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by Tom Greenaway

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Tom Greenaway is a principal in the Washington National Tax group of KPMG LLP in Boston. He thanks Brant Hellwig, Jim Sowell, George Hani, and Aaron Vaughan for their valuable comments on drafts of this report.

In this report, Greenaway explains self-help options for handling tax mistakes in different contexts.

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> Wisdom too often never comes, and so one ought not to reject it merely because it comes late.
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> — *Henslee v. Union Planters National Bank & Trust Co.*, 335 U.S. 595, 600 (1949) (Frankfurter, J., dissenting).

I. Introduction

One of the first questions that government attorneys ask testifying taxpayers at trial is whether they closely reviewed their tax returns before signing them. Taxpayers often squirm at this question on the stand, especially when the tax return contains mistakes. The question, inevitable as it may be, seems unfair in certain contexts. Tax positions and tax returns can be so complicated that they require teams of professionals to prepare and file them. The data and analysis summarized and presented on returns are sometimes beyond any one individual's ability to comprehend, given tiered partnerships and corporate consolidated groups. This is not necessarily anyone's fault; this is the reality of modern life and business combined with the complexity of the tax rules and standards.

Mistakes happen. Some errors are only identified as a taxpayer prepares a subsequent year's return or prepares for an examination by the IRS. Upon discovering errors, taxpayers often want to be forthcoming and transparent — they want to correct and disclose the error quickly. Self-correction is encouraged under our system of tax administration, which depends on voluntary

compliance. Adjustments made by taxpayers save the IRS enforcement resources.

For all those reasons, when we find material mistakes, as professionals we generally counsel our clients to fix them. This report discusses how to handle tax mistakes in a variety of contexts. After a brief scoping discussion, it sketches out some background on overarching rules and standards. The balance of the report examines rules, standards, and options for handling mistakes, organized around a timeline based on the date of discovering a mistake: (1) before the tax period ends, (2) before the original return is filed, (3) after the original return is filed, (4) before an IRS examination begins, (5) after an IRS examination begins, and finally (6) after the statutes of limitations expire. Passing each of these markers usually limits the set of available remedies.

II. Scope

A mistake is an error or fault resulting from defective judgment, deficient knowledge, or carelessness.[1] Mistakes do not include deliberate or willful bad choices. The tax law makes important distinctions depending on the mental state of the actor: Incorrect tax positions motivated by bad intent may attract criminal sanctions and steep civil penalties. This report assumes that the mistakes discussed below are not like that. In short, it does not discuss criminal or civil fraud penalty exposures apart from a few asides. As a technical matter, criminal or civil fraud cannot be cured by remedial measures.[2] As a practical matter, fixing fraudulent errors may mitigate or eliminate exposure — still, those fixes are beyond the scope of this report. An important threshold question, then, is just how much carelessness one may exhibit before entering the dangerous off-limits zones of frivolousness and fraud. The statutes, regulations, and professional standards provide important guidelines.

Another scope limitation: This report is largely limited to self-help options. Other options to correct compliance problems — like voluntary disclosures, advance pricing agreements, and prefiling agreements — require the active involvement of the IRS's enforcement divisions. And of course, fixing mistakes is a large part of the mission of the IRS's enforcement divisions. Those solutions are important but also outside the scope of this report.

Finally, aside from this paragraph, this report does not discuss how practitioners should deal with taxpayer-favorable mistakes made by the IRS. There are conflicting authorities on this topic, given the conflicting duties practitioners owe to their clients on the one hand, and the duties they owe to the system on the other.[3] For instance, American Bar Association Standards of Tax Practice Statement 1991-1 says that a lawyer should notify the IRS if an IRS mistake is computational, but need not notify the IRS if the mistake is conceptual. This statement recognizes that if the client objects to alerting the IRS to its computational mistake, the lawyer must act consistently with the duty of confidentiality under Model Rule 1.6, discussed in more detail below. Outside a tax context, in ABA Informal Opinion 86-1518, a lawyer received a contract from opposing counsel that erroneously omitted a clause, and the omission benefited the lawyer's client. The opinion concluded that the lawyer should contact opposing counsel to correct the error and need not even consult with the lawyer's own client. On the other hand, Dallas Bar Association Opinion No. 1984-4 concluded that when an administrative law judge's decision made an incorrect computation, the lawyer had no duty to correct, at least when neither counsel nor client indicated that the amount was correct and neither became aware of the error until after the decision was rendered. At the outer bound of these "government mistake" authorities, in *H Graphics Access*,[4] the Tax Court held that the taxpayer's alteration of a document prepared by the IRS was not the product of fraud or

[1] *American Heritage Dictionary of the English Language* (5th ed. 2022).

[2] *See, e.g.*, *Badaracco v. Commissioner*, 464 U.S. 386, 394 (1984) ("A taxpayer who submits a fraudulent return does not purge the fraud by subsequent voluntary disclosure; the fraud was committed, and the offense completed, when the original return was prepared and filed.").

[3] *See generally* Linda Galler, "The Tax Lawyer's Duty to the System," 16 *Va. Tax Rev.* 681 (1997).

[4] *H Graphics Access v. Commissioner*, T.C. Memo. 1992-345.

malfeasance so as to void the resulting agreement. That sort of sharp practice, even if allowable, is unwise.[5]

III. Minimum Professional Standards

Treasury has set out practice standards for a long time, for good reason.[6] The standards collected in Treasury Circular 230 set forth the minimum standards Treasury expects from practitioners.[7] The statute allows Treasury to require that practitioners must demonstrate good character, good reputation, necessary qualifications to provide good service, and competence.[8] Circular 230 provides standards for each of these requirements.

If a practitioner knows that a client has failed to comply with the law concerning any matter for which the practitioner has been retained, the practitioner is required to point out the noncompliance and advise the client of the consequences of noncompliance.[9] Although Circular 230 does not require a practitioner to instruct the client to correct the error or pay any potential tax due, there are other considerations, such as state bar rules and the recently revised American Institute of CPAs Statements on Standards for Tax Services (SSTS).

For example, AICPA SSTS, section 1.2, "Knowledge of Errors," sets forth the applicable standards for a member of the AICPA who becomes aware of: (1) an error in a taxpayer's previously filed tax return; (2) an error in a return that is the subject of a noncriminal administrative proceeding,[10] such as an examination by a tax authority or an appeals conference; (3) a taxpayer's failure to file a required tax return; or (4) an error in a tax representation engagement. As used by AICPA, the term "error" includes any position, omission, or method of accounting that, at the time the return is filed, fails to meet the standards set out in AICPA SSTS, section 2.1, "Tax Return Positions." The term "error" also includes a position taken on a prior year's return that no longer meets these standards because of legislation, judicial decisions, or administrative pronouncements having retroactive effect. However, under AICPA standards, an error does not include an item that has an insignificant effect on the taxpayer's tax liability.

In accordance with this statement, the taxpayer should be promptly informed upon discovery of any of the categories of error set out above. The AICPA member should also advise the taxpayer of the potential consequences of the error and recommend the corrective measures to be taken. If a member is requested to prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer.

The rules on this topic are consistent — but a bit different — for lawyers. ABA Model Rule 1.6 provides that a lawyer generally may not reveal client confidences without consent. Under this general rule, a lawyer is prohibited from disclosing a prior falsehood without the client's consent. The rule goes on to provide that before disclosing information, the lawyer must first encourage the client to disclose or ask for permission to disclose. If the client declines, the lawyer may consider whether one of the specified exceptions to the duty of confidentiality apply. As applied to this context, ABA Model Rule 1.6 precludes disclosing a mere innocent or even negligent (subsequently discovered) error, without consent, unless the failure to disclose works a continuing fraud on the IRS.

