Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:
(Group Manager)

from: Associate Area Counsel (Sacramento, Group 2)
(Small Business/Self-Employed)

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subject:

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

LEGEND

Taxpayer
Person A
Corporation A
Corporation B
Year 1
Year 2
Year 3
Year 4
Year 5
Year 6

ISSUES

(1). For purposes of determining if a taxpayer omitted more than 25% of their gross income under I.R.C. § 6501(e) (hereinafter referred to as the substantial omission

exception), whether the denominator of the formula used to determine the percentage of gross income omitted would include the taxpayer's proportionate share of gross income of any partnerships that were reported on a filed Form 1065 and reflected on the taxpayer's Form 1040.

(2). Using the facts of this case, what would the Service need to show in order for I.R.C. § 6501(c)(10) (hereinafter referred to as the listed transaction exception) to apply?

CONCLUSIONS

(1). Yes. In order to calculate the amount of gross income omitted, the denominator of the formula, which consists of the amount of gross income stated in the return, would include the taxpayer's proportionate share of gross income of any partnerships that were reported on a filed Form 1065 and reflected on the taxpayer's Form 1040.

(2). Under the facts of this case, what the Service would need to show will depend on the years involved. With respect to the years , the listed transaction exception would not apply since there was no duty of disclosure under the regulations promulgated under I.R.C. § 6011. With respect to the tax years the listed transaction exception may apply if (a) the transaction involved in this case is "substantially similar" to the transaction listed in Notice 2003-22; (b) the taxpayer had a duty to disclose the transaction; and (c) the taxpayer failed to disclose. Since the statute of limitations on assessment appears to be open for all years (§ 6501(e)) it does not appear necessary to rely upon this exception at this time. If you perceive the need to rely upon this exception in the future, please let us know and we will provide further analysis.

FACTS

The taxpayer is a physician. At some point in either year 1 or 2, she purchased a tax avoidance scheme from . The scheme operated first by having all of the taxpayer's gross receipts from her Subchapter S corporation or sole proprietorship deposited into a bank account under the name of . is a corporation controlled by . Each physician involved in this scheme has a sub-bank account under the name of . Since the income does not belong to , it does not report any of the deposits as income.

As part of the transaction, the taxpayer signs an agreement with a foreign corporation called , which is an corporation. Essentially holds itself out as a factoring entity. Normally a factor would lend money to a business secured by the business' accounts receivables. In this case, the taxpayer has very few accounts receivable. The gross receipts are in the form of cash or cash equivalents.

From the bank account, some percentage of the money is transferred to pursuant to a wire transfer. The percentage varies depending on the particular client. The percentage is approximately 50 percent. The other 50 percent of the deposits are transferred to the taxpayer's Subchapter S corporate bank account. The Subchapter S corporation would only report as income the amounts that were deposited into its bank account. From the Subchapter S bank account, the taxpayer would pay the expenses incurred in her medical practice. In this particular case, the taxpayer is treated as an employee of the Subchapter S and would only report the "wages" received from the Subchapter S on her Form 1040. Usually the expenses of the medical practice are sufficient to offset the income deposited into its bank account. To the extent that profit or loss is incurred in the Subchapter S the taxpayer would report that on her Form 1040.

The money wired to would not appear on any domestic tax return. The investigation is currently focusing on whether the clients have access to the money that is transferred to .

The revenue agent assigned to the case has under audit returns for the tax years 2 through . The Year 5and 6 returns are open under the normal three-year statute of limitations on assessment. We need to determine whether the assessment statute for each of the tax years 2 through 4 is open (e.g., under the substantial omission exception under section 6501(e)).

The taxpayer also appears to have an interest in two partnerships. The partnerships were disclosed on the taxpayer's returns. These two partnerships are not related to any of the audit related transactions involved in this case.

