

1997

Rethinking Imposition of a Legal Duty to Correct Material Tax Return Errors

Judson L. Temple

Oklahoma City University School of Law

Follow this and additional works at: <https://digitalcommons.unl.edu/nlr>

Recommended Citation

Judson L. Temple, *Rethinking Imposition of a Legal Duty to Correct Material Tax Return Errors*, 76 Neb. L. Rev. (1997)

Available at: <https://digitalcommons.unl.edu/nlr/vol76/iss2/2>

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in Nebraska Law Review by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.

Rethinking Imposition of a Legal Duty to Correct Material Tax Return Errors

TABLE OF CONTENTS

I. Introduction	225
A. Propriety of a Duty to Correct Material Tax Return Errors	225
B. Penalty Structure and Statutes of Limitations	226
C. Article Organization	227
II. Merits of an Amended Return Obligation	228
A. Current Lack of a Duty to Correct Tax Return Errors	228
B. Justifications for Requiring Taxpayer Correction of Material Errors	231
C. Constitutional Barriers to an Amended Return Obligation	234
III. Definition of a Proposed Amended Return Obligation ..	235
A. Definition of “Error”	236
1. Return Positions Less Likely than Not to Prevail	236
2. Retroactive Changes in the Law	238
B. “Materiality” Defined	239
1. Basic Definition	239
2. “Materiality” of Multiple Errors	240
3. “Materiality” of Errors with No Impact on Tax Liability	240
C. Taxpayer’s “Knowledge” of an Error and a Duty to Investigate	241
IV. Amended Return Obligation and the Penalty Structure	243
A. Current Penalty Structure	243

© Copyright held by the NEBRASKA LAW REVIEW.

* Professor, Oklahoma City University School of Law. The author wishes to thank Professor Eric T. Laity and Shirley A. Cox, a former legal research and writing instructor, for their comments on an earlier draft of this Article.

B.	Penalties: A Normative Approach	245
1.	Parity Structure Defined	245
2.	Existing Penalties Contrasted with a Parity Structure	247
C.	Penalty Recommendations: Obligatory Amended Returns Filed	248
1.	Abrogation of Penalty Exposure for Nonfraudulent Errors Voluntarily Corrected	248
2.	Nonabrogation of Penalty Exposure for Fraudulent Errors	249
a.	Immunization from Fraud Penalties Undermining the Duty to File a Correct Return	250
b.	Lesser Appeal of Relief for Taxpayers Committing Fraud	250
c.	Fraud Penalty Relief Unlikely to Enhance Tax Compliance	251
d.	Difficulty of Formulating a Workable Rule that Waives Criminal Fraud Penalties	251
3.	Countervailing Considerations	253
a.	Fairness of Compelling Taxpayers to Provide Evidence of Fraudulent Conduct	254
b.	Inhibiting Effect on Taxpayers Who Fear Innocent Errors Will Be Treated as Fraudulent	256
D.	Penalty Recommendations: Breaches of a Duty to Amend	257
1.	A Parity Structure Favored	258
2.	No Double Penalty	261
3.	Reasonable Opportunity to Comply with a Duty to Amend	261
V.	Amended Return Obligation and Statutes of Limitations	263
A.	Current Statutes of Limitations	263
B.	Limitations Periods: A Normative Approach	265
C.	Limitations Period Recommendations	265
1.	Nonfraudulent Original Returns	266
2.	Fraudulent Original Returns	268
VI.	Conclusions	270

I. INTRODUCTION

A. Propriety of a Duty to Correct Material Tax Return Errors

A lingering oddity of the procedural rules governing federal taxation is the failure of those rules to unambiguously require a taxpayer who discovers she has materially understated her federal tax liability on her federal tax return to file an amended return correcting the errors, assuming the errors are discovered before expiration of the limitations period for the taxable year to which the return relates.¹ The propriety of a duty to file an amended return might seem to follow from a federal tax system that imposes upon the taxpayer, not the government, the burden of making a correct determination of tax liability.²

Only two reasons seem to excuse the taxpayer's failure to correct an error on an amended return if the taxpayer discovers the error within the period of limitations. First, the error might be *de minimis* (not material) so that its correction is not worth the taxpayer's time, trouble, or expense. Second, the taxpayer's discovery of the error might be so recent that the taxpayer has not yet had a reasonable amount of time to discharge her obligation to correct the error.

If this analysis is correct, any duty to amend must be properly circumscribed. The duty should be limited to "material" errors, with ma-

1. The creation of a legal duty to file amended returns has been controversial. See James A. Bruton, III, *Correcting (Or Not Correcting) Erroneous Tax Returns*, 47 INSR. ON FED. TAX'N § 53.03, at 53-7 n.16 (1989)(stating that a legal duty is favored by the Committee on Standards of Practice of the American Bar Association Tax Section, but disfavored by the Committee on Civil and Criminal Penalties of the American Bar Association Tax Section). A legal duty was recommended in a preliminary draft on civil penalties by the IRS. EXECUTIVE TASK FORCE, COMMISSIONER'S PENALTY STUDY, INTERNAL REVENUE SERV., REPORT ON CIVIL TAX PENALTIES (Working Draft, Chapters 1-4, 8)(1988), *microformed on* Doc. 88-9517, ch. 8, at 33 (Tax Notes Microfiche Database)[hereinafter Working Draft]. This recommendation was replaced in the final report by a recommendation that a comprehensive study be conducted. EXECUTIVE TASK FORCE, COMMISSIONER'S PENALTY STUDY, INTERNAL REVENUE SERV., REPORT ON CIVIL TAX PENALTIES (1989), *microformed on* Doc. 89-1586, at VIII-45 to -46 [hereinafter IRS Penalty Study]. See also Bruton, *supra*, § 53.03, at 53-7 n.17, 53-8 nn.18-19.

Commentators also have expressed divergent positions. A legal duty seemed to be generally favored (largely on equitable grounds) by Kenneth L. Harris, *On Requiring the Correction of Error Under the Federal Tax Law*, 42 TAX LAW. 515 (1989), but its wisdom questioned (largely because of practitioners' experience that the "existing system works well" and that a formal rule "would simplify the process to the point of rigidity") by Bruton, *supra*, § 53.10, at 53-45.

2. Although it is sometimes said that the taxpayer *self-assesses* her tax liability, technically the taxpayer determines and reports the tax due. I.R.C. § 6001 (1996). The Internal Revenue Service *assesses* tax liability based on information provided by the taxpayer and other information available to the IRS. I.R.C. §§ 6201-6207 (1996).

teriality defined to enable a taxpayer to determine whether or not an error is material. Errors, the net effect of which entitle the taxpayer to a refund of taxes paid, normally should not give rise to a legal obligation to amend. The taxpayer's self-interest in not overpaying her federal taxes should sufficiently assure that the taxpayer will file an amended return whenever the refund involved justifies the taxpayer's time, trouble, and expense of filing a corrected return.

Further, noncompliance with a duty to amend should not be penalizable until the expiration of a reasonable amount of time to comply with the duty, an amount of time that must be statutorily defined. No duty to amend can follow if discovery of the error occurs after expiration of the limitations period for the taxable year to which the error relates. A duty to amend is predicated upon the existence of an unpaid tax. Once the statute of limitations expires, the unpaid tax is no longer a debt owed to the government. The taxpayer's duty to report additional tax must expire concomitantly with the government's ability to assess and collect it.

This Article examines the law's failure to require taxpayers to correct material understatements of their tax liabilities and the consequences of this failure, and recommends enactment of a legal duty to amend. This Article suggests a definition of the legal duty to amend that assures that the duty is properly circumscribed.

A duty to amend might (or might not) be accompanied by a correlative duty to investigate. If imposed, the duty to investigate would be applicable when the taxpayer reasonably suspects that a material reporting error may have been committed and would be undertaken to determine whether in fact an amended return is required. This Article supports extending the duty to amend to incorporate a correlative duty to investigate in appropriate circumstances and identifies circumstances that would give rise to the duty to investigate. It is recognized, however, that a viable tax compliance system might include a duty to correct *known* material understatements of tax liability without requiring the taxpayer to investigate possible, but unconfirmed reporting errors.³

B. Penalty Structure and Statutes of Limitations

The enactment of a legal duty to amend raises a number of questions concerning the relationship between the duty to amend and applicable penalties or statutes of limitations. What effect should the taxpayer's corrected amended return have on penalties otherwise applicable to the erroneous original return? What penalties should be applicable if the taxpayer fails to comply with a duty to file an amended return? What effect, if any, should filing an amended return

3. See *infra* section III.C.

have on the statute of limitations for the taxable year at issue? What effect, if any, should failure to file an amended return have on the statute of limitations for the taxable year at issue?

There is a complete spectrum of possible answers to these questions. The approach favored in this Article proceeds from the observation that enactment of a legal duty to amend would subject the taxpayer to a continuous, ongoing duty to correctly report tax liability. The duty would begin with the due date of the original return and would end with the expiration of the period of limitations for the assessment of tax for the taxable year.

This Article argues that, if a legal duty to amend is enacted, a taxpayer culpably committing or perpetuating a reporting error generally should face the same exposure to penalty whether the culpable behavior occurs at the time of filing of the original return or at some later date within the limitations period. Similarly, a taxpayer voluntarily correcting a reporting error generally (but not always) should enjoy the same mitigated (or eliminated) exposure to penalty whether the error is caught and corrected before the original return is filed or at some later date within the limitations period.

Under current law, the limitations period within which the Internal Revenue Service may assess additional tax generally depends on the magnitude and culpability of the taxpayer's reporting errors. This Article argues that if a legal duty to amend is enacted, a taxpayer culpably committing or perpetuating a reporting error generally should face the same duration of exposure to an IRS audit whether the culpable behavior occurs at the time of filing of the original return or at some later date within the limitations period. Similarly, a taxpayer correcting a reporting error generally (but not always) should enjoy the same reduced duration of exposure to an IRS audit whether the error is caught and corrected before the original return is filed or at some later date within the limitations period.

It is important to realize that although adoption of a legal duty to correct tax return errors raises questions about the penalty structure and applicable statutes of limitations that will best accommodate the duty, any debate about these questions is not a debate about the propriety of adoption of a legal duty to amend. Instead, penalty issues and limitations period issues are subsidiary issues to be resolved once it is determined that adoption of a legal duty to amend is appropriate. This is so even though tax compliance clearly is impacted not only by adoption of a duty to amend, but also by the choices of appropriate penalties and accompanying limitations periods.

C. Article Organization

Part II of this Article examines the law's failure to require correction of material tax return errors, the consequences of this failure, and

the merits of an amended return obligation. The conclusion endorses the promulgation of a rule requiring taxpayers to correct material reporting errors by amending erroneous tax returns. Part III examines the definitional problems engendered by such a rule and suggests a resolution of these problems. Part IV recommends a penalty structure applicable to both original return errors corrected by timely amended returns and breaches of the duty to amend. Part V recommends a statutes of limitations structure that is applicable to both original return errors corrected by amended returns and breaches of the duty to amend. Part VI summarizes the major conclusions and recommendations.

II. MERITS OF AN AMENDED RETURN OBLIGATION

A. Current Lack of a Duty to Correct Tax Return Errors

The procedural provisions of the Internal Revenue Code⁴ (the Code) require taxpayers with sufficient income to file a return,⁵ impose filing deadlines on taxpayers,⁶ and specify penalties for failure to file correctly or failure to pay taxes.⁷ These provisions, however, generally do not refer to amended returns.⁸ Instead, the Code generally contemplates only the filing of a single return.⁹ The failure of the statutory framework to incorporate a role for amended returns was recognized in *Hillsboro National Bank v. Commissioner*,¹⁰ subsequently cited in *Badaracco v. Commissioner*.¹¹ *Badaracco* held that an amended return did not commence the running of the statute of limitations when the original return was fraudulent. The Court acknowledged the statutory nonrecognition accorded an amended return:

[T]he Internal Revenue Code does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return; instead, an amended return is a creature of administrative origin and grace. Thus, when Congress provided for assessment at any time in the case of a false or fraudulent "return," it plainly included by this language a false or fraudulent original return.¹²

4. Unless otherwise specified, all references to sections of the Internal Revenue Code are to the provisions of the Code as amended through November 4, 1997.

5. I.R.C. § 6012.

6. *Id.* §§ 6071-6081.

7. *Id.* §§ 6651-6724.

8. 4 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 111.1.7, at 111-12 n.54 (2d ed. 1992).

9. I.R.C. § 6213(g) (including amended returns as "returns" for tax assessment purposes). This section is the Code's only reference to amended returns, although the term appears in the caption to I.R.C. § 6501(c)(7) (extending by 60 days the limitations period for the assessment of tax shown on a return filed within 60 days of the date the limitations period would otherwise expire).

10. 460 U.S. 370, 378-80 n.10 (1983).

11. 464 U.S. 386, 393 (1984).

12. *Id.*

Treasury regulations permit the filing of amended returns for purposes of correcting errors and making or changing various tax elections.¹³ The regulations do not, however, impose a duty on taxpayers to file amended returns.¹⁴ Treasury regulations provide that if a taxpayer "ascertains" that income was improperly omitted from a prior year's return, the taxpayer "should, if within the period of limitation," file a corrected amended return and pay any additional tax due.¹⁵ If the taxpayer "ascertains" that an item was improperly included in income on a prior year's return, the taxpayer "should, if within the period of limitation," file a claim for credit or refund of any resulting tax overpayment.¹⁶ Similarly, Treasury regulations provide that if a taxpayer "ascertains" that a liability was improperly omitted from a prior year's return, the taxpayer "should, if within the period of limitation," file a claim for credit or refund of any resulting tax overpayment.¹⁷ If the taxpayer "ascertains" that a liability was improperly claimed on a prior year's return, the taxpayer "should, if within the period of limitation," file a corrected amended return and pay any additional tax due.¹⁸ Thus, the Treasury regulations encourage, but do not require, the correction of tax return errors.¹⁹

Because a taxpayer has no duty to correct material reporting errors, a taxpayer's exposure to penalties generally is not worsened by

-
13. For an analysis of the varying uses of amended returns predating the United States Supreme Court's decision in *Badaracco*, see Susan L. Brennan, *The Uncertain Status of Amended Tax Returns: Their Varying Impact on Tax Deficiencies, Tax Elections, and the Statute of Limitations on Civil Tax Fraud*, 7 REV. TAX'N INDIVIDUALS 235 (1983).
 14. The Secretary of the Treasury is granted the authority to require taxpayers to file returns. I.R.C. § 6011(a). It is unclear, in light of *Badaracco*, whether the Secretary has general authority to require filing of amended returns to correct original return errors. See BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE § 207.4.1, at 104 (1997)(stating that the Secretary "may arguably" possess such authority); Harris, *supra* note 1, at 516 (expressing similar uncertainty). Clearly, however, modifying statutory penalties and limitations periods to apply to the original return, as amended, in the manner suggested in this Article would require congressional action.
 15. Treas. Reg. § 1.451-1(a) (as amended in 1993)(emphasis added).
 16. *Id.* (emphasis added).
 17. Treas. Reg. § 1.461-1(a)(3) (as amended in 1994)(emphasis added).
 18. *Id.* (emphasis added).
 19. William L. Raby, *Amended Returns—Still an Undefined Solution*, 60 TAX NOTES 1617, 1618 (1993)("[A]s a rule of behavior, the word 'should' seems more aspirational than mandatory."); Joseph E. Ronan, Jr., *Do Clients Have a Duty to File Amended Tax Returns?*, 33 PRAC. LAW. 25, 26-27 (1987)("The use of 'should' rather than 'must' in those regulations would appear to indicate a precatory, and not a mandatory, provision, and can therefore be construed as imposing a form of 'moral duty' which can be disregarded by a taxpayer without legal consequences.").

her failure to correct reporting errors.²⁰ For example, in *Broadhead v. Commissioner*,²¹ an accountant responsible for preparation of the original return informed the taxpayer of an original return reporting error²² that led to a significant understatement of taxable income.²³ The accountant prepared an amended return and instructed the taxpayer to file it. The taxpayer refused to do so. The Tax Court rejected the IRS's imposition of a civil fraud penalty, holding that no duty existed to file an amended return and, if the taxpayer had submitted an amended return, the IRS could have rejected it.²⁴ The court found that the fraud penalty was appropriate only if the IRS could establish that the taxpayer acted with fraudulent intent when the original return was filed. Other cases have reached similar results.²⁵ Thus, whether tax return errors are innocent errors not subject to penalty, negligent errors subjecting the taxpayer to a negligence penalty, or fraudulent errors subjecting the taxpayer to penalties for fraud depends on the taxpayer's knowledge and behavior that led to the commission of the errors. The taxpayer's *postfiling* knowledge and behavior are irrelevant to the imposition of penalties except to the extent that proof of such knowledge or behavior sheds light on what the taxpayer must have known or done (or failed to do) when committing the errors.

