Waive or Walk: Considerations for Extending the Statute of Limitations

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Intuitively, most taxpayers likely assume that giving a tax authority more time to examine their tax return is a bad idea. After all, an extension of the statute of limitations provides state auditors with more time to audit and likely refine an assessment. However, there are times when agreeing (or requesting) an extension of the statute of limitations is justifiable or necessary. This installment of A Pinch of SALT explores the issues that arise when a taxpayer is considering whether to agree to, or request, an extension of the limitation on assessments during a state audit. We further suggest some ideas that can make the decision easier, such as having a corporate policy on signing waivers.

Waivers at the Federal Level

The federal rules for extending the statute of limitations forms the basis for many states’ rules, so a brief discussion of the federal rules is helpful to provide a basis for reviewing some state variances. A taxpayer and the IRS, before the expiration of the statute of limitations prescribed for the assessment of any tax (excluding estate tax), can agree in writing to an extension of the assessment limitation.1 Although a taxpayer can agree to an unconditional consent, allowing the IRS to examine any issues on the return,2 the IRS is required to notify the taxpayer of the taxpayer’s right to refuse to extend the period of limitations, or to limit the extension to a certain period of time or to particular issues.3 At the federal level, an agreement to extend the period for assessment also extends the period during which the taxpayer may claim a refund or credit to six months after the agreed time of extension of the assessment period.4 The main purpose of allowing an extension of the assessment period is to avoid interruption of the established process of tax return examination by the imminent expiration of the statutory period of limitations for assessment.5 The IRS likely will take immediate steps to allow it to assess any tax if a taxpayer refuses to sign a consent, which means that a notice of deficiency will likely follow shortly after any such refusal to agree to a waiver.6

The Internal Revenue Code does not restrict the length of an extension or the extent of the continued examination; therefore, the parties have the flexibility to negotiate the tax issues covered by the consent as well as the length of the extension period. Forms 872 and 872-A are the forms typically used to effectuate an extension of the statute of limitations. Form 872 is used for extensions that typically are referred to as “fixed-date” consents, which extend the assessment period to an agreed-on date, the most common type of extension. Form 872-A allows for an “open-ended” extension, which is for extensions that do not expire on a certain date. An open-ended extension period generally remains open

1IRC section 6501(c)(4)(A).
2See Internal Revenue Service Publication 1035 (June 2007).
3IRC section 6501(c)(4)(B).
4Treas. Reg. section 601.105(f).
5Id.
6Supra note 2.
Typical State Waiver Provisions and Their Differences

Most state rules for extending the period of assessments are based, in part, on the federal rules. For example, New Jersey provides that:

If, before the expiration of the period prescribed herein for the assessment of additional tax, a taxpayer consents in writing that such period may be extended, the amount of such additional tax due may be determined at any time within such extended period. The period so extended may be further extended by subsequent consent in writing made before the expiration of the extended period. The consent of a taxpayer to extend the period of assessment shall extend the period in which the taxpayer may file a refund claim with respect to the identical taxes and tax periods for which the limitations periods have been expressly extended by written consent of the taxpayer.8

Notably, the provisions of New Jersey and many other states that pertain to waivers provide for an automatic extension of time to file an application for credit or refund whenever an extension of the assessment limitation is executed.9 That is not always the case. For instance, Georgia law provides that when an extension agreement is entered into between the commissioner and a taxpayer the commissioner “is authorized . . . to extend similarly the period within which a claim for refund may be filed,”10 which suggests that such an extension to the period for claiming a refund is not automatic. Georgia’s separate treatment of extensions for assessments and refunds creates a trap for the unwary. No taxpayer should agree to extend the statute of limitations unless the extension allows the taxpayer additional time to identify and claim refunds.

When a particular state provision does provide for the automatic extension of time to file a claim for refund whenever a waiver is signed, taxpayers must pay close attention to the length of that automatic extension. Similar to the federal provision, many state provisions regarding extending the assessment period extend the time for filing a refund claim to a period ending some time after the extended assessment period ends (for example, six months).11 That is not the case in all states. For instance, in Iowa and Oklahoma an agreement extending the period for assessment automatically extends the period for a refund claim, but only to the same date of the assessment extension period.12 Therefore, if an assessment is issued close to the end of the extended period, rather than having additional time to file a claim a refund, a taxpayer will have to act quickly, since the time to file such a claim is the same as the extended assessment period.

