records and the agent should submit a copy to the IRS Quality Review staff.[6] The case will normally close within 10 days of IRS receipt of the copy;[7] however, the case is not officially closed until the taxpayer receives notice that the case has been accepted for review by the IRS Quality Review staff.[8] Notice is delivered by means of a closing letter (IRS Letter 987), which is signed by the IRS group manager and specifically states that the case is closed.[9] IRS Letter 987 is not required and may not be issued in every situation.

The standard forms used in excepted agreed cases[10] include IRS Form 4549-A,[11] which is typically only signed by the IRS, and IRS Form 870, which is only signed by taxpayers. Taxpayers should note that these forms serve different purposes. The taxpayer may execute an IRS Form 870,[12] execute an IRS Form 4549, or otherwise agree to the full amount of the deficiency. However, execution of these forms waives the statutory restriction upon assessment and collection of deficiencies and allows the IRS to assess the tax liability as reflected on the form without issuing a statutory notice of deficiency.[13] If, on the other hand, the taxpayer does not execute IRS Form 870 or agree to the full amount of the deficiency, and the taxpayer decides not to advance the case to IRS Appeals, the IRS will mail a notice of de-

[2] A Competent Authority Agreement is an agreement between the IRS and a foreign tax authority affecting a U.S. taxpayer's U.S. federal tax liability and foreign tax liability. These agreements are made pursuant to Mutual Agreement Procedure (MAP) settlements. While the terminology can be used interchangeably among practitioners, the IRS is likely to refer to the MAP settlement process.

[3] *Internal Revenue Manual* §4.10.8.3 [hereinafter IRM].

[4] IRS Form 4549 (2010).

[5] *See* IRS Form 4549 (2010); IRS Form 4605 (2010).

[6] *See Saltzman*, *IRS Practice & Procedure* ¶ 8.13[1] (2002).

[7] IRM §4.10.8.1.4(1)(A).

[8] *See Saltzman*, *IRS Practice & Procedure* ¶ 8.13[1] (2002).

[9] *Id.* §4.10.8.3.7.

[10] IRM §4.10.8.4 defines an excepted agreed case as ''[w]hen the taxpayer agrees to proposed adjustments, but the examination results are subject to review or additional processing or some other condition, the taxpayer may waive the statutory restriction upon assessment and collection of the deficiency of tax.'' Also, IRM §4.10.8.4.1 defines which cases require excepted agreed reports. For example, partially agreed corporate and individual cases, cases presenting whipsaw issues, and Joint Committee cases would require excepted agreed reports.

[11] Form 4549–A, *Income Tax Discrepancy Adjustments*, is used to detail specific adjustments to income, penalties, and interest for unagreed and excepted agreed cases for individuals, corporations, taxable fiduciaries, and taxable small business corporations. The form also calculates the taxpayer's adjusted tax liability for all tax years included in the IRS examination. Typically there will be a Form 4549-B, *Income Tax Examination Changes*, attached, detailing the related Form 5701, *Notice of Proposed Adjustment*, issued during the IRS examination.

[12] Signing the waiver does not preclude assertion of a further deficiency by the IRS or a request for further consideration of the issues by the taxpayer; thus, excepted agreed cases are ''excepted'' from the IRS's case reopening criteria. *See* IRM §4.10.8.4(3). A comparison of the differences between regular agreed and excepted agreed cases is beyond the scope of this article.

[13] IRM §4.10.8.4. Additionally, the taxpayer will not have the right to petition the tax court for a redetermination of the deficiency.

ficiency and wait 90 days post-issuance to assess the tax.[14]

Taxpayers should note that execution of IRS Form 870 does not constitute a final determination for federal purposes because it is nonbinding on either the taxpayer or the IRS. Thus, a taxpayer could sign the IRS Form 870, pay the assessed tax, file a claim for refund, and later proceed with refund litigation if the claim is denied. Also, if the assessment period has not yet expired, the IRS can increase the tax deficiency asserted under audit when it considers the refund claim.

What Constitutes a Final Determination for State Purposes?

Taxpayers generally must report adjustments to their federal returns to states in which the adjustments alter items on their state returns. Ordinarily, this reporting obligation is triggered when a federal adjustment becomes final. Most states rely on the concept of finality, and many states use the phrase ''final determination'' to define when an adjustment becomes final.[15] Some of these states, including Colorado, Missouri, and Nebraska, provide detailed guidance as to what constitutes a final determination,[16] while others, such as Connecticut,[17] do not provide a clear definition.