Further, if the return error results in underpayment of tax, the taxpayer's refusal to amend the return and pay additional tax, without more, does not appear to be criminal tax evasion.²⁶ Nor does the

20. See John McGown, Jr., *Individuals Escape Penalties for Failure to Amend Incorrect Federal Income Tax Returns*, 24 IDAHO L. REV. 235, 244-46 (1988)(citing *Hauser v. Commissioner*, 29 T.C.M. (CCH) 908 (1970); *Broadhead v. Commissioner*, 14 T.C.M. (CCH) 1284 (1955)(holding that tax fraud must be established on the basis of conduct as of the time of filing the tax return, not on the basis of postfiling conduct), *aff'd*, 254 F.2d 169 (5th Cir. 1958); *Semple v. Commissioner*, 10 T.C.M. (CCH) 795 (1951)). McGown incorrectly states that *Broadhead* was reversed on other grounds by the Fifth Circuit. *Id.* at 245 n.51. But see *Estate of Maceo v. Commissioner*, 23 T.C.M. (CCH) 258 (1964), discussed by McGown, in which the taxpayer's filing of amended returns after the taxpayer was alerted to criminal investigation inquiries by a state agency was found to be "strong evidence of fraudulent intent on the *original* returns." McGown, *supra*, at 246 (emphasis added).

21. 14 T.C.M. (CCH) 1284 (1955), *aff'd*, 254 F.2d 169 (5th Cir. 1958).

22. The error was the fault of an assistant to the accountant and the taxpayer was "in no way responsible" for the error. *Id.* at 1287.

23. *Id.* (finding that taxable income was understated by \$54,872.81 because of the error).

24. *Id.* at 1289.

25. See cases cited *supra* note 20.

26. *Spies v. United States*, 317 U.S. 492, 498-500 (1943)(Tax evasion, a violation of I.R.C. § 7201, requires a willful "commission" to satisfy the statutory requirement that there be an "attempt." A willful "omission" of failing to file a required tax return and failing to pay taxes, without more, does not violate the statute.).

refusal constitute a willful failure to pay tax²⁷ because, without a duty to correct the filed report, there apparently is no failure to pay (willful or otherwise) until the government detects the error and demands payment.²⁸

Thus, the authors of a recent treatise note that case law supports the conclusion that the Code does not require the filing of amended returns.²⁹ Nevertheless, taxpayers often have substantial incentive to correct material reporting errors even though not legally compelled to do so. Presumably, many taxpayers will want to file amended returns simply to do the right thing.³⁰ Others may fear that a refusal to correct will be viewed as evidence that the original errors were knowingly and intentionally committed. Still others may wish to capitalize on current regulatory provisions that mitigate or eliminate the taxpayer's exposure to penalties if errors are corrected before commencement of an IRS audit.³¹

B. Justifications for Requiring Taxpayer Correction of Material Errors

The failure of tax procedural rules to explicitly require the correction of material errors leaves open an opportunity for tax avoidance that appears to be unnecessary, unfair, and not consonant with the duty imposed on taxpayers to initially determine and report their correct tax liabilities. When the opportunistic taxpayer asks her tax adviser whether she has a legal obligation to file an amended return, the adviser must answer, "No."³²

27. The willful failure to pay tax is a crime under I.R.C. § 7203.

28. See WOLFMAN ET AL., *supra* note 14, § 207.4.1, at 105 n.55.

29. *Id.* § 207.4.1, at 105.

30. *But see* Ronan, *supra* note 19, at 26 (stating that taxpayers "tend to resist" filing amended returns for the following reasons: the added cost and bother of doing so; reluctance to pay additional tax, interest, and possibly penalties; fear that an amended return will increase the chance of being audited; and concern that, if the amount underpaid is significant, an amended return might be treated as an admission of wrongdoing that will trigger a criminal investigation).

31. See *infra* subsections IV.C.1 and IV.C.2 (explaining taxpayers' decreased exposure to penalties for filing amended returns under current law in the context of a penalty structure recommended to accompany adoption of a legal duty to amend). See also WOLFMAN ET AL., *supra* note 14, § 207.4.1.1, at 106-07 (explaining the benefits to taxpayers from correcting tax return errors).

32. Professional codes of conduct require lawyers, accountants, and other tax return preparers to inform a client of an error on the tax return. WOLFMAN ET AL., *supra* note 14, § 207.4.2, at 107-08. The client normally is to be advised to correct the error, with the possible exception of an error exposing the client to criminal liability. *Id.* (comparing ABA Comm. on Professional Ethics, Formal Op. 314 (1965) (providing that a lawyer must advise the client to correct the error), with AMERICAN INST. OF CERTIFIED PUB. ACCT., STATEMENT ON RESPONSIBILITIES IN TAX PRACTICE No. 6, §.03 (Aug. 1988) (providing that a CPA should recommend to the client appropriate action to be taken), and Treasury Circular 230, 31 C.F.R.

This gap in the tax compliance rules is unnecessary because no undue complications stem from a statutorily imposed duty to file amended returns to correct material errors. The gap is unfair because it differentiates the tax reporting obligations of taxpayers with equal tax liabilities: taxpayers who either do not make errors or detect their errors before the return filing date, and taxpayers who detect their errors after the return filing date but within the period of limitations. Nor is the gap consonant with the concept of self-reporting, which forms the foundation of our tax compliance system. Self-reporting is rooted in the theory that taxpayers possess the information needed to accurately determine their tax liabilities and that the government neither possesses this information nor has the resources to acquire it for the masses of taxpayers. Indeed, placing upon the government the obligation to detect errors of which taxpayers already are aware seems to invite greater governmental intrusion into the private affairs of taxpayers than is necessary.³³ Altogether, little or no justification exists for waiving the taxpayer's obligation to report a significant tax that the taxpayer knows to be a debt owed to the government.³⁴

It seems safe to assume that taxpayers, although not required to do so, generally will take the time and trouble to correct material errors that were made in favor of the government when the correction entitles taxpayers to substantial refunds. The failure to require a taxpayer to correct material errors made in her own favor invites the taxpayer's participation in the "audit lottery."³⁵ This audit lottery may give the taxpayer a ninety-eight percent chance or better of not

§ 10.21 (1988)(stating only that a practitioner before the IRS must inform the client of the error)).

33. See Harris, *supra* note 1, at 529 ("The cost of shifting the discovery function to the government, in terms of intrusion into citizens' privacy, may . . . be substantial.").
34. The primary reason that an amended return proposal has been resisted by some professional groups is the concern that required amended returns might violate the Fifth Amendment's privilege against self-incrimination. See generally WOLFMAN ET AL., *supra* note 14, § 2.07.4.4, at 113-14 (citing resistance by the ABA Tax Section Committee on Civil and Criminal Penalties). Fifth Amendment concerns are discussed *infra* section II.C.
35. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 78-79 (3d ed. 1995)(An audit lottery participation is described as an "opening bid" philosophy adopted by "[m]any corporations and individuals" in which "every issue [is resolved] in favor of paying less, on the assumption that they will not be audited or that, if they are audited, the revenue agent will overlook or compromise certain issues. At worst, they will pay the taxes due plus interest."). See also WOLFMAN ET AL., *supra* note 14, § 201.2, at 45-47 (describing the audit lottery as an outgrowth of the questionable philosophy that a tax return is a submission in an adversarial proceeding); Judson L. Temple, *The Tax Return and the Standard of Accuracy—Part I*, 15 REV. TAX'N INDIVIDUALS 315, 324-25 (1991)(describing the audit lottery and the congressional response to it, which was in the form of a "substantial understatement" penalty under I.R.C. § 6661 (repealed 1989), and replaced in modified form by I.R.C. § 6662(b)(2)).

being audited,³⁶ therefore enabling the taxpayer to avoid forever payment of a tax known to be owing.

Unfortunately, the economic effects of enacting a legal duty to correct material tax return errors are unclear. The "gap" in the taxpayer's self-reporting obligations iterated above is not necessarily responsible for any meaningful portion of the "tax gap"—the gap between the federal income taxes owed and the federal income taxes actually collected. The tax gap is estimated at nearly one hundred billion dollars annually³⁷ and reflects both deliberate and inadvertent reporting errors. The contribution of the "gap" in taxpayers' reporting obligations to the "tax gap" depends upon the extent to which, if at all, the absence of a legal duty to correct material reporting errors results in more uncorrected errors and less tax revenue than otherwise would occur. The extent to which enactment of a legal duty to amend would alter taxpayers' reporting behavior cannot be predicted.

In the absence of empirical evidence, the effects of an amended return obligation on tax compliance must be gauged on the basis of more abstract reasoning.³⁸ It would seem, however, that taxpayers who are willing to defraud the government on their original returns would have little incentive to file corrected amended returns. Thus, an amended return obligation would be more likely to alter the behavior of taxpayers committing unintentional errors who (1) discover their errors within the period of limitations, (2) would not have bothered to correct the errors under current law, but (3) would bother if acquainted with a legal duty to correct.

This group may not be large. Assume that it is not large or that a legal duty to amend would not materially affect tax revenues *in the aggregate*. In this situation, the imposition of a legal duty still seems appropriate if, as is likely to be the case, the nuisance costs to the

36. *IRS Auditing More Poor People, Fewer Rich People, GAO Says*, 71 TAX NOTES 1212 (1996)(citing a General Accounting Office report of an audit rate of 1.67% for 1995).

37. George Guttman, *IRS Updates Estimates on Individual Tax Gap*, 71 TAX NOTES 857 (1996)(stating that for 1992, the last year for which estimates were available, the IRS estimated the income tax gap at between \$93.2 billion and \$95.3 billion, a range that excluded tax owed for illegal income (citing IRS Publication 1415, *Individual Income Tax Gap Estimates for 1985, 1988, and 1992* (Apr. 96))).

38. See Harris, *supra* note 1, at 532-34 (an amended return obligation holds up well when measured against five criteria used to analyze legislation designed to improve tax compliance: (1) increasing equity; (2) maximizing revenue; (3) minimizing the tax compliance burden on taxpayers and third parties; (4) increasing administrative efficiency; and (5) minimizing intrusion into the taxpayer's privacy). Harris suggested improvements to an obligatory amended return proposal drafted by Frederic G. Corneel for consideration by the ABA Section of Taxation. Frederic G. Corneel, *ABA Section of Taxation, Statutory Amended Return Proposal* (1985)[hereinafter Corneel Proposal], reprinted in Harris, *supra* note 1, app. at 559-75.

relatively small group of taxpayers whose tax compliance improves as the result of enactment of the legal duty are justified by both the additional revenue collected by the government from these taxpayers and the reduction in costs incurred by the IRS to audit these taxpayers.

To summarize, equitable considerations strongly countenance extension of the self-reporting duty to include a duty to correct material errors discovered within the period of limitations. This extension seems appropriate even if adoption of the duty results in insignificant aggregate revenue increases. The self-reporting obligation should not be an obligation that ends upon a tax return's due date. Instead, it should be an obligation that *begins* on the return's due date (although the taxpayer may discharge the obligation sooner by filing an early return) and *ends* at the expiration of the limitations period for the assessment of tax for the taxable year.

C. Constitutional Barriers to an Amended Return Obligation

The Fifth Amendment's privilege against self-incrimination has been touted as a barrier to the imposition of a legal duty to require corrected amended returns of individual taxpayers³⁹ who have criminally falsified information on original returns.⁴⁰ Analysis of relevant case law, however, leads to the opposite conclusion. Generally, the Fifth Amendment privilege must be claimed on the return itself and does not provide legal justification for failure to file a return.⁴¹ Further, laws requiring disclosure of potentially incriminating information have been declared unconstitutional only when the statutes themselves target a class of individuals "inherently suspect of criminal activities."⁴² A legal duty imposed on all taxpayers to correct material errors, whether those errors reflect deliberate noncompliance or

39. The privilege against self-incrimination extends to individuals, but not corporations or other collective entities. *Bellis v. United States*, 417 U.S. 85 (1974).

40. *Bruton*, *supra* note 1, § 53.06, at 53-21 n.73.

41. *Harris*, *supra* note 1, at 544 (citing *United States v. Sullivan*, 274 U.S. 259 (1927)). The Fifth Amendment privilege may be claimed on the return instead of reporting the source of the income if the income is derived from an illegal activity. It is unclear, however, whether the taxpayer may in some circumstances be excused from reporting the amount of the income. *Id.* at 544 n.120 (*contrasting United States v. Booher*, 641 F.2d 218, 220 (5th Cir. 1981)(requiring disclosure of the amount of the income), *with United States v. Paepke*, 550 F.2d 385, 394 (7th Cir. 1977)(Tone, J., concurring)(stating that the amount of income could be suppressed if it might be an incriminating factor)).

42. *Harris*, *supra* note 1, at 545 (citing *Marchetti v. United States*, 390 U.S. 39 (1968); *Grosso v. United States*, 390 U.S. 62 (1968); *Albertson v. Subversive Activities Control Bd.*, 382 U.S. 70 (1965)).

unintentional mistakes, would not target a suspect class and would appear to withstand constitutional challenge.⁴³

III. DEFINITION OF A PROPOSED AMENDED RETURN OBLIGATION

If the tax compliance structure is to include a legal obligation to correct material errors discovered within the limitations period, the legal obligation requires definition. It is necessary to define what constitutes an "error" that is subject to the obligation. Further, the definition of error must explain when the error is "material." It is also necessary to define when a taxpayer is to be charged with either "knowledge" of the error or the possibility of error that is sufficient to give rise to a duty to amend or a duty to investigate further.

43. As discussed *infra* subsections IV.C.1 and IV.C.2, it may be advisable to excuse penalties attributable to nonfraudulent return errors, while not excusing either civil or criminal penalties attributable to fraudulent errors when the taxpayer complies with a duty to file a timely amended return correcting these errors. This approach would discriminate against taxpayers who commit criminal (or civil) tax fraud on the original return by penalizing them more severely than taxpayers who commit nonfraudulent errors.

