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To: Leon Black <[REDACTED]>

Subject: Re: [External] since you enjoy being an accountant

Date: Thu, 18 May 2017 12:51:50 +0000

The general, three-year statute of limitation for the IRS to assess tax is often applied. Far less often, in the case of fraudulent or unfiled tax returns, there is no statute of limitation. In between is the six-year statute of limitation when an item omitted from a return is more than 25% of the gross income stated on the return. Practitioners may encounter such a possibility only infrequently and therefore overlook it. Moreover, as evidenced by case law, the application of the extended statute of limitation is anything but clear-cut.

This article provides insight into how the six-year statute of limitation is applied and discusses what types of omissions trigger it.

The statutory background

Secs. 6501(a) and (b) provide that, generally, the statute of limitation to assess income tax is three years from the later of the date a tax return is filed or the date the return is due. In addition, Sec. 6501(c) deals with cases where a false return was filed, where there is a willful attempt to evade taxes, or where no return was filed. In these cases, there is no limitation on the time to assess the tax. Also addressed are some specific instances where the limitation period is extended. These include failure to disclose information about listed transactions or certain foreign transactions. These special limitation period extenders are beyond the scope of this article.

Sec. 6501(e)(1) provides that the period for assessment of taxes is extended to six years when there has been an omission from gross income on a return of an amount more than 25% of the gross income stated in the return. Sec. 6501(e)(2) provides a similar rule for omissions from the reportable value of a gross estate or total gifts of items includible on a filed estate or gift tax return, and Sec. 6501(e)(3) provides a similar rule for returns of certain excise taxes. In addition, Sec. 6501(e)(1)(ii) extends the period to six years for failure to report specified foreign financial assets whose total value exceeds \$5,000.

This article is focused only on omissions from gross income on income tax returns, and the calculation would seem to be straightforward: If gross income reported on a tax return is \$100,000, for example, an omission of more than \$25,000 will trigger the six-year statute of limitation. However, as seasoned tax practitioners well know, not much in the application of tax law is simple.

Making the calculation

In calculating the percentage of gross income that was omitted, tax practitioners need to remember that there is no line on tax forms for *gross* income for purposes of Sec. 6501(e), only *total* income: lines 22, 11, 6, and 8 on tax year 2014 individual, corporation, S corporation, and partnership returns, respectively. Gross income will need to be separately determined in accordance with Sec. 61, and issues such as cost of goods sold, property basis, and capital losses will have to be dealt with as discussed below. Gross income might be higher than total income, and this works to the taxpayer's advantage, since a higher denominator would make the omission percentage lower.

Income from a passthrough entity

A question arises about when the statute of limitation starts to run if an individual has income from a passthrough entity. For example, an individual taxpayer might have a different tax year than a passthrough business entity. Maybe the individual filed an extension and the business entity did not, or there could be other due-date timing differences. The rule is generally settled that the limitation period is based on when the individual files his or her own tax returns with the passed-through items (see, e.g., *Bufferd*, 506 U.S. 523 (1993)).

Application of the 6-year statute of limitation

Tax practitioners are well-aware that in the ordinary course of preparing tax returns or advising clients, the decisions they make on how to treat “gray area” or unusual items will affect potential disputes with the IRS. Practitioners need to be mindful that their decisions might also unexpectedly trigger the six-year statute of limitation.

Frequently seen areas where additional caution is warranted include:

- Alimony income;
- Timing of reporting revenues;
- Omission of a taxpayer’s share of passthrough entity income;
- Constructive income, such as constructive dividends and income reclassified from loans, or improper assignment of income to others;
- Income in respect of a decedent; and
- Reallocated income, such as under Sec. 482.

Some taxpayer circumstances and arguments such as the following come up time and time again.

The trade or business exception

Many taxpayers report income from a trade or business. A special rule requires that gross income from the sale of goods or services for purposes of Sec. 6501(e)(1) is the total amount received or accrued, without reduction for the cost of the goods or services sold (Sec. 6501(e)(1)(B)(i)). The numerator in testing for a more-than-25% omission will therefore be higher than might otherwise be expected if the omission is from such sales receipts. The “silver lining” is that the denominator will similarly be higher, and the net effect will depend on a calculation of two gross numbers, not two net numbers.

Example 1. A taxpayer operates a sole proprietorship, which is his only source of income. The business originally reports sales of \$100,000, cost of goods sold of \$70,000, and a gross profit of \$30,000. Assume there is a question about the timing of when to report an additional sale of \$20,000, with \$5,000 as the cost of goods sold and a \$15,000 gross profit.

If the additional sale is omitted from the current tax return on which it is properly includible, the omission percentage will be calculated as only 20% ($\$20,000 \div \$100,000$) and not 50% ($\$15,000 \div \$30,000$). The taxpayer will not be subject to the six-year statute of limitation.

The special trade or business rule also applies to returns and allowances, which are subtracted from gross receipts to determine gross income for other purposes (*Pittsburgh Milk Co.*, 26 T.C. 707 (1956)) but not for purposes of the six-year statute of limitation (Chief Counsel Advice (CCA) 201023053).