Determining when a federal adjustment becomes final in states that provide little or no guidance on the matter can be a challenge.

States that provide detailed guidance as to what constitutes a final determination have similar provisions in their laws; however, there are often subtle differences among them. Timing differences regarding the receipt or approval of audit report forms by the IRS can create variations among the states in determining the effective date of a final determination. For example, a final determination is deemed to occur for Colorado purposes when the first of a series of listed events occurs (including IRS acceptance of a taxpayer-executed IRS Form 870 or 870-AD),[18] but a final determination is not triggered in Texas until all administrative appeals with the IRS have been exhausted or waived. It is worth noting that Texas does not consider an action or proceeding in the U.S. Tax Court or any other federal court an administrative appeal with the IRS, therefore a final determination can occur regardless of whether such action or proceeding occurs.[19] Missouri, on the other hand, lists a series of events that constitute a final determination, including the taxpayer signing IRS Form 870, but if the ''signature of an authorized representative of the IRS is also required'' (*e.g.*, Closing Agreement, IRS Form 4549, or an 870-AD), a final determination is not triggered until the ''taxpayer receives notice of the signing by the IRS.''[20]

Many states, including Colorado, Missouri, and Nebraska, refer to the payment of additional tax as a final determination-triggering event.[21] Colorado and Nebraska also specify that the final judgment of virtually any court of competent jurisdiction will constitute a final determination.[22] Missouri, however, specifically states that ''[a] decision by the United States Tax Court, United States District Court, United States Court of Appeals, United States Court of Claims or the United States Supreme Court which has become final'' is a final determination.[23]

Determining when a federal adjustment becomes final in states that provide little or no guidance on the matter can be a challenge. In these states, taxpayers often take a practical approach and look to the documents executed as well as the events that result in adjustments being deemed final for federal purposes, such as:

- the taxpayer's execution of an agreement form with the IRS;[24]
- the taxpayer's payment of any portion of a tax deficiency;[25]
- the date that any judgment by a court on a disagreed adjustment becomes final;[26] and
- the date all administrative appeals with the IRS or other competent authority have been exhausted or waived.[27]

Partial Agreements

The partial agreement scenario arises when a taxpayer agrees with some, but not all, of an IRS proposed adjustment. This scenario creates added complexity for taxpayers trying to determine when to report agreed adjustments. In this situation, taxpayers are presented with a seemingly undesirable position of immediately filing state amended returns that reflect the agreed adjustments and filing a second set of amended returns when the unagreed adjustments become final. In such

[14] If the taxpayer receives a statutory notice of deficiency, the taxpayer will have the right to petition the tax court for intercession prior to paying the deficiency or pay the assessed tax liability and file a refund claim in either the Court of Federal Claims or federal district court. The strategic decision of how to proceed at the close of an IRS examination should not be entered into lightly, and consultation with an experienced tax advisor is recommended.

[15] *See, e.g.*, Cal. Rev. & Tax. Code §18622(a) (final federal determination); Colo. Rev. Stat. §39-22-601(6)(a); Mo. Code Regs. tit. 12, §10-2.105(1); N.J. Admin. Code §18:7-11.3(a); N.Y. Tax Law §211.3.

[16] *See, e.g.*, Colo. Rev. Stat. §39-22-601(6)(b); Mo. Code Regs. tit. 12, §10-2.105(3); Neb. Admin. Code §24-046.04.

[17] Conn. Gen. Stat. §12-226(a).

[18] Colo. Rev. Stat. §39-22-601(6)(b)(I)-(II). The IRS Form 870-AD is similar to IRS Form 870, but is used by the IRS Appeals Division rather than at the examination level. Additionally, in contrast to the IRS Form 870, the IRS Form 870-AD generally prohibits refund claims relating to agreed issues included on the IRS Form 870-AD.

[19] 34 Tex. Admin. Code §3.544(d)(2).

[20] Mo. Code Regs. tit. 12, §10-2.105(3)(B).

[21] Colo. Rev. Stat. §39-22-601(6)(b)(IV) (discussing the ''payment of additional tax by the taxpayer''); Mo. Code Regs. tit. 12, §10-2.105(3)(A) (discussing the ''payment of any additional federal income tax''); Neb. Admin. Code §24-046.04F.

