Office of Chief Counsel
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Memorandum

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

This is in reply to your request concerning the application of six-year period of limitations under IRC § 6501(e) that is triggered by a taxpayer's substantial omission of gross income from the computation of tax shown on the return. In particular, you ask whether Colony, Inc, v. Commissioner, 357 U.S. 28 (1958) has any application regarding whether an overstated basis is taken into account in determining whether gross income has been omitted in the reporting of a sale of business property. You also ask what is the standard for an adequate disclosure of an item of omitted gross income.

LEGEND

Partnership X =
GP =
Partner LLC =
Date 0 =
Date 1 =
Date 2 =
Date 3 =
$v =

$w =
$x =
$y =
$z =

ISSUES

(1) If the full amount of the proceeds from the sale of property used in a trade or business is shown on a partnership return, but the basis of the property is overstated, whether any gross income has been omitted from the return for purposes of the six-year period of limitations for substantial omissions of gross income?

(2) What is the standard for determining whether the taxpayer may avoid the six-year period of limitations on assessment (otherwise triggered by a substantial omission of gross income from the tax shown on a return) by disclosing the omitted item in the return (or in a statement attached to the return) in a manner that adequately apprises the Service of the nature and amount of the item?

CONCLUSIONS

(1) Overstating basis for the sale of property used in a trade or business results in an omission of gross income for purposes of the six-year period because gross income is determined after reducing sales proceeds by basis except in the case of a sale of a good or service; the sale of property used in a trade or business is not a sale of a good or service for such purposes.

(2) A disclosure is adequate if the omission is apparent from the face of the return to a "reasonable man."

FACTS

Partnership X, is a TEFRA partnership. Partnership X's general partner, GP, is an S corporation. Partnership X has several individual limited partners, a corporate limited partner, and limited liability company limited partner, Partner LLC. Partnership X's 1998 Form 1065, U.S. Partnership Return of Income, is a short-year initial return which shows the "Date started business" as Date 1. The omitted gross income arises from a sale on Date 3 which was reported on Form 4797, *Sales of Business Property*/[1] that was attached to the 1998 Form 1065. The Revenue Agent examining the 1998 Form 1065 found that the sales receipts were fully reported on Form 4797; however, the Revenue Agent believes that the basis of the assets, prior to the step-up, was zero. The Revenue Agent believes that Partnership X stepped-up the basis of business property

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1 The Form 4797 reports the sale of property used in a trade or business, the disposition of noncapital assets (other than inventory or property held primarily for sale to customers in the ordinary course of a trade or business), and the disposition of capital assets not reported on Schedule D.

under IRC §§754 and 743(b) after entering into a series of steps designed for this purpose. The Revenue Agent believes the transaction fails under an economic substance theory and the National Office agrees that the transaction was abusive.

The sale transaction

Partnership X only reported one sale on Form 4797. Part III, *Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254 and 1255*, reports a sale of "oil & gas properties" acquired on Date 0 and sold on Date 3. The gross sales prices is $v, the cost or other basis plus expense of sale is $w, which is also the adjusted basis (no deprecation or depletion is shown as reducing that amount) leaving a total gain of $x. That gain is subject to recapture of $y as section 1254 property (for intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs), leaving $z as net section 1231 gain.

The step-up in basis transaction

Schedule B line 11 reveals that there was a distribution or transfer (e.g., by sale or death) of a partnership interest during the tax year. The form instructions for that line provide that if there was a distribution or transfer, the partnership may elect to adjust the basis of partnership assets under IRC § 754 by attaching the statement described under Elections Made by the Partnership on page 6 of the instructions. The following statements were provided on a separate sheet attached to the Form 1065:

Statement Regarding a Partnership Technical Termination

> Pursuant to IRC Sec. 708(b)(1)(B) and the regulations there under, Partnership X terminated on Date 1. On that date, certain partners sold over 50% ownership interest in the partnerships capital and profits to Partner LLC. On Date 2 Partner LLC acquired additional partnership interests through purchases. These transactions resulted in a new partnership for federal income tax purposes (the "new" partnership retains the same federal employee identification number).
>
> As reflected within the capital accounts, the partnership books were restated to reflect the value of the assets as required in the regulations under IRC 704. As reflected within this return, in the event of a sale of these assets, proper adjustments have been made to reflect the tax basis and the proper taxable gain.

Section 754 Election Statement

> The partnership hereby elects, pursuant to IRC Section 754, to adjust the basis of partnership property as a result of a distribution of property or sale or exchange of a partnership interest as provided in IRC Sections 734(b) & 743(b).