To that point, ABA Model Rule 4.1 provides that in the course of representing a client, a lawyer should not knowingly make a false statement of material fact or law to a third person or fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless

[5] Practitioners, even more than everyone else, must turn square corners when dealing with the government. *See Rock Island R.R. v. United States*, 254 U.S. 141, 143 (1920).

[6] 31 U.S.C. section 330 was enacted as part of 23 Stat. 258, the "Horse Act of 1884," to help fight frivolous post-Civil War lost property claims.

[7] I set aside Circular 230's regulatory reach here, which has been successfully challenged and limited in certain contexts. *See Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014); and *Ridgely v. Lew*, 554 F. Supp. 3d 89 (D.D.C. 2014). In any event, Circular 230 sets forth Treasury's view on the topic of minimum practitioner standards, and Treasury's view informs many of the penalty and other considerations set out in this report.

[8] 31 U.S.C. section 330(a)(2).

[9] Circular 230, section 10.21.

[10] The term "administrative proceeding" does not include a criminal proceeding.

disclosure is prohibited by Rule 1.6. A lawyer has an absolute duty not to make false assertions of fact, but is not required to disclose weaknesses in the client's case. A lawyer also operates under a duty not to mislead the IRS deliberately or affirmatively, either by misstatements or silence or by permitting the client to mislead the IRS.

A lawyer cannot take steps to defend issues the lawyer knows to be wrong. ABA Model Rule 3.1 provides that a lawyer should not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good-faith argument for an extension, modification, or reversal of existing law.

Applying these rules to our context, assume the taxpayer is planning to make or maintain a false statement to the IRS in the course of an audit. Both AICPA members and lawyers must attempt to persuade the taxpayer not to make that statement. Neither practitioner can do anything to indicate agreement or any complicity with the false statement. The practitioner may have to withdraw from the representation if continued participation — even silent participation — misleads the IRS.

The degree of difficulty plays into a mistake analysis, too. A practitioner must be diligent about the accuracy of any written or oral submissions to the IRS, including tax return preparation.[11] The practitioner may not rely on unreasonable factual or legal assumptions or unreasonable representations. Not everything is black and white in tax, so practitioners and regulators have developed a set of standards to measure uncertainty. Practitioners lump those standards together under the colloquial term "comfort levels."[12] For the purposes of this report, the comfort levels that matter most are reasonable basis (with disclosure)[13] and substantial authority (without disclosure).[14] Outside tax shelters and other specialized contexts, such as transfer pricing and valuation, any tax position taken at a lower comfort level than these two potentially exposes the practitioner and the taxpayer to accuracy-related penalties. Most practitioners and taxpayers consider open exposure to penalties akin to a mistake that should be fixed, if possible.[15] As noted earlier, practitioners are also prohibited from advancing frivolous positions to the IRS.[16]

IV. Overarching Principles, Standards, Doctrines

A taxpayer's ability to fix tax mistakes is governed by a series of rules, principles, standards, and doctrines — some basic, some obscure. This section introduces some of these concepts, first covering the annual accounting period, plus its two important exceptions, claim of right and the tax benefit rule. It then discusses the substance-over-form doctrine, the doctrine of election, and the duty of consistency.

A. Annual Accounting Period and Exceptions

The annual accounting period is a critical factor in any mistake analysis. *Sanford & Brooks*[17] is the key case, and its facts illustrate the point nicely. A dredging company suffered losses on a U.S. government contract. After the work was abandoned, the company sued the United States on a breach of warranty claim. Years later, the company won its suit and recovered its prior years' operating losses from the government. The IRS argued that the recovery was includable in income to the company in the year of recovery. The company argued that the recovery simply put

[11] Circular 230, section 10.22.

[12] *See generally* Jasper L. Cummings, Jr., "The Range of Legal Tax Opinions, With Emphasis on the 'Should' Opinion," *Tax Notes*, Feb. 17, 2003, p. 1125; Robert Rothman, "Tax Opinion Practice," 64 *Tax Law.* 301 (2011); *see also* Anonymous, *Levels of Opinion Commonly Found in Tax Opinions* at Appendix 1 (undated).

[13] Section 6662(d)(2)(B)(iii) (no "understatement of tax" if a position with reasonable basis is properly disclosed).

[14] Reg. section 1.6662-4(d). Most practitioners assume that a substantial authority comfort level is sufficient to avoid penalty exposure. That assumption is not always a good one to make. It is possible to have substantial authority for a position and remain exposed to penalties. *See, e.g.*, reg. section 1.6662-3(b)(2) (providing that a taxpayer who takes a position contrary to a regulation without exercising reasonable diligence is negligent); reg. section 1.6662-6 (imposing documentation requirements to avoid penalties on section 482 adjustments).

[15] Reasonable cause and good-faith defenses to penalties are important but beyond the scope of this report.

[16] Circular 230, section 10.34.

[17] *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

the company back where it started, with no overall profit to show for all its efforts, so the recovery should not be taxed. The Supreme Court disagreed, holding for the government, reasoning: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." Absent legislative rules, erroneous income inclusions cannot be undone in a later year.

The claim of right provides some legislative relief from this harsh result. If income was erroneously included in one year because it appeared that the taxpayer had an unrestricted right to the payment, but the item was later repaid through a deductible payment, the taxpayer has the choice to either claim the deduction in the later year or take a credit equal to the tax attributable to the erroneous income inclusion in the earlier year.[18] This rule is helpful when the tax rate was higher in the year of inclusion than in the year of deduction because the credit is worth more than a current deduction in those situations. In most other situations, deducting the prior inclusion in the year of discovery or repayment is simpler.

The tax benefit rule provides a different standard for deductions, losses, and credits. Under the tax benefit rule, a taxpayer that recovers an amount it deducted in a prior year must report the recovery as income except to the extent that the taxpayer did not receive a tax benefit from that prior year deduction (that is, to the extent that the previous deduction did not reduce the amount of income subject to tax).[19] A deduction will be treated as having produced a reduction in tax if the deduction increased a carryover that has not expired at the end of the tax year in which the recovery occurs.[20] Generally, when a taxpayer takes a deduction for a liability in one year and that liability is extinguished in a later year, the taxpayer must recognize in income in the later year the amount of the prior deduction.[21]

The purpose of the tax benefit rule, as stated by the Supreme Court in *Hillsboro National Bank*,[22] is "to approximate the results produced by a tax system based on transactional rather than annual accounting."[23] The scope of the tax benefit rule must be addressed by considering the facts and circumstances of each case.[24] The rule's application is not automatic, but applies "only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based."[25] In other words, "only if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction can the Commissioner require a compensating recognition of income when the event occurs in the later year."[26] To illustrate the "fundamentally inconsistent" principle with an example, the Supreme Court in *Hillsboro National Bank* stated that if a taxpayer deducts rent attributable to year 2 in year 1, and then in year 2 converts the leased business property to personal use, which is fundamentally inconsistent with the taxpayer's business, then the tax benefit rule is invoked.[27] In applying the tax benefit rule, courts have generally held that there need not be a literal recovery to apply the rule.[28] The rule should be applied flexibly whenever there is an actual recovery of a previously deducted amount or when there is some other event that is

[18] Section 1341.

[19] Section 111(a), (b).

[20] Section 111(c).

[21] *See Mayfair Minerals Inc. v. Commissioner*, 456 F.2d 622 (5th Cir. 1972) (accrual basis taxpayer took deductions for contingent refunds that were never paid to customers and had to recognize income in a later year when its liability to issue refunds was extinguished by the statute of limitations).

