

Reporting Federal Audit Adjustments to State Tax Authorities

Issue

Reporting federal income tax changes to state tax authorities imposes a significant compliance burden on taxpayers, their tax representatives, and tax administrators. There is no consistent method for reporting federal tax adjustments to state tax authorities because states have not adopted a uniform notification period and method for reporting federal adjustments.

This issue is particularly relevant given the likelihood that states will consider changes to the reporting of federal audit adjustments to implement the new federal partnership audit regime.

Background

An IRS audit is often a lengthy and expensive process for the taxpayer. After the IRS audit concludes and adjustments to the taxpayer's federal return are agreed to or determined, the taxpayer faces challenges in communicating these changes to states.

Of those states that require taxpayers to report federal adjustments to their state tax authority, 16 do not specify the form the report should take, 12 require the taxpayer to file an amended state return, and several others suggest, but do not require, using an amended return as a reporting mechanism. For a taxpayer doing business in multiple states, a single change to the taxpayer's federal returns can require filing many different types of amended state returns or forms with different state tax departments.

Even if states used the same form in all jurisdictions, the taxpayer must comply with many different due dates. Time periods for reporting the adjustments range from 30 days to two years. While most states automatically grant the taxpayer additional time to make adjustments to the state return when a federal change occurs, the length of the extension ranges from 90 days to five years.

The differences among states in determining what constitutes a federal change is of particular concern. Some states require a report when the IRS audit begins, while others require the report when the taxpayer signs a form agreeing to a federal adjustment.

A single change to a taxpayer's federal tax return can trigger different reporting requirements and deadlines among the states. Uniform state laws for reporting federal changes would help mitigate the uncertainty and administrative complexity of the current system for the benefit of taxpayers and the states.

Importance to CPAs

CPAs assist clients with federal and state tax compliance and planning, including federal audit changes to states. Failure to notify states of the federal adjustments can result in lost refund opportunities and the imposition of penalties and interest on the taxpayer. Adopting a uniform state notification process would minimize the complexities and compliance burdens for taxpayers, CPAs, and the state tax authorities.

AICPA Position

The AICPA supports state CPA society efforts to work with policymakers to develop fair, reasonable, and administrable rules that minimize the complexities and burdens to taxpayers and state tax authorities alike.

To help reduce the ambiguities in various state statutes and to alleviate the burden of evaluating the various state requirements for reporting federal changes, the AICPA joins the Tax Executives Institute and the Council On State Taxation in supporting states' adoption of uniform, fair, and efficient state procedures to report federal income tax changes, including:

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 (on a uniform form – see Appendix A) such changes to the state and allow the filing of simplified forms via a paper return without regard to the means required for originally filed returns (i.e, no mandatory electronic filing for amended returns);
3. To prevent the imposition of interest, the ability to make advanced payments before there is a “final determination” that triggers the filing responsibility for an amended return or report; and
4. Limiting the issues open for adjustment to those items that are altered as a result of the federal change (providing an automatic extension for a minimum one-year period after the normal statute of limitations has expired for assessments and filing refund claims for those changes arising directly from the federal adjustment, commencing on the date the federal change is reported).
5. As it relates to changes in tax liability, states should consider implementing a standard minimum threshold before the filing of an amended return is required.
6. Further related to changes in tax liability, states should allow taxpayers the right to offset state tax liability changes resulting from federal audit adjustments against other adjustments to state items unrelated to the federal audit.