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Unlike the federal rule, which requires the IRS to notify taxpayers of their right to limit the issues, many state provisions are silent as to such a right. For example, California specifically recognizes the taxpayer’s right (and the Franchise Tax Board’s obligation to notify the taxpayer of that right) to limit an extension to a particular period of time, but does not address limiting a waiver to specific issues.13 Despite the right not being specifically stated and similar to the flexibility at the federal level in negotiating waiver agreements, taxpayers that are requested to sign a state waiver typically do have the ability to limit the issues to which the extended period will apply. As discussed more fully below, such narrowing of the continued examination is one of many practical considerations that a taxpayer should consider when requested to sign a waiver.

When to Walk and When to Waive: Practical Considerations

Whether to agree to or to request a waiver of the statute of limitations requires the consideration of several important issues. First and foremost, the decision to extend is dependent on the individual facts and circumstances, and taxpayers should give careful consideration before consenting to or requesting a waiver. Those facts and circumstances include: the relationship with the auditor and audit team; the circumstances surrounding the reason for the extension request (for example; delays because

7Id.
8N.J. Admin. Code section 18:2-2.6(b).
9See, e.g., N.Y. Tax Law section 1147(c); Del. Code Ann. 30 section 539(c)(1); Ark. Code Ann. section 26-18-306(d).
11NYCRR 8-2.2; Ark. Code Ann. section 26-18-306(d). New York allows for an additional six months to file a claim for refund, while in Arkansas a taxpayer is given an additional 60 days.
12Iowa Admin. Code 701-51.2 (422)(3); Okla. Stat. section 223(B).
13Calif. Revenue and Taxation Code section 19067(b).
of auditors’ actions or the taxpayer’s actions); the potential tax liability; and the likelihood of an assessment (that may be based on estimate) if a waiver is refused.

**Requesting a Waiver**

The benefits of an extension of the statute of limitations are not always a one-way street. The additional time might also be beneficial to taxpayers. Numerous reasons arise for not fully responding to a state’s information document request, including overly broad and overly extensive requests, the tax department’s limited resources, and inadequate time provided to a tax department to respond to the request. An extension allows taxpayers additional time to produce documentation that may support its positions on the return. Further, agreeing to a reasonable waiver could go a long way toward maintaining an amiable relationship with an auditor who may be back to audit later periods. Most importantly, some states limit the ability of taxpayers to introduce information on appeal (or in litigation) that was not provided during the course of an audit. If a taxpayer has information that supports its position, a waiver may be needed to ensure that the record is fully developed.

**Time Period of the Extension**

Regarding the period of the extension, a taxpayer should discuss with the examiner the reasons for the requested extension and grant only the minimal amount of time needed to complete that examination. However, the extension should not be unrealistic because an overly short extension will lead inevitably to yet another extension.

**Issues Included in the Extension**

Limiting a requested extension to particular issues can be an effective tactic and compromise in consenting to additional time to allow a state to audit. Issue limitation will allow the statute of limitations to close all noncovered issues except those specified in the waiver agreement. In specifying the covered issues, it is important to take into account the interaction of various issues. For instance, an agreement to keep the statute of limitations open to allow a state additional time to audit a nonbusiness income position will have consequences on the taxpayer’s apportionment formula calculation and possibly on the use of net operating losses. Consideration of those cascading consequences is important in defining the scope of the issue for purposes of the waiver.

**Interest and Penalty Considerations**

An evaluation of interest imposed on underpayments and overpayments should be taken into account in determining whether a waiver is justified. For instance, some states pay substantial amounts of interest on overpayments and therefore a taxpayer that believes it is due a refund may be in no hurry to expedite an audit because the interest earned on the overpayment may be higher than other available investment options. However, high interest rates imposed on underpayments may militate toward a short waiver period, or perhaps none at all.

Although this is not very common, there may be an opportunity to toll the running of interest during the extension period. For example, Hawaii allows all interest on underpayments to be tolled during the assessment period if the taxpayer submits a cash bond deposit.

