Amended Returns — Imposing a Duty to Correct Material Mistakes

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The amended returns proposal would create a duty for a taxpayer to correct material factual errors on its tax return when the error is discovered. Failure to correct an erroneous but innocent representation is considered to be a form of deceit in American tort and contract law.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project can be found at ''The Shelf Project: Revenue-Raising Projects That Defend the Tax Base,'' *Tax Notes,* Dec. 10, 2007, p. 1077, *Doc 2007-22632*, *2007 TNT 238-37*. Shelf project proposals follow the format of a tax committee report in explaining current law, the reasons for change, and the proposal itself.

The amended return proposal would require a taxpayer to file an amended return to correct an innocent factual error large enough to be worth correcting once the error is discovered. Failure to correct a prior representation on discovery of its falseness is a form of deceit under American nontax law. A taxpayer should not deceive his government.[1]

I. Current Law

A. Internal Revenue Code

The Internal Revenue Code does not require a taxpayer to file an amended return to correct a mistake discovered after the filing of the original tax return.[2] The words ''amended return'' scarcely appear in the code.[3] Reg. sections 1.451-1(a) and 1.461-1(a) provide that a taxpayer ''should'' file an amended return when the taxpayer ascertains an error on a prior tax return, and pay any additional tax due within the period of limitations.[4] IRS Publication 17, *Your Federal Income Tax*, has long said that you should correct your return if, after you have filed it, you find that ''you did not report some income, [or] you claimed deductions or credits you should not have claimed.'' The publication states that you should ''use Form 1040X, Amended U.S. Individual Income Tax Return, to correct a return you have already filed.''

In *Broadhead v. Commissioner,* the Tax Court held that Treasury regulations do not require a taxpayer to file an amended return, even after being advised to do so by an accountant.[5] In *Broadhead*, the taxpayer's accountant advised the taxpayer that his closing inventory accounts were in error under accounting principles after the filing of the taxpayer's original income tax return.[6] The IRS argued that Broadhead ''willfully and deliberately attempted to evade and defeat his income taxes when he refused to file the amended return after being advised to

[1]Prior scholarly commentary supporting the amended return includes Kenneth L. Harris, ''Requiring the Correction of Error Under the Federal Tax Law,'' 42 *Tax Law*. 515, 536 (1989) (concluding that an amended return is within a taxpayer's duty to file a true and amended return, and finding no administrative difficulties); Judson Temple, ''Rethinking Imposition of a Legal Duty to Correct Material Tax Return Errors,'' 76 *Neb. L. Rev*. 223 (1997) (failure to require amended returns is a ''lingering oddity'' of procedure).

[2]The term ''amended return'' refers to a return filed after an original return has been filed for a taxable period and after the due date, including extensions, for the original return. That an amended return is filed after the due date of the return distinguishes it from a ''superseding return,'' which will be defined and discussed below.

[3]The three places in the code that the words ''amended returns'' appear are in section 965(b)(2) (exception to amounts to be included for the temporary dividends received deduction) and in the desciptive headings of section 6501(c)(7) (exception to the statute of limitations on assessment) and section 6662A(e)(3) (special rule with respect to the imposition of the accuracy-related penalty on understatements). Sections 6501(c)(7) and 6662A(e)(3) are discussed further below.

[4]Reg. section 1.451-1(a) provides that ''if a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due.'' Under reg. section 1.461-1(a), ''if a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due.''

[5]*Broadhead v. Commissioner*, 14 T.C.M. (CCH) 1284 (1955).

[6]*Id*.

do so by his accountant.''[7] The Tax Court held that the taxpayer ''was not required by statute to file an amended return, and if one had been tendered for filing, [the IRS] could have declined to accept it.''[8] In *Badaracco v. Commissioner*, the Supreme Court implicitly accepted *Broadhead*, saying that ''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.''[9]

An amended return, Form 1040X, does not generally affect the status of the original return. The filing of an amended return does not change the statute of limitations that began to run with the original return.[10] In *Kaltreider Construction Co. v. United States*, the corporate taxpayer had filed an amended return and paid the additional tax shown due on the amended return within the original return's three-year statute of limitations.[11] However, more than two years after payment of the additional tax, the corporation filed a claim for refund shortly after a court ruled that the additional tax should have been paid by the individual owners of the corporation and not the corporation itself.[12] Rejecting the taxpayer's argument that the three-year period of limitations should begin to run from the time the amended return was filed, the Third Circuit Court of Appeals found that the claim for refund was not timely filed, stating, ''the statute of limitations begins to run from the date the original return was filed, and the filing of the amended return does not operate to extend the statute.''[13] There is a limited exception under section 6501(c)(7) in which an amended return will extend the statute of limitations: If the IRS receives a written document showing an additional tax due, signed by the taxpayer, within 60 days before the expiration of the statute of limitations, the period for assessment of the additional amount shall not expire for 60 days after the date of receipt of such document.