[22] Colo. Rev. Stat. §39-22-601(6)(b)(V); Neb. Admin. Code §24-046.04G.

[23] Mo. Code Regs. tit. 12, §10-2.105(3)(E).

[24] Colo. Rev. Stat. §39-22-601(6)(b)(I).

[25] N.J. Admin. Code §18:7-11.3(c).

[26] Colo. Rev. Stat. §39-22-601(6)(b)(V).

[27] Tex. Tax Code Ann. §171.212(b).

case, taxpayers will likely incur additional costs associated with having to file two sets of amended state returns. If taxpayers wait until all adjustments have become final before filing amended returns, they risk the denial of refunds and the potential imposition of penalties and interest on the late payment of tax attributable to the agreed adjustments.

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While many states do not provide specific guidance, Florida, New Jersey, and other states with detailed provisions normally view partial agreements as constituting a final determination given that tax is assessed and paid or refunded related to the agreed adjustments.[28] Taxpayers should file amended returns for agreed adjustments within state-mandated time frames for reporting federal adjustments, even when prospective amended returns may be required due to the future finalization of unagreed issues. Taxpayers should file amended returns for the agreed adjustments to comply with state reporting deadlines, preserve the right to file a refund claim, and avoid additional interest and penalties.

State Notification Procedures

When federal adjustments become final, taxpayers must become familiar with the notification procedures for each state in which they are required to report the adjustments. These procedures vary from state to state, but they normally require taxpayers to file an amended return and other required documents before the expiration of a specified reporting deadline.

States normally require taxpayers to report federal adjustments by filing amended returns with specific attachments. Many states, such as Indiana,[29] require taxpayers to use dedicated amended return forms. Other states allow taxpayers to utilize original return forms if the taxpayer identifies on the return that it is an amended filing. Depending on the state, taxpayers identify these returns as amended either by checking a box labeled ''Amended''[30] or by writing a similar phrase on the return.[31]

Deadlines for reporting federal adjustments vary among the states. The majority of states require taxpayers to file amended returns within 90 days after a federal adjustment has become final. Additionally, some states call for notification deadlines of 30,[32] 60,[33] or 120[34] days, or longer.[35] If a taxpayer has required amended filings in a local jurisdiction (*e.g.*, a city or county), they should be aware that such local jurisdiction may have different—and perhaps shorter—notification timing requirements from those specified by the state in which such local jurisdiction is located.

Impact of Federal Adjustments

Adjustments to items on a federal return may impact the taxpayer's overall state tax liability since the majority of states use federal taxable income as a starting point in calculating state taxable income. The impact of these adjustments, however, may not be reported in the same manner for all states.

States that have decoupled from certain provisions of the Internal Revenue Code (I.R.C.) may require an addition or subtraction modification in calculating state taxable income. Many states decouple from federal bonus depreciation, I.R.C. §108(i) discharge of indebtedness rules, and the deduction for state and local income taxes. Colorado, for example, does not require a state-level adjustment for federal bonus depreciation,[36] while Indiana completely disallows federal bonus depreciation in computing state taxable income.[37] In addition, Arkansas has decoupled from the provisions of I.R.C. §108(i), thus completely disallowing for state purposes deferral of income arising from discharge of indebtedness.[38] Kansas, however, fully conforms to these provisions, allowing taxpayers to defer discharge of indebtedness income for state purposes.[39] When IRS adjustments impact items that are treated differently for state purposes, changes to addition or subtraction modifications are typically required.

[28] Fla. Admin. Code r. 12C-1.023(4); N.J. Admin. Code §18:7-11.3.

[29] Indiana Form IT-20X.

[30] *See* Oregon Form 20.

[31] *See* South Carolina Dept. of Rev., *2010 Corporate Tax Booklet* 7. South Carolina requires taxpayers to check an ''amended'' box and write ''amended'' on the face of the return. *See id.*

[32] *See, e.g.*, Colo. Rev. Stat. §39-22-601(a); Miss. Code Ann. §27-7-51(4).

[33] *See, e.g.*, Alaska Stat. §43.20.030(d); Fla. Stat. §220.23(a)(3).

[34] *See, e.g.*, 35 ILCS 5/506(b)(2); 34 Tex. Admin. Code §3.584(f)(2).

[35] *See, e.g.*, Ind. Code Ann. §6-3-4-6(b) (effective for modifications to a taxpayer's federal income tax liability made after Dec. 31, 2010, Indiana extends the filing deadline from 120 days to 180 days).