This discriminatory effect would have no constitutional implications. Criminal conduct typically is penalized more severely than conduct that (perhaps through an absence of the requisite *mens rea*) either is not criminal or is criminal conduct of a lesser degree. Thus, the discriminatory effect of more severe criminal sanctions does not breach citizens' constitutional rights.

The Fifth Amendment issue, across a broad spectrum of self-reporting statutes, is whether the self-reporting statutes serve a prosecutorial purpose by targeting a class of persons whose behavior is inherently criminally suspect. Harris, in a detailed analysis of the federal courts' interpretations of these statutes, concluded that a legal duty to file an amended return correcting material original return errors would not violate the Fifth Amendment's privilege against self-incrimination. Harris, *supra* note 1, at 545-49. In support of his conclusion, Professor Harris noted the following: (1) the duty to file an amended return would apply to taxpayers committing noncriminal original return errors as well as to taxpayers committing criminal errors; (2) the amended return obligation would have as its principal purpose the proper payment of federal taxes, not a prosecutorial purpose; (3) the amended return requirement would not establish any necessary linkage to prior criminal activity; and (4) the duty to amend would not create a different quandary for the taxpayer who criminally falsifies the original return than the quandary faced by a taxpayer who is required to report illegally-obtained income on the *original* return—the latter duty does not violate the Fifth Amendment's privilege against self-incrimination. *Id.* Each of these factors distinguishes a duty to correct material tax return errors from self-disclosure obligations that have been held to violate the Fifth Amendment privilege.

Thus, the contrary conclusion reached by Professor Bruton, *supra* note 1, § 53.06, at 53-21, seems wrong. Bruton concluded that "[a]lthough no court has decided the precise issue, it seems clear that taxpayers who have previously filed incorrect returns form a 'suspect class' who cannot be compelled to incriminate themselves by filing amended returns." *Id.*

A. Definition of "Error"

An error obviously must include any mathematical miscalculation and any reported position that is clearly wrong. The tax treatment of an item on the return—such as its exclusion from income, its deduction from income, or its credit against tax liability—presents a more difficult question: Should such tax treatment be described as an "error" if the position taken with respect to the item is probably wrong, but might be sustained if litigated?

1. Return Positions Less Likely than Not to Prevail

Whether the reporting position taken with respect to the item is an "error" should depend on whether or not the taxpayer is entitled to take that position on the original return. Section 6662, the Code's "accuracy-related penalty,"⁴⁴ sets forth the circumstances under which the taxpayer is entitled to claim a tax return position that is less likely than not to prevail if the matter is litigated.⁴⁵ If the taxpayer's reported position with respect to the item did not expose the taxpayer to either a possible § 6662 accuracy-related penalty or a § 6663 civil fraud penalty,⁴⁶ then the position taken would not be defined as an "error" even if the item ultimately was determined to be incorrectly reported. If the treatment of the item on the tax return exposed the taxpayer to either a possible § 6662 accuracy-related penalty or a § 6663 fraud penalty, then the position taken would be within the definition of an "error."⁴⁷

44. This language appears in the caption of I.R.C. § 6662.

45. Professor Johnson favors a reporting standard permitting only tax return positions that are "as-likely-as-not" to prevail, not positions "less-likely-than-not" to prevail. Calvin Johnson, *True and Correct: Standards for Tax Return Reporting*, 43 TAX NOTES 1521 (1989). See also Temple, *supra* note 35, at 316 ("The position advocated here is that taxpayers should be required to report uncertain items in the manner that is most probably correct.").

46. For a definition of civil fraud see *infra* note 73.

47. The American Institute of Certified Public Accountants [hereinafter AICPA] defines an error, for purposes of delineating responsibilities of the CPA, to include both (1) any undisclosed position taken on the return that the CPA does not have a "good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged," and (2) any "frivolous" position, even if disclosed. AMERICAN INST. OF CERTIFIED PUB. ACCT., STATEMENT ON RESPONSIBILITIES IN TAX PRACTICE NO. 2, § 112.02 (Aug. 1988)(revised May 1991), and AMERICAN INST. OF CERTIFIED PUB. ACCT., STATEMENT ON RESPONSIBILITIES IN TAX PRACTICE NO. 6, § 162.01 (Aug. 1988)(revised May 1991)[hereinafter AICPA STATEMENTS], reprinted in WOLFMAN ET AL., *supra* note 14, app. at 482-83, 496. This definition is tailored to I.R.C. § 6694, which penalizes *return preparers* for undisclosed positions for which there is no realistic possibility of success and for frivolous positions, whether or not disclosed, if the preparer knew or reasonably should have known of the positions.

The standards of I.R.C. §§ 6662 and 6663 (governing taxpayers) are phrased in language different than I.R.C. § 6694 (governing return preparers). While the

As so defined, an error would include any "frivolous" position, that is, any position that was "patently improper," since such positions always subject the taxpayer to a § 6662 penalty.⁴⁸ Indeed, any return position for which the taxpayer lacked a "reasonable basis" would be a negligent position and would subject the taxpayer to the § 6662(b)(1) negligence penalty.⁴⁹ This would constitute an error. If a position, other than a tax shelter position, was supported by "substantial authority,"⁵⁰ then it would not be an error since the position would not be penalizable under § 6662, even if the taxpayer's position was rejected in litigation.⁵¹

Similarly, a nonnegligent position, other than a tax shelter position, would not be an "error" if "adequately disclosed" to the IRS⁵² since a position so disclosed would not be subject to the § 6662 penalty. This would be true even if ultimately the position was determined to be incorrect. Generally, a position is "adequately disclosed" if it is reported to the IRS in a manner authorized by Treasury regulations and is calculated to direct the IRS's attention both to the item

discrepancy may be unfortunate, it makes sense to define an "error" that the taxpayer is obligated to correct in terms of the reporting standards of I.R.C. §§ 6662 and 6663, which define the standards to which taxpayers are held under the Code, rather than the standards applicable to return preparers under I.R.C. § 6694.

48. See Treas. Reg. § 1.6694-2(c)(2) (1991)(applicable to return preparers, but incorporated by reference in the "reasonable basis" standard applicable to taxpayers). See also *infra* note 49.
49. Treas. Reg. § 1.6662-3(b)(1) (1995). Further, the "reasonable basis" standard required to avoid negligence is "significantly higher than the not frivolous standard applicable to preparers under section 6694 and defined in § 1.6994-2(c)(2)." *Id.* § 1.6662-3(b)(3). See generally WOLFMAN ET AL., *supra* note 14, § 202.3.1.1.
50. This concept is defined in Treas. Reg. § 1.6662-4(d) (1995). "Authorities" include, *inter alia*, tax treatises, statutes, congressional committee reports, case decisions, and the more significant administrative promulgations, which include private letter rulings issued after October 31, 1976, even though such rulings are binding only for the taxpayers who are parties to the rulings. *Id.* § 1.6662-4(d)(3)(iii) (1995). Notably excluded from the list of authorities are both conclusions reached in treatises or legal periodicals and in legal opinions, including in opinions rendered by tax professionals. Whether authorities are "substantial" may depend on a variety of factors, including the age of the authorities, the identity of the issuers, whether or not they are well-reasoned or merely conclusory, and the array of supporting or opposing authorities. *Id.* § 1.6662-4(d)(3)(i), (ii).
51. I.R.C. § 6662(d)(2)(B)(i).
52. *Id.* § 6662(d)(2)(B)(ii)(I). If nonnegligent, the disclosed item will have a § 6662(d)(2)(B)(ii)(II) "reasonable basis" of support. See *supra* note 49 and accompanying text. A corporation, however, is statutorily denied a "reasonable basis" for, and so is negligent with respect to, a tax treatment of an item attributable to a "multiple-party financing transaction" that does not "clearly reflect" corporate income. I.R.C. § 6662(d)(2)(B); Treas. Reg. § 1.6662-3(b)(1) (1995).

and to the uncertainties regarding the correctness of the position taken with respect to the item.⁵³

A "tax shelter," for reporting purposes, includes any arrangement or investment a significant purpose of which is tax avoidance or tax evasion.⁵⁴ A tax shelter position of a noncorporate taxpayer is not subject to penalty if substantial authority supports the position and the taxpayer reasonably believes the position is more likely than not correct.⁵⁵ Thus, a tax shelter position satisfying these dual requirements would not be a reporting "error." On the other hand, a tax shelter position failing either the "substantial authority" test or the "more likely than not correct" condition would be an error. If the error is material, a taxpayer acquiring knowledge of the error would have a duty to correct it by means of an amended return.

The § 6662 accuracy penalty is excused if the taxpayer demonstrates both "reasonable cause" for the error and that the taxpayer had acted in good faith.⁵⁶ "Reasonable cause" for making the error frequently would not constitute "reasonable cause" for perpetuating the error through failure to file an amended return. Thus, an "error" obligating the taxpayer to file an amended return would include many original return positions for which the § 6662 accuracy penalty is excused by the application of the "reasonable cause" exception.

2. *Retroactive Changes in the Law*

A tax return that is correct when filed might become erroneous through a change in the law that has retroactive application. This arguably would give rise to a duty to amend. Suppose, for example, the taxpayer filed a return adopting a position supported by a decision of a federal circuit court of appeals. Subsequently, the United States Supreme Court reversed this decision, rendering the taxpayer's position erroneous. Suppose, in the alternative, that Congress enacted tax legislation with retroactive effect that rendered incorrect a position claimed on the tax return. In either case, the taxpayer's return, although correct when filed, would become erroneous.

If the taxpayer is viewed as having a continuous duty to correctly report her tax liability, then errors created by retroactive changes in the law should be treated as errors giving rise to the duty to amend.⁵⁷

53. The mechanics of making "adequate disclosure" are set forth in Treas. Reg. § 1.6662-4(f) (1995).

54. I.R.C. § 6662(d)(2)(C)(iii).

55. *Id.* § 6662(d)(2)(B)(i), (C)(i)(II). If the taxpayer is a corporation, this exception is inapplicable. Nevertheless, the corporation may still rely on the "reasonable cause" exception of I.R.C. § 6664(c).

56. *Id.* § 6664(c)(1).

57. The AICPA's definition of an error includes positions that become errors because of retroactive changes in the law. AICPA STATEMENTS, *supra* note 47.

Therefore, such errors, if material and if discovered within the period of limitations, should obligate the taxpayer to file an amended return to correct the errors.⁵⁸

B. "Materiality" Defined

1. Basic Definition

It seems apparent that a duty to correct tax return errors must be limited to material errors. Having to reexamine tax returns or financial records is at best a nuisance for the taxpayer and may be costly in terms of money or time. The taxpayer should be burdened with this obligation only when the error or possibility of error is sufficiently serious to warrant such trouble.

A practical definition of materiality seems to require measurement by both absolute and relative floors. For example, an error might be deemed material when the error causes a "substantial understatement" of tax within the meaning of § 6662(b).⁵⁹ As so defined, an error would be material if it resulted in an understatement of tax equal to the larger of (1) \$5,000 (\$10,000 for corporations other than S corporations or personal holding companies),⁶⁰ or (2) ten percent of the tax required to be shown on the return for the taxable year.⁶¹

In the absence of the absolute floor (\$5,000 or \$10,000), a taxpayer with two dollars of reported tax liability would be required to amend to correct an error that caused a one dollar underpayment of tax. In the absence of the relative floor (ten percent), a corporate taxpayer with \$100,000,000 of taxable income and a \$35,000,000 tax liability would be required to amend to correct an underpayment of tax of \$10,000. In either case, the nuisance costs of correcting the error would outweigh the importance of a fully accurate report of the taxpayer's income.

58. "[I]t would seem to follow that a taxpayer should have an obligation to correct a prior position which is subsequently invalidated by retroactive law (assuming that the retroactive law requires amendment of the prior position)—even though the prior position was not in error at the time of filing." Harris, *supra* note 1, at 538. *But see* Working Draft, *supra* note 1, at 33 ("A taxpayer should be required to file an amended return when the taxpayer becomes aware that a previously filed return was materially incorrect at the time it was filed." (emphasis added)).

59. The Corneel Proposal, *supra* note 38, proposed limiting the amended return obligation to "material" errors. Materiality was measured by the "substantial understatement" provision of the Code as then embodied in I.R.C. § 6661. Section 6661 was replaced in 1990 by I.R.C. § 6662. *See* Harris, *supra* note 1, at 534-35. This Article endorses the same approach as was taken in Harris' article, using the "substantial understatement" standards now incorporated in I.R.C. § 6662(b)(2), (d). By contrast, AICPA's definition of an error excludes any item having an "insignificant effect" on the client's liability. AICPA STATEMENTS, *supra* note 47.

60. I.R.C. § 6662(d)(1)(A)(ii), (B).

61. *Id.* § 6662(d)(1)(A)(i).

2. "Materiality" of Multiple Errors

If the taxpayer makes multiple errors (some of which may be offsetting), materiality probably should be measured by the net effect of the errors on tax liability. Multiple errors are likely to be more of a nuisance to correct than single errors. Therefore, if a tax deficiency caused by a single error is not material, the case for requiring amendment of a return can be no stronger when the same tax deficiency arises from the net effect of multiple errors.⁶² Although it could be argued that multiple errors require more time or expense to fix and therefore deserve a higher threshold of materiality, there is no predictable correlation between the number of errors and the time or expense that must be expended to correct them. Calibrating the materiality threshold to the number of errors to be corrected unduly complicates matters and assumes a nonexistent quantifiable relationship between the number of errors and the time or expense required to correct them. It is preferable to utilize a single threshold of materiality. The duty to amend would arise if the net effect of the taxpayer's errors was an understatement of tax liability that exceeded this threshold.

3. "Materiality" of Errors with No Impact on Tax Liability

Another difficulty relates to errors on the tax return that have no impact on tax liability. Consider whether the taxpayer errors in the following situations should be deemed material. Schedule B (Form 1040) 1996, Line 12 poses the question: "During 1996, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust?" Suppose the answer is "yes," but the taxpayer incorrectly marked the "no" box. Or suppose, instead, the taxpayer failed to answer the question when filing Schedule B. Suppose again that a taxpayer incorrectly listed \$5,000 of deductible interest as deductible charitable gifts under circumstances causing no net change in tax liability.

As a general proposition, errors that have no impact on tax liability probably should not be considered "material" since the determination and collection of the proper tax is the only purpose of requiring tax returns. "Check the box" questions on tax return forms, however, seek information that is particularly important to the IRS in properly discharging its functions.⁶³ Thus, incorrect answers to "check the box" questions might be deemed to be material errors.

62. See Harris, *supra* note 1, at 538-39 (stating that the net effect of multiple errors should determine materiality).

63. "[The] failure to accurately report the existence of a foreign bank account or trust on Schedule B of an individual income tax return may be material [for tax fraud purposes] even if accurate amounts of income have been reported on the return." Bruton, *supra* note 1, § 53.02, at 53-5 (citing *United States v. Payner*, 447 U.S.