Property sales

A number of nonbusiness taxpayers have raised an argument that, like the calculation for sales of goods and services, the gross income from reported sales of property or securities should be considered the gross selling price unreduced by any related basis or costs. This serves to increase the gross income as originally stated in the return (the denominator) and thereby lowers the resulting percentage of any omitted unreported income. If successful, this argument would often save such taxpayers from application of the six-year statute of limitation when the 25% calculation is made. Unfortunately, this has not been a winning argument for taxpayers who are not in a trade or business.

The courts have consistently held that using the gross selling price for sales of goods and services in a trade or business without any reduction for costs is a specific statutory exception. Otherwise, the general rule of Sec. 61(a)(3) that gross income includes “gains derived from dealings in property” applies for purposes of Sec. 6501(e)(1). Thus, for purposes of the 25% calculation, gross income from property sales other than sales of

goods by a trade or business will in fact be *net* gains rather than the amount realized, resulting in a lower denominator (see, e.g., *Insulglass Corp.*, 84 T.C. 203 (1985), and, recently, *Barkett*, 143 T.C. No. 6 (2014)).

Example 2. The only income for the year of a taxpayer that is not a trade or business is from the sale of property. The taxpayer reports the sale of land for \$100,000 with a basis of \$70,000 and a net gain of \$30,000. The taxpayer omits the sale of some other property for \$20,000 with a basis of \$5,000 and a net gain of \$15,000.

The omission percentage is calculated as 50% ($\$15,000 \div \$30,000$), not 20% ($\$20,000 \div \$100,000$). The taxpayer will be subject to the six-year statute of limitation. Readers should compare this result with Example 1 above.

In a slightly different twist, a number of taxpayers have overstated the basis of property sold (other than goods sold by a trade or business) and consequently underreported the gain from the sale and, by extension, gross income. In cases where the underreported gain due to the basis overstatement is large enough, the IRS has attempted to apply the six-year statute of limitation because, according to its position as expressed in final regulations it issued in 2010 (Regs. Sec. 301.6501(e)-1(a)(1)(iii)), such taxpayers have omitted more than 25% of gross income stated in the return. Numerous taxpayers challenged this regulation in the courts, resulting in a split of opinion in the appellate circuits, with some deciding a basis overstatement results in omission of gross income as contemplated by the statute of limitation and others deciding it does not. For a good discussion of the conflict, see [“Tax Matters: Circuit Split Deepens on Six-Year Period for Basis Overstatements,”](#) *JofA*, May 2011, page 58.

Because of the split among the circuits, the Supreme Court agreed to hear *Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), and decide the issue. The Court effectively invalidated Regs. Sec. 301.6501(e)-1(a)(1)(iii), so underreported gain due to a basis overstatement will not be considered gross income for purposes of the 25% test and the six-year statute of limitation. For a discussion, see [“Judicial Deference to Regulations: Home Concrete & Supply, LLC,”](#) *The Tax Adviser*, Jan. 2013, page 36, and [“Home Concrete Decision Offers Limited Guidance,”](#) *JofA*, March 2013, page 58.

The tax liability affected

If a taxpayer omits more than 25% of the gross income stated in a return and the three-year statute of limitation has expired, a question arises of whether the extended statute-of-limitation period applies to a taxpayer’s entire tax liability for a particular tax year or whether it applies only to those items constituting a substantial omission of gross income. Unfortunately for taxpayers, it appears that the former is the case, and the IRS can adjust the tax liability for everything on the return and not just increase the tax for the omitted income (*Coilestock*, 102 T.C. 380 (1994)).

The burden of proof

Expiration of a statute of limitation is an affirmative defense. Therefore, if the taxpayer can prove that the general, three-year statute of limitation has expired, the burden of proof shifts to the IRS to prove that the six-year limitation period or one of the special exceptions to the three-year statute of limitation applies. For the six-year period to apply, the IRS is thus required to prove that the taxpayer did in fact omit gross income that should have been included, and that the amount omitted exceeded 25% of the gross income stated in the return (see, e.g., *Reis*, 1 T.C. 9 (1942), *aff’d*, 142 F.2d 900 (6th Cir. 1944)). There is no indication in the statutes or in the cases that if a taxpayer can prove an omission was unintentional or an honest mistake, that this will be considered as a factor.

The effect of filing an amended return

It is easy to imagine that, after filing a return, a taxpayer or tax adviser might discover an error, or new facts might come to light. Can a taxpayer then file an amended return and avoid the six-year statute of limitation? Generally, the answer is “no.” An amended return does not result in a new, shortened statute of limitation.

Many of the cases deal with amended returns in the context of an initial fraudulent return for which there would be no limit on the period during which the IRS could make an assessment of tax. The principle of law seems to be clear: No new statutory period results from an amended return (see, e.g., *Badaracco*, 464 U.S. 386 (1984), *aff'd* 693 F.2d 298 (3d Cir. 1982)).