Similarly, if the taxpayer had filed a fraudulent original return, the filing of an accurate amended return does not change the fraudulent nature of the original. In *Badaracco*, the Supreme Court held that the section 6501(c)(1) exception applies when a taxpayer files a false or fraudulent return and then later files a nonfraudulent amended return, allowing the assessment of additional taxes ''at any time,'' even after three years have passed.[14]

The code prescribes penalties for taxpayers and return preparers that understate tax liability. Treasury regulations provide that accuracy-related provisions apply to additional tax shown on amended returns.[15] Under section 6662, a taxpayer faces a penalty of 20 percent of the portion of underpayment that is attributable to negligence or disregard of rules or regulations or any substantial understatement of tax.[16] Negligence in this instance is defined to include ''any failure to make a reasonable attempt to comply'' with the code provisions, and disregard includes any ''careless, reckless or intentional disregard.''[17] A substantial understatement of income tax is defined as the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 for corporations).[18]

The tax return preparer is also subject to penalties for understatement of tax.[19] In 2007 Congress increased the penalty amounts on tax return preparers[20] and raised the standards of conduct to avoid the return preparer penalty. To avoid a penalty after the 2007 amendments, the tax return preparer must have a reasonable belief that the position was more likely than not to be sustained on its merits if the position is not adequately disclosed on the tax return.[21] If the position is adequately disclosed, it needs only to have a reasonable basis.[22] A position meets the more likely than not standard if it has a greater than 50 percent likelihood of being upheld.[23] The reasonableness and likelihood of a position may be established by authorities described in reg. section 1.6662-4(d)(3)(ii).[24] Proposed amendments to the Circular 230 standards would incorporate the new more likely than not and reasonable basis standards as the minimum standards of professional conduct for practice before the IRS.[25]

Section 6651(a) imposes civil penalties of 5 percent of the tax due for each month the failure to file a return

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[7]*Id*.

[8]*Id*.

[9]*Badaracco v. Commissioner*, 464 U.S. 386, 393 (1984).

[10]Michael Saltzman, *IRS Practice and Procedure*, para. 5.02[2][b], RIA (revised 2d ed. 2002) (citing *Kaltreider Construction Co. v. United States*, 303 F.2d 366 (3d Cir.), *cert. denied*, 371 U.S. 877 (1962)).

[11]*Kaltreider Construction Co.*, 303 F.2d at 367.

[12]*Id*.

[13]*Id*. at 368 (quoting 10 Mertens, Federal Income Taxation section 57.15).

[14]Saltzman, (quoting *Badaracco*, 464 U.S. at 393).

[15]Reg. section 1.6664-2(c)(2) and (3).

[16]Section 6662(a) and (b). The substantial understatement of tax can arise from an understatement of income tax, a substantial valuation misstatement, a substantial overstatement of pension liabilities, or a substantial estate or gift tax valuation understatement. Section 6662(b)(2) through (5).

[17]Section 6662(c).

[18]Section 6662(d).

[19]Section 6694.

[20]Section 6694(a) and (b); Notice 2007-5, 2007-3 IRB 269, *Doc 2006-25337*, *2006 TNT 245-6*; Circular 230 section 10.34. Section 8246 of the Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28, 121 Stat. 190, amended several code provisions related to the tax return preparer penalty. The 2007 act increased the section 6694(a) penalty from $250 to the greater of $1,000 or 50 percent of the tax return preparer's income from the tax return preparation service. The section 6694(b) penalty for willful and reckless conduct was increased from $1,000 to the greater of $5,000 or 50 percent of the income from the tax preparation service.

[21]Section 6694(a)(2)(A) through (C)(i).

[22]Section 6694(a)(2)(C)(ii).

[23]Reg. section 1.6662-4(d)(2).

[24]Notice 2007-5; Circular 230 section 10.34.

