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Memorandum

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to: Bradford A. Johnson, Associate Area Counsel (Hartford)
Large and Midsized Business CC:LM:F:HAR
Attn: Raymond M. Boulanger, Senior Attorney CC:LM:F:HAR:B

from: Janice R. Feldman, Assistant to the Branch Chief
Procedure & Administration (Administrative Provisions and Judicial Practice)
CC:PA:APJP:B02

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subject: IRC 6501(e) & How to Determine Gross Income

This memorandum responds to your request for assistance regarding an issue raise by a Team Coordinator that concerns what constitutes gross income for purposes of the six-year period of limitations on assessment under I.R.C. § 6501(e)(1). Section 6501(e)(1) uses a percentage of gross income to measure whether the omission of an amount from the gross income stated on an income tax return is substantial and, thereby, triggers an extended period of assessment.

ISSUES

Issue 1: How is the amount of gross income stated in a tax return determined for purposes of section 6501(e)(1) where the computation shown thereon includes items of capital loss as well as items of capital gain.

Issue 2: Whether a capital loss transaction may result in an omission of gross income for purposes of section 6501(e)(1) if the loss is disallowed in its entirety.

CONCLUSIONS

Issue 1: The amount of gross income stated in the return takes into account items of capital gain but not those of capital loss.

Issue 2: Like the amount of gross income stated in the return, the amount of gross income omitted takes into account items of capital gain but not those of capital loss. A capital loss transaction does not result in an omission of gross income even if the loss is disallowed in its entirety. If the adjustment goes beyond disallowing the loss and results in gain being recognized on the transaction (because either the amount realized was understated or the basis was overstated) an omission of gross income results.

FACTS

The following figures were provided by the Team Coordinator for purposes of discussing Issue 1:

Gross Receipts	$1,000,000	
Cost of goods sold	250,000	
Gross Profit		$750,000
Interest		300,000
Capital gain	$200,000	
Capital loss	<500,000>*	
Net capital gain income		-0-
(*net capital loss of $300,000 is carried forward)		
Total		$1,050,000

At issue is the treatment of the capital gain and the capital loss items; the methods for determining gross income stated in the return for purposes of this issue are as follows:

Method A: Start with $1,050,000, which reflects a netting of the capital items -

Gross income per return before special rule in section 6501(e)(1)(A)(i)	$1,050,000
Special rule in section 6501(e)(1)(A)(i) (add back Cost of Goods Sold)	250,000
Gross Income for section 6501(e) purposes	$1,300,000

Method B:

Gross Receipts	$1,000,000

Cost of goods sold	250,000	
Gross Profit		$750,000
Interest		300,000
Capital gain		200,000
Gross income per return before special rule in section 6501(e)(1)(A)(i)		$1,250,000
Special rule in section 6501(e)(1)(A)(i) (add back Cost of Goods Sold)		250,000
Gross Income for section 6501(e) purposes		$1,500,000

LAW & DISCUSSION

Section 6501(e)(1) provides 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. Because we reference the 1939 Code, below, we note that this language is the same as that in section 275 of the 1939 Code.[1]

Issue 1: Amount of Gross Income Stated in the Return[2]

A. General meaning of gross income for purposes of section 6501(e)(1)

With the exception of section 6501(e)(1)(A)(i), where the statute carves out a special definition for trade or business gross income from the sale of goods or services (which is not at issue here), gross income for purposes of section 6501(e)(1) is defined by reference to I.R.C. § 61. See Northern Ind. Pub. Serv. Co. & Subs. v. Commissioner, 101 T.C. 294, 299 n. 7 (1993). Under section 61, only the gain from the sale of property is included in gross income, and not the entire amount of the sale proceeds. Section 61

[1] The 1954 Code added subsections (A)(i) and (A)(ii) to the above to end confusion about certain applications of the language that are not relevant here. Subsection (A)(i) defines gross income to include cost of goods and subsection (ii) allows an item omitted from the computation of income on the return to, nevertheless, not be taken into account for purpose of the 25 percent test if the amount was disclosed on the return in a manner that apprised the Service of the nature and amount of the omitted item.

