

## Tax Returns: To Amend or Not to Amend?

by Robert W. Wood



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In this article, Wood examines the factors that taxpayers should weigh when considering whether to file amended tax returns.

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Do taxpayers have an obligation to file amended tax returns to correct prior reporting errors they discover? Even if there is no requirement to file amended returns, should taxpayers file them for strategic or other reasons? Does it depend on the years involved, the size or number of the errors, or if taxpayers are under audit?

Does it matter how the error came to light, when you discovered it, or even what you knew or should have known when you filed your original return? These sound like fundamental tax questions on which everyone would agree. But if you ask tax practitioners, you might get a mix of responses.

It may seem surprising that there is no explicit requirement in the IRC, regulations, or case law

providing that a taxpayer must file an amended tax return upon discovering a reporting error. The IRS tends to use the word “should” when describing circumstances in which an amended return is indicated.

Amended returns are mentioned in the regulations and the code.<sup>1</sup> But the ability and even the wisdom of filing amended tax returns is not the same thing as a legal duty. The Supreme Court has held that “none of these provisions, however, requires the filing of [an amended return].”<sup>2</sup>

Tax returns, whether original or amended, must contain and be verified by a written declaration that is made under penalties of perjury.<sup>3</sup> If a taxpayer submits a return without the executed penalties of perjury statement, that return is a nullity.<sup>4</sup>

Even altering the perjury wording — which many taxpayers have tried — can spoil the return completely. The IRS takes the perjury legend seriously, as does the tax law. If taxpayers do not believe their tax returns to be true and correct in every material matter, they can be found guilty of a felony and may be fined up to \$100,000 and imprisoned for up to three years.<sup>5</sup>

As noted, the Supreme Court has held that there is no legal requirement to file an amended tax return.<sup>6</sup> Similarly, the Tax Court has held that taxpayers are not required to file an amended return even when an originally filed tax return is

<sup>1</sup> Reg. sections 301.6211-1(a), 301.6402-3(a), 1.461-1(a)(3)(i). Section 6213(g)(1).

<sup>2</sup> *Badaracco v. Commissioner*, 464 U.S. 386 (1984).

<sup>3</sup> Section 6065.

<sup>4</sup> *Beard v. Commissioner*, 82 T.C. 766, 777 (1984); *Hettig v. United States*, 845 F.2d 794 (8th Cir. 1988); *United States v. Moore*, 627 F.2d 830 (7th Cir. 1980); *Williams v. Commissioner*, 114 T.C. 136 (2000).

<sup>5</sup> Section 7206(1).

<sup>6</sup> *Badaracco*, 464 U.S. at 397. See also *LPCiminelli Interests Inc. v. United States*, No. 1:09-cv-00274, at 8 (W.D.N.Y. 2012).

discovered to be incorrect. The failure to file an amended return in this context does not, by itself, establish an intent to evade tax.<sup>7</sup>

On the other hand, when it comes to serious errors that might look criminal, one useful guide is to ask how the error happened and what the taxpayer knew when he filed the original return. Was the error discovered later by the taxpayer, an accountant, or someone else? Did the taxpayer believe the tax return was true, correct, and complete when he filed it?

If the taxpayer believed the tax return was correct when filed, the need to file an amended return is clearly reduced. Mistakes happen, and the fact that the taxpayer believed the tax return was correct when he signed and filed it should obviate bad intent. But what about the reverse? There is exposure — even potential criminal exposure — if the taxpayer knew the return was inaccurate when he signed and filed it.

In that event, you might assume that all signs would point to the wisdom of amending the return to correct the errors. That is often true, although it is not always so clear. For example, does filing an amended return that differs materially from the original return serve to admit that the original return was false? These are the kinds of issues that necessitate specialty tax counsel to consider the specific facts and circumstances facing the client.

An original return that reported \$100,000 of income might look odd next to an amended return reporting \$3.1 million of income. Even that wild disparity might be explained if the taxpayer believed the \$3 million was a loan, the advance on a prepaid variable forward contract, or some other nontaxable item. The details matter, and so do the timing and context.

A taxpayer who, after filing his return, realizes that he should have reported additional income should in most cases amend and report it. But what if the taxpayer is already under audit or even under criminal investigation? Amending is still worth discussing, but the amendment may turn out to be used against the taxpayer, in effect as an admission. Thoughtful professional tax advice about the nature of the error, the nature of

the taxpayer, and the attendant circumstances is a good idea.