**Rejecting a request for a waiver could give an auditor an incentive to more aggressively assess penalties.**

The prospect of suffering the imposition of penalties also affects a taxpayer’s stance on waivers. Many tax penalties are subjectively imposed, and rejecting a request for a waiver could give an auditor an incentive to more aggressively assess penalties. Also, some states’ amnesty programs provide for the abatement of penalties, but failure to participate in the program can lead to mandatory penalty assessment. A waiver could extend an audit beyond the time period of an amnesty program, thus making the benefits of the program unreachable.

**Corporate Waiver Policy**

To maintain consistency and predictability for tax department personnel and state tax auditors, it is fundamental for a business to have a corporate policy that describes the situations under which the taxpayer will consider consenting to or requesting a waiver. Although some taxpayers have corporate policies to not grant waivers unless there is some unique circumstance, most taxpayers have well-defined policies that describe: the conditions under which a waiver will be granted; a time range for the extension; a requirement that the waiver apply to assessments and refunds; and an expectation that the waiver be limited to given issues.

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14See, e.g., United Parcel Service Co. v. Director, Div. of Taxation, 25 N.J. Tax 1, 45 (N.J. Tax 2009) (holding that “[p]laintiffs may not rely on information withheld during the audit process, and not produced until shortly before or at trial, as a basis for challenging the Director’s [] analysis.”).

15Wis. Stat. section 71.82(1)(b).

16Hawaii’s interest rate on underpayments is 8 percent annually. Hawaii Tax Information Release 2008-03, Dec. 15, 2008. It should be noted, however, that a cash bond may also create an additional audit expense.
In addition to documenting the policy, it is important to communicate it to tax department personnel and to auditors at the commencement of an audit. Failure to communicate the policy will undermine its utility and suggest to a state auditor that the policy is not uniformly followed.

Simply Refusing Does Not Warrant a Jeopardy Assessment
As discussed, taxpayers are under no obligation to consent to a waiver of the statute of limitations. However, states often raise the possibility of a jeopardy assessment if a taxpayer does not consent. A jeopardy assessment, which is often based on an estimate or extrapolation, can yield an unrealistically large assessment that puts the taxpayer at a disadvantage in negotiating a resolution to the audit and also may have detrimental financial statement effects. In fact, the threat of a jeopardy assessment is the most common rationale for agreeing to a waiver. Some taxpayers have been conditioned to believe that the serial granting of waivers is necessary to avoid a jeopardy assessment. Other taxpayers are asserting taxpayer bill of rights to avoid this type of leverage. And some taxpayers have successfully challenged state attempts to issue jeopardy assessments when the taxpayer has fully cooperated during the course of the audit.17

State Extension Because of a Federal Waiver
As discussed, the IRS and a taxpayer can enter into a waiver agreement generally by signing a Form 872 or 872-A. That federal extension can affect a state’s statute of limitations as well. Even if no federal waiver is signed and a taxpayer reports a federal change to a state by filing an amended state return for a tax year that is otherwise closed, the state statute is reopened to allow the state time to return for an audit.22 The state may also have detrimental financial statement effects. In fact, the threat of a jeopardy assessment during the course of the audit was invalid, held that, despite the statute granting “broad authority to issue a jeopardy assessment by the words ‘if the commissioner believes,’ this belief is tied into the question of whether there is a ‘reasonable belief’ that the taxpayer’s actions will impair the collection of tax.” Id. at *7. (For the decision, see Doc 2009-7377 or 2009 STT 62-14.)

State law typically provides for an automatic extension of the statute of limitations on a federal waiver being signed. Uncertainty arises as to what, if any, limitations there are to the automatic state extension. That is well illustrated by the relevant California statute, which provides for an extension of “six months after the date of the expiration of the agreed period for assessing deficiencies in the federal income tax.”19 The statute is silent as to any limitations to the extension, leaving the implication that the state could issue a notice of deficiency during the extending period on any issue, regardless of whether the federal extension has been limited to specific issues. Delaware’s statute is also unclear, but seems to imply that any issue limitation at the federal level would also apply to the state, by providing that any agreement with the IRS shall constitute an agreement with Delaware to extend the limitation period.20 That seems to suggest that the terms of the agreement at the federal level will be the same at the state level. New Jersey and Arizona, however, specifically limit the extension to items arising out of those provided for in the federal waiver.21 Colorado takes an interesting approach by allowing any deficiency assessments by the state during the automatic extension period to be limited to those arising out of items adjusted at the federal level only if the taxpayer’s state return has been audited and settlement has been made regarding the return.22