LAW

Section 6501(e)(1)(A) of the Internal Revenue Code provides that if the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

(i) in the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

ANALYSIS

Partnership level TEFRA adjustments and IRC § 6229(c)(2) versus partner-level adjustments and IRC § 6501(e)

We anticipate that any adjustments arising in connection with the subject issues will be partnership level TEFRA adjustments and IRC § 6229(c)(2); i.e., the gain from the sale of partnership assets. We understand that as Revenue Agent is contesting the form of the transaction, the adjustments may turn out to be related to the sale of partnership interests. Usually, adjustments concerning sales of partnership interests are not a partnership item; however, Treas. Reg. § 301.6231(a)(3)-1(a)(3) includes as a partnership item the optional adjustments to the basis of partnership property under IRC § 754, including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest. As the Revenue Agent considers the economic substance of the transaction, if the agent has questions concerning the nature of the adjustments and the appropriate notices for any proposed assessment, the agent may wish to contact .

While the six-year period applicable in the subject case appears to be that in IRC § 6229(c)(2)[/2], we look to the law as developed under IRC § 6501(e) to apply that

2 The period of limitations for assessing income tax with respect to any person which is attributable to partnership items (or affected items) for a partnership taxable year is three years after the date on which the partnership return was filed or the last day for filing such return (determined without regard to extensions), whichever is later. IRC § 6229(a). If a partnership omits from gross income an amount in excess of 25 percent of the amount of gross income stated on its partnership return, then IRC § 6229(a) is applied by substituting “6 years” for “3 years.” IRC § 6229(c)(2).

TEFRA provision regarding the above issues. See Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. 533 (2000), appeal dismissed and remanded, 249 F.3d 175 (3d Cir. 2001), regarding the interplay between IRC §§ 6229 and 6501.

Issue (1)

Partnership X has properly reported $v as gross sales proceeds but understated net sales proceeds by $w. If gross income for purposes of IRC § 61(e) is gross receipts there is no omission; if gross income is gross sales proceeds reduced by basis, $w is omitted from the 1998 Form 1065 for purposes of IRC § 61(e).

IRC § 61 reflects the general principal that gross income takes into account the cost of the item sold. For example, in regard to IRC § 61(a)(2), which concerns gross income derived from business, Treas. Reg. § 1.61-3(a) provides that "in a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold." Similarly, in regard to IRC § 61(a)(3), which concerns gains from dealing in property, Treas. Reg. § 1.61-6(a) provides that the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged (which is in accordance with IRC § 1001).

Gross income for purposes of IRC § 6501(e) is defined by reference to IRC § 61 [see Northern Ind. Pub. Serv. Co. & Subs. v. Commissioner, 101 T.C. 294, 299 at note 7 (1993)], except as provided by IRC § 6501(e)(1)(A)(i), which treats the gross receipts as gross income in the case of a trade or business selling a good or service. Clearly, IRC § 6501(e)(1)(A)(i) nullifies Treas. Reg. § 1.61-3(a) for purposes of the six-year period. Just as clearly, IRC § 6501(e)(1)(A)(i) has no effect on dealings in property in a nonbusiness setting (what is referred to as a "casual sale" in some opinions). See Insulglass Corporation v. Commissioner, 84 TC 203, 210 (1985), which concerned a nonbusiness investor and indicates that IRC § 61(a)(3) is not subject to IRC § 6501(e)(1)(A)(i) ("In the case of a trade or business, 'gross income' is equated with gross receipts. Otherwise, 'gross income' means those items listed in section 61(a), which includes, among other things, gains derived from dealings in property. n5 Sec. 61(a)(3)"); Schneider v. Commissioner, T.C. Memo 1985-139, which also concerned a nonbusiness investor (a "casual sale of a capital asset").