If this approach is adopted, then the incorrect information (and possibly the failure to provide information) concerning foreign trusts would be deemed "material" errors, whereas the misidentification of interest payments as charitable gifts would not be material. It is possible, of course, that an error with no immediate effect on tax liability (and so not material) would subsequently impact tax liability. This might occur, for example, because of the impact of a loss carryback or carryover provision of the Code,⁶⁴ and so the error might subsequently become material.

C. Taxpayer's "Knowledge" of an Error and a Duty to Investigate

The duty to correct an erroneous tax return position would not arise until the taxpayer discovered the error or otherwise learned that an error had been made. One commentator suggests placing the burden on the IRS to prove that the taxpayer had "knowledge" of the error. But, if the IRS proved facts sufficient to establish that a "reasonable person" would have known of the error, then the burden would shift to the taxpayer to prove an absence of knowledge.⁶⁵ It was not suggested, however, that a taxpayer lacking knowledge of the error, but suspecting an error, should have a duty to investigate.

The duty to amend might be limited to situations where the taxpayer acquired knowledge of the need to correct an error, such as by communication from the taxpayer's accountant or other tax return preparer. In the alternative, the taxpayer might be charged with a duty to investigate suspected errors in appropriate circumstances. Including the tax return positions subject to the § 6662 accuracy penalty within the definition of error provides an avenue for imposing a duty to investigate.

Suppose, for example, the taxpayer acquired information that made her realize there was a good chance that a position taken on her original return was erroneous. The taxpayer could not be certain that the position claimed was erroneous until she reexamined the original return. Further, assuming an error was made, the taxpayer would be uncertain whether the error was sufficiently "material" to require an amended return to be filed.

The negligence penalty of § 6662(b)(1) applies to an erroneous original return position that results from the taxpayer's failure to make a

727, 728-29 (1980); *United States v. Franks*, 723 F.2d 1482, 1485-86 (10th Cir. 1983)).

64. For example, I.R.C. § 172(b)(1)(A) provides for the carryback and carryover of a net operating loss; I.R.C. § 1212 provides for the carryback and carryover of capital losses; I.R.C. § 170(b) and I.R.C. § 170(d) provide for the carryover of excess charitable contributions.

65. *Harris*, *supra* note 1, at 538.

“reasonable attempt” to comply with the tax laws.⁶⁶ The judicial standard is whether a reasonably prudent taxpayer would behave as this taxpayer did.⁶⁷ An ongoing duty to correctly self-report implies that conduct penalizable in connection with the original return should be equally penalizable in connection with filing, or failing to file, an amended return. Therefore, if the taxpayer’s failure to investigate further departed from the behavior expected of a reasonably prudent taxpayer, then the taxpayer’s failure to investigate could be treated as § 6662 negligence if in fact the original return position constituted a material error. The taxpayer’s failure to investigate a suspected material error, if it departed from the behavior expected of a reasonably prudent taxpayer, would constitute penalizable negligence even if the taxpayer was not negligent in claiming the original return position. In other words, the duty to amend based on knowledge of an error could be broadened to include a correlative duty to investigate in appropriate circumstances.

A duty to investigate delimited only by the “reasonably prudent taxpayer” standard would render the scope of the duty somewhat uncertain. This would leave the taxpayer in doubt in some circumstances about whether or not the duty was applicable. The existence of the duty, however, would expose a taxpayer who later suspected that a material reporting error was committed to the same risk of penalty faced by a taxpayer who suspected the possibility of error while preparing the return, but who chose not to investigate. This parity is consistent with a filing obligation that extends for a continuous period, beginning with the original return due date and ending with the expiration of the limitations period for the taxable year, and thus seems to be a worthy accompaniment to the duty to amend. The enactment of a duty to correct errors of which the taxpayer acquired knowledge would be appropriate, however, even if not accompanied by a correlative duty to investigate suspected errors.

An unfulfilled duty to amend or investigate would enable the IRS to assert penalizable conduct occurring at any time within the period of limitations, not simply conduct occurring prior to the original return due date. As a practical matter, however, the IRS may seldom know when a taxpayer acquires knowledge or suspicion of an error. Therefore, the duty to amend or investigate would most likely affect the behavior of a taxpayer who (1) was informed by a tax adviser that an error existed that required correction, (2) was informed by a tax adviser that an error was strongly suspected and that further investi-

66. I.R.C. § 6662(c).

67. “In measuring taxpayer negligence, the courts have generally applied the ‘reasonably prudent person’ standard of tort law, inquiring whether a reasonably prudent taxpayer would act as the taxpayer did under similar circumstances.” WOLFFMAN ET AL., *supra* note 14, § 202.3.1.1, at 51.

gation was required, or (3) independently discovered the error or possibility of error; knew of the duty to amend or investigate; and believed in complying with the law regardless of the IRS's ability to detect noncompliance.

IV. AMENDED RETURN OBLIGATION AND THE PENALTY STRUCTURE

If a legal duty to amend known material errors is enacted, which might or might not be accompanied by a legal duty to investigate suspected material errors, the questions arising include: (1) how, if at all, the taxpayer's compliance with the duty to amend should ameliorate the taxpayer's exposure to penalties for original return errors, and (2) what penalties should apply to a breach of the duty to amend or, if enacted, the duty to investigate. The approach undertaken in this Article is to identify characteristics that a good penalty structure—a normative penalty structure—usually should possess. A penalty structure with these characteristics will be referred to as a *parity structure*. It is possible to construct a penalty parity structure that incorporates the civil and criminal penalties of existing law. The resulting penalty parity structure can then be examined to see if, in all cases, it is an appropriate penalty structure to accompany enactment of a legal duty to amend.

The first step in this analysis is to describe briefly existing civil and criminal penalties. A general description will suffice.

A. Current Penalty Structure

The Code provides for both civil and criminal penalties. The civil penalties are monetary penalties; the criminal penalties are punishable by fine or imprisonment. The civil penalties include penalties for both fraudulent and nonfraudulent misconduct, with higher monetary penalties generally imposed for fraudulent misconduct than for nonfraudulent misconduct.

The penalties relevant to the analysis of a desirable penalty structure that would enforce a legal duty to file amended returns are the Code's penalties that are applied to a taxpayer's breach of a duty to file and breach of a duty to accurately report tax-related items. A monetary civil penalty for a nonfraudulent failure to file is imposed under § 6651(a); a higher monetary civil penalty is imposed under § 6651(f) if the failure to file is fraudulent. The failure-to-file penalties (nonfraudulent and fraudulent) are calibrated with reference both to the amount of tax that should have been reported and the lateness of the return.⁶⁸ In addition to either of these penalties, a flat penalty of

68. See I.R.C. § 6651(a)(1). A nonfraudulent failure to file is subject to a penalty of 5% of the amount of tax required to be shown on the return for each month, or

\$500 may be imposed under § 6702 if an individual files a frivolous return.⁶⁹ This penalty may be viewed as an additional failure-to-file penalty.

Inaccurate, but nonfraudulent, reporting of tax-related items is penalized under § 6662, which imposes a monetary penalty calculated as twenty percent of the underpayment of tax resulting from certain types of nonfraudulent reporting errors. Errors giving rise to the § 6662 penalty include errors attributable to negligence or disregard of rules or regulations;⁷⁰ errors in the form of a significant undervaluation or overvaluation of property;⁷¹ and, in the case of income tax returns, errors of any type that result in a "substantial understatement" of tax liability.⁷² Yet, to the extent that the inaccurate reporting of tax-related items is shown to be fraudulent,⁷³ then the § 6662 penalty is inapplicable.⁷⁴ Instead, a monetary penalty, calculated as seventy-five percent of the underpayment of tax resulting from fraudulent errors, is imposed under § 6663.⁷⁵

The penalty for either a nonfraudulent failure to file or for committing nonfraudulent reporting errors is excused if the taxpayer can establish "reasonable cause" for failing to file⁷⁶ or for committing the reporting errors.⁷⁷ It should be apparent from this profile of civil penalties that the taxpayer can commit nonpenalizable "innocent" reporting errors. These might be reporting errors for which the taxpayer can establish "reasonable cause." In the alternative, they might be errors committed even though the taxpayer was not negligent, and that resulted in a tax underpayment of insufficient magnitude to be

fraction of a month, by which the return is overdue, not to exceed 25% of the tax required to be shown on the return. If the failure to file is fraudulent, the applicable percentage is 15% per month (rather than 5%), not to exceed 75% of the tax required to be shown on the return. *Id.* § 6651(f).

69. *Id.* § 6702.

70. *See id.* § 6662(b)(1).

71. *See id.* § 6662(b)(3), (b)(5), (e), (g).

72. *Id.* § 6662(b)(2), (d). *See supra* subsection IV.B.1, which defines "substantial understatement" and suggests it is a suitable measure of the materiality of errors contained in any federal tax return, not only in federal income tax returns.

73. Civil tax fraud under I.R.C. § 6663 requires a showing that the taxpayer acted with "the specific intent to evade a tax known or believed to be owing." WOLFMAN ET AL., *supra* note 14, § 202.3.2, at 74 (citing *Webb v. Commissioner*, 394 F.2d 366 (5th Cir. 1968); *Watson v. Commissioner*, 54 T.C.M. (CCH) 1601 (1988); *Truesdell v. Commissioner*, 89 T.C. 1280 (1987)). Once the IRS establishes that any part of an underpayment of tax is attributable to fraud, the entire underpayment is presumed attributable to fraud except to the extent the taxpayer can prove otherwise by a preponderance of the evidence. I.R.C. § 6663(b).

74. I.R.C. § 6662(b).

75. *Id.* § 6663(a).

76. *Id.* § 6651(a)(1). The statute further provides the error must not be due to "willful neglect." *Id.*

77. *Id.* § 6664(c)(1). The statute further provides that the taxpayer must have "acted in good faith." *Id.*

penalizable under § 6662 without regard to the culpability of the taxpayer.

The criminal penalties set forth in the Code are contained in §§ 7201 to 7217.⁷⁸ The crimes relevant to a taxpayer's failure to file or to accurately report tax-related items are listed in the following sections: § 7201, which punishes the willful attempt in any manner to evade or defeat tax; § 7203, which punishes the willful failure to make a return, keep records, or supply information by any person required to do so under the Code; and § 7206(1), which penalizes the willful filing of a false return, statement, or other document.⁷⁹ Each statute specifies as an element of the crime that the taxpayer's conduct be "willful." Willful is defined as "a voluntary, intentional violation of a known legal duty."⁸⁰

B. Penalties: A Normative Approach

1. Parity Structure Defined

One approach to the imposition of penalties is that a taxpayer who voluntarily corrects an error made on the original return ought not be penalized more than a taxpayer who avoids making the error in the first instance. One condition on this approach is that the taxpayer who fails to pay taxes because she committed the error must pay the full tax amount plus interest and correct the error before the government invests resources in investigating the taxpayer's return. A *parity structure* will be referred to as a penalty system that waives penalties for original return errors that are corrected on voluntary, timely-filed amended returns, thereby placing the amending taxpayer-

78. The subsequent discussion in this Article sometimes distinguishes between non-fraudulent reporting errors and fraudulent reporting errors. Unless otherwise specified, fraudulent errors include errors subject to either the I.R.C. § 6663 civil fraud penalty or to criminal penalties; nonfraudulent errors are those subject to the I.R.C. § 6662 penalty.

79. The following provisions are relied upon for the majority of tax prosecutions: I.R.C. §§ 7201, 7203, and 7206, along with I.R.C. § 7602(2) (criminalizing the willful aiding, assisting, or counseling of falsity or fraud). McGown, *supra* note 20, at 248. In addition, the Federal Criminal Code, which punishes perjury, conspiracies, false claims, and false statements, may be used to prosecute both tax and nontax crimes. *Id.* at 247-48. See also 4 BITTKER & LOKKEN, *supra* note 8, ¶ 114.9.1, at 114-79 n.3. Altogether, the arsenal of criminal statutes available to prosecutors forms a "hodgepodge of overlapping sanctions." *Id.* ¶ 114.9.1, at 114-79.

80. 4 BITTKER & LOKKEN, *supra* note 8, ¶ 114.9.2, at 114-83 to 114-84 (citing *United States v. Pomponio*, 429 U.S. 10 (1976), both as authority that a voluntary, intentional violation of a known legal duty is sufficient to establish willfulness and as an indication that earlier references by the United States Supreme Court to "bad faith" or "evil motive" "need not (and perhaps should not) be included in the court's instructions to the jury").

ers in *parity* with taxpayers avoiding the errors in the first instance.⁸¹ A penalty parity structure in this situation reflects a “no harm, no foul” approach to the imposition of penalties. A taxpayer whose timely amended return avoids harm to government or society (in the form of governmental costs expended to secure the taxpayer’s compliance) has committed no foul and should not be penalized.⁸²

Similarly, it might be maintained that a taxpayer who negligently (or fraudulently) fails to amend her return should be subject to the same penalties as—that is, placed in parity with—a taxpayer who negligently (or fraudulently) submitted her original return. Under this view, for example, a taxpayer who innocently commits an error on the original return, but who fraudulently perpetuates the error by failing to file an obligatory amended return is in no better position than a taxpayer who fraudulently commits the error on the original return. To the extent a system of penalties has this effect, it is a *parity structure*.

In summary, under a parity structure, the taxpayer can be viewed as having an ongoing duty to correctly report her tax liability throughout the duration of the limitations period. The taxpayer’s filings during this period are to be viewed as constituting only a single tax return. The amended return, if any, should be treated as an appendix or supplemental schedule to this tax return.⁸³ Penalties applicable to tax return errors are determined based on the return as it existed at

81. The term reflects the parity of treatment between (1) taxpayers who do not commit errors that require correction, and (2) taxpayers who commit errors but correct them on a timely basis. As may be evident, the taxpayer cannot know at the time of submission of an amended return that the government has not already expended resources to investigate her erroneous return. In this Article, as explained *infra* subsection IV.C.1, an amended return filed before “the taxpayer is first contacted by the Internal Revenue Service concerning an examination of the return” (i.e., a qualified amended return as defined in Treas. Reg. § 1.6664-2(c)(3)(i) (1991)) substitutes for the expenditure of governmental resources as the test for whether an amended return is “voluntary” and “timely-filed.”

82. Interest, which would not be forgiven under a parity structure, compensates the government for its temporary loss of use of any unpaid taxes that result from the taxpayer’s original return error. If this compensation is deemed inadequate, the solution is a higher interest rate, not the imposition of a penalty. If the taxpayer who properly reports additional tax fails to pay the additional tax due, the civil penalty of I.R.C. § 6651(a)(2) for failure to pay tax and the criminal penalties of I.R.C. §§ 7201 and 7203 would remain applicable according to their terms and would not be waived.

83. In *Badaracco v. Commissioner*, 464 U.S. 386 (1984), discussed *supra* text accompanying notes 11-12, the Supreme Court’s analysis distinguished an amended return from the original return, concluding that the original return was the “return” to which I.R.C. § 6501(c)(1) made reference. This view was criticized by Douglas A. Kahn, *The Supreme Court’s Misconstruction of a Procedural Statute—A Critique of the Court’s Decision in Badaracco*, 82 MICH. L. REV. 461, 468 (1983).⁴⁴ Thus, the Supreme Court’s characterization of an original and amended return as two returns is erroneous. There is only one return—the original re-

the time of commencement of an IRS audit of the taxpayer. Further, penalties are determined on the basis of the positions reflected on that return (including any appendices or supplements) and on the basis of the taxpayer's knowledge of and conduct with respect to those return positions as of the commencement of the audit. Thus, parity offers both the appeal of equal treatment for similarly situated taxpayers and the consistent treatment of culpable conduct regardless of whether the culpable conduct occurs at the time of filing of the original return or at some later time within the limitations period.