[2] A tax return ordinarily does not provide any place for stating gross income. The “total income" as used in the forms might in some simple cases equate with gross income, but, in general, as the Tax Court has explained, “As a result [of the lack of a place for stating gross income], we have dealt with the taxpayers' tax returns by determining whether one or another item was properly an item of gross income within the appropriate contemporary statutory definition of gross income.” Harlan v. Commissioner, 116 T.C. 31, 53-4 (2001).

includes in its nonexclusive list of items that constitute gross income "[g]ains derived from dealings in property." I.R.C. § 61(a)(3). Treasury regulations further define these property gains as "the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged." Treas. Reg. § 1.61-6(a) (which is in accordance with I.R.C. § 1001). See Schneider v. Commissioner, T.C. Memo. 1985-139, in which the court rejected the taxpayer's attempt to include the gross proceeds from a sale at a capital loss in the amount of gross income stated in the return.

The definition of gross income under section 6501(e)(1) may have to take account of special meanings provided in other parts of the Code in addition to that provided in section 61; e.g., an exclusion of income. An example of a provision providing a special meaning for gross income is one that provides beneficial treatment for capital gains. Under section 117(b) of the 1939 Code (prior to the Revenue Act of 1951) only 50 percent of recognized capital gains was "taken into account" in computing net income (and corresponding treatment was provided for recognized losses). The courts held that for purposes of section 6501(e)(1)'s predecessor, section 275 of the 1939 Code, only 50 percent of such gains had to be shown on the return for the gross income to be considered fully stated. See Maloy v. Commissioner, 45 B.T.A. 1104, 1107 (1941) ("We think it evident that the term 'gross income' as used in section 275(c), supra, refers to the statutory gross income required to be reported on the return"). Maloy was cited with approval in United States v. Benedict, 338 U.S. 692, 699 n.11 (1950), a case which applied section 117(b) of the 1939 Code to a limitation for charitable contributions that was based on gross income. In Benedict, the Supreme Court found that the treatment of the half not taken into account under section 117(b) of the 1939 Code was not addressed in the Code, the legislative history, or administrative practice and, therefore, sought the purposes of the applicable sections of the Code and adopted that construction which best gives effect to those purposes. 338 U.S. at 698. The Court held that the half not to be taken into account was excluded from statutory gross income (citing Maloy).

The nature of the capital gains benefit in section 117(b) of the 1939 Code was changed by the Revenue Act of 1951 from an exclusion to a deduction from gross income. Thereafter, the courts held that all of the recognized capital gain is includable in gross income for purpose of the extended statute of limitation. See Roschuni v. Commissioner, 44 T.C. 80, 83 (1965), acq., 1965-2 C.B. 6, in which the Tax Court noted that Maloy is no longer controlling authority due to Revenue Act of 1951.

Section 117(b) of the 1939 Code was carried into the 1954 Code as I.R.C. § 1202. Section 1202 was repealed by the Tax Reform Act of 1986, and currently the capital gains benefit is generally provided neither by an exclusion nor a deduction, but instead by the application of special rates to various categories of capital gain. See I.R.C. § 1(h). This does not affect the conclusion in Roschuni that generally all capital gain is includible in gross income. However, in 1993 a partial exclusion was enacted as section 1202 for gain from certain small business stock held by noncorporate taxpayers. The partial exclusion provided for in section 1202 is similar to the partial exclusion at issue in Maloy. Following the reasoning in Maloy, "gross income" for purposes of section 6501(e) does not include the portion of capital gain excluded by section 1202.

B. Treatment of capital loss transactions for purposes of section 6501(e)(1)

I.R.C. § 63 defines taxable income generally as gross income minus the deductions allowed by chapter 1 of the Code. I.R.C. § 161 provides that in computing taxable income under section 63, there shall generally be allowed as deductions the items specified in chapter 1, part IV of the Code.

I.R.C. § 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis for determining gain, and the loss is the excess of the adjusted basis for determining loss over the amount realized.

I.R.C. § 165 (which is in chapter 1, part IV of the Code) provides a deduction for any loss sustained during the tax year and not compensated for by insurance or otherwise. Section 165(f) provides, however, that losses from sales or exchanges of capital assets (that is, capital losses) shall be allowed only to the extent allowed in I.R.C. §§ 1211 and 1212.