We believe the treatment of sales of business property is also straight forward and that any uncertainty results only from trying to apply statements in Colony, Inc, v. Commissioner, 357 U.S. 28 (1958) concerning the extended assessment period for omissions in the IRC of 1939 to the revised provision in the IRC of 1954, which remains unchanged in the IRC of 1986, and from taking statements about equating gross receipts with gross income in the case of a trade or business, such as that in Insulglass, out of context. Insulglass concerns a nonbusiness activity and the statement was made in the contest of contrasting a business and a nonbusiness activity; the case did not address compare or contrast sales of goods and services and sales of other items within the context of business activity. In Colony the taxpayer understated the gross profits on the sales of certain lots of land for residential purposes as a result of having

overstated the "basis" of such lots by erroneously including in their cost certain unallowable items of development expense. 357 U.S. at 30. The Supreme Court held for the taxpayer suggesting that an overstated basis, in contrast to the omission of sales proceeds, provides something for the Service to check. While the Supreme Court interpreted the IRC of 1939's predecessor to IRC § 6501(e), it stated its conclusion was "in harmony with the unambiguous language of § 6501 (e)(1)(A)." 357 U.S. at 37. The Supreme Court had before it a case of a sale of goods or services; the taxpayer's principal business was the development and sale of lots in a subdivision. See Colony, 26 T.C. 30, 31 (1956), aff'd 244 F.2d 75 (6th Cir. 1957), rev'd 357 U.S. 28 (1958). In cases not concerning a sale of goods or services, Colony's approach seems to conflict with IRC 6501(e). See CC&F Western Operations LP v. Commissioner, 273 F.3d 402, 406 (1st Cir. 2001), in which the First Circuit questions whether Colony's main holding carries over from the 1939 IRC for land sales in general ("Gross income on land sales is normally computed as net gain after subtracting basis. 26 U.S.C. §§ 61(a)(3), 1001(a); 26 C.F.R. § 1.61-6 (2001).")

Accordingly, we do not believe that Colony provides any authority for treating gross receipts as gross income for the sale of land or other property; rather, under the current IRC that treatment depends on whether the property sold is a good or service. The sale of business property reported on Form 4797 is not the sale of a good or service; rather it is the sale of an item that is may be used by a business to sell goods and services.

Multi-tiered pass-through arrangements

In determining the amount of income stated on a tax return for purposes of the six-year period (as well as any omissions from the computation of that income), the taxpayer's share of partnership income is taken into account.[/3] Moreover, in determining the amount of stated gross income (as well as omitted gross income) for purposes of the six-year period, second tier partnership information is taken into account. Harlan v. Commissioner, 116 T.C. 31, 53 (2001), AOD CC-2002-03 (February 19, 2002). While Harlan concern partner-level adjustments and IRC § 6501(e), as indicated above, we take the same approach with partnership-level adjustments under IRC § 6229(c)(2). In this regard, we note that Schedule B line 3 reveals that Partnership X is a partner in another partnership, thus triggering the application of Harlan.

3 Note that a threshold requirement for a tier to be taken into account is the partner must properly identify the partnership in the partner's return. Without such a reference in the taxpayer's own return there is no relief, even if another return actually discloses the transaction. Taylor v. United States, 417 F.2d 991 (5th Cir. 1969); Mel Dar Corp v. Commissioner, T.C. Memo. 1960-56, rev'd on other issue, 309 F.2d 525 (9th Cir. 1962), cert. denied, 372 U.S. 941 (1963). In general, the return which shows the disclosure normally is the only taxpayer's own return. Slaff v. Commissioner, 220 F.2d 65 (9th Cir. 1955). For example, income taxable to the beneficiary reported on the trust return is not, by itself, a disclosure for purposes of omissions on the beneficiaries' returns even though the Service knows the beneficiaries and trusts are "related." Harlan v. Commissioner, 116 T.C. 31, 53 (2001).

Issue (2)

The Tax Court has described the test of whether a taxpayer has adequately disclosed an omitted item as follows: "The proper application of the rule is whether an adjustment might be apparent from the face of the return to the elusive 'reasonable man.'" Hines v. Commissioner, T.C. Memo. 1989-17, aff'd without opinion, 893 F.2d 1330 (3d Cir. 1989). See also University Country Club, Inc. v. Commissioner, 64 T.C. 460, 471 (1975), acq. 1976-2 C.B. 3. The Tax Court explains further in another opinion as follows:

> The statement must, however, be sufficiently detailed to apprise the Commissioner and her agents as to the nature and amount of the transaction so that a decision as to whether to select the return for audit may be a reasonably informed one.

Estate of Frane v. Commissioner, 98 T.C. 341, 355 (1992), aff'd in part and rev'd in part (on another issue), 998 F.2d 567 (8th Cir. 1993; Estate of Fry v. Commissioner, 88 T.C. 1020, 1023 (1987); and University Country Club, Inc. 64 T.C. at 469. In addition, we believe that CC&F Western Operations LP v. Commissioner, 273 F.3d 402 (1st Cir. 2001), is particularly applicable to the subject case. CC&F Western Operations LP shows that the return must give a revenue agent a reason to investigate further regarding the omitted income; it is not enough that a taxpayer may string together a series of inferences that could have lead to the discovery of omitted income.