Making matters more complicated, some states will reopen the state statute of limitations based on a federal revenue agent’s report. In fact, some states will reopen an otherwise closed statute of limitations for all issues, whether related to the RAR or not.23 Taxpayers should consider the filing of a federal waiver or an anticipated federal RAR in considering whether to agree to a state waiver. Failure to do so could result in unnecessarily debating or offending a state auditor over the propriety and length of a state waiver when the statute could be extended or reopened regardless of a state agreement.

Unitary Waiving
In the case of a unitary combined group return, an issue arises about the effect of a waiver that relates to only one or some members of the group. There is not much guidance on this issue and the available authority is inconsistent and often incomplete. For example, even though each taxable member of a Massachusetts combined return computes

17See, e.g., Alexandre v. Law, CV 07 4015060S, WL 941976 (Conn. Super. Mar. 17, 2009). The taxpayer in Alexandre was issued a jeopardy assessment after refusing to sign an extension of the statute of limitations. There was no evidence to suggest that the taxpayer would obstruct the collection process, leave the jurisdiction, or remove property from the jurisdiction. The court, in concluding that the jeopardy assessment was invalid, held that, despite the statute granting “broad authority to issue a jeopardy assessment by the words ‘if the commissioner believes,’ this belief is tied into the question of whether there is a ‘reasonable belief’ that the taxpayer’s actions will impair the collection of tax.” Id. at *7. (For the decision, see Doc 2009-7377 or 2009 STT 62-14.)
23See, e.g., Calif. Revenue and Taxation Code section 19065.
its excise tax liability separately, each member is jointly and severally liable for the tax due from any member, and any assessment issued for one entity is deemed an assessment against all members of the combined group. Further, each member’s apportionable income is based on the taxable income of the entire combined group, thus any item adjusted for one entity will cause a change in income to all members of the group. With that said, it still seems unclear how an extension for one entity would affect the others — all the more reason to have the waiver agreement drafted in a way to specifically address this issue.

Further, in West Virginia the statute of limitations open for a particular member of a combined group remains open for that member, even if the statute of limitations has expired for one or more other members of the combined group. Although that policy does not address the specific situation of how the group would be treated if one member of a combined group has granted a waiver, it does indicate that, for statute of limitations purposes, the group is not treated as one taxpayer, but rather as individual taxpayers. Thus, in West Virginia a waiver might have to be executed for each member of the group.

Conversely, a ruling in Illinois held that a waiver applied to an entire unitary group, despite the members in question having filed as separate taxpayers for the applicable years because the Department of Revenue found the members should have filed as a unitary group. The implication is that members of a unitary group will be treated as one taxpayer for purposes of waivers.

Other states specifically address the effect that a waiver for one entity has on the rest of the combined group. California provides, by regulation, that for unitary combined groups electing to file a group return “waivers to extend the statute of limitations for issuing Notices of Proposed Assessments must be executed by the key corporation and are effective for all taxpayer members.” In light of the inconsistency and lack of clarity pertaining to waivers in the context of combined returns, a taxpayer in the process of negotiating an extension should attempt to determine if there is a rule on point in the state and, if limiting the extension to some taxpayers is possible, should consider whether doing so is advantageous.

Conclusion

Deciding whether to sign, or request, an extension of the statute of limitations involves both practical and legal considerations that, if not carefully examined, can cause unforeseen results. A carefully considered corporate policy regarding state statutory waivers that is clearly communicated to state auditors can mitigate tension over waiver requests. In forming that policy, taxpayers should take into account the importance of state auditor relations, the risk tolerance associated with jeopardy assessments, interest rates on under- and overpayments, penalties and amnesty programs, and the status of federal audits. Serial state waivers should be avoided when possible because they create the expectation for future waivers and increase the likelihood of old, lingering audits.