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TAX LITIGATION ISSUES

Expert Analysis

Should a Client File an Amended Tax Return?

From time to time, tax professionals learn that a client previously filed a false return. Sometimes that revelation comes when an accountant discovers an innocent mistake while preparing a subsequent return for the client, and on other occasions the client will "come clean" and admit to an accountant or (preferably) a lawyer that a prior return intentionally omitted income or claimed false deductions. While the Internal Revenue Service gives taxpayers the option of amending prior returns, there is no legal requirement to do so. However, each year between three and four million taxpayers file amended returns on Form 1040-X. Advising a client as to whether he should avail himself of the option of amending requires careful consideration of the pros and cons of curing past errors.

By
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Option to Amend

The Internal Revenue Code does not explicitly provide for amended tax returns. Rather, 26 C.F.R. § 1.451–1 provides that "if a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he *should*, if within the period of limitation, file an amended return and pay any additional tax due." The use of the word "should," as opposed to "must," makes clear that taxpayers are not legally obligated to amend an erroneous tax return.

In *Broadhead v. Commissioner*, 14 T.C.M. (CCH) 1284 (1955), an accountant informed his client of an error on a previously filed return that resulted in a significant understatement of taxable income. The accountant prepared an amended return, which the client refused to file. The IRS subsequently audited the return and imposed a fraud penalty in addition to the tax deficiency. The taxpayer challenged the fraud penalty arguing that he had been unaware of the error when he filed the return. In response, the commissioner argued that the taxpayer had "willfully and deliberately attempted to evade and defeat his income taxes when he refused to file the amended return after being advised to do so by his accountant." The Tax Court rejected this argument and held that the taxpayer "was not required by statute to file an amended return," and that the fraud penalty would only be appropriate if the IRS could establish that he had acted with fraudulent intent at the time he filed the original return.

Similarly, in *LPCiminelli Interests v. United States*, 09-CV-274 (JTC), 2012 WL 5499444 at *8 (W.D.N.Y. Nov. 13, 2012), the government argued that a corporate taxpayer had violated the "anti-avoidance rule" of the regulations concerning consolidated returns by not reporting that a subsidiary had been inactive at the time the corporation filed its 2004 return and then "failing to file an amended return for the year (or years) during which the income from [the subsidiary] was actually realized." The court rejected the latter argument, concluding that "there is nothing in the wording of [26 C.F.R. § 1.451–1], or in the language of the tax code itself, explicitly requiring the taxpayer to file an amended return."

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Standards of Conduct

While the regulations and case law make clear that taxpayers have no legal obligation to amend, tax professionals are required to notify clients when they learn of mistakes on a previously filed return. Thus, Section 10.21 of Treasury Circular 230 provides that "a practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with

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the revenue laws of the United States or has made an error in or omission from any return, ... must advise the client promptly of the fact of such noncompliance, error, or omission."

Section 10.21 does not distinguish between innocent and intentional errors. Moreover, while the practitioner is further required to "advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission," Circular 230 does not impose an obligation to advise the client to amend, nor is the practitioner required to withdraw if the client decides not to do so. By contrast, the AICPA directs members to recommend that a taxpayer correct errors on previously filed returns. See AICPA Statement on Standards for Tax Services No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings*.

When and How to Amend

This leaves the question of whether (and under what circumstances) it might be advantageous for taxpayers to amend their returns. Of course, some taxpayers amend their returns to correct an error in the government's favor and claim a refund. By contrast, especially where the three-year statute of limitations set forth in 26 U.S.C. § 6501(a) is about to expire, a taxpayer whose erroneous return underreported income due to an honest mistake may reasonably conclude that the benefit of curing that innocent mistake and paying the additional tax (with interest) is insufficient to justify the time, expense and risk associated with extending the limitations period.

The decision to file an amended return is more complicated when the taxpayer intentionally underreported income (or overstated deductions) on the original return. In such a situation, deciding whether to file amended tax returns requires consideration of the possible ramifications on any current or future criminal investigation or prosecution.

Where the taxpayer seeks advice before IRS agents are on the scene, there is an opportunity to mitigate the risk of a criminal prosecution either by making a formal voluntary disclosure or by quietly amending the problematic returns. Through the voluntary disclosure program, taxpayers who come forward before the IRS learns of their misconduct can obtain substantial (but not absolute) certainty that they will not be subject to criminal prosecution, albeit at a substantial (and certain) financial cost. Under current guidelines, taxpayers making a voluntary disclosure are required to amend six years of tax returns, and to pay back taxes, interest and a 75% fraud penalty for the year with the highest tax liability over the six-year period. See *Internal Revenue Service*: Memorandum for Division Commissioners, Chief, Criminal Division, *Updated Voluntary Disclosure Practice* (November 20, 2018) available at https://www.irs.gov/pub/foia/ig/spder/lbi-09-1118-014.pdf.

Because an amended return filed with the IRS is sworn under penalties of perjury, it must be complete and accurate, and a client cannot amend a tax return to correct one error on the originally filed return without curing all such errors.

In many cases, making a quiet disclosure may be tempting since historically IRS-CI has not pursued criminal charges against taxpayers who amend their returns before they are under investigation. Thus, some clients may prefer the quiet disclosure route from an economic perspective since they might "run lucky" and avoid imposition of the civil fraud penalty. However, if the taxpayer and the professional are wrong about the IRS's state of knowledge or the pendency of an investigation, the amended tax return filed outside the voluntary disclosure program will simply provide an admission that the original return was false, leaving the defendant's awareness of the errors as the sole issue to be contested in a criminal prosecution.

Additionally, in *Badaracco v. Commissioner*, 464 U.S. 386, 393 (1984), the U.S. Supreme Court held that an amended return did not start the running of the statute of limitations when the original return was fraudulent. Thus, because the civil statute of limitations does not run where the IRS establishes that the taxpayer has engaged in fraud, see 26 U.S.C. § 6501(c)(1), amending a fraudulent tax return as part of a quiet disclosure subjects the taxpayer to substantial (and indefinite) financial exposure for penalties.

Conclusion

While there is no legal obligation to amend a tax return, there are often good reasons for taxpayers to do so. However, because the decision to amend is generally made with imperfect information regarding the government's awareness of the misconduct, especially where the errors on the initial return expose the taxpayer to criminal charges, care must be taken in deciding whether the benefits of amending returns warrant the risk of making admissions that could color any subsequent prosecution. Finally, because an amended return filed with the IRS is sworn under penalties of perjury, it must be complete and accurate, and a client cannot amend a tax return to correct one error on the originally filed return without curing all such errors.

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