### No Cherry-Picking

What about the scope of the amendment? Can you just fix one error — maybe one in your favor? No. You don't have to file an amended return, but if you do, you must correct everything. This is the IRS's version of "in for a penny, in for a pound." You can't cherry-pick and make only those corrections that get money back but not those that increase your tax liability.

*Example:* You file your original return and believe it to be accurate. Six months later, after you've already received the \$3,600 refund you claimed, you discover you forgot to report a stock loss that would have netted you an additional \$1,000. You also discover that you underreported your earnings from a partnership because you just received an amended Form K-1 saying that instead of the \$50,000 of income you reported (from the first Form K-1), your share of the income was actually \$150,000. If you amend, you must correct both errors, not just the one in your favor. If you don't amend, the IRS may send you a bill based on the revised Form K-1 the partnership sent you.

### Math and Other Errors

Some errors do not merit an amended return. Math errors are not a reason to file an amended return because the IRS will correct them. Likewise, you usually shouldn't file an amended return if you discover you omitted a Form W-2, forgot to attach the necessary schedules, or experienced other glitches of that sort. The IRS may process your return without them or will request them if needed.

There are certain parts of your original return that you cannot change with an amended return. You can change your filing status on an amended return from married filing separately to jointly, or from qualifying widow(er) to head of household filing status. However, you cannot change from married filing jointly to married filing separately after the due date for the original return has passed.

<sup>7</sup> *Broadhead v. Commissioner*, T.C. Memo. 1955-328.

## Ethical Issues

There can be ethical issues for tax lawyers, accountants, and other tax practitioners. What if an adviser counsels a client to file an amended tax return and the client resists? The applicable portion of the regulations known as Circular 230 does not affirmatively require correction of the noncompliance, error, or omission, nor does it require the tax professional to disengage from a client who refuses to make the correction. Ultimately, the decision to file an amended return is made at the client's discretion.

## IRS Statute of Limitations

Although filing an amended tax return is not legally required, it can be a wise strategic decision in many cases, and timing is always relevant. You can generally amend tax returns within three years of your original filing. If you are asking for money back, with an amended return that reports a smaller tax due than the original return, that three years is inflexible.

On the other hand, if you are reporting more income than you did on your original return and are therefore paying additional taxes, the IRS may accept the amended return and your additional payment. Sometimes, though, if you are trying to amend beyond the first three years and even though you are sending the IRS money, the IRS will reject it. I am not aware of whether there is a way to predict when the IRS will accept or reject the payment.

In general, the IRS has a three-year statute of limitations within which to audit, and that period begins upon the filing of the original return.<sup>8</sup> But there are many types of income, types of errors, and factual circumstances that give the IRS six years to audit.

For example, the statute is six years if your return includes a substantial understatement of income. Generally, this means you have omitted more than 25 percent of your gross income.

Suppose that you earned \$200,000 but reported only \$140,000. You omitted more than 25 percent, so you can be audited for six years. How about a big overstatement of your tax basis in an

asset that you sold? Is that the same as an omission of income? The IRS has long argued that it is the same thing because you effectively omitted income.

However, in *Home Concrete*,<sup>9</sup> the Supreme Court held against the IRS, ruling that overstating basis is not the same thing as omitting income. Shortly thereafter, Congress overrode the Supreme Court and gave the IRS six years to audit in those cases, so that is the current law. Other situations also give the IRS six years to audit.

Take offshore accounts. The usual three years is doubled if you omitted more than \$5,000 of foreign income (say, interest on an overseas account) from your return. Forms concerning foreign assets and foreign gifts or inheritances are important long after six years. For example, if you receive a gift or inheritance of more than \$100,000 from a non-U.S. person, you must file IRS Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." If you fail to file it, the IRS statute of limitations never starts to run.

And don't forget about the Foreign Account Tax Compliance Act, which became law in 2010 and mostly took effect in 2015. Form 8938, "Statement of Specified Foreign Financial Assets," was added to the tax law by FATCA. Form 8938 requires U.S. filers to disclose the details of foreign financial accounts and assets over specific thresholds. This form is separate from the foreign bank account reporting requirements and is normally filed with your tax return. The threshold for disclosure can be as low as \$50,000, so it pays to check out the filing requirements for your situation.

If you are required to file Form 8938 and you omit it, the IRS statute of limitations never starts to run. If you own part of a foreign corporation, it can trigger extra reporting requirements, including filing a Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations," to disclose, among other things, information about who owns the corporation's stock. If you fail to file a required Form 5471, your entire tax return remains open for audit indefinitely. The IRS can make adjustments to

<sup>8</sup>Section 6501(a).

