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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.

LEGEND

Taxpayer/Partnership	=
Individual	=
Transferror Partner (Holding Trust)	=
Holding Corp	=
Redeemed Partner	=
Business	=
Transferee Partner	=
Purchaser	=
State	=
$A	=
$B	=
$C	=
$D	=
$E	=

$F	=
$G	=
$H	=
$I	=
$J	=
$K	=
$L	=

ISSUES

(1) Whether the sale of an asset, which is used in a trade or business and which has an overstated basis, can cause an omission of gross income, which may trigger the six year period of limitations on assessment under I.R.C. § 6501(e)(1).

(2) Whether Taxpayer/Partnership made an adequate disclosure of the nature and amount of the omitted items of gross income on its return.

CONCLUSIONS

(1) Yes. The sale of an asset, which is used in a trade or business (as opposed to being a good sold, or a service provided in the course of that trade or business) and which has an overstated basis, can cause an omission of gross income, which may trigger the six year period of limitations on assessment.

(2) No. Taxpayer/Partnership did not made an adequate disclosure of the nature and amount of the omitted items of gross income on its return based on our review of the return.

FACTS

The Transaction

At issue is the return of Taxpayer/Partnership and the omission of gain thereon from its sale of assets (used in Business) to an unrelated party, Purchaser. Taxpayer/Partnership was created to hold the assets of Business. Taxpayer/Partnership started operations on ; the assets had been held by Redeemed Partner previously. The basis for those assets was inflated in several steps described below. The parties involved in these steps include Individual who operates and, indirectly owns, Business. Individual is also the grantor/beneficiary of the Transferor Partner (Holding Trust). Transferor Partner (Holding Trust) owns Holding Corp which in turn owned Redeemed Partner. Initially, Redeemed Partner owned 99% an interest Taxpayer/Partnership and Transferor Partner (Holding Trust) owned the other 1% interest. Transferor Partner (Holding Trust) also owns Transferee Partner.

Step 1. Taxpayer/Partnership is created. Subsequently, a disparity between inside and outside basis in Taxpayer/Partnership is manufactured when

Taxpayer/Partnership redeems Redeemed Partner's interest in Taxpayer/Partnership by issuing a promissory note which is guaranteed by Transferor Partner (Holding Trust). Transferor Partner (Holding Trust) includes this redemption note in its outside basis under I.R.C. § 752(a).

Step 2. Transferor Partner (Holding Trust) transfers its interest in Taxpayer/Partnership to Transferee Partner and Taxpayer/Partnership makes an I.R.C. § 754 election with an I.R.C. § 743(b) adjustment.

Step 3. Taxpayer/Partnership sells Business to Purchaser for cash after adjusting the basis of the assets pursuant to the § 743(b) adjustment.

As a result of these steps, the gain on the sale of the appreciate assets of Business is deferred until payments on the redemption note are made.

The Reporting

Taxpayer/Partnership filed a final (as well as the initial) year return for the period to . Taxpayer/Partnership reports gain of $A from Form 4797, which an attachment shows includes $B from the sale of the assets of Business to Purchaser. Although the first page of the Form 1065 is an IRS form, most of the rest of the return was filed on State forms.

State Schedule D-1 "Sales of Business Property" shows the $A and under the part headed "Ordinary Gains and Losses" shows the $B gain with the notation "SEE ATTACHED." The attachment shows a sale of "Goodwill/Trademarks" on with a gross sales price of $C, depreciation allowed of $D, and a cost of $E, and the resulting gain of $B.

A statement is attached to the return labeled "Adjustment to Basis of Property Resulting from I.R.C 754 Election." The statement indicates an I.R.C. § 743(b) adjustment of $F. The statement provides a balance sheet dated in two columns: one in terms of "Tax Adjusted Basis" and the other in terms of "Value." Under the balance sheet category "Liabilities & Capital" the line item "Capital" is shown as $G in the "Tax Adjusted Basis" column and $H in the "Value" column. The statement also shows the "Computation of Adjustment to Transferee Partner Basis in Property" and computes the $F I.R.C. § 743(b) adjustment as the difference between the $G and the $H.

An attachment for the reconciliation of Transferee Partner's Capital shows the following: Transfer of partnership interest - $I, Capital Contributed - $J, and Cash Distribution – negative $K, leaving Withdrawals and Distributions of negative $L.

LAW

The omitted gain was reportable on a partnership return and, therefore, the six year period in I.R.C. § 6229(c)(2) is at issue. I.R.C. § 6229(c)(2) provides for a six year statute of limitations where a TEFRA partnership omits from the calculation of gross income shown on an income tax return an amount properly includible therein, which is in excess of 25% of the gross income stated in the return. I.R.C. § 6229(c)(2) sets forth a special rule to extend the period of limitations prescribed by I.R.C. § 6501 and both the definition of gross income and the adequate disclosure provision of I.R.C. § 6501(e)(1)(A) are encompassed in I.R.C. § 6229(c)(2). Rhone-Poulenc Surfactants & Specialties v. Commissioner, 114 T.C. 533, 540 (2000).