[22] *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983).

[23] *Id.* at 381.

[24] *Id.* at 386.

[25] *Id.* at 383.

[26] *Id.*

[27] *Id.* at 385; *see also United States v. Bliss Dairy Inc.*, 460 U.S. 370 (1983).

[28] *See, e.g., Tennessee-Carolina Transportation Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978) ("There need not be an actual physical recovery of some tangible asset or sum in order to apply the tax benefit rule; the rule should apply whenever there is an actual recovery of a previously deducted amount or when there is some other event inconsistent with that prior deduction."); *Ballou Construction Co. Inc. v. United States*, 611 F. Supp. 375 (D. Kan. 1985) ("Actual recovery by a taxpayer is not required before tax benefit rule can be applied, only a later event which is fundamentally inconsistent with an earlier deduction.").

fundamentally inconsistent with the prior deduction.[29]

B. Substance-Over-Form Doctrine

The substance-over-form doctrine, among other things, reminds us that while a taxpayer's intent is sometimes important, it is almost never controlling if intent does not match the form of the transaction. *Weiss*[30] offers an apt summary of the point. "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants, and . . . we must regard matters of substance, and not mere form."[31] Another well-cited maxim demonstrates that the substance-over-form doctrine, as a tool, is usually a one-way ratchet turning in favor of the tax authorities. A taxpayer may organize its affairs as it chooses, but it must accept the tax consequences of that choice, whether contemplated or not.[32]

C. Doctrine of Election

The doctrine of election, when it applies, binds a taxpayer to an initial choice on a return if the taxpayer had the right to choose one or more alternative or inconsistent rights, and if nothing suggests that Congress intended to allow the taxpayer to change the initial choice after the tax return filing deadline.[33] Courts generally interpret the doctrine of election as applied to federal tax law to consist of two elements: (1) a free choice between two or more alternatives; and (2) an overt act by the taxpayer communicating the choice to the IRS.

Several rationales support the general principle that elections and other choices taxpayers report on their returns are considered binding, including:

- preventing administrative burdens and inconvenience in administering the tax laws, particularly if the new method requires a recalculation of tax liability for other years or other taxpayers;
- protecting against loss of revenue by preventing taxpayers from using hindsight to choose the most advantageous method of reporting;
- promoting consistent accounting practices (foreclosing adjustments based on hindsight), thereby securing uniformity; and
- providing an equitable and fair tax system by treating similarly situated taxpayers consistently.[34]

D. Duty of Consistency

The duty of consistency is based on the theory that a taxpayer and the IRS owe each other the duty to follow the tax treatment of their tax items and may not take advantage of their own wrong.[35] The duty of consistency should prevent either party from taking one position on one tax return and a contrary position on a later return after the statute of limitations has expired for the earlier, inconsistent return.

There are three essential elements of the duty of consistency: (1) a representation or omission by the taxpayer (or the IRS); (2) reliance by the IRS (or the taxpayer) on that representation or omission; and (3) an attempt by the taxpayer (or the IRS) after the statute of limitations has run to change the previous representation or omission to

[29] *See Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom Union Trust Co. of Indianapolis v. Commissioner*, 111 F.2d 60 (7th Cir. 1940). *See also First Trust and Savings Bank of Taylorville v. United States*, 614 F.2d 1142 (7th Cir. 1980) (when taxes a bank paid on behalf of its shareholders and deducted from its income were later refunded to the shareholders, the bank realized income under the tax benefit rule despite its claim that it served merely as a conduit for transmittal of the refunds to its shareholders without having realized a recovery within the meaning of the tax benefit rule).

[30] *Weiss v. Stern*, 265 U.S. 242 (1924).

[31] *Id.* at 254.

[32] *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (citing *Higgins v. Smith*, 308 U.S. 473, 477 (1940), and other cases).

[33] *See Pacific National Co. v. Welch*, 304 U.S. 191, 194-195 (1938) (concluding taxpayer made a binding election regarding timing of income recognition by reporting the income from the transactions in question on its return according to a particular method). *See generally* John Keenan, Matthew Cooper, and Teresa Abney, "Common Procedural Questions About Elections," *Tax Notes Federal*, July 18, 2022, p. 367.

[34] *See J.E. Riley Investment Co. v. Commissioner*, 311 U.S. 55, 59 (1940); *Mamula v. Commissioner*, 346 F.2d 1016, 1018-1019 (9th Cir. 1965); *Barber v. Commissioner*, 64 T.C. 314, 319-320 (1975); *Estate of Curtis v. Commissioner*, 36 B.T.A. 899, 906-907 (1937).

[35] *R.H. Stearns Co. v. United States*, 291 U.S. 54, 61-62 (1934). *See generally* Steve R. Johnson, "The Taxpayer's Duty of Consistency," 46 *Tax L. Rev.* 537 (1991).

recharacterize the situation in a way to harm the other party.[36] Courts sometimes add other elements. If the duty of consistency applies, the potentially harmed party may act as if the previous representation, on which the other party relied, continued to be true, even if it is not. The duty of consistency applies to facts and mixed questions of fact and law, but it does not apply to pure questions of law if both sides have access to the relevant facts, presumably on the theory that it is never reasonable to rely on another person's legal interpretation.

V. Fixing Mistakes

With those background concepts in mind, we now turn to the heart of the matter, discussing ways to fix mistakes, proceeding in a timeline fashion because options dwindle as time passes. For instance, the first question in any mistake analysis is almost always: Is the relevant statute of limitations still open?

A. Before the Tax Period Closes

Section 446(a) provides the general rule that taxable income is computed under the method of accounting the taxpayer regularly uses to compute income for nontax purposes. So many of the options available to a taxpayer to fix mistakes under its method of book accounting are available for tax purposes too.[37] But not all of them. The Supreme Court has explained the practical difference between book and tax accounting: "Financial accounting . . . is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be."[38] Moreover, the general book-conformity rule is subject to the important exception set out in section 446(b) that the taxpayer's method of accounting must clearly reflect income, in the opinion of the secretary. Methods of accounting are discussed in more detail below.

The general rule is that the chosen form of a transaction controls for tax purposes. Backdating or correcting documents and agreements to properly memorialize the original understanding of the parties may be consistent with this rule and may be respected for tax purposes.[39] On the other hand, backdating that attempts to retroactively change the terms of an agreement deserves closer scrutiny.[40] Backdating that fabricates the underlying transaction will be disregarded for tax purposes and should attract penalties if discovered.[41]

There is an important, albeit narrow, exception to this general principle: the rescission doctrine. Under the rescission doctrine, courts and the IRS have disregarded transactions so long as (1) all parties to a transaction are returned to the relative positions they would have occupied had no contract been made, and (2) the restoration is achieved within the tax year of the transaction.[42] Rescission is a nontax legal concept that generally refers to the cancellation or abrogation of a contract.[43] Rescission offers the erroneous a narrow, complicated, and difficult path to follow.[44] Since 2012, the IRS has declined to issue rescission rulings.[45]

[36] *Beltzer v. United States*, 495 F.2d 211 (8th Cir. 1974). Many courts have adopted the *Beltzer* formulation of the doctrine. *E.g.*, *Kielmar v. Commissioner*, 884 F.2d 959, 965 (7th Cir. 1989); *Herrington v. Commissioner*, 854 F.2d 755, 758 (5th Cir. 1988); *Hess v. United States*, 537 F.2d 457, 463 (Ct. Cl. 1976); *Johnston v. United States*, 605 F. Supp. 26, 28 (D. Mont. 1984); *Unvert v. Commissioner*, 72 T.C. 807, 815 (1979), *aff'd on other grounds*, 656 F.2d 483 (9th Cir. 1981).