Under section 1211(a), a corporation is allowed to apply otherwise deductible capital losses to the extent of capital gains. Section 1211(b) allows noncorporate taxpayers to do the same and, in addition, allows a deduction of up to $3,000 of any excess (married taxpayers filing separately are limited to $1,500). Any capital loss that exceeds these limitations (i.e., a net capital loss, see I.R.C. § 1222(10)) is carried back or carried over to other years under section 1212.

If an individual has a single capital transaction for a year that results in a $1,000 loss, there is no argument for having the $1,000 section 165 deduction reduce gross income for purposes of section 6501(e)(1). The treatment of a capital loss in the determination of gross income for purposes of the extended assessment statute was established under the 1939 Code in Green v. Commissioner, 7 T.C. 263 (1946), aff'd., 168 F.2d 994 (6th Cir. 1948). The taxpayer reported "net long-term gain (or loss) from sale or exchange of capital assets - (Loss) 130,142.36" for the 1938 tax year. 7 T.C. at 276. The Tax Court upheld the taxpayer's contention that gross income must be computed without any deduction for the long-term capital loss, stating that,

> Nothing is contained in any of the provisions of section 22 [the 1939 Code's predecessor of I.R.C. § 61] requiring an adjustment to be made in the computation of gross income on account of capital losses. Provision for deduction of such losses is found in subsection (g) of section 23, entitled 'Deductions from Gross Income.'[3]

[3] 1939 Code section 23(g) contained provisions similar to current sections 165(f) and (g).

7 T.C. at 277. The Tax Court concluded that "It seems clear from these provisions that capital losses form no part of the gross income, but are to be deducted from gross income in arriving at net income." 7 T.C. at 277. Green was cited with approval in Benedict, 338 U.S. at 699 n.11 and in Northern Ind. Pub. Serv. Co., 101 T.C. at 299. The same reasoning was followed in the 1985 Schneider memorandum decision: "Thus, in arriving at 'gross income stated in the return' under section 6501(e), petitioners' computation is *unaffected by capital losses sustained* or gross proceeds derived from dealing in real property" (emphasis added).

Neither Green nor Schneider explicitly discussed the effect of section 1211 or its predecessor on the definition of gross income.[4] However, as the reference in section 165(f) makes clear, section 1211 is simply a provision that limits the amount of a deduction; it does not change a section 165 deduction to an exclusion, offset, or other type of adjustment to gross income. Accordingly, for purposes of section 6501(e)(1), the netting procedure in section 1211 has no effect on the gross income stated in the return.

While the effect of the netting procedure for purposes of the extended statute of limitations has not been directly addressed by the courts, the Service did argue that capital gains netting did not affect gross income in Sicanoff Vegetable Oil Corp. v. Commissioner, 251 F.2d 764 (7th Cir. 1958), a case concerning personal holding company income for the 1950 tax year. At issue was a 1939 Code provision that defined personal holding income as "the portion of the gross income which consists of gains from futures transactions." The taxpayer argued that the provision required a netting or an offsetting of those futures transactions that resulted in gain and those that resulted in loss, with the inclusion of the single composite gain in gross income. The Service argued, as follows, that the general statutory scheme of the Code supported a contrary answer.

> Further, respondent contends, it is obvious from usage throughout chapter one that the term 'gains' in itself does not mean a netting of gains and losses. He points out that in § 117(d)(1) *[the predecessor of I.R.C. § 1211(a)]* . . . the term 'gains' is used as distinguished from 'losses' where the Code provides that: 'In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.' The same section provides in addition that, in the case of a corporation, the excess of gains from sales or exchanges of capital assets over the losses from such sales or exchanges is 'net capital gain.' (Section 117(a)(10)(A) . . .) [*see I.R.C. § 1222(9) and (11), defining "capital gain net income" and "net capital gain"]*. Respondent urges and the Tax Court found that the term 'gains' would not be used by

[4] Green focused on whether gross income should be reduced by the $130,142.36 capital loss, which may have been net of gains. If there were such gains, they should have been included in gross income and the issue should have been whether the full amount of loss should have been taken into account as a negative amount. The primary issue in Schneider was whether the taxpayer could include only the amount realized, without regard to basis, in gross income.