Omission of gross income (Issue 1)

I.R.C. § 6501(e)(1)(A)(i) provides that 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.

The Service has the burden to establish that omission from gross income exceeds 25%. With the exception of I.R.C. § 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, gross income for purposes of I.R.C. § 6501(e) is defined by reference to I.R.C. § 61. See Northern Ind. Pub. Serv. Co. & Subs. v. Commissioner, 101 T.C. 294, 299 at note 7 (1993). Under I.R.C. § 61, gain from the sale of real or personal property is included in gross income, not the sale proceeds.[1]

Taxpayers may attempt to rely on the Supreme Court's decision in Colony v. Commissioner, 357 U.S. 28 (1958). Colony held that gross income under I.R.C. § 6501(e)'s predecessor, I.R.C. § 275(c) of the 1939 Code, equaled gross proceeds, but, 1939 I.R.C. § 275(c) is distinguishable. In Colony, the taxpayer's principal business was the development and sale of lots in a subdivision.[2] The taxpayer disclosed the gross proceeds from the sale, but overstated its cost basis. I.R.C. § 6501(e)'s current language show that, after Colony's transaction, Congress clarified the meaning of "gross income" such that while Colony's holding would remain the same under the current Code, it is not dispositive of the facts of the subject case. 1939 I.R.C. § 275 made no attempt to define gross income, but I.R.C. § 6501 does.

In Colony the Supreme Court found the language "omits from gross income an amount properly includible therein" critical, but ambiguous, and looked to the legislative

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[1] Section 61 includes in its nonexclusive list of items that constitute gross income is "[g]ains derived from dealings in property at 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).

[2] See Colony, 26 T.C. 30, 31 (1956), aff'd 244 F.2d 75 (6th Cir. 1957), rev'd 357 U.S. 28 (1958).

history where it determined that "in enacting § 275 (c) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors." 357 U.S. at 36. While the purpose of the extended assessment statute may remain the same, it is no longer relevant whether an overstated basis puts the Commissioner at a special disadvantage because the ambiguity regarding whether an overstated basis can create an omission of gross income has been eliminated by I.R.C. § 6501(e)(1)(A)(i). I.R.C. § 6501 applies Colony's gross receipts test only to trade or business income arising from the sale of a good or service. This partial definition implies that Congress did not intend the gross receipts test to apply to other types of income.[3] Colony's income was trade or business income from the sale of a good, and, therefore, I.R.C. § 6501's gross receipts test would have applied.[4]

Adequate disclosure (Issue 2)

I.R.C. § 6501(e)(1)(A)(ii) provides the amount omitted, for purposes of the 25% omission test, does not include any amount "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."

The returns of partnerships and S corporations of which the taxpayer is a member are considered together with the taxpayer's return to determine the amount omitted from gross income if the taxpayer references such an entity on the taxpayer's return. Rose v. Commissioner, 24 T.C. 755, 769 (1955). Accordingly, information disclosed in a partnership return or the return of an S corporation will be taken into consideration in determining whether an omitted item was adequately disclosed on the return of a partner or S corporation shareholder for purposes of I.R.C. § 6501(e)(1)(A)(ii). See George E. Quick Trust v. Commissioner, 54 T.C. 1336, 1346 (1970), acq. 1970-2 C.B. xxi, aff'd per curiam, 444 F.2d 90 (8th Cir. 1971). Moreover, if any first tier partnership or S corporation properly references its interest in a partnership or S corporation, disclosures on the returns of those second tier entities are taken into

[3] See CC & F Western Operations, L.P. v. Commissioner, 273 F.3d 402, 406 n.2 (1st Cir. 2001) (Whether Colony's main holding carries over to section 6501(e)(1) is at least doubtful. That section's first "special rule" adopts Justice Harlan's gross receipts test but only for sales of goods and services. 26 U.S.C. § 6501(e)(1)(A)(i). The arguable implication is that it does not apply under section 6501 to other types of income. . . . But we need not resolve this issue).

[4] The Supreme Court did not purport to explain how an interpretation under the 1954 Code should incorporate its analysis. Apparently, each party did look to the 1954 Code for support, but the Court only comment, "And without doing more than noting the speculative debate between the parties as to whether Congress manifested an intention to clarify or to change the 1939 Code, we observe that the conclusion we reach is in harmony with the unambiguous language of § 6501(e)(1)(A) . . . ." 357 U.S. at 37.

account. See Harlan v. Commissioner, 116 T.C. 31 (2001), concerning second tier partnerships.

The burden of going forward under I.R.C. § 6501(e) shifts to the taxpayer regarding adequate disclosure. Hines v. Commissioner, T.C. Memo. 1989-17, aff'd without opinion, 893 F.2d 1330 (3d Cir. 1989) citing University Country Club, Inc. v. Commissioner, 64 T.C. 460, 468 (1975), acq. 1976-2 C.B. 3 ("To prevail, petitioner must prove that the income tax return . . . contained a statement adequate to apprise the Commissioner of the nature and amount of the item omitted"). 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, presumably applying Third Circuit law. See also University Country Club, 64 T.C. at 471. The Tax Court explains that the statement on the return providing the disclosure "must . . . be sufficiently detailed to apprise the respondent and his agents of 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); University Country Club, Inc., 64 T.C. at 469.