[25]Proposed Treasury amendments to Circular 230, 31 CFR section 10.34(a) and (e), by reference to section 1.6662-4. In addition to the proposed regulations under Circular 230 there are also proposed regulations under sections 6694 and 6695, see 73 *Fed. Reg.* 34,560 (proposed June 17, 2008) (to be codified at 26 C.F.R. pts 1, 20, 25, et al.)

continues, up to 25 percent in the aggregate.[26] If the failure to file is shown to be due to fraud, the civil penalty can be up to 75 percent of the tax shown on the return.[27] Section 7203 provides that a failure to file a return is a misdemeanor, subject to up to a $25,000 ($100,000 for a corporation) fine and one year's imprisonment. The civil and criminal penalty provisions for failure to file a tax return do not apply to amended returns.

B. Administrative Practice

While the code is basically silent regarding amended returns, there are approximately 300 provisions concerning amended returns in the Treasury regulations. These provisions consistently require that the amended return can be considered only if the original return was not fraudulent. One key provision is reg. section 1.6664-2, which takes into account any additional tax shown on a qualified amended return in calculating any tax underpayment for the section 6662 accuracy-related penalty.[28] A taxpayer will sometimes rationally file an amended return to reduce or avoid the accuracy-based penalty.

The IRS attempts to discover errors that are either simple mathematical errors or missing income, reported by third-party payers on IRS forms, such as Form W-2, Form 1099, or Form K-1. Annual statistics for 2006-2007 show that the IRS detected 3 million taxpayers who made 4 million mathematical errors on their returns.[29] When the IRS does find simple addition or subtraction mistakes, it notifies the taxpayer, and automatically adjusts the return under the math error process unless the taxpayer timely objects.[30] The IRS computer software is capable of comparing documents and identifying inconsistencies from Forms W-2, 1099, K-1, and other forms that are reported to the IRS. While there may not be a penalty for an honest mistake, interest will accrue from the filing date of the original return for any underpayment of tax.

The IRS's chances of discovering errors on tax returns other than those involving simple math or matching documents are low. Currently, the IRS audits 1 percent of returns, including both field and ''correspondence'' audits.[31] As a result, mistakes on returns that are not easily checked through math or document comparison programs have a substantial likelihood of going undetected.

II. Reasons for Change

The imposition on taxpayers of a duty to file an amended return to correct for innocent mistakes on the original tax return would make the taxpayer's tax obligations consistent with general legal and ethical standards under torts and contracts law to not engage in ''deceit''; enforce long-standing ethical duties on taxpayers for whom an ethical obligation is not sufficient; serve to resolve the asymmetry where taxpayers have an incentive to correct errors when correction is in the taxpayer's favor but not when correction is in the government's favor; and make the duty for correcting mistakes discovered after the due date for the return consistent with duties under current law when the mistake is discovered before the due date for the return.

A. Common-Law Deceit

A taxpayer certifies by signing the tax return that the return is ''true and accurate.'' Failure to correct a representation thought to be true and accurate when made when it is later discovered that the representation is false is a tort of deceit under American common law.[32] The Restatement of Torts states:

> One who, having made a representation which when made was true or believed to be so, remains silent after he has learned that it is untrue and that the person to whom it is made is relying upon it in a transaction with him, is morally and legally in the same position as if he knew that his statement was false when made.[33]

Similarly, under contracts law, a failure to correct an innocent mistake is itself a misrepresentation. There is a duty to correct a statement that a party made in good faith when the party discovers the statement is not true[34]:

> A, seeking to induce B to make a contract to buy a thoroughbred mare, tells B that the mare is in foal to a well-known stallion. Unknown to A, the mare has miscarried. A learns of the miscarriage but does not disclose it to B. B makes the contract. A's nondisclosure is equivalent to an assertion that the mare has not miscarried, and this assertion is a misrepresentation.[35]

The United States, as a collector of tax revenues for the public good, is owed a duty no less than the general duty of the world not to commit the tort of deceit, and no less

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[26]Section 6651(a).

[27]Section 6651(f).

[28]Reg. section 1.6664-2(c)(2) and (3). A qualified amended return is defined as an amended return or timely request for a section 6227 administrative adjustment (partnership return items), filed after the due date of the original return and before the IRS first contacts the taxpayer or another person concerning an examination or investigation of the return.

[29]Statistics of Income Tax Stats, IRS Data Book: 2006-2007, Table 15. Math errors include: tax calculation, earned income tax credit, exemption number/amount, standard/itemized deduction, child tax credit, adjusted gross taxable income amount, refund/amount due, filing status, adjustments to income, other credits, withholding or excess Social Security payments, or other miscellaneous errors.