2. Existing Penalties Contrasted with a Parity Structure

Current penalties do not always achieve parity. For example, if a taxpayer submits a fraudulent original return that is timely followed by a corrected, nonfraudulent amended return, the taxpayer remains subject to the fraud penalty under current law.⁸⁴ This does not achieve parity. A parity structure would treat the amending taxpayer no differently than a taxpayer whose original return was nonfraudulent. On the other hand, a negligent error cured by a timely submitted amended return absolves the taxpayer from the negligence penalty under current law.⁸⁵ In this situation, the existing penalty structure does achieve parity.

Since no duty to amend exists under current law,⁸⁶ the law generally does not penalize a taxpayer for return errors based on the taxpayer's postfiling knowledge or conduct.⁸⁷ Parity generally is not achieved in this situation because different consequences are assigned to taxpayer conduct accompanying an error depending on whether the conduct precedes or follows submission of the original return. For ex-

turn, as it reads before being modified by the amendment and as it reads afterwards.”).

84. As an evidentiary matter, a timely corrected amended return may cast doubt on whether the taxpayer acted with fraudulent intent when filing the original return. Nonetheless, if the existence of original return fraud is established, the amended return does not vitiate exposure to the fraud penalty. See Treas. Reg. § 1.6664-2(c)(2) (1991) (denying the benefits of a “qualified amended return” to fraudulent positions). See also *George M. Still, Inc. v. Commissioner*, 19 T.C. 1072, 1077 (1953) (“[A] taxpayer who has filed a fraudulent return may not, by subsequently filing an amended return and paying the tax due, bar the respondent from assessing additions to tax for fraud.”), *aff’d*, 218 F.2d 639 (2d Cir. 1955); Rev. Rul. 56-54, 1956-1 C.B. 654 (upholding the application of the civil fraud penalty under the Internal Revenue Code of 1939 even though the taxpayer filed delinquent returns showing the correct tax liability).

85. The amended return is “timely submitted” if it is a “qualified amended return” that requires submission before “[t]he time the taxpayer is first contacted by the Internal Revenue Service concerning an examination of the return.” Treas. Reg. § 1.6664-2(c)(3)(i) (1991). For further discussion, see *infra* subsection IV.C.1.

86. See *supra* section II.A.

87. See *supra* note 20 and accompanying text.

ample, in *Broadhead v. Commissioner*,⁸⁸ the taxpayer's refusal to file an amended return prepared by his accountant did not convert an originally innocent error into a fraudulent error. Under parity it would do so, presuming that the taxpayer's like refusal to report the proper amount of taxable income on an original return prepared by the accountant would constitute fraud.

The next question to address is the extent to which a parity penalty system might be appropriate under an obligatory amended return regime. Section IV.C addresses this question in the context of a taxpayer who complies with a legal duty to amend. In this context, the issue is the extent to which the amended return should mitigate or eliminate the taxpayer's exposure to penalties based on errors made on the original return. It is useful to consider separately cases in which the original return errors are nonfraudulent (undertaken in subsection IV.C.1) and cases in which the original return errors are fraudulent (undertaken in subsection IV.C.2).

C. Penalty Recommendations: Obligatory Amended Returns Filed

1. Abrogation of Penalty Exposure for Nonfraudulent Errors Voluntarily Corrected

Although current law does not require taxpayers to correct reporting errors made on the original return, a taxpayer who files a timely amended return correcting *nonfraudulent* original return errors eliminates her exposure to penalties arising from her commission of these errors. Specifically, the taxpayer's nonfraudulent original return errors, if subject to penalty at all, are penalized under § 6662, the Code's accuracy-related penalty. Treasury regulations promulgated under § 6664 permit a "qualified amended return"⁸⁹ to negate the § 6662 penalty otherwise applicable to nonfraudulent errors. A "qualified amended return" is an amended return filed before "[t]he time the taxpayer is first contacted by the Internal Revenue Service concerning an examination of the return."⁹⁰ This rule should be continued to secure

88. 14 T.C.M. (CCH) 1284 (1955). For further discussion of *Broadhead*, see *supra* text accompanying notes 21-24.

89. Treas. Reg. § 1.6664-2(c)(2), (3) (1991).

90. *Id.* § 1.6664-2(c)(3)(i). A taxpayer's amended return is not a qualified amended return with respect to items reported in accord with instructions provided by a pass-through entity (such as a partnership or S corporation) unless it is filed before the pass-through entity is first contacted by the IRS in connection with an examination of the return to which the pass-through item relates. *See id.* § 1.6664-2(c)(3)(iii). Similarly, the taxpayer's amended return is not a qualified amended return with respect to tax shelter items for which the taxpayer claimed a benefit on the return, unless it is filed before the tax shelter promoter (or any other person exposed to penalty under I.R.C. § 6700(a)) is first contacted by the

parity if amended returns to correct material errors become obligatory.

If qualified amended returns continue to negate penalties for non-fraudulent errors once a legal duty to amend is adopted, the resulting penalty structure conforms to a parity structure. In short, the taxpayer filing the qualified amended return will be subject to the same penalty (none) that she would have faced had the corrected position been originally reported. This relief from exposure to penalties for nonfraudulent errors should encourage taxpayers to correct their original return mistakes, an incentive that exists under current law.

Clearly, an amended return filed after the taxpayer is notified of an IRS audit cannot be allowed to exempt the taxpayer from nonfraudulent civil penalties. Otherwise, taxpayers would make sport of the Code's penalties for nonfraudulent reporting errors. Taxpayers would decline to amend their returns unless audited. Once audited, amended returns would be filed negating the imposition of penalties.⁹¹

Note that a qualified amended return currently absolves the taxpayer from penalties attributable to nonfraudulent errors whether or not these corrected errors are material. Upon adoption of a legal duty to amend, qualified amended returns should continue to be given this effect to secure parity even if the errors corrected are not material and no duty to amend arises.

2. *Nonabrogation of Penalty Exposure for Fraudulent Errors*

The analysis is quite different if the original return error is fraudulent. Under current law, a qualified amended return that corrects the original return error neither mitigates nor eliminates the taxpayer's exposure to civil or criminal fraud penalties.⁹² Thus, existing law does not attempt parity between (1) a taxpayer who commits original return fraud and then repents and amends before the onset of an IRS audit, and (2) a taxpayer who commits no fraud on the original return.

At least four arguments can be marshaled in favor of the continuation of current rules rather than adoption of a parity structure if amended returns become required. These arguments favor continuing to exclude civil and criminal *fraud* penalties from original return penalties waived by the timely filing of an obligatory amended return.

IRS concerning an examination of the tax shelter activity. See *id.* § 1.6664-2(c)(3)(ii).

91. See *George M. Still, Inc. v. Commissioner*, 19 T.C. 1072, 1077 (1953) (reaching the similar conclusion that a nonfraudulent amended return filed after commencement of an IRS audit could not be permitted to preempt the IRS's imposition of civil fraud penalties), *aff'd*, 218 F.2d 639 (2d Cir. 1955).

92. See *supra* note 84 for a discussion of civil penalties. Tax crimes, like other crimes, are punishable once the elements of the offense have been satisfied and cannot be negated by subsequent repentant behavior.

The arguments are generally inapplicable, however, to the timely correction of *nonfraudulent* errors. The arguments are as follows: (1) immunizing the taxpayer from fraud charges would undermine the taxpayer's obligation to file a correct original return; (2) taxpayers committing fraud are less deserving of relief than taxpayers committing nonfraudulent original return errors; (3) any adverse impact on tax revenues from nonwaiver of civil or criminal penalties for fraudulent original returns is likely to be minimal; and (4) it is difficult to formulate a workable rule that exculpates the taxpayer from criminal fraud penalties that is not subject to abuse by taxpayers who file fraudulent original returns. These arguments will be considered sequentially.

a. Immunization from Fraud Penalties Undermining the Duty to File a Correct Return

As noted in a 1989 IRS report on penalty reform,⁹³ penalties set and validate standards of taxpayer behavior. The standard of behavior expected of all taxpayers is that they file correct original returns. Nonfraudulent errors, even if culpable, are essentially unintentional violations. That is, the taxpayer, although perhaps careless or even grossly negligent, does not knowingly file an incorrect return. Fraudulent reporting errors are intentional errors,⁹⁴ which if excused would have the effect of endorsing a lower standard of behavior: taxpayers may file returns they know to be incorrect if the errors are corrected before the IRS has an opportunity to commence audits of the taxpayers.⁹⁵ Thus, validation of the standard of reporting expected on the original return militates in favor of nonabatement of penalties for tax-fraud.

b. Lesser Appeal of Relief for Taxpayers Committing Fraud

A closely allied argument is that original return fraud is a more culpable offense and seemingly less deserving of relief than non-fraudulent original return errors. Current regulations, which allow a qualified amended return to negate civil penalties for nonfraudulent errors but not civil penalties for fraudulent errors, can be justified by the greater severity of fraudulent offenses.

93. IRS Penalty Study, *supra* note 1, ch. 3.

94. *See supra* note 73.

95. Since, as a practical matter, some delay is inevitable before the commencement of an audit, this lower reporting standard would effectively require the government to make short-term loans to any taxpayer desiring to receive one.

c. Fraud Penalty Relief Unlikely to Enhance Tax Compliance

The primary reason to impose a duty to correct material original return errors is to clarify taxpayers' obligations to correctly determine and disclose their tax liabilities, not only on filing day, but for a continuous period ending only with the expiration of the limitations period for the taxable year. Taxpayers risking civil or criminal fraud penalties by willfully and knowingly violating reporting standards on filing day appear unlikely to be lured into filing nonfraudulent returns within the limitations period by the promise of amnesty from these penalties. Therefore, little negative impact can be expected from retaining taxpayers' exposure to civil and criminal fraud penalties even though they file timely amended returns correcting their original return errors. By contrast, taxpayers committing nonfraudulent original return errors, as a group, should be far more likely to comply with reporting obligations if such penalties are waived.

d. Difficulty of Formulating a Workable Rule that Waives Criminal Fraud Penalties

An offer of amnesty from charges of criminal fraud raises special concerns. Many criminal tax fraud charges brought against individuals are the culmination of an investigative process that originates with an investigation of an occupation, industry, or geographic area.⁹⁶ The investigation might have been triggered initially by information acquired by IRS or other governmental personnel or by investigative news reporters.

Suppose such a broad-based investigation was under way and a taxpayer who committed tax fraud and learned of or suspected the existence of the investigation filed a nonfraudulent amended return before the IRS contacted the taxpayer. A substantial portion of the IRS's criminal investigative efforts would be defeated if such an amended return was permitted to immunize this taxpayer from criminal prosecution.

Other difficulties would be encountered if a narrower exculpatory rule was promulgated. For example, consider a rule immunizing from

96. MICHAEL I. SALTZMAN, *IRS PRACTICE AND PROCEDURE* ¶ 12.03[1][b], at 12-12 (2d ed. 1991). These broad-based investigations, conducted by "special agents" of the IRS's Criminal Investigation Division, are termed "general" investigations. *Id.* at S12-4 to S12-6 (Cum. Supp. No. 1 1997). Individuals identified in a "general" investigation as likely candidates for criminal tax prosecution become the targets of a "primary" investigation. *Id.*

Either a general or primary investigation may arise from the IRS's General Enforcement Program (GEP), which is designed to provide "some coverage of all types of taxes and violators in as many income brackets, occupations and businesses, and geographic areas as possible" or from the IRS's Special Enforcement Program (SEP), which focuses on taxpayers deriving income from illegal activities or sources. *Id.* ¶ 12.02[2], at 12-6.

criminal prosecution taxpayers whose amended returns were "voluntary" and not triggered by knowledge, suspicion, or fear of an IRS audit. These difficulties were illuminated by a "formal" voluntary disclosure policy in effect from 1945 to 1952.⁹⁷ Under the formal policy, taxpayers who voluntarily disclosed tax deficiencies and who fully cooperated with the government in the determination and payment of the correct tax were not recommended to the Department of Justice for criminal prosecution, although penalties for delinquency, negligence, or civil fraud were not necessarily waived. While termed a "formal" policy, the policy was not directed by statute. Instead, the policy was administratively conceived, implemented, and publicized through a series of pronouncements.⁹⁸ This policy led to extensive litigation by taxpayers who were subject to criminal prosecution. These taxpayers sought to suppress the information provided to the IRS on amended tax returns (often provided well after an investigation had begun), allegedly relying on the voluntary disclosure policy.⁹⁹ The litigation bred by the formal policy and the confusion over its scope led to its termination by the IRS in 1952.¹⁰⁰

97. *Id.* ¶ 12.03[3][c], at 12-35. The policy originated in 1934 as a "confidential internal practice," and was not disclosed to the public until 1945. Bruton, *supra* note 1, § 53.07, at 53-22 to 53-23 n.77.

98. Gerald L. Wallace, *Penalties and Prosecutions for Evasion of the Federal Income Tax*, 1 TAX L. REV. 329, 341-42 (1946). *See also* Bruton, *supra* note 1, § 53.07, at 53-22 to 53-24. Prominent among these was the statement by Secretary of the Treasury Vinson, providing in part:

No honest American need fear this drive against tax evaders. No one is going to jail for an honest mistake in filling out his tax return. Treasury policy even permits the willful evader to escape prosecution if he repents in time. The Commissioner of Internal Revenue does not recommend criminal prosecution in the case of any taxpayer who makes a voluntary disclosure of omission or other misstatement in his tax return or of failure to make a tax return. Monetary penalties may be imposed for delinquency, for negligence and for fraud, but the man who makes a disclosure before an investigation is under way protects himself and his family from the stigma of a felony conviction. And there is nothing complicated about going to a collector or other revenue officer and simply saying, "There is something wrong with my return and I want to straighten it out."

Wallace, *supra*, at 342 (quoting the Washington Post, Aug. 21, 1945).

99. *See* SALTZMAN, *supra* note 96, ¶ 12.03[3][c], at 12-36 nn.77-81. *See also* Bruton, *supra* note 1, § 53.07, at 53-24 n.80 ("All too frequently, taxpayers who learned, accidentally or otherwise, that their returns were being audited would attempt to make a 'voluntary' disclosure in order to avoid prosecution. The official view in such cases was that the disclosure would be treated as voluntary unless the Bureau could prove beyond a reasonable doubt that the taxpayer did have knowledge of the pending investigation at the time he made his disclosures." (quoting H.R. REP. NO. 82-2518, at 11 (1953))).
100. SALTZMAN, *supra* note 96, ¶ 12.03[3][c], at 12-36. *See also* Harris, *supra* note 1, at 550 ("[T]his formal policy was abandoned in 1952 in reaction to increasing litigation regarding the timeliness of the disclosure and the definition of commencement of investigation by the Service." (citations omitted)).