As indicated by the First Circuit in CC&F Western Operations LP v. Commissioner, 273 F.3d 402 (1st Cir. 2001), the return must give the Commissioner 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 led to the discovery of omitted income. In that case, CC&F Western Operations LP (CC&F) was formed to sell interests in several partnerships. CC&F's Form 1065 omitted income arising from being relieved of a share of partnership liabilities upon the sale of several of the partnership interests. CC&F had attached the Sch. K-1 for the partnerships, which showed its share of the liabilities of those partnerships. The Court, however, found that nothing in the Form 1065 indicated the allocation of debt or other sales terms. In rejecting the taxpayer's contention that if the Service had combined the amounts reported on the Sch K-1s attached to the return, the Service would have been alerted to the omission because of the large discrepancy between the debt and the reported sales price, 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.

ANALYSIS

Omission of gross income

The sale at issue in Taxpayer/Partnership is not a sale of its goods or services, but, rather, of an asset created by Taxpayer/Partnership in the course of its trade or business that helps it sell goods or services. Accordingly, Taxpayer/Partnership has omitted gross income.

Adequate disclosure

The adequacy of disclosures depends on the nature of the omission. We understand you have recommended two alternative grounds for disallowing the step-up in basis. The alternatives are as follows:

> (1) Any promissory notes given by the partnership to any of its purported partners did not constitute partnership liabilities for purposes of I.R.C. § 752(a). As a result, the purported assumptions of such obligations by the partners of the partnership did not result in an increase of the partners' bases in the partnership. Consequently, the partnership may not increase the basis of the partnership property pursuant to I.R.C. §§ 754 and 743(b).
>
> (2) The increased basis may be disregarded for Federal tax purposes under judicial doctrines, including the economic substance doctrine and the step transaction doctrine

In regard to the first ground, Taxpayer/Partnership's return discloses that Redeemed Partner's interest was redeemed. The return does not disclose that the liability for the redemption note distributed to Redeemed Partner was assumed by Transferor Partner (Holding Trust) and that Transferor Partner (Holding Trust) increased its outside basis by the amount of the note. The disclosures regarding the I.R.C. § 754 election and the I.R.C. § 743(b) inside basis adjustment do not provide any disclosures regarding the genesis of the outside basis adjustment that generates the inside adjustment. The disclosure of the sale of goodwill/trademarks likewise discloses nothing about the outside basis manufactured by the redemption note that ultimately inflated the disclosed cost basis of the goodwill/trademarks.

In regard to the second ground, Taxpayer/Partnership's return lacks disclosures about the relation of the parties. The return discloses that Transferor Partner (Holding Trust) transferred its interest to Transferee Partner. The return does not disclose that Transferor Partner (Holding Trust) and Transferee Partner are ultimately owned by the same person. Moreover, the return does not disclose that Redeemed Partner, as well as Transferor Partner (Holding Trust) and Transferee Partner, are ultimately owned by the same person. In this regard, we note the return of Taxpayer/Partnership is at issue in a TEFRA proceeding and Taxpayer/Partnership has no interest in another partnership or S corporation and, therefore, no gross income (and with it disclosures) to take into account under Rose and Harlan. Taxpayer/Partnership does not take into account the gross income of its members and, therefore, any returns of the upper tiers and ultimate owner(s) are not taken into account.

Large dollar amounts are disclosed for the I.R.C. § 743(b) adjustment as well as for both the contributions to capital by Transferee Partner and the partnership distributions to Transferee Partner; however, without a disclosure of the nature of the omission that relates to these amounts, the disclosure is not adequate. A large number on a return may suggest that the Commissioner may wish to examine return. We would agree that if the Service performed an examination of Taxpayer/Partnership's return, it would have uncovered the abusive transactions. The fact that the Service might decide to audit a return because of large dollar amounts does not satisfy the requirement that the taxpayer apprise the Service of the nature and amount of the omitted item of gross income; I.R.C. § 6501(e)(1)(A)(ii) requires that the disallowance be apparent on the return to a "reasonable man." To obtain the relief offered by I.R.C. § 6501(e)(1)(A)(ii), the taxpayer must provide a disclosure that starts an investigation in the direction of the omitted item, and not one that simply starts the Service down a path without any notion of the item, but that winds up at that item due to the examination efforts of the Service. Common sense dispels any other approach. The Service cannot examine every return with large numbers. If the taxpayer points to any disclosures in the subject case, they should be of the latter type and the inferences expected from them should be "too thin and doubtful" to meet the requirements of I.R.C. § 6501(e)(1)(A)(ii). See CC&F Western Operations LP, 273 F.3d at 408.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Branch 2 of Administrative Provisions and Judicial Practice at
if you have any further questions.