> Congress to refer to the concept of 'net capital gain' as contended by petitioner and that if Congress had meant 'net capital gain' it would have said just that. Finally, respondent points out that § 111(a) of the 1939 Code, . . . *[the predecessor of I.R.C. § 1001(a)]* obviously envisioned a separate computation of gain or loss from each sale of an asset as a preliminary to the addition of gains to gross income and subsequent deduction of losses.

251 F.2d at 767. The court adopted the taxpayer's position, citing the specific purpose of the personal holding company provisions and the fact that Congress had changed the statute, in what the court felt was a clarification. However, the Service's analysis of the structure of the1939 Code is relevant for purposes of the subject issue because the same reasoning applies to the interpretation of section 6501(e) under the 1986 Code, and supports the position that capital losses do not reduce "gross income" for that purpose.

As noted in the excerpt from Sicanoff quoted above, in addition to section 1211, the Code contains certain other netting procedures that are used in the determination of the character of capital gains and losses and which capital gains tax rate will apply. For example, under I.R.C. § 1231, gains and losses from certain assets and transactions are netted to determine whether the gains and losses are capital or ordinary in nature, and sections 1(h) and 1222 perform a number of netting procedures to determine the rates at which different types of capital gains will be taxed. However, like section 1211, these provisions do not affect the basic character of a capital loss (or a section 1231 loss) as a section 165 deduction that is taken into account in determining taxable income under section 63, not gross income under section 61.

We note that while a netting approach might favor the Service in regard to determining the amount of *stated* gross income, it might work against the Service in determining the amount of *omitted* gross income for purposes of section 6501(e)(1). If the capital gains and losses were net, and a gain transaction was not reported, then if the taxpayer was still left with a net capital loss after the inclusion of gain, the taxpayer might argue there was no omission of gross income, as the inclusion of the gain item did not increase the stated gross income but only decreased the amount of stated loss. The Service would be left arguing that the meaning of gross income for purposes of determining what is stated in the return is not consistent with that for determining if gross income has been omitted. We believe that the interpretation that captures the omission in such a case is more consistent with the purpose of section 6501(e)(1). See, e.g., Burbage v. Commissioner, 82 T.C. 546, 558 (1984) (100% of capital gain included in determining both amount stated and amount omitted, citing Roschuni).

Accordingly, we believe Method B is the correct method for determining gross income stated in the return.[5]

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[5] It appears that the Service previously argued that the netting of capital items reduces gross income for purposes of section 6501(e)(1). See Insulglass Corp. v. Commissioner, 84 T.C. 203, 210 (1985) n.6 ("We do not address respondent's alternative contention that petitioners' commodities gains and losses should

Issue 2: Omission of Gross Income

For section 6501(e) purposes, as discussed in connection with Issue 1 the same treatment of capital gains and losses should normally apply for both determining the amount stated in the return and the amount omitted from the return.

The Service's adjustment for a sales transaction may result in the complete elimination of a loss; i.e., the Service may find that the amount realized was understated or basis was overstated. The inflation of a deduction will not cause an omission of income if the Service's adjustment only eliminates the loss. Compare Green, 7 T.C. at 277 (capital losses form no part of the gross income, but are to be deducted from gross income in arriving at net income).). For example, if a return reports a $100 loss on a sale resulting from an amount realized of $50 and a basis of $150, and the Service adjusts the basis down to $50 resulting in no gain or loss on the sale, there is no omission of gross income. If, however, the Service's adjustment of a sales transaction reporting a loss goes beyond simply eliminating the loss and results in a gain, the amount of that unreported gain constitutes an omission of gross income for purposes of section 6501(e)(1). For example, if in the preceding example, the Service adjusts the basis down to $10, resulting in $40 of gain on the sale, there is an omission of $40.

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be offset, and that petitioners' thus had no gains from dealings in commodities under sec. 61(a)(3)"). As explained in this memorandum, we disagree with this approach.