Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Associate Area Counsel
(Small Business/Self-Employed)

from: Senior Technical Reviewer
(Procedure & Administration)

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subject: Application of the Six-Year Statute Under IRC § 6501(e) with Late Filed Form 1120-S

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

ISSUES

What value, if any, should be considered to be disclosed on an individual return (Form 1040) from an S-Corporation return (Form 1120-S) filed more than three years after the filing of the Form 1040 for purposes of determining whether there is a substantial understatement of gross income for purposes of applying the six-year statute under IRC § 6501(e).

CONCLUSIONS

The pro-rata share of S-corporation income attributed to the amount disclosed on the original return of the taxpayer is the only income which is disclosed for purposes of IRC § 6501(e)(1). Where information is provided to the IRS after the filing of the return of the taxpayer, that information is not considered to be disclosed on the return and is omitted gross income for purposes of IRC § 6501(e). The determination of whether the six-year statute applies is made at the time the original return is filed. Information discovered or provided by the taxpayer after that return is filed (for example, during an audit, in amended returns, or in subsequent information returns), regardless of whether such information would ordinarily be considered disclosed, is only includable if it is filed with, or prior to, the return of the taxpayer.

FACTS

A taxpayer filed a Form 1040 in year one showing a certain amount of income from a named S-corporation. More than three years after the filing of the Form 1040, and outside of the ordinary three-year period to assess, the S-corporation filed a Form 1120-S revealing that the taxpayer's distributive share of S-corporation income which was in excess of 125% of the sum reported on the taxpayer's individual return for the tax year (Form 1040). The question is whether or not the Form 1120-S constitutes a disclosure for purposes of IRC § 6501 since it was referenced in the original Form 1040. It does not.

LAW AND ANALYSIS

IRC § 6501(a) generally requires the IRS to assess any tax within three years after the return was filed. For purposes of IRC § 6501(a), a "return" is the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit). IRC § 6501(a). There are several exceptions to the three-year period for assessment. IRC § 6501(e)(1) provides that the period of limitation on assessment is extended to six-years when there is a substantial omission of income equal to twenty-five percent or more of the gross income reported on the return.

The purpose of extending the period of limitations under IRC § 6501(e) is to level the playing field when the taxpayer's omission of income places the IRS at a disadvantage in discovering errors. Colony, Inc. v. Comm'r, 357 U.S. 28, 36 (1958). Under the statute, items which are adequately disclosed in the return (or attachments and schedules), are not considered omissions for purposes of determining a substantial omission. IRC § 6501(e)(1)(B)(ii). In order to adequately apprise the IRS, "The statement must be sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one." Estate of Fry v. Comm'r, 88 T.C. 1020, 1023 (1987). While a disclosure must be more substantial than supplying the IRS with "a 'clue' which would be sufficient to intrigue a Sherlock Holmes", the disclosure need not recite every underlying fact. Quick's Trust v. Comm'r, 54 T.C. 1336, 1347 (1970), affd. 444 F.2d 90 (8th Cir.1971); Benson v. Comm'r, T.C. Memo. 2006-55. Although a misleading statement may provide a "clue" to omitted gross income, it does not adequately apprise the IRS of the nature and amount of an item. Phinney v. Chambers, 392 F.2d 680, 685 (5th Cir.1968); Estate of Fry v. Comm'r, 88 T.C. 1020, 1023 (1987).

When an individual's return contains a reference to other documents or returns, those references can serve as notice to the IRS. Benson v. Comm'r, T.C. Memo. 2006-55; Reuter v. Comm'r, T.C. Memo.1985–607. Specifically, when a return includes a reference to a partnership return, "partnership returns are considered together with individual returns to determine the amount omitted from gross income." White v. Comm'r, 991 F.2d 657, 661 (10th Cir.1993), affg. T.C. Memo.1991–552; Benson v.

Comm'r, T.C. Memo. 2006-55. Similarly, when a return includes a reference to an S-corporation, "the corporate information return on Form 1120–S must be considered along with taxpayers' individual returns in resolving the issue of adequate disclosure." Benderoff v. United States, 398 F.2d 132, 135 (8th Cir.1968); see also Roschuni v. Comm'r, 44 T.C. 80, 85-86 (1965).