[36] Colo. Rev. Stat. §§39-22-103(5.3), -304(1).

[37] Ind. Code Ann. §6-3-1-3.5(b)(5).

[38] Ark. Code Ann. §26-51-404(b)(10).

[39] Kan. Stat. Ann. §§79-32, -109, -138.

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Federal audit adjustments may not only affect state returns filed during the period under audit, but also later years if the adjustments reduce certain carryforward items, such as capital losses or net operating losses (NOLs), that have been utilized in later years. Most state statutes and regulations indicate that a taxpayer must file an amended return when an ''IRS change or adjustment to *federal taxable income* becomes final.'' These statutes contemplate a broad view of ''change'' and ''adjustment,'' and most states would likely consider the effect in the later year to be a change or adjustment to federal taxable income even though it only indirectly results from an adjustment made in an earlier year.

Florida has adopted a rule for NOL carryovers, which provides that: ''if the reduction or addition to a net operating loss effects a change in the deduction for a net operating loss carryover for a subsequent taxable year for which a return has already been filed, an amended return will be required for the subsequent tax year(s) in which there is a tax effect.''[40] Accordingly, taxpayers should consider the long-term effects of an adjustment in addition to the short-term consequences.

STARTING POINT

The first step in preparing to file state amended returns to reflect RAR adjustments is determining the correct starting point to which the adjustments are applied. Often times, this key step is not as simple as just layering the RAR adjustments onto the originally filed return amounts. Rather, the amounts per the originally filed returns may be inaccurate if the taxpayer has previously amended these returns, failed to amend these returns to reflect prior federal amended return adjustments, or undergone adjustments as a result of state notices or audit determinations that affect apportionment, state apportionable income, or modifications to the state income tax base. Although not explicitly stated statutorily on a state-by-state basis, in order to begin with a truly accurate starting point to which to apply the RAR adjustments, all these potential adjustments need to be considered and factored into the starting point.

When a taxpayer has previously amended its state returns, has been audited at the state level, or has received state notices that affect apportionment, state apportionable income, or state modifications, the resulting adjustments need to be incorporated in order to ensure that the return's starting point on which to layer the RAR adjustments corresponds to what each state considers to be the last filed results for a given year for that taxpayer. Where these adjustments are not factored in, any state amended returns filed may trigger notices from the states stipulating that the previously filed amounts do not correspond to the amounts on record. As such, it is pivotal to make sure that the previous history of each state return is explored to ascertain whether all of these various adjustments have been considered and incorporated into the starting point.

In instances where the federal return has been previously amended or where the original state return had errors and such adjustments were not historically reported to each of the states, there are several factors to consider when determining the correct ''true-up'' required of the originally filed return amounts to arrive at the correct starting point. First, consider whether applicable state statutes of limitation for adjusting the taxpayer's return for items other than RAR adjustments have expired. Second, if in fact the state statutes of limitation have expired, determine whether the state allows adjustments other than those stemming from an RAR.[41] Commonly, where a state statute of limitations has expired, any amended return prepared to report RAR adjustments is generally limited to reporting only those adjustments and, thus, true-up adjustments would not be permitted. Some states allow non-RAR adjustments to be included with the amended return reporting RAR adjustments, but often only to the extent the non-RAR items offset amounts that would otherwise be due as a result of the RAR adjustments.

CONSOLIDATED GROUPS

When a federal consolidated group undergoes an IRS audit, one of the challenges taxpayers may face is determining which entities are impacted by the agent's adjustments and the amounts, by adjustment, attributable to the respective entities. This is especially pertinent when the taxpayer has multiple combined groups for state purposes or files state and local income tax returns on a separate company basis.

Many taxpayers have complex business structures that can create additional compliance challenges when filing state amended tax returns to report IRS audit adjustments. The composition of a taxpayer's federal consolidated group may differ from its various state combined groups as certain entities may be excluded (*e.g.*, non-unitary or entities with unique apportionment provisions) while additional entities may be included that are not part of the federal consolidated group (*e.g.*, worldwide unitary returns, unitary companies more than 50 percent but less than 80 percent owned). Even among the states, combined groups can vary depending on the rules and requirements of each jurisdiction. Consequently, taxpayers should make certain that adjustments are being reported correctly on a state-by-state basis. For example, adjustments attributable to a particular entity should only be reported in states where

[40] Fla. Admin. Code r. §12C-1.023(4).