[37] Distinguishing between an error and a change in estimate for financial accounting purposes can sometimes be difficult. That topic is beyond the scope of this report.

[38] *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 543 (1979).

[39] *Baird v. Commissioner*, 68 T.C. 115 (1977); *Moore v. Commissioner*, T.C. Memo. 2007-134. In some contexts, judicial supervision may be required to effect these sorts of corrections. *E.g.*, reg. section 26.2601-1(b)(4)(i)(C) (governing judicial constructions of trust instruments to resolve ambiguities or correct scrivener's errors).

[40] *E.g.*, *Pittsburgh Realty Investment Trust v. Commissioner*, 67 T.C. 260 (1976); *Melnik v. Commissioner*, T.C. Memo. 2006-25. *See generally* Jeffrey L. Kwall, "Backdating," 63 *Bus. Law.* 1153 (Aug. 2008).

[41] *E.g.*, *Dobrich v. Commissioner*, 188 F.3d 512 (9th Cir. 1999) (sustaining fraud penalty, noting that "by backdating documents the Dobrichs attempted to circumvent section 1031(a)'s identification requirement").

[42] *See, e.g.*, *Penn v. Robinson*, 115 F.2d 167 (4th Cir. 1940); Rev. Rul. 80-58, 1980-1 C.B. 181.

[43] Some foreign jurisdictions have judicial processes, such as rectification, to allow for retroactive and remedial changes to agreements. These processes may be useful for foreign tax purposes, but they will likely be disregarded for federal tax purposes.

[44] *See generally* New York State Bar Association Tax Section, "Report on the Rescission Doctrine" (Aug. 11, 2010).

[45] *See, e.g.*, Rev. Proc. 2012-3, 2012-1 IRB 113.

B. Before the Original Return Is Filed

1. Transfer pricing adjustments.

Transfer pricing is a book-tax adjustment topic all to itself. The headline for practitioners on this topic is that taxpayers should try their best to get their transfer pricing right on their original returns for several different reasons. The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of tax on those transactions.[46] The government views section 482 as an antiabuse tool, providing only limited rights for taxpayers to use it to their advantage.

The IRS historically took the position that taxpayers could not invoke section 482 at all to reallocate the results of controlled transactions.[47] The 1962 regulations were blunt on this subject: "Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions."[48] The Justice Department successfully defended this bright-line position in refund litigation.[49]

As applied, however, the IRS's rigid administrative position is arguably incompatible with the overarching general principle that the arm's-length standard applies in every case, not to mention our tax treaty obligations. Perhaps for this reason, the 1968 regulations softened the rule by mandating that the IRS allow a narrow category of setoffs as a defense to primary transfer pricing adjustments.[50]

The IRS and Treasury further softened the rule in the 1994 regulations. They explained the change in the preamble to those regulations:

> Section 1.482-1T(a)(3) provides . . . that only the district director may apply the provisions of section 482, but clarifies that this restriction does not limit the taxpayer's ability to report its true taxable income. *It has been asserted in the past* that taxpayers were not permitted to report results that differed from transactional results in order to reflect an arm's length result on the tax return.[51] [Emphasis added.]

To be clear, the IRS and Treasury had made those assertions, in the prior regulations. Accordingly, the "clarification" set out in the 1994 preamble may be read to be more in the nature of a concession in favor of establishing a better balance with the controlling general arm's-length principle.

In any event, reg. section 1.482-1(a)(3) now provides:

> *Taxpayer's use of section 482.* If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, *no untimely or amended returns will be permitted to decrease taxable income* based on allocations or other adjustments with respect to controlled transactions. See section 1.6662-6T(a)(2) or successor regulations.[52] [Emphasis added.]

In *Intersport*,[53] the Court of Federal Claims rejected a taxpayer's transfer pricing refund claim on the grounds that the claim was barred by reg. section 1.482-1(a)(3). The court also concluded that the claim was not allowable as the correction of a mistake, either. The government argued that to even entertain a "mistake" analysis, the taxpayer would have to come forward with some evidence of an actual allocation agreement that

[46] Reg. section 1.482-1(a)(1).

[47] *See, e.g., Liberty Loan Corp. v. United States*, 498 F.2d 225 (8th Cir. 1974), *rev'g* 359 F. Supp. 158 (E.D. Mo. 1973).

[48] Reg. section 1.482-1(b)(3) (1968).

[49] *E.g., Pikeville Coal v. United States*, 37 Fed. Cl. 304 (1997); *OTM Corp. v. United States*, 572 F.2d 1046 (5th Cir. 1978).

[50] Reg. section 1.482-1(d)(3) (1968), now reg. section 1.482-1(g)(4).

[51] T.D. 8470.

[52] Reg. section 1.482-1(a)(3).

[53] *Intersport Fashions West v. United States*, 103 Fed. Cl. 396, 404 (2012).

was in existence when the original return was filed, and then demonstrate how a "mistake in calculation" occurred.[54]

One final word on transfer pricing. APAs are generally considered prospective in nature. Yet they can serve a useful role in bridging a change in a taxpayer's transfer pricing approach, given the ability to obtain rollback treatment for APAs in certain contexts.[55]

2. Inconsistent position reported by partner.

Correcting mistakes stemming from partnership-related items can get complicated. As a rule, a partner must treat partnership-related items consistently with the treatment of those items by the partnership.[56] But there is an important exception to this rule. If a partner determines that a partnership-related item is reported to the partner in error, the partner may take an inconsistent position on the partner's original (or amended) return and attach a Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)."[57] Failure to file Form 8082 exposes partners subject to the centralized partnership audit rules[58] to "math error" assessment and correction by the IRS and potentially exposes the partner to additions to tax under section 6651.[59] The discussion of how partnerships may fix errors on previously filed returns follows.

C. After the Original Return Is Filed

1. Superseding returns.

A tax return filed before the due date (including extensions) that corrects or changes data reported on the original return is commonly called a superseding return.[60] A superseding return is generally treated as the taxpayer's return for all purposes. Any corrections provided in the superseding return are in effect incorporated into, and treated as relating back to, modifying, and superseding, the original return. This rule generally includes all returns filed within the time for filing original returns as extended.[61] The filing of the original return does not revoke or consume an extension of time to file. A taxpayer, therefore, may file more than one superseding return after its original return if the superseding returns are filed before the extended due date of the return — as long as the taxpayer remembered to file an application for extension in the first place.

A timely filed superseding return can be a good way to correct errors on the original return, such as perfecting or making an election that must be made on a timely filed return. Superseding returns may also provide taxpayers additional time to refine estimates or finalize favorable transfer pricing adjustments and gather transfer pricing contemporaneous documentation that may provide penalty protection under section 6662(e).

2. Correcting estimates with true-ups.

So far, this report has mostly used black-and-white terms around fact-based mistakes, but reality often is painted in shades of gray. Despite the precision that the tax law demands, practice sometimes requires the use of estimates, and both the regulations and the professional standards acknowledge that reality. If a taxpayer accrues an amount of income or liability based on a reasonable estimate and the exact amount is later determined, any difference will be taken into account in the year of the subsequent determination.[62] These sorts of changes in

[54] *Id.* at 406 n.14.

[55] Rev. Proc. 2015-41, 2015-35 IRB 263, sections 2.02(4)(c) and 5.02.

[56] Section 6222(a).

[57] Section 6222(c); reg. section 301.6221-1(c). *See also* 2019 final regulations, T.D. 9844 (clarifying that the term "partner's return" for purposes of reg. section 301.6222-1 includes any amendment to the partner's original return).