Since then, the IRS has maintained an "informal" voluntary disclosure policy that provides no guarantees of nonprosecution. Nevertheless, significant factors that are likely to influence the IRS not to recommend prosecution to the Department of Justice include (1) the taxpayer's voluntary disclosure of unpaid tax, and (2) the taxpayer's full cooperation with the IRS in ascertaining and paying the correct tax to the extent of the taxpayer's ability to pay.¹⁰¹

The difficulties encountered under the formal voluntary disclosure policy illustrate the risks involved in adopting a formal rule that exculpates taxpayers who file voluntary amended returns from criminal fraud charges.¹⁰²

3. *Countervailing Considerations*

The foregoing arguments *against* permitting a corrected amended return to mitigate a taxpayer's exposure to penalties for civil or criminal fraud committed on the original return are inconclusive. It is also necessary to ask (1) whether it is appropriate to *require* amended returns of taxpayers and then impose civil fraud charges or prosecute them for criminal fraud partially on the basis of information contained in the amended returns, and (2) whether taxpayers committing *non-fraudulent* original return errors might hesitate to comply with an amended return obligation for fear of a mistaken assertion of civil or criminal fraud penalties by an overzealous IRS. These are legitimate

In 1986, the Senate Finance Committee proposed to include, as part of the Tax Reform Bill of 1986, a statutory formal voluntary disclosure policy not considered by the House of Representatives. S. REP. No. 99-313, at 211-12 (1986)(discussing H.R. 3838, 99th Cong. (1986)). The proposal was narrowly defeated by the United States Senate. 132 CONG. REC. 14,779 (1986). The proposed legislation would have provided immunity from criminal prosecution for tax violations if disclosure was made "to the Secretary of the Treasury or his designee before notice of an inquiry or investigation into the taxpayer's tax affairs is given to the taxpayer (or a related party) by the Internal Revenue Service, any other law enforcement agency, or any tax administration agency." I.R.C. § 559 (proposed form), reprinted in Bruton, *supra* note 1, § 53.07[1], at 53-29.

101. SALTZMAN, *supra* note 96, ¶ 12.03[3][c], at 12-36 to 12-37 & S12-13 to S12-15 (Cum. Supp. No. 1 1997). See also Bruton, *supra* note 1, § 53.07, at 53-26 (contrasting "volumes of litigation" under the formal policy with "only one reported decision [United States v. Hebel, 668 F.2d 995 (8th Cir. 1982), cert. denied, 456 U.S. 946 (1982)] in nearly 30 years of use" of the informal policy). *Hebel* held that the IRS's informal policy conferred upon the taxpayer no rights to nonprosecution regardless of whether the taxpayer's cooperation with the IRS was voluntary. *United States v. Hebel*, 668 F.2d 995 (8th Cir. 1982).
102. See Bruton, *supra* note 1, § 53.07, at 53-24 n.80 ("Regardless of the possible merits of the policy, however, it is clear . . . that the difficulties of administering [the formal policy] were all but insuperable." (quoting H.R. REP. No. 82-2518, at 11 (1953))). See also SALTZMAN, *supra* note 96, ¶ 12.03[3][c], at 12-36 n.83 ("One of the major obstacles in formalizing a voluntary disclosure policy is the difficulty in drafting a regulation or statute that would not have the same defects as the original Treasury policy—i.e., defining when a disclosure is voluntary.").

concerns, but neither justifies an automatic waiver of civil fraud or criminal penalties for a taxpayer filing a qualified amended return.

a. *Fairness of Compelling Taxpayers to Provide Evidence of Fraudulent Conduct*

The appropriateness of the government's use of required returns to support the imposition of fraud penalties apparently is not a constitutional issue,¹⁰³ but instead is a matter of "fairness." The Corneel Proposal¹⁰⁴ noted that "a majority of the members of the Committee on Standards of Tax Practice [of the ABA Tax Section] believed that, regardless of Fifth Amendment concerns,¹⁰⁵ it would be undesirable for the Service to insist on amended returns and then to play 'gotcha' with the taxpayer."¹⁰⁶

The privilege against self-incrimination is a constitutional privilege, and it would seem material for purposes of evaluating the constitutionality or fairness of obligatory amended return that prosecutorial use of information reported on a compelled original return does not violate the privilege. The taxpayer would be required only to *file* the amended return; the taxpayer would be entitled to claim the privilege, if necessary, on the amended return just as she could have claimed the privilege on the original return. Thus, although the amended return would be required, incriminating information disclosed on the return would be submitted *voluntarily* since the taxpayer would have been privileged to suppress this information. In other words, a taxpayer fraudulently filing an original return and charged with a legal obligation to amend would face a quandary not distinguishable from the quandary facing a taxpayer who has accepted illegal income that the taxpayer is charged with reporting on an original return. If it is fair, as well as constitutional, to require the latter taxpayer to file an original return—the current posture of the law—then it should be equally fair, as well as constitutional, to require the former taxpayer to file an amended return.

Moreover, it is not clear that "fairness" dictates that criminal tax behavior be treated as though it was a game in which the truth is to be suppressed unless ascertained from preapproved sources. The Fifth

103. See *supra* note 43.

104. *Supra* note 38.

105. A 1986 memorandum from Corneel to the Commissioner of Internal Revenue Service argued that the required filing of amended returns would not violate the Fifth Amendment even without protection from subsequent criminal prosecution. Corneel Proposal, *supra* note 38, reprinted in Harris, *supra* note 1, app. at 562-63.

106. *Id.* Harris endorsed this sentiment, advocating a "limited use immunity" provision that would preclude the government from using information obtained from a required amended return in its prosecution of the taxpayer. Harris, *supra* note 1, at 555-57.

Amendment privilege against self-incrimination has its underpinnings in coerced confessions.¹⁰⁷ Coercion is objectionable because it demeans the individual and yields evidence of questionable validity. If the taxpayer's original return is *already* a criminally false report, then, as will be explained in subsection IV.D.2, the taxpayer would not be exposed to additional criminal penalties as a result of the taxpayer's noncompliance with the duty to amend.¹⁰⁸ Therefore, the taxpayer would not be coerced by the threat of increased sanctions to file an amended return; the taxpayer would retain the Fifth Amendment privilege to avoid including incriminating information on the amended return if one was filed. In short, if a taxpayer did amend, and if the nonfraudulent amended return was used to facilitate criminal prosecution, the self-incrimination would not arise from circumstances analogous to the principles that led to the disfavor of self-incriminating evidence.

Additional reassurance that the IRS's use of information disclosed on required amended returns probably would be "fair" stems from the IRS's current reluctance under its "informal" voluntary disclosure policy to prosecute cases in which the taxpayer has voluntarily disclosed past noncompliance.¹⁰⁹ Currently, even if the taxpayer's original return clearly reflects criminal fraud, prosecuting a taxpayer whose correct amended return was not induced by knowledge of an IRS investigation presents "significant trial hazards, since a disclosure is evidence from which a finder of fact may determine that the original act or omission was not 'willful' in a criminal sense."¹¹⁰ The same trial hazards, as well as a continuation of the IRS's "informal" voluntary disclosure policy, would make unlikely the prosecution of taxpayers who voluntarily complied with a legal duty to correct their returns. The unusual case in which the IRS and Department of Justice would decide to press forward with criminal prosecution, based substantially on information disclosed on an obligatory amended return, would likely involve sufficiently repugnant taxpayer conduct such that the decision to prosecute would be "fair."

107. See generally LEONARD W. LEVY, *ORIGINS OF THE FIFTH AMENDMENT* (MacMillan 1986)(1968).

108. Although the potentially applicable criminal penalties would not change, it might be easier in some situations for the government to prove a criminal failure to file a required amended return than a criminal falsification of the original return.

109. See *supra* note 101 and accompanying text.

110. SALTZMAN, *supra* note 96, ¶ 12.03[3][c], at 12-37. See also Bruton, *supra* note 1, § 53.07, at 53-25 ("A true voluntary disclosure is a particularly unattractive case for the government to use as an example to deter other taxpayers [sic] criminal conduct. Rather than deterring the initial crime, routine prosecution of such cases might actually deter remedial actions that are, in fact, beneficial to the tax system.").

If concerns about using information on compelled returns to further criminal prosecution are resolved satisfactorily, the same arguments should resolve concerns about the use of this information to impose the less onerous civil fraud penalties. Moreover, the privilege against self-incrimination is unavailable in *civil* litigation.¹¹¹ This should eliminate concerns about the propriety of imposing *civil* fraud penalties based on information disclosed on obligatory amended returns.

b. Inhibiting Effect on Taxpayers Who Fear Innocent Errors Will Be Treated as Fraudulent

A potentially more significant concern is whether taxpayers committing nonfraudulent errors might decline to file required amended returns out of concern that the IRS would perceive their errors as fraudulent and seek to impose civil or criminal fraud penalties.

Under current policy, substantial numbers of cases of apparent tax evasion are passed over by the government. Instead, the government chooses to focus its resources on the most aggravated cases of criminal fraud that offer the greatest likelihood of successful prosecution. A leading treatise¹¹² summarizes the selection process in the following terms:

In the audit process, the IRS unearths far more cases exuding an aroma of tax evasion than can be prosecuted, given the limited funds earmarked for the extensive investigations and prosecutorial efforts required to establish guilt beyond a reasonable doubt, as well as the clogged channels through which cases must move while being reviewed by the IRS, the Department of Justice, and the U.S. Attorneys throughout the country. At each stage, the case must be placed on a seamless spectrum of tax delinquency, which begins at one end with taxpayers who resolve all doubts in their own favor, are negligent, fail to keep records, or engage in shabby but not heinous conduct and which consists at the other end of aggravated cases of deliberate omissions, false statements, destruction of records, and payoffs to government officials. In deciding when delinquency should be prosecuted and when a civil penalty is sufficient, the IRS and the Department of Justice screen cases at several levels in order to weed out the weak ones. Both agencies are interested in the deterrent effect of publicity as well as in retributive punishment.¹¹³

In light of this emphasis on "aggravated cases," the chances should be fairly remote that a taxpayer who is *not guilty* of criminal fraud would be misperceived as having engaged in fraudulent conduct. As noted, the existence of an amended return not induced by an IRS investigation would itself be a significant factor tending to remove the taxpayer from the "aggravated cases" category.¹¹⁴

111. See generally MCCORMICK ON EVIDENCE § 121(a) (John W. Strong ed., 4th ed. 1992).

112. 4 BITTKER & LOKKEN, *supra* note 8.

113. *Id.* ¶ 114.9.1, at 114-80 (footnote omitted).

114. See *supra* note 101 and accompanying text.

It is also relevant that current Treasury regulations encourage the filing of amended returns to correct errors. Substantial numbers of taxpayers do so, even though the amending taxpayers have no guarantee that the IRS will not seek to impose civil fraud or criminal penalties. It is hard to see how the overall level of taxpayer compliance would decline if the aspirational standard embodied in the regulations was made mandatory.

D. Penalty Recommendations: Breaches of a Duty to Amend

The discussion in section IV.C endorsed, under an obligatory amended return regime, a continuation of policies currently applicable to taxpayers who voluntarily correct original return errors. Specifically, nonfraudulent penalties would be waived if the taxpayer filed a qualified amended return; penalties for civil or criminal fraud would not be waived automatically, but would remain imposable at the IRS's discretion. The other important issue to be addressed is what penalties should apply when taxpayers *fail* to comply with the duty to amend.

A taxpayer filing an erroneous original return normally will not be subject to the § 6651(a)(1) failure-to-file penalty.¹¹⁵ Under an obligatory amended return regime, the amended return might be viewed as a separate "return," in which case the failure to file an obligatory amended return would trigger the failure-to-file penalty.¹¹⁶ A more integrated approach, however, adopts the view expressed by Professor Kahn:¹¹⁷ *only one* "return" is filed and any amended returns are treated as supplements or appendices to the original return. Under this view, the failure-to-file penalty would remain irrelevant under an obligatory amended return regime since a "return" (the original return) would constitute the required filing. The applicable penalty for breach of the duty to amend would be determined with reference to the degree of noncompliance with the reporting standards¹¹⁸ contained in § 6662, which penalizes nonfraudulent reporting errors, and

115. See *supra* section IV.A for a discussion of the failure-to-file penalty and other current Code penalties. The failure-to-file penalty may apply if the filed return is frivolous or is so lacking in requisite information that it does not qualify as a "return." See generally 4 BRITKER & LOKKEN, *supra* note 8, ¶ 111.1.8 (discussing the consequences of filing returns that are deficient, skeletal, or tentative).

116. The Corneel Proposal adopted this approach, but only if the failure to file the amended return was "willful" and no failure-to-file penalty attached to the original return. Corneel Proposal, *supra* note 38, reprinted in Harris, *supra* note 1, at 540 & app. at 572-73.

117. See *supra* note 83 and accompanying text.

118. See *supra* section IV.A for a discussion of current reporting standards, including I.R.C. §§ 6662 and 6663.

§ 6663, which penalizes errors attributable to fraud.¹¹⁹ This Article favors Professor Kahn's more integrated concept of what constitutes a "return" for purposes of determining applicable penalties under an obligatory amended return regime.

1. *A Parity Structure Favored*

A penalty parity structure¹²⁰ equitably recognizes that if taxpayers have a continuous duty, extending from the date of filing until expiration of the period of limitations, to correctly report their tax liabilities, a breach of this duty should result in the same exposure to penalty regardless of when the breach occurs. For example, a taxpayer might commit a material but nonnegligent error on the original return. This error would *not* be subject to the "substantial understatement" penalty of § 6662(b)(2) if the taxpayer had "reasonable cause"¹²¹ for the resulting underpayment of tax.¹²² In this case, the original return error would not be a penalizable error. Suppose, moreover, that within the period of limitations the taxpayer discovered the error and thus was subject to the duty to amend. Although the *commission* of the error was not penalizable, the taxpayer's *failure to correct* the error under a parity structure might, depending on the circumstances, result in one of the following consequences: constitute negligence subjecting the taxpayer to the negligence penalty;¹²³ lack reasonable cause subjecting the taxpayer to the substantial underpayment penalty;¹²⁴ or constitute a fraudulent attempt to evade tax sub-

119. For example, an I.R.C. § 6651(f) fraudulent failure to file an amended return would be treated as an I.R.C. § 6663 fraudulent misreporting of the items on the return. If, however, the "material" error had no impact on tax liability (*see supra* subsection III.B.3), a penalty of a fixed amount for a fraudulent failure to file an obligatory amended return would be appropriate, as would a penalty of a lesser fixed amount for a negligent failure to file an obligatory amended return.

120. *See supra* subsection IV.B.1.

121. I.R.C. § 6664(c)(1).

122. *See supra* section IV.A for a discussion of civil penalties applicable to nonfraudulent errors.

123. An example might be careless inattention to the duty to amend even though the taxpayer had knowledge of a material error that she was obligated to correct. The test, applying the negligence standard of tort law, would be whether a "reasonably prudent person" would have amended the return in a like situation. *See supra* note 67 and accompanying text.

