



State Reporting Requirements for Federal Tax Changes

Policy Position

Position: *State and local reporting of federal tax changes can impose a significant compliance burden on multijurisdictional companies. A fair and efficient state procedure for reporting federal tax changes should include: 1) a clear definition of what constitutes a “final determination” that triggers a reporting requirement; 2) a minimum period of at least 180 days (or six months) to report such changes to the state; 3) the ability to make advanced payments before there is a “final determination” that triggers the filing responsibility for an amended return; and 4) a limitation on issues open for adjustment to those items that are altered as a result of the federal change (after the normal statute of limitations has expired).*

Explanation: Large multistate businesses are often required to file hundreds, if not thousands, of amended returns/reports at the state and local level when a federal tax change is made by the taxpayer and/or the Internal Revenue Service.¹ Compliance with these reporting requirements is best achieved by state and local governments adopting uniform and even-handed rules for reporting federal tax changes that are consistent regardless of whether a refund or payment results from the change. Filing interim reports of changes is not an efficient use of resources for either the state or taxpayers. The following are key elements of a fair and efficient state reporting procedure for federal tax changes:

- **Final Determination:** All states that require a taxpayer to report federal tax changes, including any applicable local taxes, should link the filing requirement to a “final determination” made regarding a taxpayer’s federal income tax liability. The absence of clear, consistent rules creates compliance problems and wrongfully subjects taxpayers to penalties and interest for noncompliance. Moreover, some states require “interim” notification prior to a final determination of federal tax liability or refund – a practice that needlessly creates additional confusion over a taxpayer’s compliance responsibilities, *e.g.*, traps for the unwary. In defining what constitutes a “final determination,” COST recommends the following definition as a best practice:

A ‘final determination’ is deemed to occur when the latest of any of the following circumstances exist with respect to a federal taxable year:

- (1) The taxpayer: (i) has a final income tax liability resulting from a federal audit including any requisite review by the congressional Joint Committee on Taxation; (ii) has not filed a petition for redetermination or claim for refund for

¹ Unless a state’s e-filing system easily facilitates such filings and payments, a state should not require e-filing for reporting federal changes.

any portion of the audit; and (iii) has allowed the time to file such petition or claim to lapse.

(2) The taxpayer has signed all federal Forms 870, closing agreement(s), or other IRS form(s) for the tax period consenting to the deficiency or consenting to any over-assessment that are final for all issues and no longer subject to appeal.²

(3) A decision from the U.S. Tax Court, District Court, Court of Appeals, Court of Claims, or Supreme Court becomes final.³

(4) The taxpayer has exhausted all rights to protest an assessment or claim a refund for all entities that are included in, or have income or factors that are reflected in, the taxpayer's returns that are filed with the state.

- *Time Period for Reporting and Auditing:* Taxpayers need adequate time to report federal tax changes to the states. The necessary adjustments relating to federal tax changes, especially when taking into consideration the states' decoupling from certain Internal Revenue Code provisions such as bonus/accelerated depreciation, require sufficient time for analysis and accurate reporting. COST recommends a state's law provide at least 180 days (or six months) to report IRS adjustments to states. States must also be flexible regarding the method of reporting the changes to avoid overly restrictive and inefficient filing requirements. For instance, a federal tax change that does not affect the taxable income reported to the state should have a simplified method to report the close of the federal audit. In addition, the time provided for a state to audit a taxpayer's adjusted liability (relating to a federal change) should not be greater than a taxpayer's right to claim a refund (related to the federal change).
- *Prepayment Process:* Taxpayers should be allowed to submit advance payments relating to partial (agreed upon) federal tax changes without the filing of an amended return. This would permit taxpayers, if they so choose, to make tax payments to a state after a portion of the known federal issues are agreed to (prior to the final federal determination date). This change would allow taxpayers to reduce interest costs associated with reporting the federal tax change while the rest of the IRS audit process is completed. Currently, many states have statutes that prohibit (either intentionally or unintentionally) these types of advance payments.
- *State Statutes of Limitation Waived Only for Federal Tax Changes:* When the normal time period for the state to assess additional tax and for a taxpayer to claim a refund has passed, a state should provide that only those items that are the subject of the federal tax change should be open for adjustment (tax due and refund). The statute of limitations should not remain open for any other issues, including items that are related to amended returns or audits in other states.

² A taxpayer with an ownership interest in a pass-through entity also does not have a "final determination" to report until all the taxpayer's adjustments, including those that flow up to the taxpayer, are final for the taxpayer's tax period.

³ This best practice clarifies that a taxpayer should not be required to file a return or a request for refund until all aspects of the federal audit for a given period are final (while still being allowed to make payments on a liability at any time to mitigate interest and any potential penalties).