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Chapter 7: Federal Income Revisions

General Discussion

The Internal Revenue Service ("IRS") will occasionally revise a business' federal tax return (most frequently during an audit) that in turn affects the Tennessee franchise and excise tax calculations. Because federal income revisions ("FIR") generally affect franchise and excise tax liabilities, taxpayers are required to report the revisions to the Department of Revenue (the "Department"). In such circumstances, the taxpayer does not file an amended franchise and excise tax return, but instead the taxpayer must complete the [Franchise and Excise Tax Federal Income Revision](#) form, which can be found on the Department's website.¹

⚠ Please Note: The amount entered on Line 1 on the first column of the FIR form should be the taxpayer's net income on a separate entity basis and should equal Schedule J, Line 1 of the last franchise and excise tax return as filed by the taxpayer, or as audited by the Department, for the period being revised.

⚠ The FIR form should be filed in lieu of an amended return (Form FAE 170/174). The Taxpayer SHOULD NOT file an amended return to report FIRs to the Department.

When reporting FIRs, the taxpayer must also provide the Department with the following supplemental information:

- A letter of explanation regarding the adjustments made to federal taxable income.
- Supporting documentation, including federal Form 4549 (or any variation of this form) and any other pertinent pages from the federal Revenue Agent Report ("RAR") concerning the examination changes.
- If the taxpayer files a consolidated federal return, provide either a schedule detailing the changes that apply only to the Tennessee taxpayer for which the revisions are being reported or a reconciliation reflecting all adjustments for each entity included in the consolidated federal return.
- If the taxpayer files an amended federal return in relation to an FIR, provide a copy of the Form 1120X or the first page of the amended federal return.

- If the taxpayer is requesting a refund, the completion date of the federal revisions must be shown on the RAR, and if a Form 1120X was filed, a statement of adjustments and/or a copy of the refund check from the IRS must be included.
 - If the amount of the refund request is \$200 or more, the taxpayer must also submit a completed [Report of Debts form](#).

The IRS uses several forms to report federal audit adjustments to the taxpayer. Federal Form 4549 – Income Tax Examination Changes – is the primary report that lists changes by type and calculates a tax amount due or overpaid. There are numerous variants of this form, including Forms 4549-A, 4549-B, and 4549-E. Additionally, federal Form 5278 has the same information as Form 4549, but it reports proposed changes that are not necessarily agreed to by the taxpayer.

When a FIR is reported, the auditor will likely request a copy of Form 4549 that is signed by both the federal examiner and the taxpayer. This form has lines for adjustments to income, taxable income per return or as previously adjusted, and the net federal tax due or overpaid net of credits and penalties.

- For corporations, the amount reported on Form 4549, Line 3, “Taxable Income Per Return or as Previously Adjusted,” comes from federal Form 1120, Line 30, “Taxable income” (after net operating loss and special deductions).
 - The first line of the Tennessee FIR form reads “Federal income or loss from Schedule J, Line 1.”
 - An auditor will be looking to reconcile the federal Form 4549, Line 3 amount with the Tennessee FIR form, Line 1 amount. Differences may exist because either the Tennessee form amount does not include federal net operating losses and special deductions, or previous FIRs were not reported.

The federal audit changes are reported on Form 4549, Line 1 as “Adjustments to income.” An adjustment that decreases an expense will be reported as a positive number, because it is effectively an increase to income. The “Total adjustments” reported on Form 4549 will be transferred to the Tennessee FIR form, Line 1, Column 2.

The taxpayer (and the auditor alike) must pay special attention to the various types of federal audit adjustments reported on Form 4549 because some adjustments may necessitate an additional adjustment for excise tax purposes due to certain modifications required under

excise tax law.² For example, Form 4549 may report a decrease in dividend income, but for excise tax purposes, the auditor needs to determine if there is a decrease in Schedule J, Line 1 net income as well as a decrease in the Schedule J, Line 17 dividends received deduction. There are various other federal audit adjustments that may require a “double adjustment.” Such adjustments include:

- contribution expenses
- capital losses
- expenses for which a federal credit was claimed
- bonus depreciation
- nonbusiness earnings

FIRs may affect the excise tax, interest, penalties (decrease only), credits, and net operating loss/tax credit carryovers for several tax years. Taxpayers especially need to contemplate changes in net operating loss and tax credit carryover utilizations that may result from the reporting of FIRs. For example:

- If a taxpayer has utilized a large Tennessee net operating loss carryover that originated in Year 1 in Year 5 but has now reported FIRs that affect Year 3, any net operating loss carryover that was available as of Year 3 (without regard to the amount utilized in subsequent tax years) will be applied first to Year 3 and then to Year 5 if any carryover amount remains.