[30]Section 6213(b).

[31]IRS, ''Fiscal Year 2007 IRS Enforcement and Service Statistics,'' *available at* http://www.irs.gov/pub/irs-news/irs_enforcement_and_service_tables_fy_2007.pdf

[32]W.W. Page Keeton, ''Fraud — Concealment and Nondisclosure,'' 15 *Tex. L. Rev.* 1, 6 (1936).

[33]American Law Institute, Restatement (Second) of Torts, section 2(c), comment h (1977).

[34]*See* E. Allen Farnsworth, *Contracts*, 254 section 4.11 (2d ed. 1990); *In re Williams*, 314 Or. 530, 840 P.2d 1280 (1992) (attorney disciplined for failure to disclose that the tenant had vacated premises); *Loewer v. Harris*, 57 F. 368, 374 (2d Cir. 1893) (seller who in good faith asserted output of brewery was expanding was under duty to correct error when he discovered output was contracting).

[35]*Id.*, Illustration 2.

than the duty owed to the other party to a contract. Under the U.S. tax system of self-reporting, the United States relies on a tax return filed by the taxpayer as the statement of the taxpayer's income and tax liability. Tax law requires taxpayers to file accurate returns and imposes penalties, some quite considerable, for failing to comply. A tax return represents the final disposition of the amount of income tax due in substantially all cases, because fewer than 1 percent of all returns are audited and challenged by the IRS. A failure to correct a material representation, discovered to be incorrect after the filing of a return, affects a deceit against the United States under general legal and ethical norms.

B. Ethical Obligations Need Legal Enforcement

The Treasury regulations and Publication 17 have long stated that a taxpayer *should* file an amended return when an error is discovered. If the duty to file an amended return is in fact an ethical obligation to the United States, then the ethical obligation should not be enforced by law. For some people an ethical obligation is not a sufficient reason to engage in proper behavior, and they treat an ethical requirement with disdain. Ethical obligations, however, state our common values. The ethical norms against deceit against one's nation should be enforced by law. Moving the obligation from the realm of ethics to that of law means that tax professionals will help enforce the duty.

The holding in *Broadhead* that the taxpayer has no legal duty to correct her own tax return on a routine inventory matter is inconsistent with the more general legal and ethical rules of American jurisprudence. Within the general legal and ethical norms of American business, a party must correct an innocent representation when it is discovered that the representation is false. The accountant in *Broadhead* was the only tax professional on the scene, and he and not the taxpayer had the accounting understanding to see and correct the clear and unsupportable inventory error. Routine errors should be corrected within a system that depends so completely on the tax return certified to be true and accurate.

C. Incentive to Make Errors

Without a statutory taxpayer duty to correct mistakes, there is an incentive to make or at least tolerate errors. When a mistake is found in the government's favor, the taxpayer has the economic incentive to correct it to save tax. When the mistake is in the taxpayer's favor, however, there is neither an economic nor legal incentive to correct the mistake if it was innocent when made. While fraudulent or negligent mistakes are subject to a penalty, mistakes that were not known to be erroneous when the return was filed are not subject to a penalty. Taxpayers who make innocent errors are rewarded with an unjust windfall because the errors are so rarely corrected. The system creates an incentive to make a mistake ''accidentally on purpose,'' or at least the taxpayer is better off if he is not so meticulous as to catch his errors in his favor.

D. Discovery Before and After Due Date

The duty regarding errors depends on whether the discovery occurs before or after the due date of the return. A mistake discovered before the due date of a return creates a duty to file a superseding return to accurately report the tax liability by the due date.[36] Assuming a due date for filing the return of April 15, a taxpayer who filed a return on February 15 and discovered a mistake on April 13 is required to file a superseding return by the due date to file an accurate return for the tax period. If the same taxpayer discovered the mistake on April 16, the requirement to correct the mistake is not a legal obligation, and there are no penalties for the decision not to amend the return.

III. Description of Proposal

The proposal would impose a duty to file an amended return within 60 days of the discovery, within the statute of limitations for the original return, of a material error of fact on the original tax return. ''Discovery'' of an error requires the taxpayer to know in fact of the error, but the taxpayer may not be willfully blind, and knowledge by the taxpayer's bookkeeper, accountant, lawyer, or other agent with loyalty to the taxpayer will ordinarily be imputed to the taxpayer. The penalties now applied on the original return would apply for failure to file an amended return. The penalty for the original return and the penalty for failure to file the amended return would not be cumulative. This proposal covers only errors of fact, and a future proposal will address the correction of a legal error.

