

TAXATION

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Revenue Reconciliation Act Will Limit Corporate Planning

by Robert Willens

How Stock Acquisitions Will Trigger Section 384

by Mark J. Silverman and Kevin M. Keyes

**New Rules for Reporting Employee Expenses Will Have
Immediate Consequences**

by Robert M. Brown, Deborah Walker, and Nick J. Zieser

**What Obligations Do Taxpayers and Preparers Have to Correct
Errors on Returns?**

by Sheldon D. Pollack

**New Foreign Currency Regulations Provide Guidance
Under Section 988**

by Randall M. Wilson and Robert G. Nassau

**Obtaining Tax-Advantaged Financing for Investments in the
Caribbean Basin**

by Alan S. Lederman

**When Can a Survivorship Interest in Joint Tenancy
Property Be Disclaimed?**

by John M. Beehler

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TAXATION

VOLUME 72, NO. 2, FEBRUARY 1990

NEWSLINE: PAGE 66

CORPORATIONS, SHAREHOLDERS

- 68 Revenue Reconciliation Act will limit corporate planning
Robert Willens
- 73 New decisions
- 74 How stock acquisitions will trigger Section 384
Mark J. Silverman and Kevin M. Keyes

PERSONAL

- 80 New rules for reporting employee expenses
Robert M. Brown, Deborah Walker, and Nick J. Zieser
- 86 Innocent spouse rules affected by S corp. items
- 86 Pre-need funeral trusts
- 87 New decisions

PROCEDURE

- 90 What obligations do taxpayers and preparers have to correct errors on returns?
Sheldon D. Pollack
- 93 Overassessment did not terminate 872-A
- 93 IRS answers practitioner queries
- 94 Attorney's fees award determined issue-by-issue
- 94 New decisions

INTERNATIONAL

- 96 New foreign currency Regs. provide guidance
Randall M. Wilson and Robert G. Nassau
- 104 Obtaining tax-advantaged financing for investments in the Caribbean Basin
Alan S. Lederman
- 109 New decisions

ESTATES, TRUSTS, & GIFTS

- 112 When can a survivorship interest in joint tenancy property be disclaimed?
John M. Beehler
- 117 IRS agrees on effect of uncashed checks to charities
- 117 Will contents can affect charitable deduction
- 118 Son's services were consideration for joint interest
- 118 New decisions

LETTER RULINGS

- 120 Holding company's pre-merger existence
- 120 "Unique item" for long-term contracts
- 121 Unmarried joint owners and the residence exclusion
- 121 Attribution rules for warrants and options
- 121 Restaurant is not unrelated

PARTNERSHIPS & S CORPORATIONS

- 122 Allocation Regs. on nonrecourse debt amended
- 123 Officer who is not a shareholder cannot be S corp. TMP
- 123 FPAA sent to dissolved TMP's address was valid
- 124 New decisions

SHOP TALK

- 126 IRS revokes Section 1031 partnership conversions ruling
- 126 Ruling requests and postal nightmares
- 126 More on living in sin and Section 280A
- 127 Planning under new actuarial and valuation tables

- 79 Tax meetings
- 119 Tax literature
- 124 Classified advertising

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What Obligations Do Taxpayers and Preparers Have to Correct Errors on Returns?

The Regulations and cases suggest amended returns "should" be filed and, in any event, later returns must accurately reflect the correct tax.

BY SHELDON D. POLLACK

Inevitably, taxpayers make errors in preparing their returns, which are reflected in the tax liability shown. Errors may consist of mathematical miscomputations, incorrect assumptions of facts, or improper characterization of certain items (e.g., whether an item is properly includable or deductible). Such "good faith" errors may lead a taxpayer to incorrectly report income and deductions, resulting in an erroneous determination of tax due. At a later date (i.e., after the return is filed and after the due date), the taxpayer or the tax advisor may discover the error.

Two important issues arise as a result of the discovery of an error on a previously filed return. First, must the taxpayer amend the original return to correctly restate income? Second, if the taxpayer does not amend the return, how is the taxpayer's reporting position determined in subsequent years when relying on items that reflect the prior error?

Must the Return Be Amended?