124. Presumably, if the taxpayer *did* have "reasonable cause" for her failure to amend—perhaps, for example, because of illness—the same factor or factors establishing "reasonable cause" would also establish that the taxpayer was not negligent so that the I.R.C. § 6662 penalty would be inapplicable.

jecting the taxpayer to the civil fraud penalty¹²⁵ or, in sufficiently egregious circumstances, to criminal prosecution.¹²⁶

Is there any reason not to favor a parity structure? Is there any reason, for example, to disfavor criminalizing an error that originally was an innocent error if the taxpayer knowingly and willfully perpetuates the error, as this exhibits conduct that would have constituted tax evasion if it had been responsible for the original misreporting? One commentator finds as the most disturbing aspect of obligatory amended returns the prospect "that individuals who make unintentional errors on returns could later be claimed to have committed a crime by failing to file an amended return."¹²⁷ The fear seems to be that of victimization of taxpayers through unjustified prosecutions. But what reason is there to believe the IRS would recommend prosecution of, or the Department of Justice actually would prosecute, a taxpayer based on evidence of willful *perpetuation* of an error that is any less compelling than the evidence—beyond a reasonable doubt—of willful *commission* of the error, which is currently required to successfully prosecute tax evasion? The same factors that now compel the government to focus on the most aggravated cases of *submission* of fraudulent returns should also constrain the government to prosecute only the most flagrant cases of *perpetuation* of reporting errors if amended returns become obligatory.¹²⁸

Another commentator opposes criminalizing the failure to file an obligatory amended return because of "a host of potential constitutional problems arising from the vagueness of the triggering event . . . 'knowledge' of the prior error."¹²⁹ Criminal prosecutions under current law, however, must establish the taxpayer's "knowledge" of wrongful items reported on the return, seemingly an equally vague concept, but one not held to create constitutional infirmities. Amended return obligations do not seem to present constitutional issues distinct from those arising in the original return context.

In *Cheek v. United States*,¹³⁰ the Supreme Court squarely addressed the issue of the degree of "knowledge" that will support a

125. The civil fraud penalty would be applicable whenever the taxpayer's refusal to amend constituted action (or inaction) undertaken with "the specific intent to evade a tax known or believed to be owing." See *supra* note 73 and accompanying text.

126. See 4 BITTKER & LOKKEN, *supra* note 8, ¶ 114.9.2, at 114-90 ("[T]he evidence in virtually any successful civil fraud case would support a [criminal] conviction under § 7201, notwithstanding that guilt in a criminal case must be proved beyond a reasonable doubt, rather than by the 'clear and convincing' standard that suffices for the civil penalty.").

127. Bruton, *supra* note 1, § 53.10, at 53-45.

128. See *supra* note 113 and accompanying text.

129. Harris, *supra* note 1, at 541 n.105 (parentheses omitted). Harris does not elaborate further on this objection to the imposition of criminal penalties.

130. 498 U.S. 192 (1991).

criminal conviction. The Court vacated the conviction of an airline pilot, finding fault with the judge's instruction to the jury that an "honest but unreasonable belief" that wages were not income was not a defense to the criminal charges.¹³¹ The Court reiterated that conviction of tax evasion under § 7201 or failure to file or failure to pay under § 7203 requires proof that the violations were "willful" to safeguard against convictions stemming from taxpayers' insufficient knowledge of complicated tax laws.¹³² Citing *United States v. Murdock*,¹³³ the *Cheek* Court reiterated that

Congress did not intend that a person, by reason of a bona fide misunderstanding as to his liability for the tax, as to his duty to make a return, or as to the adequacy of the records he maintained, should become a criminal by his mere failure to measure up to the prescribed standard of conduct.¹³⁴

The safeguards that Congress afforded taxpayers by criminalizing only "willful" noncompliance with the tax laws should protect taxpayers equally well against abusive prosecutions of violations of a newly enacted duty to amend.¹³⁵

Not all commentators have been hesitant to broaden taxpayers' exposure to criminal sanctions. One student commentator favored criminalizing *reckless noncompliance* with the Code,¹³⁶ a lesser degree of culpability than willful noncompliance. Under this standard, the taxpayer's reckless failure to file an obligatory amended return would be criminalized. This commentator addressed concerns of overzealous governmental prosecution by noting the high costs of governmental prosecutions,¹³⁷ the negative publicity engendered by losing a tax prosecution case,¹³⁸ the ensuing loss of public support if the government was perceived as "ganging up" on innocent taxpayers,¹³⁹ and the

131. *Id.* at 207.

132. *Id.* at 200-02.

133. 290 U.S. 389 (1933).

134. *Cheek v. United States*, 498 U.S. 192, 200 (1991)(quoting *United States v. Murdock*, 290 U.S. 389, 396 (1933)).

135. As explained *supra* section III.C, the duty to amend known material errors might be broadened to include a duty to investigate suspected material errors. This duty would be breached if the taxpayer's failure to investigate departed from the conduct expected of a reasonably prudent taxpayer, that is if the taxpayer's inaction constituted negligence. The consequence of a breach of the duty to investigate would be liability for a civil negligence penalty. Neither the civil fraud penalty nor criminal penalties would apply to violations of a duty to investigate in situations where the evidence is insufficient to establish that the taxpayer had "knowledge" of material errors giving rise to the duty to amend.

136. Walter T. Henderson, Jr., Comment, *Criminal Liability Under the Internal Revenue Code: A Proposal to Make the "Voluntary" Compliance System a Little Less "Voluntary,"* 140 U. PA. L. REV. 1429 (1992).

137. *Id.* at 1459.

138. *Id.*

139. *Id.* at 1460.

ultimate protection afforded by a jury of one's peers.¹⁴⁰ These factors would be equally likely to constrain overly zealous prosecutions of taxpayers failing to comply with a duty to amend.

More conservative penalty schemes might impose lesser sanctions on breaches of the duty to amend. The bottom line, however, is that willful, flagrant breaches of the duty to amend do not deserve lesser sanctions than equally willful, flagrant refusals to correctly report income on the original return. So long as the government, as it does now, focuses its resources on the most aggravated cases of willful non-compliance, justice would be forthcoming.

2. *No Double Penalty*

No reason justifies doubly penalizing a taxpayer for committing a penalizable error on the original return and for failing to comply with a legal duty to correct the error. For example, a taxpayer who negligently omits income from the original return and negligently fails to comply with the duty to amend seemingly should be subject to a single negligence penalty for failure to report this income. There is simply an ongoing case of negligence.¹⁴¹ The "penalty" for failure to amend in this situation would be the taxpayer's continuing exposure to the negligence penalty, an exposure that would disappear if the taxpayer corrected the error on a qualified amended return. In like manner, a taxpayer guilty of tax evasion by the falsification of the original return would not be guilty of a second crime of tax evasion merely by failing to file an obligatory amended return. A single crime of tax evasion would exist, although the proof thereof could take into account the reasons behind the taxpayer's failure to file the obligatory amended return.

3. *Reasonable Opportunity to Comply with a Duty to Amend*

If an amended return is due, a due date must be specified. The due date must give the taxpayer a reasonable opportunity to comply with the duty to amend. For example, the amended return might be required within sixty days¹⁴² after the taxpayer acquired knowledge that a material error had been committed or, if the law imposed a duty to investigate, within sixty days after the taxpayer acquired sufficient knowledge of the possibility of a material error that the taxpayer's

140. *Id.*

141. Similarly, the Corneel Proposal, *supra* note 38, would not have imposed a penalty for failure to file an obligatory amended return in addition to a penalty for failure to file the original return. See Harris, *supra* note 1, at 540.

142. Sixty days is the time allowed to the IRS to assess additional tax liability when the taxpayer files an amended return within 60 days of the date on which the period of limitations for the assessment of tax for the taxable year would otherwise expire. I.R.C. § 6501(c)(7).

failure to investigate further would constitute penalizable negligence.¹⁴³

The purpose of the sixty-day rule would not be to limit the taxpayer's opportunity to avoid penalty by filing a qualified amended return. An amended return would be a qualified amended return, absolving the taxpayer from the negligence penalty, if the amended return was filed before the IRS had contacted the taxpayer,¹⁴⁴ even if filed after the sixty-day period and even if the error corrected was not material. Instead, sixty days would mark the beginning of the period when the taxpayer's failure to file might worsen the taxpayer's exposure to penalty. For example, under a penalty parity structure, a negligent failure to amend within the sixty-day period would subject the taxpayer to the negligence penalty even if the original error giving rise to the duty to amend was not a penalizable error. Similarly, a fraudulent failure to amend within the sixty-day period would subject the taxpayer to the civil or criminal fraud penalty even if the commission of the original error resulted only from negligence or from a nonnegligent innocent mistake.

Suppose the taxpayer discovered a material error a short time, one week for example, before the expiration of the limitations period for the taxable year. The simplest rule to adopt might be that if the limitations period expired before the taxpayer had been given a reasonable opportunity to amend her return, then no duty to amend would arise. Under this rule, if the statutory "reasonable opportunity" was sixty days, then the taxpayer's discovery of a material error within sixty days of the expiration of the limitations period would give rise to no duty to amend. The taxpayer, of course, would retain the option of amending her return nonetheless. By filing a qualified amended return, the taxpayer's exposure to penalty caused by the original return error would be eliminated. Having no duty to amend, if the taxpayer declined to amend her return, was then audited and assessed additional tax before expiration of the limitations period, the taxpayer would be subject to penalty, but only to the extent the taxpayer's conduct with respect to the filing of the original return was penalizable conduct. Since the taxpayer had no duty to amend, the taxpayer's knowledge of the error and inaction could not increase the severity of the original return error. For example, the taxpayer's inaction could not convert a nonpenalizable original return error into a negligent or fraudulent error.

143. While this formulation of the rule renders the due date of the amended return somewhat uncertain, the uncertainty arises from the inherent uncertainty in the concept of negligence. The factual issue is no more difficult than the issue of whether a taxpayer's conduct with respect to an *original* return has been negligent and should give rise to a penalty.

144. See *supra* subsection IV.C.1.

An alternative approach would provide that the limitations period would expire on the later of (1) its normal expiration date, or (2) sixty days from the date of the taxpayer's acquisition of knowledge giving rise to the taxpayer's duty to amend or duty to investigate further. This approach, however, would create different limitations periods for different taxpayers, a complication that might not be worth the benefit of extending the duty to amend to errors discovered or suspected during the sixty days preceding the normal limitations period expiration date.

V. AMENDED RETURN OBLIGATION AND STATUTES OF LIMITATIONS

Statutes of limitations exist to provide closure to prior tax years and finality to the determination of tax obligations for those years.¹⁴⁵ Just as the concept of penalty parity is useful to examine how existing penalties might be incorporated into a regime in which amended returns are obligatory, so too the concept of *limitations period parity* is useful to examine how existing statutes of limitations might be incorporated into a regime in which amended returns are obligatory.

A. Current Statutes of Limitations

A somewhat general observation is that the more egregious the taxpayer's reporting errors, the longer the time allowed for the IRS to commence an audit of the taxpayer's return. If the taxpayer's original return is nonfraudulent, then the limitations period for the assessment of tax begins on the later of (1) the due date of the original return, or (2) the date the original return is filed.¹⁴⁶ The limitations period for the assessment of tax is normally three years.¹⁴⁷ If, however, the taxpayer's nonfraudulent original return omits gross income in excess of twenty-five percent of the gross income stated in the return, then the IRS has six years, instead of three years, in which to make an assessment of tax.¹⁴⁸ A fraudulent original return does not

145. See *Burnett v. New York Cent. R.R.*, 380 U.S. 424, 428 (1965) (stating that statutes of limitations "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them." (quoting *Order of R.R. Telegraphers v. Railway Express Agency*, 321 U.S. 342, 348-49 (1944))).

146. I.R.C. § 6501(a), (b)(1).

147. *Id.* § 6501(a).

148. *Id.* § 6501(e)(1)(A). Similarly, omissions from the gross estate of amounts in excess of 25% of the gross estate stated in the estate tax return extends the limitations period for estate tax assessment from 3 years to 6 years. *Id.* § 6501(e)(2). Similar rules govern the omission of gifts from gift tax returns (I.R.C.

trigger a limitations period¹⁴⁹ so that tax, interest, and penalties may be assessed at any time.¹⁵⁰ If the taxpayer does not file a return, the limitations period does not begin to run.¹⁵¹

An amended return showing additional tax due generally has no effect on the limitations period.¹⁵² For example, a limitations period of six years is not shortened to three years by the filing of an amended return reporting the omitted gross income.¹⁵³ Similarly, a nonfraudulent return correcting a fraudulent original return does not curtail the IRS's unlimited period for the assessment of tax.¹⁵⁴ If, however, an amended return is filed within sixty days of the date on which the limitations period would otherwise expire, the IRS must assess the additional tax shown on the return within sixty days after receipt of the amended return.¹⁵⁵ The taxpayer and the IRS may agree to extend the limitations period by any amount of time if such agreement is entered into before the limitations period otherwise expires.¹⁵⁶

If the taxpayer's original return constitutes a tax crime, the IRS generally has three years from the date of commission of the crime to indict the taxpayer,¹⁵⁷ but the limitations period is six years for the more important tax violations.¹⁵⁸ A corrected amended return does

§ 6501(e)(2)) and omissions of excise taxes from excise tax returns (I.R.C. § 6501(e)(3)). Although the textual discussion of limitations period parity focuses on federal income tax returns, the concept of limitations period parity is equally applicable to the federal wealth transfer taxes and the federal excise taxes.

149. *Id.* § 6501(c)(1).

150. If any part of the underpayment of tax is attributable to fraud, then the assessment period is unlimited with respect to all items pertaining to the taxable year, including any erroneous items on the return not attributable to fraud. *United States v. Diehl*, 460 F. Supp. 1282 (S.D. Tex. 1978), *aff'd*, 586 F.2d 1080 (5th Cir. 1978).

151. I.R.C. § 6501(c)(3).

152. *Badaracco v. Commissioner*, 464 U.S. 386, 393-94 n.8 (1984); *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934). If the original return is nonfraudulent, but the amended return is fraudulent, *Badaracco* seems to imply that the 3-year (or 6-year) statute of limitations applicable to the nonfraudulent original return continues to apply. Professor Kahn doubts that most courts would reach this result, however, if the matter was litigated. Kahn, *supra* note 83, at 471.

153. *E.g.*, *Houston v. Commissioner*, 38 T.C. 486, 489 (1962).

154. *Badaracco v. Commissioner*, 464 U.S. 386 (1984). The Supreme Court's reasoning and conclusion are criticized by Kahn, *supra* note 83.

155. I.R.C. § 6501(c)(7).

156. *Id.* § 6501(c)(4).

157. *Id.* § 6531.

158. Section 6531 of the Code specifies a limitations period of 6 years under the principal statutes used to prosecute criminal tax reporting violations: § 6531(2) covering § 7201 tax evasion; § 6531(4) covering § 7203 failure to file or failure to pay; § 6531(5) covering § 7206(1) filing a false return or false statement; and § 6531(3) covering § 7206(2) aiding, assisting, or counseling falsity or fraud.

not negate the commission of the crime, although it might dissuade the IRS from instituting criminal proceedings.¹⁵⁹

B. Limitations Periods: A Normative Approach

Statutes of limitations that accompany a legal duty to amend might be designed to affect a parity structure. A limitations period parity structure will exist to the extent the submission of an amended return gives the IRS the same amount of time to investigate the return, as amended, that the IRS would have had if the amended items had been submitted on an original return.¹⁶⁰ For example, a non-fraudulent return ordinarily gives the IRS three years from the later of (1) the date the return is filed, or (2) the due date of the return to assess tax.¹⁶¹ A fraudulent return does not create a limitations period for the assessment of tax.¹⁶² Therefore, under a parity structure, a fraudulent return followed after the original return due date by a non-fraudulent amended return (curing the original return fraud) would commence a three-year statute of limitations beginning with the date the amended return was filed.¹⁶³ A nonfraudulent original return fraudulently amended, under a parity structure, would suspend the running of the statute of limitations. Similarly, a fraudulent *failure* to amend an erroneous but nonfraudulent original return (subjecting the taxpayer to a fraud penalty under a penalty parity structure) would suspend the running of the limitations period.

