A Return to Troy: Qualified Amended Returns and the Civil Fraud Exception

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At some point, Congress and the IRS will be forced to acknowledge that it is simply impossible to resolve the tax gap[1] through enactment of additional penalties and increased enforcement. Under any scenario, improved tax compliance requires taxpayers (and those who ought to be taxpayers) to voluntarily come into compliance. When errors are discovered in a filed return, tax practitioners often pave the road to compliance through assurances that the tax equivalent of waterboarding is not a typical government response to receipt of an amended return. Some assurances are purportedly provided in reg. section 1.6664-2(c)(2) relating to the timely filing of a qualified amended return (QAR). Generally, the QAR regulations are intended to encourage voluntary compliance by permitting taxpayers to avoid accuracy-related penalties if an amended return is filed before the IRS begins an investigation of the taxpayer or of the promoter of a transaction in which the taxpayer participated.

IRS Commissioner Douglas Shulman has repeatedly encouraged taxpayers to "get right" with the government. Circular 230[2] requires practitioners to advise taxpayers of the potential penalties associated with noncompliance.[3] However, practitioners have long encouraged taxpayers to get into compliance because it is simply the right thing to do. When advised of an error in a return, most noncompliant taxpayers want to come into compliance, although all will inquire about the potential consequences of amending returns that are not otherwise under examination. Some believe an amended return constitutes a red flag ensuring the examination of every open tax year. Others are simply reluctant to believe that the government won't seek out some exception within the QAR regulations as a method of asserting penalties against the now low-hanging fruit identified within the amended return.

Logically, the information set forth in an amended return should be substantially accurate. In fact, since taxpayers would either amend every potentially questionable item in the return or do nothing, most amended returns are likely bulletproof. A taxpayer desiring to be less than forthright in an amended return should likely not file the return. Practitioners should decline any engagement involving the filing of a less-than-accurate amended return (unless the potentially questionable issues are appropriately disclosed). From the government's perspective, an amended return setting forth a deficiency represents the preservation of limited enforcement resources and the ability to focus those resources elsewhere. The government should respond with a hearty "Thank you!" — not an aggressive examination attempting to ferret out any potential penalties that may lie between the complexities of the QAR regulations.

Recent IRS examinations of QARs in several unrelated situations (not involving previously undeclared foreign accounts) around the country seem to support the contention that the historical reliance by practitioners and taxpayers on the sanctity of the QAR regulations may now be somewhat misplaced. They should beware of the QAR Trojan horse, which seems to be appearing more

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[1]The tax gap — the difference between the amount of tax imposed on taxpayers for a given year and the amount that is actually paid voluntarily and timely — represents, in dollar terms, the annual amount of noncompliance with our tax laws. Since the tax gap represents unpaid taxes, any estimate is, at best, an estimate. The federal gross tax gap is estimated at $345 billion per year (based on IRS tax gap data for tax year 2001). IRS enforcement activities, coupled with other late payments, recover about $55 billion of the gross tax gap, representing a net federal tax gap of approximately $290 billion and a noncompliance rate of 15 to 16 percent. *See* "IRS Updates Tax Gap Figures," IR-2006-28 (Feb. 14, 2006), *Doc 2006-2947, 2006 TNT 31-6* (includes tax gap data for tax year 2001).

[2]Regulations governing practice before the IRS are set forth in 31 CFR part 10 and are published in pamphlet form as Treasury Department Circular 230. The regulations prescribe the duties and restrictions relating to that practice and the disciplinary sanctions for violating the regulations. A copy of Circular 230 is available at http://www.irs.gov/pub/irs-pdf/pcir230.pdf.

(Footnote continued in next column.)

[3]Circular 230, section 10.21, "Knowledge of client's omission":

> A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

often at the gates of taxpayers coming into compliance through the filing of an amended return.