In determining whether a taxpayer should correct a prior year's return, the annual accounting concept must first be considered. Taxpayers are required to compute taxable income (or

net losses) and file returns on a taxable year basis.¹

It is well established that the only year in which to correct a factual error is the year of the original return. Furthermore, as is discussed below, it is possible that none of the established general principles that would permit a compensating correction in a different tax year (e.g., the tax benefit rule or other equitable principles) will apply to prevent a double tax benefit.²

No requirement to amend. Although the Code and Regulations explain when a taxpayer is permitted to file an amended return, there is no provision requiring the filing of such a return. Reg. 1.451-1(a) states that if a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, the taxpayer *should*, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, under Reg. 1.461-1(a)(3)(i), if a deduction was improperly claimed in a prior taxable year, the taxpayer *should*, if within the period of limitation, file an amended return and pay any additional tax due. The use of "should," rather than "shall" or "must," indicates that it is probably advisable to file an amended return, but it is not mandatory.³

In *Badaracco, Sr.*, 464 U.S. 386 (1984), the Supreme Court held that the filing of an amended return does not start the running of the three-year statute of limitations if the origi-

nal return was fraudulent. The Court noted that although Regs. 301.6211-1(a), 301.6402-3(a), 1.451-1(a), and 1.461-1(a)(3)(i) refer to an amended return, none of them requires the filing of such a return.⁴

Professional responsibilities. Since the Code, the Regulations, and the Supreme Court (in *Badaracco*) all suggest that a taxpayer *should* file such a return, a tax advisor must advise a client of this if an error on a filed return is later discovered. Section 10.21 of Treasury Circular 230 states that the advisor is required to tell a client that he or she did not properly file a return and that an amended return should be filed for the year at issue.⁵ However, the advisor is not required to tell the client that there is a *duty* to amend the original return, and the advisor has no *duty per se* to withdraw from representation if the client fails to file an amended return.

ABA provisions. Formal Opinion 85-352 (1985) of the ABA Ethics Committee (Opinion) discusses a lawyer's responsibility in advising a taxpayer with respect to reporting a position on a return.⁶ The Opinion states that with regard to the preparation of returns, an attorney has a duty not to deliberately mislead the Service, either by misstatements, silence, or by permitting a client to mislead. Consequently, to the extent an attorney advises a client as to the proper method of reporting a posi-

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tion for the tax year at issue, the attorney may not deliberately mislead the Service or permit the client to do so.

In addition, tax advisors are subject to penalties under Section 6701 if they knowingly aid and abet a client in understating tax liability for subsequent years by using figures known to be incorrect (because they are derived from the incorrect income previously reported). Amending the return is the most conservative approach and is least likely to result in the Service charging the taxpayer with civil or criminal penalties for being deliberately misleading as to the error. Assuming a client has been advised regarding the obligation to file an amended return and has made an informed decision not to amend, subsequent returns also must not mislead the Service, through either misstatement or silence. Therefore, disclosure of calculations that use items from the erroneous prior return is strongly advised.

The Opinion also addresses the issue of an attorney's responsibility in advising the taxpayer with respect to a reporting position on a tax return, specifically as to the applicable standard for supporting that reporting position. The advice must be based on the attorney's "good faith belief" that there is a realistic possibility of success in litigating a challenge to the decision *not to file* an amended return. Because there is no legal duty to file an amended return, an attorney who so advises a client would appear to fully satisfy the requirements of the Opinion.⁷

Nevertheless, the tax advisor is often placed in a tenuous ethical position in which difficult questions arise: Must the advisor investigate the facts and circumstances surrounding

a purported "good faith" error committed by a client? How strong a position must an advisor take in advising a client that an amended return should be filed (knowing that as a practical matter, a particular client will not amend a return absent a legal duty to do so)? Thus, the advisor's professional obligations may counteract the general conclusion that there is no statutory duty to file an amended return.

The Current Year's Return

If errors were made and the taxpayer chooses not to file an amended return, the income shown on the original return is erroneous and understated (even if it was filed in good faith and was based on all facts known at the time of filing). Generally, taxpayers cannot adjust income for any subsequent year to rectify or compensate for an understatement of adjusted gross income (and related tax liability) on a prior unamended return. The taxpayer cannot allocate taxable income (or deductible expenses) to any period other than the proper accounting period, regardless of whether the taxpayer or the Government would benefit from the improper allocation.⁸

Indeed, an effort by the taxpayer to compensate for any incorrect and insufficient determination of one year's tax liability by allocating the taxable income to another year might be construed by the Service as an attempt to *conceal* the previous erroneous understatement. Therefore, subsequent returns must be accurately and correctly filed, leaving the Service to assess a deficiency for the year of the error. If the statute of limitations has already run for that year, it may be too late to correct the error, regardless of whether the taxpayer or

the Government was adversely affected by it.

Correcting erroneous information.