[58] Certain small partnerships with no passthrough partners may opt out of the centralized partnership audit rules. *See* section 6221(b). Partnerships subject to the centralized partnership rules are sometimes called "BBA partnerships" after the Bipartisan Budget Act, which gave us these tricky rules.

[59] Section 6222(b).

[60] *See Haggar Co. v. Helvering*, 308 U.S. 389, 395-396 (1940); *see also Mamula v. Commissioner*, *rev'g* 41 T.C. 572 (1964); *Reaver v. Commissioner*, 42 T.C. 72 (1964); Internal Revenue Manual 3.5.61.1.8.

[61] *See A.J. Crowhurst & Sons Inc. v. Commissioner*, 109 F.2d 131 (3d Cir. 1940); Rev. Rul. 78-256, 1978-1 C.B. 438 (holding that an amended return filed before the due date (including extensions) constitutes the return for purposes of section 6655). On the other hand, an amended return that is filed after the due date (including extensions) does not incorporate anything into the original return. *See Badaracco*, 464 U.S. at 386; *Wm. B. Scaife & Sons Co. v. Commissioner*, 117 F.2d 572 (3d Cir. 1941).

[62] Reg. section 1.451-1(a) (income); reg. section 1.461-1(a)(3) (liabilities).

estimate, when presented on tax returns, are colloquially called "true-ups." Most commonly, true-ups are used for state tax accruals, late-received partnership allocations, and other difficult-to-ascertain items. The use of estimates in tax admittedly creates tension (or lessens it, depending on your perspective) with the primacy of the annual accounting period.

Reasonableness and disclosure are key elements of the use of estimates. To that end, as better information becomes available after a taxpayer has filed its return, the regulations and professional standards encourage taxpayers to improve the precision of the items reported on the original return over time through the use of true-ups. AICPA SSTS Number 2.4.2 provides a guide on the use of estimates:

> Unless prohibited by statute, administrative rule, or judicial holdings, a member may use estimates, whether from the taxpayer or other sources authorized by the taxpayer . . . in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer's estimates should be presented in a manner that does not imply greater accuracy than exists.

So taxpayers generally may report reasonable and disclosed estimates and correct them in subsequent periods through true-ups. Beware, however: As a matter of common sense, a large true-up adjustment may call into question the reasonableness of the original estimate.

3. Necessity of amended return.

With one arguable exception discussed below,[63] the code contains no requirements to file amended returns.[64] As the Supreme Court has explained, "the 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."[65] In practice, taxpayers regularly file amended returns. Yet, the code and regulations only set forth statutory filing dates for one original return, and — aside from claims for refund — there are no specific procedural provisions for amending incorrect returns. While the code doesn't require it, the regulations counsel taxpayers to file amended returns if, within the period of limitation, the taxpayer ascertains that an item of income or liability was incorrectly included or omitted in a prior year.[66]

4. Qualified amended returns.

Treasury and the IRS encourage taxpayers to voluntarily come forward and correctly identify errors on returns. A qualified amended return (QAR) is an amended return filed to correct an error or provide disclosures missing from the original return to avoid the accuracy-related penalty. For the accuracy-related penalty, the "underpayment" is based on any adjustments to the tax as reported on the QAR, not the originally filed return. So if the practitioner identifies an issue that would increase the taxable income of a taxpayer, the practitioner should consider whether a QAR is appropriate. Filing one or more federal QARs generally triggers an obligation to file amended state and local returns, which can be costly and burdensome, especially for taxpayers that operate in multiple jurisdictions.

A QAR must also be filed before:

- the taxpayer is initially contacted by the IRS about any examination (including a criminal investigation) regarding the return;
- the IRS contacts any promoters regarding an investigation into a tax shelter activity in which the taxpayer participated directly or indirectly;
- the IRS contacts a passthrough entity (as defined in reg. section 1.6662-4(f)(5)) regarding an examination of the return to which the passthrough item of the taxpayer relates;

[63] *See* section 905(c).

[64] A search of the Treasury regulations reveals a handful of suggestions from the IRS to file amended returns, mostly having to do with timing issues. The Treasury regulations provide no sanctions for noncompliance with these suggestions.

[65] *Badaracco*, 464 U.S. at 386, *citing Hillsboro National Bank*, 460 U.S. at 370.

[66] Reg. section 1.451-1(a) (income); reg. section 1.461-1(a)(3) (liabilities).

- a John Doe summons is served regarding the tax liability of a person, group, or class that includes the taxpayer regarding an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly; and
- the commissioner announces by revenue ruling, revenue procedure, notice, or announcement, a settlement initiative to compromise or waive penalties, in whole or in part, regarding a listed transaction for which the taxpayer has claimed any direct or indirect tax benefit.[67]

Clients often ask whether filing an amended return increases their chances of being audited, and the answer — unhelpful as it may be — is "it depends." An amended return reporting more tax may be a QAR that mitigates penalty exposure, and if the explanation included in the amended return for the change is comprehensive, the amended return may decrease, rather than increase, audit potential for the tax year. After all, part of the mission of the IRS is to help taxpayers meet their tax responsibilities, and if taxpayers properly use self-help mechanisms like amended returns, then audit potential should go down.

Having said that, filing an amended return generally increases the possibility that an IRS classification team will look at the amended return (and original return, presumably) for audit potential. Refund claims generally increase audit potential, especially on hot-button issues like credits. And taxpayers guarantee themselves an audit if they file amended returns or tentative carryback allowances claiming refunds over the Joint Committee on Taxation review thresholds: $2 million generally and $5 million for C corporations.[68]

D. Partnerships

As noted, fixing mistakes in a partnership context presents special issues. Each year, some partnerships erroneously report items of income, deduction, and credit on their original returns. For instance, some partnerships receive additional information after filing their returns. Further, laws and regulations often change, sometimes retroactively. These changes force partnerships to reconsider the tax reporting of partnership-related items from prior years.

The centralized partnership audit regime provides a mechanism that allows and encourages partnerships to self-correct for errors — the administrative adjustment request (AAR) process.[69] Partnerships subject to these rules may choose to pay any imputed underpayment attributable to those changes,[70] or they may push out changes to partnership-related items to their partners — favorable, unfavorable, or otherwise.[71] A non-passthrough partner, in turn, may offset a favorable pushout adjustment from affected years against other unfavorable items in the reporting year when taking these adjustments into account at the partner level. These partners must make a cumulative computation of the total overpayment or underpayment of tax attributable to a change reported on an AAR. The application of these rules is complicated, and while there are some workarounds,[72] many traps for the unwary remain.[73] Most importantly, filing an AAR restarts the three-year statute of limitations on assessment for a partnership tax period.[74] This is a different result than the general rules, in which the filing of an amended return generally does not affect the statute of limitations on assessment.[75]

E. Foreign Tax Credits

A foreign tax redetermination — while not necessarily a mistake — will often affect previously claimed foreign tax credits. For example, suppose a taxpayer claims an FTC in

[67] Reg. section 1.6664-2(c)(3)(i)(B)-(E).

[68] Section 6405.

[69] Not all partnerships are subject to these centralized partnership audit rules. *See* section 6221(b). Well-advised partnerships that can elect out of these rules generally do.

[70] *See* section 6226(b)(1).

[71] *See* section 6226(b)(2).

[72] Kristen A. Parillo, "Tax Pros Find Workarounds for Late or Erroneous Schedules K-1," *Tax Notes Federal*, Dec. 19, 2022, p. 1737.