Disclosure

Sec. 6501(e)(1)(B)(ii) provides a disclosure exception in calculating the amount of gross income omitted from a return. If an amount is disclosed in a return or in a statement attached to a return in a way that adequately informs the IRS of its nature and size, that amount will not be taken into account in determining the amount of omitted gross income for purposes of the extended statute of limitation. This sort of rule is becoming more common throughout the tax law—negative consequences can be avoided by disclosure. Since every case is unique, what constitutes adequate disclosure depends on the specific facts of each case. The good news for taxpayers is that the level of disclosure to avoid the extended statute of limitation is lower than the standard of disclosure to avoid certain accuracy-related penalties under Sec. 6662 (*Schmidt*, T.C. Memo. 1989-188).

In *Colony, Inc.*, 357 U.S. 28 (1958), the Supreme Court adopted a “clue” standard, where the extended statute of limitation will not apply as long as there is adequate disclosure to allow the IRS to make a reasonably informed decision on whether to select a return for audit—that is, the return on its face gives the IRS a “clue to the existence of the omitted item.” The clue does not have to reveal an exact amount or “each and every underlying fact” (*George Edward Quick Trust*, 54 T.C. 1336, 1347 (1970), *aff'd*, 444 F.2d 90 (8th Cir. 1971)).

It might seem reasonable to think that filing an amended return would be an alternative means of disclosing additional information to avoid the six-year statute of limitation. However, even if an amended return is filed within three years of filing the original return, the IRS takes the position that there has not been adequate disclosure (CCA 201118020).

A frequent taxpayer defense to the application of an extended statute of limitation is that there was adequate disclosure when information on a taxpayer’s return is considered along with the tax return of a related or associated entity. It appears that the IRS is generally required to seek its clue from passthrough entity returns. For example, in the *Quick Trust* case, the court held there was adequate disclosure when the taxpayer’s return was considered along with the partnership return for a partnership in which the taxpayer held an interest. The IRS is not required to consider information from completely separate taxable entities. In *Benson*, T.C. Memo. 2006-55, the IRS was not required to seek clues on the return of a controlled C corporation.

The IRS will be deemed to have gotten a proper clue from a related entity’s tax return only if that return is filed prior to or with the taxpayer’s individual return (CCA 201333008). Thus, when a Form 5500, *Annual Return/Report of Employee Benefit Plan*, was filed more than three years after an individual’s return, it did not cure an omission of income on the taxpayer’s return, and it did not constitute adequate disclosure (*Heckman*, T.C. Memo. 2014-131).

Walking a tightrope

The six-year statute of limitation may cause practitioners to feel as if they are walking a tightrope in resolving unusual or questionable items—on the one hand hoping they are not called upon to explain unusual or difficult tax treatment of an item, and on the other hand not wanting to provide too much disclosure or extend the statute of limitation.

Tax practitioners should be aware that once the 25% test has been met, the six-year statute of limitation is triggered, and it applies to more than just the omitted items. It also gives the IRS more time to question and to make additional tax assessments for items that were reported, even though the initial three-year limitation period has expired as to those items.

EXECUTIVE SUMMARY

The general, three-year statute of limitation for an assessment of income tax under Sec. 6501 is extended to six years for an omission from gross income of more than 25% of the gross income stated in the return.

For this purpose, gross income from sales of goods or services by a trade or business is the total amount received or accrued not reduced by costs or expenses.

However, gains from dealings in property other than in the course of a trade or business are net gains, rather than the amount realized. The denominator for the 25% threshold will usually be correspondingly lower, more likely subjecting an investor to the extended statute of limitation.

If the six-year period applies, the IRS may, during that period, adjust a taxpayer's liability for all items on the return, and filing an amended return reporting the omitted income does not shorten the period.

Disclosure of the omitted income through such means as a statement attached to the return or in the contemporaneously filed return of a passthrough entity may avoid the extended period.

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To comment on this article or to suggest an idea for another article, contact Paul Bonner, senior editor, at [REDACTED].

AICPA RESOURCES

JofA articles

- "[Home Concrete Decision Offers Limited Guidance](#)," March 2013, page 58
- "[Tax Matters: Circuit Split Deepens on Six-Year Period for Basis Overstatements](#)," May 2011, page 58

The Tax Adviser article

"Judicial Deference to Regulations: *Home Concrete & Supply, LLC*," Jan. 2013, page 36

Publications

- See more at: <http://www.journalofaccountancy.com/issues/2015/feb/gross-income-omissions-assessment-period.html#sthash.L0eaXR4k.dpuf>

On Thu, May 18, 2017 at 8:49 AM, Leon Black <[REDACTED]> wrote:

Jeffrey – I can't open this – keeps crashing my computer

From: jeffrey E. [mailto:jeevacation@gmail.com]
Sent: Thursday, May 18, 2017 7:03 AM
To: Leon Black
Subject: [External] since you enjoy being an accountant

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