A. General Rule

Under the proposal, a taxpayer has a duty to file an amended return within 60 days of the time when a taxpayer first becomes aware of a material mistake on the original return.

Material. For the duty to file an amended return to be enforced by the IRS, the error must result in tax that is material. A material error is larger than a de minimis error, defined as an error ''so small as to make accounting for it unreasonable or administratively impracticable.''[37] If the discovered errors cumulatively would yield tax of less than $1,000, then, under the proposal, the taxpayer would not have an obligation to file an amended return. The ethical duty to correct an error may extend to amounts less than $1,000 of tax, but under the proposal the failure to correct such errors would not be subject to penalty.

Discovery. The amended return duty requires a subsequent discovery of error after the filing due date. Ordinarily, that requires that the taxpayer actually know that the representation on the original return was an error. A taxpayer would not be entitled to be ''willfully blind,'' however, when he thinks that the representation is likely to be in error and avoids the knowledge available

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[36]''A tax return filed prior to the due date and changing the data reported on the original return is a type of return that is commonly referred to as a 'superseding' return.'' *See, e.g.,* IRM 3.5.61.1.3. A superseding return is generally treated as the taxpayer's 'return' and the corrections provided in the superseding return are in effect incorporated into, and treated as relating back to, and modifying or superseding the original return. *See Haggar Co. v. Helvering*, 308 U.S. 389, 395-396 (1940); ILM 200645019, *Doc 2006-22969*, *2006 TNT 219-22*.

[37]Section 132(e)(1).

to him.[38] Knowledge by an agent, attorney, accountant, or tax adviser who is loyal to the taxpayer and under a normal professional obligation to report errors[39] would ordinarily be imputed to the taxpayer because enforcement of the tax law depends on the expertise of loyal tax advisers on site. A taxpayer is responsible to hire and supervise capable agents working for him, and errors by the taxpayer's agents are ultimately the responsibility of the taxpayer. Knowledge of error would not, however, ordinarily be imputed from a former tax return preparer or former agent who is no longer retained by the taxpayer.

Return errors. The obligation to correct return errors does not replace the basic ''sanctity of the accounting year'' premise that returns are filed according to the facts as of the close of the tax year. For example, if a taxpayer pays too much rent for his business premises during the tax year, and the mistake is not found and the rent is not refunded until a following year, the rent is deductible when paid, and the refund is income when returned. The rent was paid in error, but reporting the rent on the tax return as paid was not an error, and no amended return is required to correct it. A sham in fact discovered after the return for the year is due would require an amended return, because the sham in fact prevents the taxpayer position from having any factual support.

Legal errors. This proposal imposes only a duty to correct errors of fact. A future proposal will address clarifications or interpretative modifications of law rendered after the return is filed. Ordinarily, authoritative interpretations of the law apply to the tax year covered by the decision even when the decision is rendered many years later. The law should be uniform for all taxpayers and not just for the party before the court. Taxpayers file amended returns for refunds when interpretations move their way, and symmetry implies they should volunteer tax when interpretations clarify that their original tax return position was not sustainable. A court, rather than amended return procedures, should decide that a decision is prospective only. Legal interpretation of many issues, however, can go back and forth between taxpayer and government favor over the course of many years, and further thought is needed to propose a remedy applying decisions of law rendered after the return is filed.

Duty only within the statute of limitations. The duty to file an amended return would arise only if the error is discovered within the period before the expiration of the normal statute of limitations for assessments for the original return. The statute of limitations now extends for a three-year period after the due date or the filing of the original return. If the taxpayer discovers an innocent error after the expiration of the statute of limitations, there is no legal duty to amend the return.

[38]Harris, *supra* note 1, at 536.

[39]*See* Circular 230 section 10.21, which governs practice before the IRS and provides that a practitioner before the IRS who is retained by a client for tax must advise the client of error or omission on a return or document filed with the IRS.

Noncumulative penalties. The penalties and duties for an original return would apply to the amended return. The taxpayer would pay the higher of penalties for the original or the amended returns. The penalties would not be added to one another, however, so as to penalize the taxpayer both for errors on the original return and the failure to correct them. For example, if the original return is found to be fraudulent and not innocent, there would ordinarily be no added penalty for failing to correct the fraud, because the penalty for fraudulent return is higher than the penalty for failure to file the amended return.