History of IRS Enforcement

As stated by President Kennedy, ''Change is the law of life. And those who look only to the past or the present are certain to miss the future.''[4] Tax enforcement must be fair, strong, steady, and consistently applied over time from taxpayer to taxpayer. As succinctly stated by Chief Judge Friendly in *Sirbo Holdings*:

> the Commissioner has a duty of consistency toward similarly-situated taxpayers; he cannot properly concede [an issue] in one case and, without adequate explanation, dispute it in another having seemingly identical facts which are pending at the same time.[5]

When trying to predict the future of tax enforcement, a brief history lesson may be instructive. Senate Finance Committee hearings conducted in late 1997 targeted various perceived abuses by the IRS leading to the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA '98).[6] In part, RRA '98 inappropriately handcuffed the business operations of the IRS by threatening IRS employees with termination if taxpayers asserted they were being ''harassed.''[7]

Most IRS employees have great pride in their service to the government. Following RRA '98, few wanted to take any action that might have historically been deemed proper but could also subject them to termination. In the 1990s, a ''scorched earth'' collection policy was not unusual if taxpayers failed to appropriately respond to IRS collection efforts. However, enforced tax collection or criminal investigations necessarily involve some degree of interactions with taxpayers and their representatives that some might assert to be harassment. From 1998 through 2002, just about every publicly available statistic summarizing IRS enforcement efforts exhibited a significant decline. Further, during this period, there was little or no significant new hiring of IRS revenue agents, revenue officers, Appeals officers, and counsel. Aggregate IRS staffing declined significantly, total returns filed increased substantially, gross accounts receivable increased approximately $60 billion, the unfiled return inventory increased approximately 500,000, and the audit rate substantially declined.[8] The IRS was mostly out of business as a direct result of an act of Congress.

While struggling with somewhat limited resources, the IRS also faced adverse publicity from various national financial and business publications implying that only ''chumps'' seem to comply with the Internal Revenue laws.[9] Later, the IRS was characterized as ''out of control,'' apparently having a license to ''gratuitously humiliate innocent taxpayers'' in the enforcement process.[10] Later, on the conclusion of Charles O. Rossotti's term as IRS commissioner, a headline declared, ''Departing Chief says I.R.S. is Losing War on Tax Cheats.''[11] Journalists ultimately began to notice the enhanced IRS enforcement efforts. One magazine article, ''The IRS Wants You to Fess Up: Message from the federal government: We've got our house surrounded. Come out with your hands up. Should you?'' said ''the day of reckoning is at hand.''[12]

Ten Facts About Amended Returns

Amended returns, voluntarily filed with the government, serve as strong support for tax administration in the United States. The government and practitioner communities support taxpayers coming into compliance in advance of any IRS contact. A recent IRS fact sheet is designed to encourage the amendment of tax returns by listing the following facts:

> 1. If you need to amend your tax return, use Form 1040X, Amended U.S. Individual Income Tax Return.
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> 2. Use Form 1040X to correct previously filed Forms 1040, 1040A or 1040EZ. The 1040X can also be used to correct a return filed electronically. However, you can only paper file an amended return.
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> 3. You should file an amended return if you discover any of the following items were reported incorrectly: filing status, dependents, total income, deductions or credits.
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> 4. Generally, you do not need to file an amended return for math errors. The IRS will automatically make the correction.
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> 5. You usually do not need to file an amended return because you forgot to include tax forms such as W-2s or schedules. The IRS normally will send a request asking for those documents.
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> 6. Be sure to enter the year of the return you are amending at the top of Form 1040X. Generally, you must file Form 1040X within three years from the

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[4]This quotation was referenced in prepared remarks of IRS Commissioner Douglas Shulman before the National Press Club, Apr. 13, 2009, *Doc 2009-8422, 2009 TNT 69-5*.

[5]*Sirbo Holdings, Inc. v. Commissioner*, 476 F.2d 981 (2d Cir. 1973).

[6]P.L. 105-206, effective July 22, 1998.