Limitations period parity would provide identical audit exposure for taxpayers committing or perpetuating identical types of reporting errors, thereby providing for consistent, equitable treatment of similarly situated taxpayers. Therefore, limitations period parity has a natural appeal, although there are overriding reasons not to adopt a parity structure in some situations.

C. Limitations Period Recommendations

The existing statutes of limitations obviously do not achieve parity. For example, a taxpayer who faces a limitations period of infinite duration because she filed a fraudulent original return has no opportu-

159. See *supra* subsections IV.C.2.d and IV.C.3.

160. Parity, however, will not allow the IRS more time to audit a taxpayer who corrects an error than a similarly situated taxpayer who does not correct an error, which clearly would be inequitable.

161. I.R.C. § 6501(a), (b)(1).

162. *Id.* § 6501(c)(1).

163. It seems irrelevant whether or not the taxpayer's amended return is filed voluntarily (i.e., is a "qualified amended return"). The purpose of statutes of limitations is to terminate stale disputes. Once a nonfraudulent amended return is filed, the reason for an indefinite limitations period disappears. See Kahn, *supra* note 83, at 476-77. Thus, limitations period parity, unlike penalty parity, is not defined in terms of whether or not the amended return is voluntarily filed.

nity to shorten the period to three years by means of a nonfraudulent amended return.¹⁶⁴ A taxpayer has no opportunity to shorten the limitations period to three years by filing a timely amended return if the taxpayer files an erroneous but nonfraudulent original return that omits from gross income an amount in excess of twenty-five percent of the gross income stated in the return. Instead, the taxpayer remains bound by the six-year statute of limitations triggered by the original return.¹⁶⁵ In these and other cases, would a parity structure be a better accompaniment to an obligatory amended return regime? This question is first considered in the context of nonfraudulent original returns and then in the context of fraudulent original returns.

1. *Nonfraudulent Original Returns*

Suppose a taxpayer filed a nonfraudulent return, triggering a three-year limitations period and then subsequently filed a nonfraudulent amended return that improperly restated a smaller amount of gross income. Assume further that the gross income that should have been reported on the return now exceeded twenty-five percent of the gross income stated on the return, as amended. Should an *extension* of the limitations period to six years be triggered? For either of two reasons, the answer appears to be "no."

First, this extension apparently would not be needed to achieve parity. The six-year limitations period applies under current law only to the extent the omitted gross income is not "disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item."¹⁶⁶ The hypothetical taxpayer's inclusion in the original return of gross income omitted from the amended return seems to have adequately apprised the IRS of the nature and amount of the item.¹⁶⁷ Therefore, if the information shown on the original and amended returns had all been set forth on an original return, only a three-year limitations period, not a six-year limitations period, would have been triggered. Second, if taxpayers knew that an amended return might lengthen the limitations period, they might be discouraged from filing amended returns.¹⁶⁸ The amended return in this situation would not be obliga-

164. See *supra* section V.A.

165. See *supra* section V.A.

166. I.R.C. § 6501(e)(1)(A)(ii).

167. See *Colony, Inc. v. Commissioner*, 357 U.S. 28, 36 (1958)(finding that the extended limitations period provided by § 275(c) of the Internal Revenue Code of 1939, the precursor of § 6501(e)(1), reflected the "special disadvantage" the IRS faced in detecting omitted income for which the return on its face provided "no clue").

168. Kahn, *supra* note 83, at 480. See also *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180 (1934)("Supplement and correction . . . will not take from a taxpayer,

tory; rather, it would show a reduction of taxable income. It may be poor policy to discourage the filing of "honest"¹⁶⁹ amended returns.

By contrast, no real policy consideration opposes limiting a six-year limitations period created by the original return to the lesser of (1) three years, or (2) the remainder of the six-year period, by the filing of a curative amended return.¹⁷⁰ The shorter limitations period would achieve the equitable advantage of placing the amending taxpayer in parity¹⁷¹ with taxpayers whose original returns reflected the taxpayer's positions, as amended, and would encourage compliance with the duty to amend by offering a reduced limitations period.¹⁷²

Suppose the taxpayer amended a *nonfraudulent* original return by filing a *fraudulent* amended return. Assuming that the fraudulent amended return requested a refund that was paid, the IRS would have five years after making the refund within which to seek its recovery.¹⁷³ Would the better policy be that the fraudulent amended return should suspend the running of the limitations period, placing the amending taxpayer in parity with taxpayers whose original returns were fraudulent?

The justifications for an unlimited assessment period for fraudulent returns are that (1) a fraudulent return does not provide the accounting to the government necessary for a proper assessment of tax,¹⁷⁴ and (2) the proof of fraud is arduous and time-consuming, requiring the government to unearth evidence not only of incorrectly reported items, but also proof that the taxpayer acted with fraudulent intent in misreporting these items.¹⁷⁵ In the situation hypothesized, the government's case is somewhat advanced by the nonfraudulent original return, pinpointing the items in dispute and establishing the taxpayer's original conviction that a different tax treatment was ap-

free from personal fault, the protection of a term of limitation already running for his benefit.").

169. "An *honest* return is one in which deficiencies, if any, are attributable to bona fide differences of judgment or to innocent errors caused by oversight or negligence." Kahn, *supra* note 83, at 461 n.1 (emphasis added).
170. Professor Kahn argues that as a matter of interpretation of enacted law, courts may have erred by "mechanically" applying the rule that amended returns don't *lengthen* the limitations period to prevent amended returns from *shortening* the limitations period "without questioning whether different considerations were present." Kahn, *supra* note 83, at 480.
171. See *supra* note 158.
172. In this situation, the amended return would show increased tax due and would be an obligatory amended return if the amount originally underpaid was "material."
173. I.R.C. § 6532(b).
174. See *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180 (1934)(recognizing as a "return" a document that purports to be and sworn to as a return and which "evinces an honest and genuine endeavor to satisfy the law").
175. See *Badaracco v. Commissioner*, 464 U.S. 386, 398-99 (1984)(noting the difficulty of proving fraud cases and the possibility that the taxpayer's underlying records might have been falsified or destroyed).

propriate than that later claimed. Nonetheless, there seems little reason to encourage a *fraudulent* amended return by protecting it with a finite limitations period. A suspension of the statute of limitations when the fraudulent amended return is filed—achieving parity—seems appropriate.¹⁷⁶

A more common situation might feature a taxpayer who first filed a nonfraudulent original return, triggering a three-year limitations period, but then who fraudulently failed to amend. Suppose, for example, following enactment of an obligatory amended return requirement, the taxpayer's accountant informed the taxpayer that the previous year's return (nonfraudulently but erroneously prepared by the accountant) omitted twenty percent of the taxpayer's gross income for that year and that an amended return was required by law. The taxpayer refused to file the amended return and thereby converted the nonfraudulent error into a fraudulent error. The likelihood that the amended return would be filed might be greater if the accountant was able to inform the taxpayer that her failure to file the amended return would suspend the running of the three-year limitations period and would enable the IRS to assess tax, interest, and penalties at any time.¹⁷⁷ Thus, equity and enhanced tax compliance both appear to be served in this situation by adoption of a limitations period parity rule—a suspension of the limitations period.

2. *Fraudulent Original Returns*

A parity structure would provide a taxpayer who filed a nonfraudulent amended return following a fraudulent original return with the same limitations period protections enjoyed by a taxpayer whose original return was nonfraudulent. Thus, the amended return would commence the running of a three-year limitations period (six years if the

176. As a practical matter, fraudulent amendments of nonfraudulent returns may not occur with enough frequency to make the limitations period issue of much importance. This is so because the taxpayer may well hesitate to attempt to deceive the government about items that were previously disclosed nonfraudulently.

177. Professor Harris is reluctant to allow an unlimited limitations period when a nonfraudulent original return is followed by a fraudulent failure to amend, "subjecting taxpayers in borderline cases to the potential of litigation in the distant future." Harris suggests extending the limitations period for an additional 3 years as a compromise solution. Harris, *supra* note 1, at 542-43. But the risk of litigation in the distant future of borderline cases is no greater than the risk that exists under current law: original return borderline cases will be litigated in the distant future. The argument ignores the reality that the IRS, possessing the burden of proof in fraud cases by clear and convincing evidence, is constrained by limited resources to pursue the more egregious cases. This situation is unlikely to change if amended returns become obligatory. The more distant the future, the less likely the available evidence will be clear and convincing and the less likely that the IRS will be willing to consume substantial resources to pursue what would be relatively stale cases.

amended return, although nonfraudulent, omitted income in excess of twenty-five percent of the gross income stated in the return, as amended). The limitations period would begin running on the date the nonfraudulent amended return was filed.

Assuming, as argued above,¹⁷⁸ that the amended return should fail to negate the taxpayer's exposure to civil fraud or criminal penalties stemming from the fraudulent original return, a three-year statute of limitations probably would be too short. Under current law, the unlimited period of limitations for civil penalty purposes,¹⁷⁹ combined with the six-year limitations period for criminal purposes,¹⁸⁰ effectively gives the government six years to complete an investigation of possible fraud. During the six years, the government retains the option to seek civil fraud penalties, criminal penalties, or both. Because cases of suspected fraud require more time to develop, the time granted to the IRS to develop its case probably should not be reduced to fewer than six years if no criminal indictment is issued within the six-year period, or a stated period of time (perhaps one year) following conclusion of criminal proceedings if a criminal indictment is issued.¹⁸¹ If this approach is followed, a nonfraudulent amended return that cured the original return fraud would have no effect on criminal statutes of limitations, but would commence the running of a limitations period on civil assessments that would expire at the later of (1) three years after the submission of the nonfraudulent amended return,¹⁸² or (2) six years from the date of filing of the fraudulent original return, or (3) in the event a criminal indictment is issued within six years of filing the original return, one year following conclusion of the criminal proceedings.¹⁸³

178. See *supra* subsection IV.C.2.

179. I.R.C. § 6501(c)(1).

180. See *supra* section V.A.

181. An IRS auditing agent is instructed to both suspend the examination once she has "firm" indications of fraud and refer the case to the Criminal Investigation Division (CID) of the IRS. SALTZMAN, *supra* note 96, ¶ 8.06[7], at 8-63. A joint investigation by the agent and the CID may ensue. Under I.R.C. § 7602(c), the IRS is barred from issuing a civil summons once a case is referred to the Department of Justice for criminal prosecution. Further, a criminal conviction (or guilty plea) collaterally estops the taxpayer from denying civil fraud. 4 BITTKER & LOKKEN, *supra* note 8, ¶ 114.6, at 114-58. These considerations frequently motivate the IRS to await the outcome of criminal proceedings before pressing civil fraud penalties.

182. This period would be 6 years in the unlikely event that the amended return, although nonfraudulent, omitted income in excess of 25% of the gross income stated in the return, as amended.

183. By contrast, Harris would impose a 3-year statute of limitations commencing with the filing of a nonfraudulent amended return if the amended return immunized the taxpayer from criminal prosecution under a "formal" voluntary disclosure program. Harris, *supra* note 1, at 541-42.

VI. CONCLUSIONS

The statutory adoption of a legal obligation to correct material tax return errors discovered within the period of limitations has a logical appeal. It is administratively unsound to impose no obligations upon a taxpayer who discovers that her tax return materially understates her tax liability. Some might fear unwarranted governmental assertions that taxpayers have inaccurately reported their tax liabilities. Some may also fear extending the period of limitations to keep the government accurately informed of the taxpayers' tax liabilities. These fears, in the reality of practice, would likely be unfounded. Further, to the extent the legal obligation increased voluntary tax compliance, it would reduce the need for intrusive governmental audits.

If a legal obligation was enacted, the taxpayer would face a continuing duty to self-report, which would extend from the due date of the original return until the expiration of the period of limitations for the taxable year. It would be appropriate, although not necessary, to extend the duty to correct material tax return errors to a duty to investigate the possibility of material tax return errors whenever a reasonably prudent taxpayer would undertake such an investigation. The threshold at which an error (or collection of errors) would become material would need to be set at a sufficiently high level to justify the taxpayer's time, trouble, and expense to make the corrections. The judgment of an appropriate threshold is implicitly contained in the § 6662(b)(2) "accuracy-related" penalty. This threshold could be incorporated as the measure of materiality of an error resulting in an underpayment of tax. If the reporting error did not cause an underpayment of tax, then it might be deemed material only if it was an incorrect response to an informational question specifically included on the tax return form.

A penalty parity structure is generally the most appropriate accompaniment to a legal duty to correct material tax return errors because it provides the most consistent treatment of errors that are committed, perpetuated, or neutralized by the taxpayer's tax return and amendments made thereto. A penalty parity structure uses notice to the taxpayer of an IRS examination of the taxpayer's return as the appropriate point in time to evaluate the culpability of the taxpayer's conduct. Under a penalty parity structure, the culpable perpetuation of an error would subject the taxpayer to the same penalty that would have applied if the same level of culpability had led to commission of the error. On the other hand, the taxpayer's correction of an error before notice of an audit would alleviate the taxpayer's exposure to penalty just as if the error had never been committed. The one situation in which penalty parity treatment seems inappropriate is when the taxpayer's original return is fraudulent. In this case, an automatic waiver of civil or criminal fraud penalties as the result of the

taxpayer's timely-filed amended return would offer too much opportunity for abuse. Instead, as under current law, the assertion of civil or criminal fraud penalties based on the fraudulent preparation of the original return would remain within the government's discretion.

A limitations period parity structure is generally appropriate under an obligatory amended return regime. Under the federal income tax, for example, a limitations period parity structure can be devised to incorporate existing limitations period differences between (1) nonfraudulent returns that do not omit income in excess of twenty-five percent of the gross income stated in the return, (2) nonfraudulent returns that omit income in excess of twenty-five percent of the gross income stated in the return, and (3) fraudulent returns. Under a parity structure, the amount of gross income omitted from the return, as amended, and the fraudulent or nonfraudulent status of the return, as amended, would determine the applicable limitations period.

In implementing this approach, if the taxpayer's original return was nonfraudulent, either a fraudulent amendment of the return or a fraudulent failure to comply with a duty to amend would suspend the running of the limitations period. If the original limitations period was six years because the taxpayer omitted income in excess of twenty-five percent of the gross income stated in the return, then a nonfraudulent amended return that reduced the unreported gross income below the twenty-five percent threshold would limit the limitations period to the shorter of (1) three years, or (2) the unexpired portion of the six-year limitations period.

If the taxpayer's original return was fraudulent, then a nonfraudulent amended return would relieve the taxpayer from unlimited exposure to audit and assessment of tax. The limitations period, however, would have to be long enough to allow the government to establish a factual foundation for the imposition of civil or criminal fraud penalties (or both) based on the fraudulent original return, should the government wish to do so. This would justify a limitations period that would end at the later of (1) three years after the submission of the nonfraudulent amended return, (2) six years from the date of filing of the fraudulent original return, or (3) in the event a criminal indictment was issued within six years of filing the original return, one year following the conclusion of the criminal proceedings.