Statute of limitations for the amended return. The time period for filing an amended return would be within 60 days of the date that the taxpayer first learns that a material mistake occurred on the prior filed tax return. The statute of limitations for the error shall extend to 3 years after the obligation to file, which is the same as 3 years and 60 days from the date of discovery. The statute of limitations for the error would not extend the statute of limitations for items on the original return that were not discovered to be erroneous within the statute of limitations for the original return.

Existing penalties apply. The penalties for errors on or failure to file an amended return would be identical to the current penalties for the original return. Section 6662 (providing for accuracy-related penalties on the taxpayer) and section 6694 (providing for penalties on tax return preparers.) would apply to taxpayers and return preparers of amended returns. Section 6651 (providing for time-related penalties for failure to file) would apply to the failure to file an amended return. As noted, the taxpayer would not pay *both* penalties for the original return or for the amended return, but only the higher of the two.

Existing criminal sanctions apply. Section 7203 criminal tax provisions would apply to the willful failure to amend a return. Under this criminal tax provision (which currently applies to the willful failure to file a return, supply information, or pay tax), the illegal act would be a misdemeanor and, on conviction, the fine could be $100,000 ($200,000 in the case of a corporation),[40] imprisonment for not more than one year, or both, in addition to the costs of prosecution. The statute of limitations for prosecution of the crime of failing to file an amended return would run from 60 days after the discovery of the material mistake until 6 years thereafter.

Tax return preparer obligations continue. The obligation of the return preparer that becomes aware of an error that necessitates an amended return should be the same duty as the return preparer of the original return. Section 6694 penalties affecting return preparers would apply to amended returns under the same standard that a position in the amended return meets the more likely than not standard. A tax return preparer no longer retained by the taxpayer would not have obligations as a tax return preparer after the termination of the relationship.

[40]While section 7203 states the fine levels are $25,000 ($100,000 for a corporation), the interplay with 18 U.S.C. 351, raises the possible fines to $100,000 ($200,000).

B. Examples

Example 1 (general case): The taxpayer timely filed her original Y1 return by the due date of April 15, Y2. The taxpayer discovers on May 15, Y2, an error that understates her tax liability by $1,100. Under this proposal, the taxpayer must file an amended return correcting this error by July 15, Y2.

Example 2 (discovery of error within 60 days of expiration of statute of limitations): The taxpayer had timely filed his original Y1 return by the due date of April 15, Y2. The taxpayer discovers on March 15, Y5, an error that understates his tax liability by $1,100. Under this proposal, the taxpayer must file an amended return correcting this error by May 15, Y5, even though this filing date would fall outside the original three-year period of limitations. The new statute of limitations on assessment for Y1 is May, Y8.

Example 3 (discovery of error after expiration of the statute of limitations): The taxpayer filed his original Y1 return by April 15, Y2. He discovers, after the expiration of the three-year statute of limitations, on May 15, Y5, an error that understates his tax liability by $2,000. The taxpayer has no obligation to file an amended return.

Example 4 (discovery of error before or on the due date of the original return): The taxpayer filed his original Y1 return on January 30, Y2. If on February 15, Y2, before the April 15, Y2, due date of the Y1 return, the taxpayer discovers an error that understates his tax liability by $5,500 (or any amount), that taxpayer is obligated under existing law to correct the error by April 15, Y2. The amended return proposal does not apply in Example 4. A return that the taxpayer may file before the due date to correct the information reported on the original return is a superseding return.[41] "A superseding return is generally treated as the taxpayer's return and corrections provided in the superseding return are incorporated into, relate back to, modify and supersede the original return."[42] The taxpayer's failure to correct the original return before April 15, Y2, would result in whatever tax and penalties apply for failure to report that result today.

Example 5 (sham discovered): The taxpayer reported $10 million losses on options on foreign currency. There is controversy as to whether the taxpayer had a profit motive or if his claimed loss represented a change of economic substance, but the taxpayer's position on the return was that the losses reflected economic substance. After the return was due, the taxpayer found that the option orders behind the claimed losses were never executed. The taxpayer's agent for the options wrote down figures on a pad of paper, which was the basis of the losses, but there never were options written or purchased. The losses are shams in fact. The taxpayer has the obligation to amend its return.

[41]15 Mertens, Federal Income Taxation section 57:17 (citing *Haggar v. Helvering*, 308 U.S. 389 (1940) (holding that as long as a corporation files subsequent returns within the time allowed for filing its returns (including extensions), the valuation shown on the last timely return would be binding)).

[42]*Id*.