[41] Oklahoma, for example, gives the Tax Commission ''the authority to audit each and every item of income, deduction, credit or any other matter related to the return'' if the item affects apportionment. Okla. Stat. tit. 68, §2375.H.4. If the item does not affect apportionment, the ''Tax Commission shall be bound by the revisions made in such final determination.'' *See id.*

the entity is either included in a combined return or files on a separate company basis.

Many taxpayers have complex business structures that can create additional compliance challenges when filing state amended tax returns to report IRS audit adjustments.

When filing amended returns prepared on a separate company basis, it is also important to determine if any of the federal adjustments result from the operation of the federal consolidated return provisions and, therefore, may be excluded in states that do not recognize these provisions. Additionally, taxpayers filing amended returns in mandatory unitary combined reporting states must also determine whether these adjustments are recognized and should not automatically assume that those states follow the federal consolidated return rules. Differences in combined group membership can also impact the computation of deferred intercompany transactions, which can change the amount of adjustments to be reported for state purposes. Taxpayers should seek to understand not only the current impact of federal adjustments, but also the potential future impact as well. For example, a depreciation adjustment can impact tax basis, depreciation allowable in later years, gain or loss on a subsequent sale, and earnings and profits.

The process of identifying the applicable entity or entities and respective amounts for each federal adjustment can be a challenge given that the focus of the IRS and taxpayers during an audit is often solely on the impact on the federal consolidated return. Taxpayers should take a proactive approach during the federal audit and work with the auditor to understand, manage, and document the adjustments and amounts attributable to the various entities. Additionally, when negotiating multiple issues with the IRS, it can be advantageous to consider the relative state implications of each adjustment. For example, it may be beneficial to concede an item with little or no state tax effect if the IRS is willing to concede a similar sized adjustment that would have a greater impact on the taxpayer's state tax liabilities.

If the taxpayer is unable to work with the IRS proactively to determine the adjustment amounts attributable to each entity, a consistent and rational approach that is objective, systematic, and verifiable may be required. This can involve identifying a measurable item that is closely correlated to an adjustment and prorating the adjustment to the various entities based on this item (*e.g.*, specific items of income or expense and ownership of depreciable assets).

AMNESTY

The current economic downturn has left many states searching for ways to increase revenue to cover budget shortfalls. Many states have taken proactive measures to mitigate their fiscal problems by enacting amnesty programs. These programs are usually administered by state revenue departments and are designed to entice taxpayers to come into full compliance with state tax laws by filing past due returns and remitting overdue liabilities in exchange for reducing, or waiving, penalties and interest that would normally apply. Over the past few years, about half the states and numerous localities have implemented amnesty programs, some of which may be in effect at the time of publication of this article. If a taxpayer is undergoing a federal audit, it should be cognizant of current, prospective, and sometimes past amnesty programs and consider participating where advantageous to do so, while understanding the potentially harsh implications of nonparticipation in programs that have concluded.

Taxpayers should be aware of the potential traps that can result from nonparticipation in past, current, and upcoming amnesty programs.

Taxpayers should confirm whether an applicable state's amnesty program allows for the filing of amended returns resulting from RARs. Also, taxpayers should consider the benefit of managing the timing of their federal audit to take advantage of available amnesty programs. If taxpayers can influence the pace of their federal audit, it might be advantageous to close as quickly as possible in order to meet amnesty deadlines. If it does not appear that a taxpayer's federal audit will be finalized with enough time to take part in a state's amnesty program, but the taxpayer's liabilities in that state are significant, it should consider filing returns with an estimated change in liability. Estimated returns may allow the taxpayer to avoid post-amnesty penalties, where applicable, while also avoiding normal penalties and interest on outstanding liabilities. However, taxpayers that decide to file estimated returns should be mindful that filing these returns will not necessarily extend or toll the statute of limitations for claiming a refund on any potential overpayment of these estimates.[42]

For many taxpayers the benefit of a particular amnesty program may be obvious, as participation frequently results in financial benefits due to penalty waiver and reduced interest. Nevertheless, taxpayers should be aware of the potential traps that can result from nonparticipation in past, current, and upcoming amnesty programs. Some states with expired amnesty programs impose post-amnesty penalties on taxpayers that did not take part in the program and were later found to have outstanding liabilities due. For example, California imposes an interest-based, "post-amnesty" penalty equal to 50 percent of the interest computed on any final assessment attributable to tax years beginning before Jan. 1, 2003, for the period beginning with the original due date of the return and ending March 31, 2005 (the last date of the amnesty program).[43] In addition, to the extent that an accuracy-related penalty is imposed on such amnesty-eligible assessments, the penalty is increased to 40 percent for any amounts not already in audit, protest, appeal, settlement negotia-

[42] *See, e.g.*, Ill. Admin. Code tit. 86, §520.105(l)(1)(B).
[43] Cal. Rev. & Tax. Code §19777.5.