[7]Section 1203 of the RRA '98 generally provides that IRS employees must be terminated from federal employment if they violate certain rules in connection with the performance of their official duties. IRS employees are subject to termination for acts including the violation of IRS policies for the purpose of retaliating or harassing a taxpayer or the taxpayer's representative and false statements under oath. The commissioner can personally mitigate the sanction of termination, but that decision is not subject to review in any administrative or judicial proceeding. *See also* Notice 99-27, 1999-1 C.B. 1097, *Doc 1999-16390, 1999 TNT 87-12*.

[8]http://www.trac.syr.edu/tracirs/trends. **[Author: Access to this website appears to be restricted.]**

[9]*See* Janet Novack, ''Are You A Chump?'' *Forbes*, Mar. 5, 2001.

[10]*The Wall Street Journal*, Review and Outlook Opinion, Jul. 17, 2002.

[11]David Cay Johnston, *The New York Times*, Nov. 5, 2002.

[12]Janet Novack, *Forbes*, Apr. 14, 2003 (the IRS was then investigating 70 accounting, law, investment, banking, and other firms for ''peddling abusive technical shelters to corporations and rich individuals'').

date you filed your original return or within two years from the date you paid the tax, whichever is later.

7. If you are amending more than one tax return, prepare a 1040X for each return and mail them in separate envelopes to the IRS campus for the area in which you live. The 1040X instructions list the addresses for the campuses.

8. If the changes involve another schedule or form, you must attach it to the 1040X.

9. If you are filing to claim an additional refund, wait until you have received your original refund before filing Form 1040X. You may cash that check while waiting for any additional refund.

10. If you owe additional tax for 2009, you should file Form 1040X and pay the tax as soon as possible to limit interest and penalty charges. Interest is charged on any tax not paid by the due date of the original return, without regard to extensions.[13]

Penalties Based on 'Underpayment' of Tax

Section 6662(a) and (b) provides for a 20 percent penalty on an underpayment resulting from negligence, a ''substantial understatement of income tax,'' a substantial valuation misstatement, a substantial overstatement of pension liabilities, or a substantial estate or gift tax valuation overstatement.[14] Section 6663 provides for a 75 percent civil fraud penalty on the portion of any underpayment attributable to fraud. For purposes of sections 6662 and 6663, an ''underpayment'' is defined in section 6664 and the regulations as the difference between the correct amount of tax (determined without regard to payments and credits) and the ''amount shown as the tax by the taxpayer on his return'' (including amounts previously assessed and credits or refunds received).[15]

QAR and the Civil Fraud Exception

In some situations, a timely filed amended return may reduce or eliminate accuracy-related penalties. The ''amount shown as the tax by the taxpayer on his return'' includes an amount shown as additional tax on a QAR, *except* that such amount is not included if it relates to a fraudulent position on the original return.[16] Reg. section 6664-2(c)(3) provides that a QAR is an amended return, or a timely request under section 6227 (regarding a request for an administrative adjustment of partnership items), filed after the due date of the original return for the specific tax year (determined with regard to extensions) and before the earliest of five dates:

A. The date the taxpayer is first contacted by the IRS concerning any examination (including a criminal investigation) with respect to the return.

Note that the contact must be by the IRS; a QAR can be filed if the taxpayer has not been contacted by the IRS even though he was contacted by others. Also, the IRS contact must be ''with respect to the return.'' An initial IRS contact does not always identify the exact reason for the contact. Also, a contact for one tax year should not bar the filing of a QAR for a different tax year.

B. The date any person is first contacted by the IRS concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters) for an activity with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan, or arrangement described in section 6700(a)(1)(A).

Contacts of a promoter under section 6700 must be examined to determine whether that promoter was a ''person'' contacted concerning the taxpayer's particular transaction. Consistent with its promoter strategy, the Service has initiated a significant number of promoter examinations to (among other objectives) obtain tax shelter client lists. The IRS frequently conducts examinations under section 6707 (failure to register penalty) and section 6708 (failure to maintain investor list penalty), not under section 6700 (promoting abusive tax shelters).[17]

C. In the case of a passthrough item,[18] the date the passthrough entity[19] is first contacted by the IRS in connection with an examination of the return to which the passthrough item relates.