Even if an amended return is not filed for a prior year, the current and subsequent years' returns must accurately reflect the taxpayer's income and deductions for the current accounting period. Thus, the "correct" and accurate reporting position must be determined using the facts and circumstances that are now known to be true.

Basis. An example of a prior error that can be reflected on a current return involves S corporation stock or a partnership interest. The taxpayer's basis in the stock or the interest reflects prior allocations of income from the S corporation or partnership. If the taxpayer previously made an error in understating income from the S corporation or partnership, should the taxpayer's basis for the current year reflect the income that was previously erroneously reported, or should it reflect the correct income (*i.e.*, the income that should have been reported)?

The problem of determining basis will arise only where a basis calculation is required, such as where losses allocated to the shareholder or partner are subject to a limitation determined by the amount of basis. The taxpayer's basis will have to be calculated to determine whether allocable losses can be deducted by the taxpayer for that year. A basis determination also will be needed if the taxpayer sells the stock or partnership interest, to determine gain or loss on the sale. However, in the absence of one of these events, basis is not an item that must be currently disclosed on a return.

A very different result will occur

¹ See Reg. 1.441-1(a) (each taxable year is a separate unit for tax accounting purposes). See also Rev. Rul. 80-58, 1980-1 CB 181.

² But see Sections 1311 through 1314 (mitigation provisions); Rice, "When and How Will the Courts Apply the Mitigation Provisions?," 69 JTAX 106 (August 1989).

³ See Wolfman, *Ethical Problems in Federal Tax Practice* 53-54 (Bobbs-Merrill, 2d ed., 1985); Harris, "On Requiring the Correction of Error Under the Federal Tax Law," 42 Tax Lawyer 515 (1989), at 517; Ronan, "Do Clients Have a Duty to File Amended Tax Returns?," 33 Practical Lawyer 25 (1987), at 26-27. See

also "An Analysis of the Status of Amended Tax Returns and the Effects of Their Use," 23 Houston L. Rev. 769 (1986); Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶ 111.1.7 (Warren, Gorham & Lamont, 1981).

⁴ See also Broadhead, TCM 1955-328, *aff'd* 254 F.2d 169 (CA-5, 1958) (no Regulation requires the filing of amended returns); GCM 35738, 3/21/74 (there is no statutory authority for filing or accepting amended returns). But see Unvert, 72 TC 807 (1979), *aff'd* 656 F.2d 483 (CA-9, 1981) (preceding Badarraco, 464 U.S. 386 (1984), and indicating that there may be an obligation to file amended returns).

The ABA Section of Taxation currently has before it a proposal, drafted by Frederic G. Corneel, that would change current law to require that a taxpayer must amend a prior return where the taxpayer becomes aware of a "material error or omission."

⁵ 31 CFR Section 10.21 (if an advisor knows that a client has not complied with the revenue laws of the U.S. or has made an error in or omission from any return, document, affidavit, or other paper that the client is required to execute, the advisor is to advise the client promptly of such fact). See also 31 CFR Section 10.51.

where basis is adjusted under Section 1016. For example, the adjusted basis of a building is determined under Section 1016(b) by reducing original basis for depreciation that was "allowed," but not by less than the depreciation that was actually "allowable."⁹ When calculating the current year's depreciation, an error in computing an earlier year's deduction must be disregarded (and the correct figure used) if it resulted in the understatement of an allowable depreciation deduction. However, the erroneous deduction must be used in the current calculation if it overstated the deduction and was "allowed."

Other reflected items. Other current items that might reflect the taxpayer's previously understated income are carryovers of an NOL or charitable deduction. If the taxpayer carries over these or similar items to the current return, the carryover must be recomputed using the correct income figure. This could lead to a reduced NOL or charitable deduction carryover to the current year.¹⁰

It is advisable that any recomputation of a current item made to account for a prior error be revealed to the Service in a short disclosure statement attached to the current return. This eliminates the risk that the Service will claim that the taxpayer concealed the prior error by making an undisclosed adjustment to current items.¹¹

Tax Benefit Rule

If the original return remains unamended, the three-year statute of limitations will generally apply, after which the Service will no longer be able to assess a deficiency. A six-year statute of limitations applies if the

taxpayer omits more than 25% of the income that is reported. (There is, of course, no limit on the period for assessment in the case of a fraudulent return, but that is not within the scope of this article.) Once the limitations period has run out, the prior erroneous understatement of income will no longer be recoverable by the Service via an assessment for that year. However, under the tax benefit rule the Service may argue that there is a "fundamental inconsistency" in the prior and subsequent return positions taken by the taxpayer, so that income should be recognized in a later (open) taxable year even if the prior year is closed.