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tions, or pending judicial proceeding as of the start of the amnesty program (Feb. 1, 2005).[44] New Jersey and Pennsylvania are currently enforcing a 5 percent nonparticipation penalty applicable to all outstanding taxes, penalties, and interest that were not paid during the amnesty period.[45] Additionally, Illinois imposes a 200 percent sanction, which doubles the rates of penalty and interest imposed on a taxpayer with an ''eligible liability'' that failed to participate in the state's amnesty program.[46] Taxpayers should also consider additional nonparticipation penalties when accounting for related uncertainties. As such, taxpayers should be aware that while participation in amnesty programs provides many financial benefits, failure to participate can potentially result in additional financial costs.

Most of the states that impose nonparticipation penalties do not specifically address the application of nonparticipation penalties to RARs, but a few do. Illinois, for example, provided that the 200 percent sanction did not apply to ''a liability that results from a Federal Change, if the Federal Change is not final as of the end of the Amnesty Program Period.''[47] However, if the federal audit was finalized during the amnesty period, and it resulted in a state tax liability that was not reported or paid before the amnesty deadline, then that liability was deemed subject to the Illinois sanction. Similarly, if a taxpayer amended its state return as a result of the issuance of an RAR after the amnesty program had concluded and incorporated an additional adjustment that did not result directly from the federal adjustment, the amount of the liability attributable to the additional adjustment would have been subject to the sanction.

COMPETENT AUTHORITY AGREEMENTS (CAAs)

Taxpayers are required to file amended state returns when federal audit adjustments impact one or more entities within the taxpayer's federal consolidated group. However, this is not the only situation in which the application of federal law may require taxpayers to file state amended returns. The CAAs entered into by the IRS and foreign tax authorities may impose amended state return filing requirements on taxpayers as well. Although taxpayers encounter this situation less frequently than the RAR scenario, it is important for taxpayers to acquire a basic understanding of this topic so they can identify and resolve related issues, should they arise.

A CAA is an agreement between the IRS and a foreign tax authority affecting a U.S. taxpayer's U.S. federal tax liability and foreign tax liability.[48] The various tax treaties delegate the authority to negotiate CAAs to the competent authorities of the specified countries. U.S. citizens and resident aliens can request assistance from the U.S. competent authority (USCA) if it is believed that the actions of the United States, a treaty country, or both, cause or will cause a tax situation not intended by the treaty between the two countries. If the United States does not have an in-force tax treaty with the country at issue, the USCA would be unable to consider the request.[49]

When a taxpayer's request for competent authority assistance is accepted, the USCA will generally consult with the appropriate foreign authority and attempt to reach a CAA that is acceptable to all parties. The USCA also may initiate competent authority negotiations where it is deemed necessary to protect U.S. interests. Once settlement is reached by the USCA and the foreign country, the IRS will send a letter to the taxpayer describing the terms of the CAA and ask whether the taxpayer accepts the provisions. If the taxpayer accepts, the USCA prepares a disposition memorandum that is forwarded to the IRS for implementation and provides the closing letters to the taxpayer.[50] The IRS will contact the taxpayer to implement the settlement and, if the taxpayer is under audit, the settlement may be implemented through an audit adjustment or the IRS may request that the taxpayer enter into a closing agreement that reflects the terms of the agreement.

The USCA does not address interest or penalties. This can create an issue because a U.S. taxing authority usually charges interest on tax deficiencies but not all treaty countries provide interest on overpayments. Penalties are considered a matter for the local examining agents and are not included in competent authority negotiations; however, the CAA may reduce the amount of the tax adjustment below the penalty threshold.