Practitioners should determine whether any such contacts were ''in connection with an examination of the return to which the passthrough item relates.'' A contact for one tax year should not bar the filing of a QAR for a different tax year.

D. The date on which the IRS serves a John Doe summons[20] relating to the tax liability of a person, group, or class that includes the taxpayer (or passthrough entity of which the taxpayer is a partner, shareholder, beneficiary, or holder of a residual interest in a real estate mortgage investment conduit) with respect to an activity for which the taxpayer directly or indirectly claimed any tax benefit on the return. The foregoing applies to any return claiming a direct or indirect tax benefit from the type of activity that is the subject of the John Doe summons, regardless of whether the summons

[13]IRS Tax Tip 2010-72.

[14]Under section 6662(h), this penalty can increase to 40 percent of an underpayment if a taxpayer's adjusted basis is grossly misstated (*i.e.*, overstated by 400 percent or more). In many tax shelter transactions, an asset's basis can become ''enhanced'' by more than 400 percent, and the IRS has been proposing the 40 percent penalty.

[15]Section 6664(a) and reg. section 1.6664-2(a), (b) and (c).

[16]Reg. section 1.6664-2(c)(2).

[17]*Bergmann v. Commissioner*, T.C. Memo. 2009-289, *Doc 2009-27623, 2009 TNT 240-20*.

[18]*See* reg. section 1.6662-4(f)(5).

[19]*See id.*

[20]*See* section 7609(f). A John Doe summons does not identify the specific person with respect to whose liability the summons is issued but must relate to the investigation of a particular person or an ascertainable group.

seeks the production of information for the tax period covered by that return.

This represents a distinction from the requirements relating to individual returns and partnership items for particular tax years.]

E. The date on which the IRS announces by revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin, a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction. The foregoing applies only to a taxpayer who participated in the listed transaction and for the tax year(s) in which the taxpayer claimed any direct or indirect tax benefits from the listed transaction.

Essentially, once the IRS announces an administrative settlement for a listed transaction, the taxpayer can no longer obtain penalty relief through the filing of a QAR.[21]]

A QAR effectively eliminates accuracy-related penalties by removing amounts shown on the amended return from the penalty calculation. Significantly, even if timely, an amended return does not qualify as a QAR if the tax deficiencies that are corrected in the amended return relate to a fraudulent position on the original return. Why? Taxpayers should be encouraged to voluntarily amend all returns, even returns that for some reason may be deemed to include fraudulent positions, before the occurrence of any of the events set forth in reg. section 6664-2(c)(3). Historically, the IRS rarely examined amended returns setting forth a deficiency. The IRS is presently conducting examinations of good-faith QARs and is aggressively seeking interviews of the taxpayer, the return preparer, and others. What is an appropriate interview response as to the reason a taxpayer decided to amend a return and report an additional tax liability? Patriotism? Sleep therapy? Should we care?

It is not recommended that practitioners routinely allow the IRS to interview the taxpayer. The taxpayer's representative may represent the taxpayer in an examination and is not required to produce the taxpayer for questioning unless an administrative summons is served on the taxpayer.[22] Agents typically seek to interview taxpayers near the commencement of an examination. Unfortunately, at that time the representative usually lacks sufficient information to determine the nature and scope of the examination. IRS examinations are typically focused and occur because of a specific reason. Determining that reason, especially following the good-faith filing of a QAR, is the foundation of every representation.