<sup>9</sup>*United States v. Home Concrete & Supply LLC*, 132 S. Ct. 1836 (2012).

your entire tax return until the required Form 5471 is filed. You can think of a Form 5471 as a bit like the signature on your tax return.

### Fraudulent Returns

If a tax return is fraudulent, the statute of limitations is extended indefinitely.<sup>10</sup> And while an amended return can make sense, filing an amended return does not cure the fraudulent original tax return for purposes of assessments and penalties.<sup>11</sup> Once fraud is committed by the filing of an original return, the offense is complete.<sup>12</sup> Some courts have considered the conduct of the accountant who prepared the tax return, rather than the taxpayer, for determining whether the statute of limitations is extended indefinitely for fraud.<sup>13</sup> Notably, section 6501(c)(1) focuses on the fraudulent nature of the return and not the identity of the perpetrator of the fraud.<sup>14</sup>

If the misstatements or omissions look major, filing an amended return is something that most advisers would likely recommend. Trying to correct something that you know is wrong demonstrates good faith. But as mentioned earlier, some thought should be given to whether the amendment could be viewed as an admission about the original return. That brings us to our next quirky rule, which applies to what is known as a qualified amended return (QAR).

### Qualified Amended Return

A QAR is an amended return filed after the return due date for the prior tax year and before the earliest of<sup>15</sup>:

- the date the taxpayer is first contacted by the IRS regarding an examination or criminal investigation concerning the return;
- the date any person is first contacted by the IRS concerning an examination of a listed transaction or reportable transaction;

- the date a passthrough entity is first contacted by the IRS in connection with an examination of the return to which the passthrough item relates;
- the date a John Doe summons is served on a third party for an activity of the taxpayer's for which the taxpayer directly or indirectly claimed a tax benefit; and
- the date on which the IRS announces by revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin, a settlement initiative to waive or compromise penalties for a listed transaction.

Any taxpayer looking at these rules and facing any of the circumstances that trigger them should get professional tax advice. As you would expect, the option to eliminate an underpayment by filing a QAR is unavailable when the position taken on the Form 1040 was fraudulent.<sup>16</sup>

How do these situations unfold in real life? One setting involves a tax return preparer who is under civil or criminal investigation by the IRS. A taxpayer who is told in an interview or otherwise that their return preparer is under investigation is likely to be worried about their own liability — civil or criminal. If a reexamination of the individual's tax returns reveals something significantly amiss, the taxpayer may want to explore filing QARs.

By filing QARs for previous tax years, the taxpayer may be able to avoid accuracy-related penalties before the IRS begins an investigation.<sup>17</sup> What if the matter is very serious? For example, suppose a grand jury subpoena is issued to the taxpayer to produce all records and documents relating to her accountant. The principal function of a grand jury is an investigation before determining whether an indictment should be filed.<sup>18</sup>

The Tax Division of the U.S. attorney's office must first approve and authorize the use of a grand jury to investigate criminal tax violations.<sup>19</sup>

<sup>10</sup> Section 6501(c)(1).

<sup>11</sup> *Badaracco*, 464 U.S. at 394. See *Brown v. Commissioner*, T.C. Memo. 1996-416, at 5. See also *Potter v. Commissioner*, T.C. Memo. 2014-18, at 5; and *Hartman v. Commissioner*, T.C. Memo. 2008-124, at 41.

<sup>12</sup> *United States v. Habig*, 390 U.S. 222 (1968).

<sup>13</sup> *Allen v. Commissioner*, 128 T.C. 37, 42 (2007).

<sup>14</sup> *Id.* at 40.

<sup>15</sup> Reg. section 1.6664-2(c)(3).

<sup>16</sup> Reg. section 1.6664-2(c)(2).

<sup>17</sup> T.D. 9186, Preamble, Background.

<sup>18</sup> *Costello v. United States*, 350 U.S. 359, 362 (1956).

<sup>19</sup> U.S. Attorney's Manual, Title 6, Criminal Tax Procedures section 6-4.120.