In CC&F Western Operations LP the partnership omitted from the Form 1065 items of gross income arising from being relieved of a share of partnership liabilities upon the sale of several partnership interests. CC&F Western Operations LP attached the Sch. K-1 of the partnerships, which showed its share of their liabilities. The court, however, found that nothing in CC&F Western's Form 1065 indicated the allocation of debt or other sales terms. Rejecting CC&F Western's contention that if the Service had combined the amounts reported on the twelve K-1s attached to the return, the court said:

> In the end, the safe harbor provision of section 6501 has to be read in light of its purpose, namely, to give the taxpayer the shorter limitations period where the taxpayer omitted a particular income item from its calculations but disclosed it in substance. The chain of inferences relied upon by Western is simply too thin and doubtful to meet this requirement. . . .

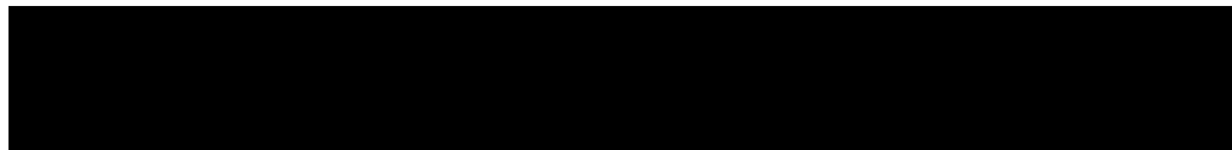
273 F.3d at 408. An example of a return providing a reason to investigate further regarding the omitted income is shown in University Country Club, Inc. In that case, the Service determined that receipts from the sale of class B stock represented taxable income to petitioner because, in substance, the stock was a license for the privilege of using petitioner's facilities; that taxpayer treated the receipts as nontaxable contributions to capital from the sale of that stock. The taxpayer attached a balance sheet that showed a capital stock account comprised of two classes of common stock and a capital surplus account; a

reconciliation schedule of the capital surplus account showed the account to be comprised of general membership for pool and golf. The Tax Court found that "reporting the dollar value of class B stock on the balance sheet of the initial return rather than classifying the proceeds from the sale of stock as income is a type of disclosure described by the Supreme Court." 64 T.C. at 469-70.

We note that it has been said that "The touchstone in cases of this type is whether respondent has been furnished with a 'clue' as to the existence of the error." George Edward Quick Trust v. Commissioner, 54 T.C. 1336, 1347 (1970), aff'd per curiam, 444 F.2d 90 (8th Cir. 1971). The origin of this "clue" test is Colony and it is routinely referenced in opinions of the Tax Court and other courts; e.g., it is the decision referenced by University Country Club, Inc. in the quote in the preceding paragraph. The "clue" does not provide a definite test as the Court continued, "Concededly, this does not mean simply a 'clue' which would be sufficient to intrigue a Sherlock Holmes. But neither does it mean a detailed revelation of each and every underlying fact." 54 T.C. at 1347. As indicated by the First Circuit in CC&F Western Operations, 273 F.3d at 407, the clue test is not based on statutory language.[/4] At this time, we are not referring to the clue test because we believe some taxpayers are taking the test out of context. CC&F Western Operations represents the best statement of our current view of the law.

Accordingly, we recommend that the Revenue Agent consider the relevant returns in view of the test stated above (if he had not already done so in his initial review of the return).[/5] After the examining function has made its review, you may wish to contact us to double-check that the test is applied properly.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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4 Colony explained why the Service is not at a disadvantage if sales proceeds are disclosed even if basis is overstated; as indicated in Issue 1, above, that explanation has limited applicability under the IRC of 1954 and the IRC of 1986. As to this Issue 2, the explanation does not address the requirement that the Service be apprised of the nature and amount of the item.

5 We note that the Service has the burden to establish the omission from gross income and that burden will be met if the Revenue Agent is correct regarding the existence of an overstated basis. If Partnership X counters by claiming the omitted item was adequately disclosed, Partnership X has the burden to establish that the return contains an adequate disclosure. Hines, supra. Further shifting of the burden of persuasion may occur if an issue of adequate disclosure develops, but the ultimate burden to persuade the court that the disclosure was adequate rests with the Partnership X. See Adler v. Commissioner, 85 T.C. 535, 540 (1985).

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If you have any questions, please contact .