After taking into consideration any tax effects resulting from net operating loss and tax credit carryovers, any tax years that reflect an overpayment of excise tax should be offset against any tax years reflecting an underpayment of excise tax (beginning with the earliest underpaid tax year). Interest is computed at the current rate³ on any net underpayment of tax from the statutory due date of the return through the date on which the tax is paid.

Statute of Limitations - FIR

The Department must assess any additional tax due within two years of the taxpayer notifying the Department of the changes made to its net income as the result of an IRS examination.⁴ For example:

- A taxpayer files an amended return on June 19, 2015, to report FIRs for the period ended December 31, 2013. The auditor determines that additional excise tax is due because of the revisions. The Department must assess the additional tax on or before June 18, 2017.⁵

If the IRS examination results in a decrease in net income, then an overpayment of excise tax will normally result. The taxpayer has three years, from the date of redetermination of the taxpayer's net income by the IRS, in which to file a Claim for Refund with the Department that is supported by proper proof.⁶ For example:

- An IRS examination of the taxpayer's federal income tax return for the tax year ended December 31, 2014, has concluded and all adjustments are finalized and agreed to by both the taxpayer and the IRS. The result of this examination is a decrease in the taxpayer's net income that will result in an overpayment of excise tax. The Form 4549 detailing the examination changes was signed and dated by the IRS examiner on July 15, 2017, which is deemed to be the redetermination date. The taxpayer must file a Claim for Refund, supported by proper proof, with the Department on or before July 14, 2020.

If the IRS audit covers tax years that are outside the statute of limitations, the Department may only adjust the franchise or excise tax base to the extent that either is directly affected by the IRS examination changes. An amended return filed as the result of an FIR does not re-open the statute of limitations for the given tax year. However, if the IRS adjustments impact tax years that are open under the statute, then all changes affecting franchise and excise taxes can be made. For example:

- As the result of an IRS examination of a tax return that is still open under the statute of limitations, the taxpayer's depreciation expense is adjusted. In addition to the impact on the taxpayer's net earnings subject to excise tax, the change in depreciation expense may increase or decrease the book value of property reported on Schedule G of the franchise and excise tax return. Also, a change in Tennessee rent expense would affect Schedule G. If Schedule G is the franchise tax base for the given tax year, then the franchise tax could increase, or decrease based on these adjustments.⁷

Audit Procedures

In the case of an FIR, a taxpayer may expect an auditor to request some, or all, of the following documents/information and perform some, or all, of the following procedures:

- Request the Department's FIR form.
- Request authoritative documentation of the IRS adjustments. This is generally the federal Form 4549 that has been signed by both the IRS examiner and the taxpayer. Please note, the federal Form 870⁸ is not deemed to provide the redetermination date for refund claim purposes.
- If the Form 4549 adjustments are for a consolidated group, request a breakdown that shows each adjustment by entity.
 - For example, a columnar schedule that shows each entity's adjustment values in a separate column, with the final column reflecting the total of all adjustments that tie to Form 4549.
- Tie the information reported on the Tennessee FIR form to the federal form(s).
- Obtain an understanding of the adjustments and consider whether they increase or decrease Tennessee taxable income.
 - For example, if dividend income changes, would the Schedule J dividends received deduction also change? If gross sales change, would the apportionment ratio change? If net income increases, would the use of a tax credit increase?
- If a refund is requested, obtain additional documents as discussed above (i.e., Report of Debts form, completion date of revenue agent's examination, copy of IRS refund check, copy of federal amended return or Form 1120X).

⚠ The taxpayer should ensure that the completion date (redetermination date) of the federal revisions is included on Form 4549 or other Revenue Agent's Report.

- Prepare and assemble the standard audit workpapers, related forms, and taxpayer communications for inclusion in the electronic audit file.

¹ [Important Notice #17-16.](#)

² See Tenn. Code Ann. § 67-4-2006(b).

³ Visit <https://www.tn.gov/revenue/tax-resources/legal-resources/tax-rates-and-interest-rate.html> to see the current interest rate in effect.

⁴ Tenn. Code Ann. § 67-1-1501(b)(3).

⁵ Tenn. Code Ann. § 67-1-1501(b)(3).

⁶ Tenn. Code Ann. § 67-1-1802(a)(3).

⁷ Tax basis records may be used for franchise tax purposes when GAAP records are not maintained. Tenn. Code Ann. §§ 67-4-2106(b), 67-4-2108(a)(3).

⁸ Federal Form 870-Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment is filed by taxpayers wishing to consent to the federal assessment of the deficiencies shown in the form in order to limit any interest charge and expedite the adjustment to their account.