POINTS TO REMEMBER

The Postman (Usually) Rings Twice: Resolving State Tax Liabilities After a Federal Tax Adjustment

By Jay Maschas*

An audit of a taxpayer's federal income tax return can result not only in a federal tax liability, but also in a state tax liability. Too often, a tax practitioner who is experienced in resolving appeals with the Service may be unfamiliar with state tax procedures even in the practitioner's home state. A practitioner's inexperience with state tax procedure may lead to unnecessary time and money charged to the client. This article serves as a general guideline for resolving state tax liabilities that result from federal audits or adjustments.

Agreed Cases

Congratulations! After several months, you and the Service examiner have agreed to some minor adjustments to your client's federal income tax return. It appears that all that is left is to accept the federal adjustments and have your client pay the agreed upon federal tax liability. Unfortunately, tax, like life itself, is not that simple.

At the conclusion of a federal audit, the Service will send a report of the adjustments to the corresponding state tax authority. Notwithstanding this notification, upon reaching an agreement with the Service, the client is under an obligation to report the adjustments to the appropriate state tax agency. In an agreed case, the practitioner should take the following steps to ensure a complete resolution for the client.

First, request copies of any state income tax returns filed for the tax years in question. If the client has already filed state income tax returns, you should presume that the Service will send notice of the federal adjustment to the state revenue department. If the client has not filed any state income tax returns, then the client has an obligation to file the income tax returns with the appropriate state revenue department.

Next, determine where the individual taxpayer is domiciled or where the business entity has nexus during the tax years in question. An examination of the state income tax returns, or the lack thereof, gives the practitioner an opportunity to determine the client's filing requirements. In the best case, the client's filing requirements are straightforward. For example, the individual client may have lived, worked, and maintained a single residence in the same state for the majority of his or her working life. On the other hand, the client may have lived, worked, and maintained a place of abode in several states. The topic of nexus and domicile is a lengthy discussion by itself. However, suffice to say, a practitioner should review the entity's locations and business model or the individual's work and living arrangements during the tax years in question. If the taxpayer has inaccurately filed returns or failed to file the proper returns, now is the time to correct the mistakes.

Next, the practitioner should determine whether the federal adjustment will result in any state tax liabilities. In the case of an individual taxpayer, the state may not have an income tax at all. There are currently nine states that do not have an individual income tax: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. In other states, the individual taxpayer may have an income tax return filing requirement, but the federal adjustment may not have an impact on the state income tax return. For example, Pennsylvania does not allow individuals to deduct itemized deductions on their state return, PA 40. If the Service disallows itemized deductions claimed on your Pennsylvania client's federal income tax return, the federal adjustment will not affect the client's Pennsylvania return and the practitioner need not file an amended Pennsylvania income tax return to report the adjustments. There are currently ten states that do not allow itemized deductions: Connecticut, Illinois, Indiana, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania, Rhode Island, and West Virginia.

Finally, the practitioner should review the best options for reporting the additional tax liability. The most obvious option is to immediately prepare and file the amended state income tax returns to avoid the accumulation of additional interest and penalties. Many states have a voluntary disclosure program wherein the state will waive penalties if the missing tax returns are filed and payment is made for tax and interest. The practitioner should also determine if the state tax department has an amnesty program.

Unresolved Cases

In unresolved tax controversies, the appeals process with the state tax department becomes more complicated. The Service may report the adjustments to the applicable states before the appeal has been fully resolved at the

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federal level. In this situation, the tax practitioner is generally left with two less than perfect options. The discussion below focuses on Maryland law; the practitioner is likely to find that rules in other jurisdictions are similar.

The first option is to appeal the state income tax assessment. The taxpayer is unlikely to find success at the state level until the appeal is resolved at the federal level because many states limit the allowable items on a taxpayer's state income tax returns to the allowed federal amounts. For example, under Maryland law, an individual's Maryland adjusted gross income and itemized deductions are limited to the individual's federal adjusted gross income and federal itemized deductions for the tax year. Md. Code Ann., Tax-Gen. §§ 10-203, 10-218(b). A corporation's Maryland modified income is the corporation's federal taxable income for the taxable year. Md. Code Ann., Tax-Gen. § 10-304(1). As a result, the representative's efforts may be hamstrung until resolution of the federal tax issues. If the practitioner elects to resolve the case through the state's appeal process, the best plan is to request a delay of the state's first hearing in order for the federal appeal to be resolved.

The second option is to pay the assessment of tax, interest, and penalty to prevent the accrual of interest while the federal tax dispute is pending. The taxpayer should then file a refund claim for the amount paid. There are, of course, concerns with taking this approach. The taxpayer may be apprehensive about paying the state tax liability up front, operating under the mistaken belief that once the state has his or her money, the state will never agree to refund it. Although the issue involved is slightly different because only local taxes were involved, the recent decision in *Armour v. City of Indianapolis*, 132 S. Ct. 2073 (2012), did nothing to assuage taxpayers' concerns about prepayment of taxes. A more difficult problem with this option is often the lack of available funds.

If the taxpayer is able to pay the amount due and the taxpayer is later victorious at the federal level, the representative must be very careful to monitor the period of limitations on refund claims. Under Maryland law, taxpayers may claim a refund of taxes no later than one year from the date of: (1) a final adjustment report of the Service; or (2) a final decision of the highest U.S. court to which an appeal of a final decision of the Service is taken. Md. Code Ann., Tax-Gen. § 13-1104(c)(2). After the federal tax issues have been resolved, the representative should file the taxpayer's amended state income tax return as soon as possible, lest disaster ensue. *See King v. Comptroller of the Treasury*, 425 Md. 171, 38 A.3d 433 (2012) (statute of limitations for filing refund suit began running when the Service identified adjustments to personal liability attributable to a partnership audit). Depending on the state, the statute may even provide for payment of interest on prepayment by the taxpayer. ■

Validity of Guidance Questioned by the Courts

By Adam C. Silva*

Two recent court decisions call into question the validity of administrative guidance issued by Treasury and the Service. In one case, the District Court for the District of Columbia held that an IRS Notice violated the Administrative Procedure Act (APA) because it failed to comply with the APA's notice-and-comment requirements. The Court of Appeals for the D.C. Circuit dealt a second blow when it invalidated a regulation, ruling that Treasury acted contrary to section 706(2) of the APA because it did not provide a reasoned explanation when it issued the regulation as required by Supreme Court precedent.

Generally, the APA requires that notice of proposed rulemaking be published in the *Federal Register* and that interested parties be given at least thirty days to comment on the proposed rules. *See* APA § 553. After consideration of the relevant matters presented, the agency must incorporate in the rules adopted a concise general statement of the rules' basis and purpose. *Id.* Additionally, the Supreme Court has held that "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choices made.'" *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

Notices are typically issued by the Service without APA notice-and-comment. *In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig.*, 2012 WL 1179063 (Miscellaneous Action No. 07-014 (RMU)) (D.D.C. April 10, 2012), involved the Service's telephone excise tax refund procedures. The D.C. Circuit had remanded the case to the district court after finding that Notice 2006-50 bound the Service, tax collectors, and taxpayers and that the district court had jurisdiction to hear the case. *Cohen v. United States*, 578 F.3d 1, 8 (D.C. Cir. 2009), *vacated in part*, 599 F.3d 652

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