In *Hillsboro National Bank*, 460 U.S. 370 (1983), and its companion case, *Bliss Dairy, Inc.*, the IRS argued that the tax benefit rule dictates that there be an inclusion of amounts previously deducted if later events are "inconsistent" with the deductions taken. The IRS further asserted that a "recovery" is not necessary for the rule to apply.

The Supreme Court agreed that a recovery is not always necessary to invoke the tax benefit rule. According to the Court, the purpose of the rule is not simply to tax recoveries; rather, it is to achieve transactional parity in tax and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that are proved to have been erroneous by an event in a subsequent year. The Court qualified this assertion, however, by stating that not every unforeseen event requires the application of the tax benefit rule. According to the Court, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination

shows that the later event is fundamentally inconsistent with the premise on which the deduction was initially based.

The Court's statement of the tax benefit rule in *Hillsboro* makes it unclear in the example above whether a subsequent adjustment to basis reflecting the corrected (greater) income allocation, or a distribution of previously untaxed income, would be inconsistent with the prior treatment of such income. To the extent that a correction gives the taxpayer an adjusted basis in the partnership interest or S corporation stock greater than that indicated by the prior erroneous statement of income, the Service may argue that there is an inconsistency. While no recovery is required under the Court's statement of the tax benefit rule, this may be a later event that is fundamentally inconsistent with the prior treatment. It is unclear whether use of the corrected income figure is *per se* a fundamentally inconsistent event. A purported distribution out of previously taxed income, which escaped taxation solely due to the taxpayer's error, may be viewed as both a recovery and fundamentally inconsistent with the prior treatment.

Recovery need not trigger income.

In *Goldberger's Estate*, 213 F.2d 78 (CA-3, 1954), the decedent had been a partner in a joint venture. The other joint venturers had concealed additional profits from the decedent in 1933. In 1944, the estate recovered some of the income not reported in 1933, but neither the estate nor the beneficiary reported the recovered income. The court noted that the estate's recovery represented a collection of profits that properly should

⁶ See ABA Formal Opinion 85-352, Daily Tax Report (BNA) No. 145 (7/29/85), at J-1; see also ABA Formal Opinion 314 (1965); Lerner and Swails, "New AICPA Statements Revise Tax Practice Responsibilities," 70 JTAX 88 (February 1989).

⁷ See also Lerner and Swails, *supra*.

⁸ Security Flour Mills Co., 321 U.S. 281 (1944); Regs. 1.451-1(a) and 1.461-1(a)(3). See also Heer-Adres Investment Co., 17 TC 786 (1951), *nonacq.*; Kline, 15 TC 998 (1950), *acq.*; Standard Paving Co., 13 TC 425 (1949), *aff'd* 190 F.2d 330 (CA-10, 1951), *cert. den.*

⁹ See also Reg. 1.1016-3(a)(1)(i).

¹⁰ See Phoenix Coal Company, Inc., 231 F. 2d 420 (CA-2, 1956); Lone Manor Farms, Inc., 61 TC 436 (1974), *aff'd* 510 F.2d 970 (CA-3, 1975) (IRS could recompute NOL carryover to reflect correction of an error made in computing the loss sustained in an earlier, closed tax year; current NOL computation must be based on "determining" the earlier loss and the correct tax liability for that year).

¹¹ Cf. Reg. 1.170A-10(e) (requiring information statement attached to return regarding computation of a charitable deduction carryover; such statement would be the most obvious place to disclose a recomputation to cor-

rect for a prior error); Reg. 1.172-1(c) (requiring statement with tax return showing computation of NOL deduction).

¹² See also Frame, 195 F.2d 166 (CA-3, 1952); Asphalt Industries, Inc., 384 F.2d 229 (CA-3, 1967), *modified* CA-3, 7/29/68.

¹³ See also B.C. Cook & Sons, Inc., 59 TC 516, 522 (1972); Twitchco, 348 F.Supp. 330 (DC Ala., 1972) (the tax benefit rule did not apply—and, thus, the taxpayer did not have to report additional income—when a lease was recharacterized as a sale, resulting in depreciation deductions that were less than the rent deductions previously taken).

have been reported by the decedent in 1933. The fact that the decedent was deceived from properly reporting it in that year did not change that fact. Accordingly, the recovery was not taxable income in 1944.¹²

This suggests that a subsequent recovery in a later taxable year may not necessarily require an inclusion in income where income was not reported in a prior closed year.¹³ It is unclear what events or tax treatment will generate taxable income under the tax benefit rule in a current year when there is understated income in a closed year. *Goldberger's Estate* implies that a prior error resulting in unreported income or an improper deduction will not necessarily yield taxable income on later recovery of the unreported funds. However, given that the facts of each case are unique, this may not always be the result.