[73] For example, a partnership may still file an AAR for a tax year after receiving an audit selection notice, but the partnership is barred from filing an AAR once the IRS has sent the next notice, a notice of administrative proceeding.

[74] Section 6235(a)(1)(C).

[75] *But see* section 6501(c)(7) (providing a brief window for the IRS to assess tax reported on amended returns reporting additional tax filed within 60 days of the expiration of the statute of limitations on assessment).

year 1 based on a foreign tax paid or accrued. In year 3, the foreign tax jurisdiction redetermines the foreign tax paid, either increasing or decreasing the liability. Section 905(c) requires taxpayers to give the IRS notice of these types of redeterminations. The regulations implementing these rules were recently overhauled.

For taxpayers that claim an FTC on their original return, the section 905(c) regulations generally require an amended return after a foreign tax redetermination.[76] Nevertheless, there does not appear to be any consequence for a taxpayer's failure to file an amended return when the change would reduce federal tax due, other than the loss of the refunds. If taxpayers waive their right to claim additional FTCs caused by a foreign tax redetermination, any carryover attributes should also be reduced by the amount of the waived refunds under the duty of consistency. The IRS takes the view that the cross-reference to section 905(c) in section 6501(c)(5) suspends the normal assessment statute of limitations for deficiencies, interest, and additions to tax resulting from a redetermination of foreign tax.[77] Finally, Rev. Rul. 72-525, 1972-2 C.B. 443, limits the IRS's ability to assess section 905(c) redetermination deficiencies, providing that additional assessments permitted under section 905(c) are limited to adjustments of FTCs caused by factors that are not ascertainable either at the time of the computation of the credit originally claimed or within the ordinary period of limitations provided by section 6501(a). All these factors — and more — should be considered when dealing with foreign tax redeterminations after the original U.S. income tax return is filed.[78]

F. 9100 Relief

Section 9100 of the code does not exist. Nevertheless, "9100 relief" is named after a set of regulations that sometimes allow taxpayers an extension of time to make (otherwise late) regulatory elections.[79] 9100 relief balances two policies. The first policy is to promote efficient tax administration by providing limited periods for taxpayers to choose among alternative tax treatments and by encouraging prompt tax reporting.[80] The second policy is to allow taxpayers that are in reasonable compliance with the tax laws to minimize their tax liability by collecting from them only the amount of tax they would have paid if they had been fully informed and well advised.[81] And because everyone always asks — no, 9100 relief is not available for a failure to timely file an application for an extension of time to file a return.[82] 9100 relief is likewise unavailable to undo a previously made election, largely because of the doctrine of election discussed earlier.

There are two types of 9100 relief: automatic and discretionary. Twelve-month automatic relief is available for certain regulatory elections (for example, section 754 elections).[83] Six-month automatic relief is available for all statutory and regulatory elections from the original due date, but only if the original return was timely filed. Six-month relief is only rarely employed, if only because most missed elections are discovered too late. Be sure to consider any available disaster relief when calculating these periods.

To qualify for discretionary 9100 relief, taxpayers must demonstrate that they acted reasonably and in good faith and there was no prejudicial result to the government.[84] Some discretionary relief standards for common lapses are set out in revenue procedures.[85] For all other

[76] Reg. section 1.905-4(b).

[77] ECC 201429026 (briefing cases and rulings that establish this general rule). *See also* IRM 20.1.9.19.1.

[78] Failure to exercise foreign competent authority rights to attempt to reduce foreign tax redeterminations may jeopardize the U.S. creditability of the redetermined foreign tax. *See* reg. section 1.901-2(e)(5)(v) (defining obligation to exhaust all "effective and practical remedies" to avoid noncompulsory payment treatment for foreign levies).

[79] The IRS and Treasury disclaim general authority to waive statutory election requirements, aside from granting automatic six-month relief for certain statutory elections, since Congress granted the IRS authority to grant "reasonable extensions" for the filing of any return, declaration, statement, or other document up to six months. Section 6081(a). This administrative modesty is hard to square with (otherwise welcome) IRS decisions to declare "transition periods" for the nonenforcement of certain statutes. *See, e.g.*, Notice 2023-10, 2023-3 IRB 403.

[80] T.D. 8742.

[81] *Id.*

[82] Reg. section 301.9100-1(b).

[83] Reg. section 301.9100-2(a)(2).

[84] Reg. section 301.9100-3(a).

[85] *E.g.*, Rev. Proc. 2008-27, 2008-21 IRB 1014 (late Foreign Investment in Real Property Tax Act elections and filings); Rev. Proc. 2009-41, 2009-39 IRB 439 (late check-the-box entity elections); Rev. Proc. 2013-30, 2013-36 IRB 173 (late S corporation elections).

late elections, discretionary relief is only available by obtaining a private letter ruling.[86] In those cases, a taxpayer acts reasonably and in good faith — the first requirement for 9100 relief — if the taxpayer satisfies any of the conditions below:

- the taxpayer filed its request for relief before the IRS discovered the taxpayer's failure to make the regulatory election;
- the taxpayer failed to make the election because of intervening events beyond the taxpayer's control;
- the taxpayer failed to make the election because, after exercising reasonable diligence, the taxpayer was unaware of the election;
- the taxpayer reasonably relied on written IRS advice; or
- the taxpayer reasonably relied on a qualified tax professional, including a professional employed by the taxpayer.[87]

A taxpayer is deemed not to have acted reasonably and in good faith if the taxpayer sought to alter a return position for which an accuracy-related penalty was or could have been imposed, was informed of all material respects of the required election, and chose not to file the election, or if the taxpayer used hindsight to decide to make the election. In this context, hindsight means that "facts have changed since the due date for making the election that make the election advantageous to the taxpayer."[88] Presumably, every missed election for which the taxpayer seeks relief will be advantageous to them — or else why make the election? So the hindsight standard, in practice, means that taxpayers should not take advantage of a change in facts since the time the election should have been made.

The interests of the government are generally not prejudiced — the second requirement for 9100 relief — if (1) granting relief will not result in a taxpayer having a lower tax liability in the aggregate for all years to which the election applies than the taxpayer would have had if the election had been timely made, or (2) the statute of limitation on assessment is open for the tax year in which the regulatory election should have been made (or any tax year that would have been affected by the election had it been timely made).[89] The interests of the government are deemed prejudiced except in "unusual and compelling circumstances" for certain accounting method change elections.[90]

9100 relief can range from mundane to amazing. At the basic level, 9100 relief is often available when a late-filed return invalidates elections made on that return, since many elections must be made on a timely filed return. At the other end of the spectrum, when presented with a difficult substantive challenge, it is often worth considering whether an alternative approach to entity status at one or more points along the way could have mitigated or even avoided current problems. If so, seeking relief to make a late entity election might be part of an effective remediation strategy.[91]

G. After an IRS Examination Begins

Generally, a QAR is not an option once the taxpayer receives a notice of examination.[92] Nevertheless, the IRS has exercised its authority granted under the regulations to extend QAR treatment to certain eligible taxpayers who disclose errors with reasonable basis on Form 15307, "Post-Filing Disclosure for Specified Large Business Taxpayers," within 30 days of a request from the IRS.[93] The IRS recently narrowed both the universe of eligible taxpayers and the eligible disclosures from prior guidance.[94] However, many experienced revenue agents and managers exercise common sense to ensure that penalties are not imposed on taxpayers who voluntarily and timely bring mistakes and errors to the examination team's attention, whether or not those taxpayers fall within the scope of the formal

[86] The procedures for obtaining a private letter ruling are set out in the first revenue procedure issued by the IRS each year. *See, e.g.*, Rev. Proc. 2024-1, 2024-1 IRB 1 (imposing a $12,600 user fee on 9100 relief ruling requests).