For a Form 1120-S to be read as incorporated by reference in the return of the taxpayer, the Form 1120-S must be in existence and within the possession of the IRS. Where a Form 1120-S is not filed until after the return of the taxpayer (Form 1040), the late Form 1120-S should be treated like information found in an amended return and disregarded for purposes of 6501(e) disclosure. See Insulglass Corp. v. Commissioner, 84 T.C. 203, 207 (1985). The Tax Court in Insulglass determined that information discovered by the IRS during an audit should be treated as information filed on an amended return. Id. The Tax Court in Insulglass found support in Houston v. Commissioner, 38 T.C. 486 (1962), and Goldring v. Commissioner, 20 T.C. 79 (1953) which held that a taxpayer's filing of an amended return that includes in income amounts which had been omitted from the original return does not prevent the IRS from invoking the six-year period provided in section 6501(e)(1)(A), based upon the omission from the original return, even though the amended return disclosed the previously omitted items. Id. This understanding of the necessary timing of the disclosure naturally extends to, and answers the question raised here.

Even if the IRS read the Form 1120-S as an addendum to the Form 1040, the late filed Form 1120-S would be the true equivalent of an amended return since it was filed after the original return and would alter representations made in the original. Gross income can only be disclosed within the meaning of IRC § 6501(e)(1)(B)(2) if the information necessary to place the IRS on notice of the nature and amount of gross income from the item is in the possession of the IRS when the return is filed. The Form 1120-S had not yet been submitted to the IRS and at the time the taxpayer's return was filed, it provided no information as to the nature or amount of gross income. Therefore, the delinquent Form 1120-S cannot constitute a disclosure. The IRS simply cannot be said to be on notice of information contained in documents, incorporated by reference, when those documents do not yet exist (or at least have not yet been filed).

The Form 1120-S is due to the IRS on the fifteenth day of the third month of the year. That is one month prior to when the individual Form 1040 is typically due. Therefore, the Form 1120-S, if filed timely, should already be within the possession of the IRS at the time the individual return is filed. Where the Form 1120-S is filed after the original individual return, the IRS is not required to consider a theoretical, non-existent Form 1120-S in conjunction with the Form 1040. In this instance, the Form 1120-S cannot be said to be incorporated into the original Form 1040 and therefore the information reported thereon was not disclosed for purposes of IRC § 6501(e)(1). Where the IRS is forced into the disadvantageous position of reviewing an individuals return without the benefit of the Form 1120-S, the taxpayer loses the benefit of any protection the disclosures in that Form 1120-S may have provided.

The listing of income from an S-corporation on a schedule attached to a Form 1040 is effectively a one line summary of the gross income, exclusions, and deductions of the corporation. See Estate of Klein v. Comm'r, 537 F.2d 701, 704 (2nd Cir. 1976). It speaks to the total gain and loss but does not provide the IRS with the ability to evaluate the accuracy of the determination and does not apprise the IRS of the nature and amount of gross income. Further, in this instance, the information reported was actually misleading. While a misleading statement may provide a "clue" to omitted gross income, it does not adequately apprise the IRS of the nature and amount of an item. Phinney v. Chambers, 392 F.2d 680, 685 (5th Cir.1968); Estate of Fry v. Comm'r, 88 T.C. 1020, 1023 (1987). The taxpayer misstated his net income from the S-corporation and the S-corporation failed to provide the IRS with the Form 1120-S, which includes the information necessary to determine whether that calculation is correct. Taken together these facts constitute a strong indication that the IRS was not on notice of the nature and amount of the item of gross income and therefore, the income was not disclosed for purposes of IRC § 6501(e)(1).

In order to determine whether or not there is a substantial understatement of gross income for the purpose of applying the six-year statute under IRC § 6501(e)(1), we must consider the amount of S-corporation income listed on the original return. Any gross income relating to the S-corporation not listed on the face of the Form 1040 (or a referenced document contemporaneously in the possession of the IRS) is an omission.

Also note that Treas. Reg. § 1.1366-1(c)(2) defines gross income of an S-corporation shareholder for purposes of IRC § 6501(e)(1).[1] The S-corporation's gross income attributable to the undisclosed taxable income is considered to be omitted.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[1] Gross income for substantial omission of items--(i) In general. For purposes of determining the applicability of the 6–year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a shareholder's gross income includes the shareholder's pro rata share of S corporation gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of S corporation gross income used in deriving the shareholder's pro rata share of any item of S corporation income, loss, deduction, or credit (as included or disclosed in the shareholder's return) is considered as an amount of gross income stated in the shareholder's return for purposes of section 6501(e). (ii) Example. The following example illustrates the provisions of paragraph (c)(2)(i) of this section: Example. Shareholder A, an individual, owns 25 percent of the stock of Corporation N, an S corporation that has $10,000 gross income and $2,000 taxable income. A reports only $300 as A's pro rata share of N's taxable income. A should have reported $500 as A's pro rata share of taxable income, derived from A's pro rata share, $2,500, of N's gross income. Because A's return included only $300 without a disclosure meeting the requirements of section 6501(e)(1)(A)(ii) describing the difference of $200, A is regarded as having reported on the return only $1,500 ($300/$500 of $2,500) as gross income from N.

[redacted]

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