State Impact of Competent Authority Agreements

Taxpayers that are affected by CAAs from a federal tax perspective should also consider the potential implications that may arise at the state tax level. For instance, if a CAA requires a taxpayer to amend its federal return, the state amended return procedures that

[44] Cal. Rev. & Tax. Code §19164(a)(1)(B). Despite the controversy surrounding it, the validity of California's amnesty penalty was upheld by the California Court of Appeal, First Appellate District, in *River Garden Retirement Home v. California Franch. Tax Bd.*, 186 Cal. App. 4th 922 (Cal. Ct. App. 2010), *petition for review denied*, 2010 Cal. LEXIS 11603 (2010). However, the validity of the penalty is also being litigated in *Microsoft Corp. v. California Franch. Tax Bd.*, Case No. CGC08471260 (where the San Francisco Superior Court issued a Feb. 17, 2011, Statement of Decision upholding the amnesty penalty; the taxpayer appealed to the First Appellate District on May 12, 2011), *Cutler v. California Franch. Tax Bd.*, Case No. BC421864 (where the superior court held against the taxpayer but did not reach the merits of the amnesty penalty issue; the taxpayer appealed to the Second Appellate District on June 14, 2011), and *Taiheyo Cement U.S.A. Inc. v. California Franch. Tax Bd.*, L.A. Superior Court No. BC422623 (pending before the California Court of Appeal, Second Appellate District).

[45] *See* N.J. Voluntary Disclosure, *available at* http://www.state.nj.us/treasury/taxation/pdf/voldisc_bit.pdf; *Pennsylvania Amnesty Guidelines*, *available at* https://revenue-pa.custhelp.com/app/answers/detail/a_id/2572.

[46] Ill. Admin. Code tit. 86, §520.101(b)(1).

[47] Ill. Admin. Code tit. 86, §520.101(b)(1)(A).

[48] A CAA is not to be confused with an Advance Pricing Agreement (APA), which is an agreement between the IRS and a taxpayer on transfer pricing allocation methodologies of income between related parties under I.R.C. §482 and its associated regulations.

[49] *But see* Rev. Proc. 2006-23, 2006-20 I.R.B. 900 for procedures for requesting the assistance of the IRS when a taxpayer is or may be subject to contradictory tax treatment by the IRS and a U.S. possession tax agency.

[50] IRM §4.60.3.1.9.

should be followed are similar to those of a traditional RAR. On the other hand, if a CAA provides for prospective changes that would be reflected only on future returns, taxpayers would have no reason to file amended state returns and would incorporate any prospective changes on their future state returns.

The terms of a CAA may require taxpayers to amend their federal consolidated return, although this is not always a requirement. If an amended federal return is not required to be filed, taxpayers must gain a better understanding of the state treatment of the CAA. Few states have released specific guidance that directly addresses this issue. One area of particular uncertainty involves the statute of limitations. CAAs can typically reopen federal statutes of limitation that were otherwise closed if the underlying treaty grants such authority. The central question that arises at the state level in this situation is whether the reopening of the federal statutes of limitation automatically reopens a state's statute of limitations for assessments and refunds.

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Resolution of this issue is vital for taxpayers expecting state tax refunds for tax years that are otherwise closed. In most cases, the taxpayer should look to the language of the state statute to understand the impact. For example, California provides that if a taxpayer extends the federal statute of limitations for assessment, the state statute of limitations will be extended to ''six months after the date of the expiration of the agreed period for assessing deficiencies in the federal income tax . . . .''[51] While this language obviously does not address CAAs, it implies that California law is based upon the federal treatment of this issue since California's limitations period expires six months after the date of expiration of the newly extended federal statute of limitations. It is worth repeating, however, that other states may treat this issue differently, and taxpayers must closely examine state law to determine the treatment of this issue in any particular state.

IMPACT OF FEDERAL STATUTE OF LIMITATION WAIVERS

Taxpayers undergoing a federal audit should be mindful of the impact that federal waivers can have on state amended return filing deadlines and the types of issues that are open for adjustment on state returns. Generally, for federal tax purposes, the statute of limitations on assessment expires three years after the return is due or filed, whichever is later.[52] A return filed before the due date for the return is not considered filed until the due date.[53] When a taxpayer files an amended return or written document reflecting an additional tax due for the taxable year within the 60 days of the assessment statute of limitations expiring, then the assessment period for the additional tax does not expire until 60 days after the IRS receives the document reporting the additional tax liability.[54] A claim for credit or refund must generally be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later.[55]