The IRS Criminal Investigation division can request to authorize a grand jury investigation to further a criminal investigation.<sup>20</sup> In some cases, there can be lines drawn with QARs. For example, suppose that there is a criminal investigation of the taxpayer's returns already underway when the taxpayer files QARs. In that event, the IRS will consider only the original return for purposes of the deficiency, penalties, and reasonable cause analysis, and not the QAR.<sup>21</sup> There appears to be no authority that directly addresses whether an investigation of the taxpayer's return preparer disqualifies the taxpayer from filing a QAR under the regulations.

However, there is case law in which a criminal investigation of the taxpayers' accountants concluded with an indictment of the accountants and a guilty plea. The taxpayers chose to file amended returns to remove the erroneous deductions after the criminal investigation of the accountants concluded but before the civil audit began.

For example, in *Ericksen*,<sup>22</sup> there was an IRS criminal investigation of the Kern Weyn Associates Inc. accounting firm and its two accountants, Curt Redinger and James Kern. Kern Weyn Associates falsified multiple above-the-line and itemized deductions for thousands of taxpayers annually.<sup>23</sup> The IRS executed a search warrant at the firm's offices and seized all individual tax returns and work papers.<sup>24</sup> Criminal informations were filed by the U.S. attorney's office against Kern and Redinger.<sup>25</sup>

They both pleaded guilty to one count of aiding and assisting in the preparation of a false federal income tax return and listed 85 returns as part of their guilty plea.<sup>26</sup> Kern and Redinger also

disclosed partial client lists to the government.<sup>27</sup> After the criminal cases against Kern and Redinger, IRS CI referred more than 200 federal income tax returns to the IRS civil division for examination.<sup>28</sup> The IRS audited between 130 and 150 individual returns.<sup>29</sup>

The court noted that some of the individuals whose returns were referred to the IRS civil division were able to amend their tax returns to remove falsely claimed deductions.<sup>30</sup> The petitioners in *Ericksen* did not amend their returns and were assessed penalties based on the erroneous prior returns.

There is additional case law suggesting that taxpayers can file amended returns even after a criminal investigation of their accountants has concluded.<sup>31</sup> However, the IRS is not required to accept amended returns.<sup>32</sup> Even if it was the return preparer at fault and not the taxpayer, the IRS can assess costly penalties against taxpayers who do not amend their returns to report the additional income. When an accountant falsifies returns, the IRS does not assess fraud penalties against the taxpayers (because they are, in effect, victims) and has only assessed accuracy-related penalties.

## Conclusion

Amended tax returns are a big and important topic, and there are additional elements not covered here. In general, there is no requirement or obligation to amend a prior tax return when a taxpayer discovers a post-filing error. But as the IRS says, taxpayers often should file amended returns. Most are filed the usual way, to correct an error, report additional income, delete an inappropriate deduction, or even ask for a refund.

<sup>20</sup> *Id.* at section 6-4.121.

<sup>21</sup> *Perrah v. Commissioner*, T.C. Memo. 2002-283 (Tax Court rejected QAR status because the Forms 1040X were filed with the IRS after it commenced an examination. Reasonable cause analysis is focused on the taxpayer's actions when the original return was filed, not the corrective actions taken after being notified of the IRS audit). See *Wilkerson v. Commissioner*, T.C. Summ. Op. 2004-99 (Tax Court refused to classify Forms 1040X as QARs when the taxpayer filed them with the Appeals Office after the IRS had issued a notice of deficiency).

<sup>22</sup> *Ericksen v. Commissioner*, T.C. Memo. 2012-194.

<sup>23</sup> *Id.* at 49.

<sup>24</sup> *Id.* at 48.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 49.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Finnegan v. Commissioner*, T.C. Memo. 2016-118 (Taxpayer's accountant was prosecuted and pleaded guilty to falsifying his tax returns. Taxpayer was interviewed by IRS CI and provided the tax returns and related workpapers. The taxpayer could have filed an amended return because his returns were not yet under audit.); *Allen*, 128 T.C. 37.

<sup>32</sup> *Badaracco*, 464 U.S. at 393 (holding that an amended return is a creature of administrative origin and grace); *Goldring v. Commissioner*, 20 T.C. 79, 81 (1953) (holding that the acceptance or rejection of an amended return is solely within the discretion of the commissioner).

It is often said that amended tax returns are more likely to be examined than initial returns. In the case of an amended return that asks for a big refund, that is particularly true. For example, suppose that your original return reports a large item as ordinary income. Then, your amended return claims that it was a long-term capital gain and requests a refund. That amendment is more likely to attract attention than if the original return had reported the item as a capital gain in the first place. As you think about amended returns, it is a useful paradigm to keep in mind.