Limits on reporting recoveries.

Even if there is a recovery of income on a later event (e.g., an attempt to use a higher basis for the stock or partnership interest), Section 111 may place a limit on the income to be recognized. Section 111, the codification of the tax benefit rule, limits the income inclusion attributable to a recovery during the taxable year of any amount deducted in any prior taxable year to the amount that actually reduced the tax in the prior year. Thus, even if the Service successfully asserts that there is taxable income in a subsequent year, and requires the inclusion in income of amounts recovered on a "fundamentally inconsistent" event, Section 111 will limit the inclusion to the tax actually saved in the prior closed year because of the understatement. If the prior understatement did not generate any tax reduction for the taxpayer in that year (e.g., because there were losses or tax credits available for that year), then no income would be includable on the recovery event (e.g., the sale of the stock or partnership interest, or a distribution from the S corporation or partnership) even if there was fundamentally inconsistent treatment of that tax item.

Conclusion

Where a taxpayer (or a tax advisor) discovers an error made in good faith

on a previously filed tax return, there is no clear statutory or regulatory obligation to file an amended return to correct the understatement of tax, even if the statute of limitations has not yet run on the original return. In such a case, however, the taxpayer "should" file an amended return. A tax advisor is put in a more precarious position. While generally not bound by professional ethics to disclose the error to the IRS or withdraw from representation if the client decides not to file an amended return, preparation of the current year's and future years' returns will most likely raise difficult questions as to how to properly report items that reflect or carry over computations based on the previous error. □

OVERASSESSMENT DID NOT TERMINATE 872-A

A deficiency notice sent to taxpayers who had signed Form 872-A was not untimely even though the IRS had previously processed an overassessment. According to the Tax Court in *Masraff*, TCM 1989-638, the 872-A had not been terminated because there had been no previous assessment that increased the tax.

The taxpayers had filed their 1980 return in August 1981, and executed the open-ended waiver of the statute of limitations in July 1984 with respect to the disallowance of losses, deductions, and credits claimed in connection with a partnership. In July 1985, the taxpayers signed a Form 870 that showed a \$30,000 decrease in their taxes for 1980, resulting from the IRS' failure to recoup a 1980 ITC carryback. After the IRS processed the \$30,000 overassessment, it discovered the error and sent the taxpayers a notice of deficiency for 1980.

Terminating 872-A consent. Form 872-A provides that the waiver of the statute of limitations on assessment may be terminated on the earliest of:

1. The Service's receipt of an executed Form 872-T.
2. The issuance of a deficiency notice.
3. The assessment date of an increase in the tax that reflects the final

determination of tax and the final administrative appeals consideration.

The taxpayers argued that the deficiency notice was time barred because the Form 872-A had been terminated when the IRS processed the overassessment. The Tax Court noted, however, that termination under this alternative hinges on an assessment of an increase in tax. Since the Form 870 showed a decrease in tax, that termination provision could not apply, and the Form 872-A remained in effect. □

IRS ANSWERS PRACTITIONER QUERIES

The Service's test program, TELETIN (which permits taxpayers to obtain Federal identification numbers by phone) and the ability to send faxes to the IRS were among the topics recently discussed at the Connecticut Society of CPAs annual meeting with the Hartford district director. Also discussed were the penalty and interest notice explanation, the Taxpayer Bill of Rights, and use of powers of attorney.

TINs. Taxpayer identification numbers (TINs) can now be obtained over the phone under a test program in some service centers called TELETIN. The IRS urges that taxpayers call the TELETIN phone number only to obtain TINs, and not for unrelated purposes.

Faxes and powers of attorney. Taxpayers receiving simple erroneous IRS notices no longer have to use the mails to correspond with the Service. Each

MARVEL NEW CO-EDITOR

With this issue, L. Paige Marvel becomes co-editor of the Procedure Department. Ms. Marvel is a partner in the Baltimore law firm of Venable, Baetjer & Howard, and is a member of the Council of the American Bar Association Section of Taxation, with responsibility for its Committees on Administrative Practice, Civil and Criminal Tax Penalties, and Court Procedure.