[87] Reg. section 301.9100-3(b)(1).

[88] Reg. section 301.9100-3(b)(3)(iii).

[89] Reg. section 301.9100-3(c)(1).

[90] Reg. section 301.9100-3(c)(2).

[91] *See, e.g.*, *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004).

[92] Reg. section 1.6664-2(c)(3)(A).

[93] Rev. Proc. 2022-39, 2022-49 IRB 1.

[94] *Compare* Rev. Proc. 94-69, 1994-2 C.B. 804.

guidance. A detailed discussion of how to disclose and resolve issues in examination is outside the scope of this report.

Close only counts in horseshoes and hand grenades — and sometimes in tax. The doctrine of substantial compliance sometimes comes into play on examination and subsequent litigation. Substantial compliance is a doctrine the courts developed to provide relief for taxpayers when the taxpayer's filing was sufficiently close to strict compliance that the taxpayer is deemed to have met its obligations. The doctrine has also been incorporated into a few regulations.[95] The Tax Court has set a five-factor standard to test for substantial compliance, based on whether:

- the regulations provide requirements with detailed specificity;
- the taxpayer's failure to comply fully defeats the purpose of the statute;
- the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default;
- the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with the original action or omission; and
- the IRS is prejudiced.[96]

A taxpayer may not qualify for relief under the substantial compliance doctrine in any situation in which the failure to strictly comply defeats the purpose of a statute.[97] The Supreme Court has said that the commissioner "may insist upon full compliance with his regulations when the regulatory requirements relate to the substance or essence of a statute."[98] The focus of the inquiry is whether the failure to comply with the literal requirements goes to the "essence" of the provision or is a relatively ancillary, minor procedural infirmity.[99]

H. After Statutes of Limitations Expire

Statutes of limitations play a vital role in tax administration, as they do across the law. Without them, we could never leave the past behind. Statutes of limitations serve many purposes, and reducing uncertainty is just one of them.[100] The statutes of limitations effectively resolve lots of tax mistakes each year, by putting correction out of reach, for better or worse.[101] As noted earlier, the first question in any mistake analysis should be: Is the statute open? If the year is closed, then the duty of consistency may play a role in open years, but otherwise the mistake is probably beyond adjustment, except as noted below.

When considering how — and whether — to fix a mistake, it is critical to understand when the relevant statutes of limitations expire for a given tax year. Most generally, there are two different initial statutes of limitations that matter for this discussion: the assessment statute and the claims statute. Section 6501 generally limits the IRS's ability to assess additional tax to three years after the original return was filed. There are many exceptions to that rule, some obvious, some obscure.[102] Section 6511(a) generally limits the taxpayer's ability to claim a refund or credit of an overpayment to three years after the original return was filed. Additional lookback rules set out in section 6511(b) may further limit the amount of a refund that may be paid on a timely filed refund claim.

Even though there is no obligation to do so, some taxpayers want to pay tax into closed years to fix mistakes. That is fine, and a perfectly acceptable practice. The IRS may not be able to assess the tax, but the IRS will absolutely keep the money. A word of warning: A taxpayer that chooses to file an amended return and pay tax into a closed year usually cannot reverse course later without picking a fight. Even if the tax is nonassessable, the IRS will not issue a refund unless the taxpayer has made an overpayment of

[95] *E.g.*, reg. sections 1.274-5T(c)(2)(v), 1.482-7(k).

[96] *American Air Filter Co. Inc. v. Commissioner*, 81 T.C. 709 (1983).

[97] *Sawyer v. County of Sonoma*, 719 F.2d 1001, 1008 (9th Cir. 1983).

[98] *Angelus Milling Co. v. Commissioner*, 325 U.S. 293, 296 (1945).

[99] *Atlantic Veneer Corp. v. Commissioner*, 812 F.2d 158, 160-161 (4th Cir. 1987). *Compare Bond v. Commissioner*, 100 T.C. 32 (1993), *with Hewitt v. Commissioner*, 109 T.C. 258 (1997).

[100] *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 300 (1946). *See generally* Tyler R. Ochoa and Andrew Wistrich, "The Puzzling Purposes of Statutes of Limitation," 28 *Pac. L. J.* 453 (1997).

[101] *See, e.g.*, IR-2023-79.

[102] For example, section 6501(e) extends the assessment statute to six years for a substantial omission of gross income, and section 6501(c)(8) extends the assessment statute indefinitely for unfiled international information returns.

tax,[103] which is different than the procedural question of whether the IRS let its assessment authority lapse. Also, it is not clear that paying a nonassessable tax releases the taxpayer from any duty of consistency in open years. A closing agreement that agrees to waive the statute of limitations (if the IRS will agree to it) would be a better approach if duty of consistency is a concern.[104]

Once the statute of limitations runs, options for fixing mistakes dwindle. We are generally left with three potential options: accounting method changes, attribute redeterminations, and mitigation. Two of these three options are also available in periods with open statutes, but we discuss them here for their special utility in these stale situations. All these remedies can effectively reach beyond the statute of limitations.

I. Accounting Method Changes

A change in the method of accounting (method change) includes a change in the overall plan of accounting for income or deductions or a change in the treatment of any material item used in that plan.[105] Method changes are limited to adjustments to the timing of the inclusion of the item.[106] A method change does not include the correction of computational errors or a change in treatment resulting in a change in underlying facts.[107] If a particular accounting practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the tax year in which taxable income is reported, it involves timing and is therefore an accounting method. Finally, the IRS must agree to a method change.[108]

The good thing about method changes in this setting is that section 481(a) provides authority for taxpayers to make an adjustment in the current year for the cumulative effect of a method change. For instance, if a taxpayer failed to properly account for an expense or liability over a series of years, if that item is properly chargeable to capital account, at least a portion of the accumulated item may be recoverable through a method change if the tax law allows for cost recovery on that capital account. Section 481(a) adjustments may include items from closed years.[109]

J. Attribute Redetermination

Attribute redetermination sometimes is an option to fix mistakes made in closed periods. Basis is the most important — and most often overlooked — attribute that may be subject to redetermination.[110] The substance-over-form doctrine and the duty of consistency may limit the ability to redetermine basis, though. The zero bound presents another interesting question in some basis calculations. It is an iron principle of tax law that there is no such thing as negative basis.[111] But what happens when a partnership or an S corporation makes distributions exceeding basis in closed years? Is the taxpayer saved by zero,[112] or does the IRS have the right to fix old and otherwise statute-barred problems by creating a suspense account that must be considered in open-year basis calculations? The IRS thinks it is the latter.[113]

Generally, the IRS, taxpayers, and the courts may redetermine items in closed years to the extent they affect net operating losses and certain

[103] *Lewis v. Reynolds*, 284 U.S. 281 (1932).

[104] *See* section 7121.

[105] Reg. section 1.446-1(e)(2)(ii)(a).

[106] Reg. section 1.446-1(e)(2)(ii)(b).

[107] *Id.*

[108] Section 446(b); *see also* Rev. Proc. 2023-24, 2023-27 IRB 1207 (listing automatic method changes); Rev. Proc. 2015-13, 2015-5 IRB 419 (setting out procedures to request approval for nonautomatic method changes).

[109] *See Bosana v. Commissioner*, 661 F.3d 250 (5th Cir. 2011); *Peoples Bank & Trust v. Commissioner*, 415 F.2d 1341 (7th Cir. 1969); *Rankin v. Commissioner*, 138 F.3d 1286 (9th Cir. 1998); *Weiss v. Commissioner*, 395 F.2d 500 (10th Cir. 1968).