A taxpayer's statutory right to have any assessment of tax made within the normal period of limitations, unless some exception applies, can be waived if the taxpayer agrees to extend the normal period of limitations. To extend the assessment statute of limitations, a taxpayer must provide the IRS with either open-ended or fixed-date consent.[56] An open-ended consent extends the limitations period for the time required for the IRS to complete its review of the case plus 90 days for administrative closing procedures, except where there has been a final determination and appeals consideration.[57] Either an open-ended or fixed-date consent can contain limiting language, which is known as a restricted consent. A restricted consent extends the statute of limitations on assessment for one or more specific issues, allowing the statute to expire on all other issues. A taxpayer has the right to request restricted consent, but the IRS is not compelled in all circumstances to accommodate the request, and, typically, restricted consent is not available for Joint Committee cases.[58]

State Impact of Federal Waivers

States generally respect the execution of federal waivers on assessment for state purposes. However, different federal waivers exist for different situations. As a result, it is important for taxpayers to understand which type of federal waiver is applicable to their audit so they

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[51] Cal. Rev. & Tax. Code §19065.

[52] I.R.C. §6501. An alternate statute of limitations on assessment may be applicable, for example, where the taxpayer has omitted more than 25 percent of the gross income. *See* I.R.C. §6501(e)(1)(A). Also, there is no statute of limitations on assessment where no return has been filed, or where the taxpayer has filed a fraudulent return. *See* I.R.C. §6501(c)(1)-(3).

[53] I.R.C. §6501(b)(1).

[54] I.R.C. §6501(c)(7).

[55] I.R.C. §6511.

[56] I.R.C. §6501(c)(4). IRS Form 872, *Consent to Extend the Time to Assess Tax*, is used to extend the statute of limitations for a fixed period of time.

[57] IRS Form 872-A, *Special Consent to Extend the Time to Assess Tax*, is one of several open-ended consent forms. It extends the period of limitations until 90 days after either the IRS office considering the case receives IRS Form 872–T, *Notice of Termination of Special Consent to Extend the Time to Assess Tax*, from the taxpayer electing to terminate IRS Form 872–A, 90 days after the IRS mails IRS Form 872–T to the taxpayer for such period to the taxpayer's last known address, 90 days after the IRS mails a notice of deficiency, plus another 60 days after the period the IRS is prohibited from making an assessment, or the date of assessment or overassessment of tax that reflects a final determination of tax and administrative appeals consideration. *See* IRM §25.6.22.7.1. Examples of assessments that do not constitute final determination and appeals consideration are tax under a partial agreement, tax in jeopardy, tax to correct mathematical or clerical errors, and tax reported on amended returns. *See* IRM §25.6.22.7.1.

[58] *See* IRM §25.6.22.8.2 and IRS Publication 1035 (Rev. 06-2007) for conditions that must be met for the IRS to enter into a restricted consent.

can understand the underlying state tax implications. Also, taxpayers should recognize statute of limitations issues in the context of RARs, in addition to situations where taxpayers self-initiate changes by filing federal amended returns. An extension of the assessment statute of limitations for federal purposes will generally extend the state's statute. Finally, as with most areas of multistate tax, taxpayers should always be familiar with the treatment of federal issues to help determine the proper treatment for state purposes since most states base their tax law on the provisions of the Internal Revenue Code.

CONCLUSION

Corporate taxpayers expecting to settle federal tax issues raised during an IRS audit should begin preparing for the state consequences immediately since the final resolution of these issues normally triggers an extensive and often costly state tax compliance process with narrow time frames. Taxpayers should also consider the potential state impact of CAAs.

In addition to the daunting task of amending potentially hundreds of state tax returns, taxpayers are often saddled with a myriad of technical issues, which include determining the correct starting point for the amended returns, rationally allocating federal audit adjustments among legal entities within a combined/consolidated group, securing the benefits of state tax amnesty programs while remaining cognizant of nonparticipation penalties, and understanding the state tax effects of executing a federal waiver. While there are many technical considerations, at a minimum, taxpayers should be certain to timely file amended state returns, if applicable, to mitigate interest and penalties and preserve the right to file a claim for refund. Given the far-reaching state tax effects stemming from federal tax changes, taxpayers may understandably experience frustration and anxiety during the initial stages of the amended return process. However, these concerns can be alleviated by taking a proactive approach to understanding the underlying issues and developing a plan for timely and effective resolution.