Practitioners cannot effectively represent their clients without knowing the nature and scope of any examination. During every examination involving an amended return (and otherwise), consider the submission of a Freedom of Information Act[23] request seeking a copy of the IRS administrative file, which would include the internal memoranda and documents prepared by the examining agent or received from third parties. If the IRS Disclosure Office might determine that an exemption applies to some or all of the requested information, the FOIA request should include a request that a privilege log be provided in the form of a Vaughn Index.[24] There may be meaningful surprises lurking within the FOIA response. Also, request information regarding any third parties the IRS may have contacted at any time regarding the examination of the taxpayer.[25]

Efficient tax administration should seek to encourage, rather than restrict, the filing of QAR in a resource-challenged environment. Taxpayers and practitioners must carefully consider whether submission of a good-faith QAR is actually in the best interest of the taxpayer. Section 6664 and reg. section 6664-2 specifically preclude the IRS from asserting the section 6662 accuracy-related penalties following the filing of a timely QAR. The informal IRS voluntary disclosure practice mostly precludes a criminal referral to the Department of Justice if a taxpayer has come into compliance in a timely manner.[26] Although the IRS has the burden of proving civil fraud by clear and convincing evidence, taxpayers must now be advised that it can be anticipated that the IRS will use the purported QAR as a road map in attempting to determine whether to assert the 75 percent fraud penalty under section 6663. Examinations of QARs for the stated or unstated purpose of determining a civil fraud penalty are simply inappropriate and do anything but promote the desired perception of the fairness of tax administration within the United States.

Examinations of amended returns are appropriate if they are done to determine the accuracy of the amended return. However, the current QAR examinations are targeting items reflected on the original return that were changed in the amended return for the sole purpose of determining the possibility of a civil fraud penalty. The government should graciously accept the amended return and payment of the tax and interest deficiencies, determine whether it is substantially accurate, and thank the taxpayer for his contribution to the continued operations of the U.S. government. It is not good policy to shoot the fish in the barrel simply because the others are more difficult to catch.

As a result of RRA '98, we should have learned that inappropriately allocated enforcement resources may

[21]Reg. section 6664-2(c)(3).
[22]Section 7521(c).
[23]5 USC section 552.

[24]In *Vaughn v. Rosen*, 484 F.2d 820 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 977 (1974), the court rejected an agency's conclusory affidavit stating that requested FOIA documents were subject to exemption. *Id.* at 828. "A Vaughn Index must: (1) identify each document withheld; (2) state the statutory exemption claimed; and (3) explain how disclosure would damage the interests protected by the claimed exemption." *Citizens Comm'n on Human Rights v. FDA*, 45 F.3d 1325, 1326 n.1 (9th Cir. 1995). A Vaughn Index "'permit[s] the court system effectively and efficiently to evaluate the factual nature of disputed information.' "*John Doe Agency v. John Doe Corp.*, 493 U.S. 146, 149 n.2 (1989) (quoting *Vaughn*, 484 F.2d at 826).
[25]*See* section 7602(c).
[26]*See* Internal Revenue Manual 9.5.11.9 (June 26, 2009).

serve only to foster future noncompliance. If your neighbor filed a good-faith QAR and then had to defend a civil fraud examination associated with the originally filed return, there is no chance you or others would similarly consider filing a QAR. Those who amend returns in a timely and voluntary manner should be treated fairly and with respect. Burning down the village in an effort to save it is bad policy for future tax compliance.

The complexity found within the code will long continue to be a significant problem for effective tax administration. We live in a country founded by smugglers and those resisting the exercise of government powers in England. Inappropriately asserting penalties will not improve tax compliance. Penalties affect only those who are actually penalized. Despite a strong, wide-ranging international enforcement effort and an increasingly significant possibility of detection and potential punishment, enforcement efforts alone will not reduce the tax gap. Fairness, or at least the perception of fairness, in enforcement will have a significant effect on the future of tax compliance in the United States. Compliant taxpayers and supportive practitioners will reduce the tax gap.

Taxpayers who are aware of questionable issues within their returns and are not under examination should consider filing a QAR to avoid the exposure to the accuracy-related penalties. When representing a taxpayer considering or following submission of a good-faith QAR, the representative should proceed with extreme caution. Next time they ask, ''Who's the chump?'' make sure it is not while defending the assertion of a civil fraud penalty on behalf of a taxpayer who attempted to come into compliance by timely filing a good-faith QAR.