[110] *See, e.g.*, reg. section 1.266-1(c).

[111] *Crane v. Commissioner*, 3 T.C. 585, 591 (1944), *rev'd on other grounds*, 153 F.2d 504 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947) (negative basis is impossible in "the very nature of things").

[112] *See* The Fixx, "Saved by Zero," YouTube (Oct. 8, 2009).

[113] *E.g.*, *Kanwal v. Commissioner*, Nos. 23766-18, 23769-18, 23776-18, 23842-18 (T.C. order July 18, 2023) (S corporation); *Surk LLC v. Commissioner*, No. 634-22 (T.C. petition Jan. 20, 2022) (partnership).

other carryover attributes in open tax years.[114] For instance, in *DHL Corp.*,[115] the IRS proposed section 482 allocations to related-party transactions. The taxpayer carried NOLs from closed years forward into the years subject to examination, and the IRS applied section 482 allocations to those closed years as applicable and recalculated the taxpayer's NOLs available for deduction in the open years before the court. The Tax Court sustained the IRS's proposed adjustment. In other cases, the IRS chooses not to redetermine NOL deductions in transfer pricing cases despite being on notice that a material transfer pricing issue existed in NOL source years. For example, in *Green Leaf Ventures*,[116] the IRS did not disallow an NOL deduction to the extent of the closed-year transfer pricing issue litigated in the open year.[117] Partnerships provide yet another exception to the general rule. As noted, there is a general consistency rule that governs the treatment of partnership-related items on partners' returns. For better or worse, that consistency rule probably locks in the treatment of partnership-related items in years closed to redetermination under section 6235 unless the IRS invokes a special enforcement regulation.[118]

What is good for the goose is good for the gander. These sorts of attribute redetermination authorities are generally available to taxpayers, too. Generally, a white paper disclosure included in the tax return explaining the attribute redetermination suffices. Of course, a taxpayer must always be able to substantiate any change in attributes, and the duty of consistency may limit the scope of attribute redeterminations.

K. Mitigation

Last, and almost certainly least, one should consider the mitigation provisions,[119] which almost always give false hope to the practitioner who is cornered into considering them. Most practitioners and IRS employees find the mitigation provisions confusing and difficult. The basic premise is simple — the mitigation provisions were designed to prevent a windfall for either the taxpayer or the IRS owing to the running of a statute of limitations.[120] But mitigation rarely applies.

The mitigation provisions, set out in sections 1311 through 1314, are a statutory response to the judicially created equitable doctrines of recoupment, setoff and estoppel as applied to unfair situations stemming from the closing of statutes of limitations. Although courts applied the equitable doctrines to correct inequitable results, their application was often uncertain. So Congress passed legislation in an attempt to clear the murky waters. Unlike the equitable doctrines, the mitigation provisions actually reopen the closed year to correct the erroneous treatment. The party raising the argument has the burden of proving the appropriateness of applying the mitigation provisions.[121]

Generally, section 1311 provides four requirements and preconditions:

- a "determination";
- the prevention of adjustment based on the determination because of the statute of limitations or some other rule of law;
- the maintenance of an inconsistent position by the party winning the determination or else meeting certain other requirements in the absence of an inconsistent position; and

[114] *See Marcello v. Commissioner*, 380 F.2d 494 (5th Cir. 1967); *Phoenix Coal Co. v. Commissioner*, 231 F.2d 420 (2d Cir. 1956); *Lone Manor Farms Inc. v. Commissioner*, 61 T.C. 436 (1974), *affd. without published opinion*, 510 F.2d 970 (3d Cir. 1975); *Hill v. Commissioner*, 95 T.C. 437 (1990); *Lord Forres v. Commissioner*, 25 B.T.A. 154 (1932); Rev. Rul. 56-285, 1956-1 C.B. 134; Rev. Rul. 81-87, 1981-1 C.B. 580; *Parker Tree Farms Inc. v. Commissioner*, T.C. Memo. 1983-357; *Leitgen v. Commissioner*, T.C. Memo. 1981-525; *Stevens v. Commissioner*, T.C. Memo. 1980-521; *Johnson v. Commissioner*, T.C. Memo. 1980-435; *Malmestedt v. Commissioner*, T.C. Memo. 1976-46; *see also* section 6214(b). The same principle of redetermination holds true for certain credit carryforwards. *See Mennuto v. Commissioner*, 56 T.C. 910, 923 (1971) (investment tax credit carryforwards); Rev. Rul. 69-543, 1969-2 C.B. 1 (credit carryforwards); Rev. Rul. 82-49, 1982-1 C.B. 5 (charitable contribution carryforwards); Rev. Rul. 77-225, 1977-2 C.B. 73. The principle of redetermination even extends to correction of taxable income for a base period year for income averaging purposes. *See Unser v. Commissioner*, 59 T.C. 528 (1973); Rev. Rul. 74-61, 1974-1 C.B. 239.

[115] *DHL Corp. v. Commissioner*, T.C. Memo. 1998-461, *aff'd in part, rev'd in part*, 285 F.3d 1210 (9th Cir. 2002).

[116] *Green Leaf Ventures Inc. v. Commissioner*, T.C. Memo. 1995-155.

[117] *Id.* at n.18.

[118] Greg Armstrong, Ossie Borosh, and Andy Roberson, "Adjusting Closed-Year Partnership-Related Items," *Tax Notes Federal*, Oct. 30, 2023, p. 847.

[119] Sections 1311-1314.

[120] *See Gooch Milling & Elevator Co. v. United States*, 78 F. Supp. 94, 100 (Ct. Cl. 1948).

[121] *Olin Mathieson Chemical Corp. v. United States*, 265 F.2d 293, 296 (7th Cir. 1959); *Chertkof v. United States*, 676 F.2d 984, 990 (4th Cir. 1982).

- a determination and proposed adjustment that affect the same taxpayer or a related taxpayer.

If these conditions are met, the party seeking adjustment must also fit the dispute within one of the seven specified "circumstances of adjustment" in section 1312. Section 1313 defines terms as used in the statute. Section 1314 provides the authority for the amount and method of adjustment.

The mitigation provisions do not come into play unless either the IRS or the taxpayer is being prejudiced by a whipsaw situation, that is, a double disallowance of an item of income or expense, or a double inclusion of an item of income or expense. The mitigation provisions can come into play only if one, and only one, of the two relevant years is open. They apply only to income taxes and only to the same type of income taxes.[122] They do not apply if some other recourse was available at the time of determination. If the determination is made before the expiration of the statute of limitations on the year of error, the mitigation provisions do not apply.[123] Theoretically, other equitable principles may be used to prevent the application of the statute of limitations, but the mitigation provisions — even if they don't apply — may displace those arguments.

VI. Conclusion

To err is human, in tax as in everything else. The good news is that we can fix most federal tax mistakes if we find them soon enough. One last piece of advice: Fix it once. If you plan to correct a mistake, address all the known problems on that return.[124] Eventually, time and the statutes of limitations dispatch almost all mistakes whether we fix them or not.[125] ■

[122]Reg. section 1.1311(a)-2(b). Section 1314(e) also states that the provisions do not apply to employment taxes.

[123]Reg. section 1.1311(a)-2(a).

[124]In general, a return preparer may rely in good faith on information provided by a client, but that rule does not cover situations in which the preparer knows that information is incorrect or incomplete, or the information appears incorrect or incomplete. Reg. section 1.6694-1(e).

[125]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This report represents the views of the author only and does not necessarily represent the views or professional advice of KPMG LLP.