LAW AND ANALYSIS

Substantial Omission Exception:

Generally, the Commissioner must assess tax within three years after the later of the due date for filing a tax return or the date on which the taxpayer files its return. I.R.C. § 6501(a). Under I.R.C. § 6501(e), however, this three-year limitation period is extended to six years when a taxpayer omits properly includable income from his or her return in an amount greater than 25 percent of the amount of gross income stated on the return. I.R.C. § 6501(e)(1)(A).

For purposes of section 6501(e)(1)(A), "gross income" includes the amounts received or accrued from the sale of goods or services without considering the cost of those sales or services but does not include any omitted amount that is adequately 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 the income. I.R.C. § 6501(e)(1)(A)(i), (ii).

Where a return reports a distributive share of income from a partnership, the computation of gross receipts must include a distributive share of the gross receipts reported on the partnership return. I.R.C. § 702(c); Hoffman v. Commissioner, 119 T.C. 140 (2002). When a taxpayer's tax return reflects income from a partnership that is itself a partner in another partnership, the Service must trace the flow of gross income from not only the first-level partnership's return but also from the second-level partnership's return to determine the taxpayer's appropriate distributive share of partnership gross income from the first-level partnership's return. Harlan v. Commissioner, 116 T.C. 31 (2001).

In the case at hand, to the extent that the taxpayer adequately disclosed pass-through entities on her Form 1040, we would need to include her proportionate share of the gross income of those entities in determining the 25 percent omission. If we assume that the omitted amount of income is $500,000 that amount would be considered the numerator in the 25 percent calculation and the amount of the income reported or adequately disclosed would be considered the denominator. The denominator would thus include the taxpayer's appropriate distributive share of partnership income.

Based on the facts available at this time, it appears that there may have been a 25 percent omission of income from the taxpayer's returns for all the years at issue; therefore, the statute of limitations on assessment may be open under I.R.C. § 6501(e).

Listed Transaction Exception:

The Service is given wide discretion under I.R.C. § 6011(a) to prescribe regulations requiring taxpayers to file returns or statements. Under this grant of authority, the Service has promulgated regulations requiring taxpayers to attach certain statements to returns which disclose participation in what are called "reportable transactions." Treas. Reg. § 1.6011-4; Temp. Treas. Reg. § 1.6011-4T. One type of reportable transaction is a listed transaction. See I.R.C. § 6707A(c)(2); Treas. Reg. § 1.6011-4(b); Temp. Treas. Reg. § 1.6011-4T(b). On October 22, 2004, Congress enacted section 6501(c)(10), which extends the statute of limitations on assessment with respect to a listed transaction that a taxpayer failed to disclose under section 6011. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 814, 118 Stat. 1418 (2004).

I.R.C. § 6501(c)(10) provides:

> LISTED TRANSACTIONS.—If a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction (as defined in section 6707A(c)(2)) which is required under section 6011 to be included with such return or statement, the time for assessment of any tax imposed by this title with respect to such

transaction shall not expire before the date which is 1 year after the earlier of--

(A) the date on which the Secretary is furnished the information so required, or

(B) the date that a material advisor (as defined in section 6111) meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to such transaction with respect to such taxpayer.

Rev. Proc. 2005-26, 2005-17 I.R.B. 965 (April 25, 2005), provides initial guidance with respect to this new statutory provision.

In order for the listed transaction exception to apply, the Service must show:

(1) That the statute of limitations on assessment for the year(s) at issue was still open as of October 22, 2004;

(2) That the taxpayer participated in a listed transaction in the year(s) at issue;

(3) That the taxpayer had a duty to disclose the listed transaction under the regulations promulgated under section 6011 in effect for the year(s) at issue;

(4) That the taxpayer failed to disclose the listed transaction in accordance with the procedures under section 6011 and the regulations thereunder; and

(5) That the taxpayer's failure to disclose occurred while the statute of limitations on assessment for the year(s) at issue was still open.[1]

Open Assessment Statute Requirement:

Section 6501(c)(10) is effective for taxable years with respect to which the statute of limitations on assessment had not expired before the date the Act was passed (October 22, 2004). If the assessment period has expired prior to October 22, 2004, then the Act will not revive that closed assessment statute. As of October 22, 2004, the period of limitations under section 6501(a) was open with respect to the returns for the years . However, with respect to the years 2 and 3, assuming the returns were timely filed, the period of limitations under section 6501(a) would have expired

[1] Note that this will only be an issue in the case of transactions that the Service lists after the taxpayer filed the return for the year(s) in which the taxpayer participated in the transaction (referred to as "post-filing listed transactions").

prior to October 22, 2004. As discussed above, it appears that the assessment statute may be open under I.R.C. § 6501(e). If the Service is able to show the 25 percent omission, then section 6501(c)(10) would be effective for those years.

Participation in a Listed Transaction Requirement:

I.R.C. § 6707A(c)(2) provides:

> LISTED TRANSACTION.-- The term 'listed transaction' means a reportable transaction which is the same as or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.

Section 6707A is effective for returns and statements the due date of which is after October 22, 2004. To the extent that section 6707A does not apply, there is a similar definition of listed transaction contained in Treas. Reg. § 1.6011-4(b)(2) or Temp. Treas. Reg. § 1.6011-4T(b)(2). In addition, Treas. Reg. § 1.6011-4(c)(4) also defines "substantially similar," as:

> The term substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. * * * Further the term substantially similar must be broadly construed in favor of disclosure.

Notice 2003-22 "Offshore Deferred Compensation Arrangement" describes a listed transaction involving an offshore employee leasing scheme. The Notice concludes by saying that "Arrangements that are the same as, or substantially similar to, the arrangement described in this notice are, * * * identified as 'listed transactions' for purposes of § 1.6011-4(b)(2) * * *." In order for us to conclude that these transactions encompass a listed transaction, we would need to conclude that the transactions are substantially similar to the transaction listed in Notice 2003-22.

In addition, we must also determine whether the taxpayer "participated" in the transaction for purposes of applying the regulation. Treas. Reg. § 1.6011-4(c)(3)(A) [2] defines participation in the following terms:

> Listed transactions. A taxpayer had participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction under

[2] This provision is contained in the final regulations. As discussed further below, the applicable provisions of the temporary regulations will also need to be consulted for the definition of participation.

> paragraph (b)(2) of this section. A taxpayer also has participated in a listed transaction if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction under paragraph (b) (2) of this section.

The taxpayer in this case did not report her entire gross receipts on her tax returns for the years at issue. The taxpayer reported on her Form 1040 only the amount of wages paid by her Subchapter S corporation in addition to the amount reflected on her Form K-1 from the Subchapter S corporation. We believe therefore that the taxpayer has "participated" in the listed transaction since the return reflects the tax consequences or tax strategy.

However, the above determinations would need to be made in coordination with the Office of the Associate Chief Counsel (Passthroughs and Special Industries). Since your inquiry was more in the nature of a general inquiry of the application of section 6501(c)(10) we did not seek to coordinate this determination with the National Office. If you determine that you need to rely upon this provision, we will seek further guidance from the National Office.

Duty to Disclose Requirement:

In order to conclude that the taxpayer had a duty to disclose the listed transaction, we will need to analyze the temporary regulations and amendments thereto, and the final regulations promulgated under section 6011. In order to determine which regulations apply, we need to know when each return was filed and when the transaction was entered into.

Notice 2003-22 was released on April 4, 2003 and published on May 4, 2003. The Notice was issued after the returns for the years 2 through 4 were filed (perhaps Year 5 as well); thus, we need to rely upon the provisions of the section 6011 regulations that apply to post-filing listed transactions for these years, assuming that the subject transaction is substantially similar to Notice 2003-22. See, e.g., Treas. Reg. § 1.6011-4(e)(2)(i). With respect to post-filing listed transactions, taxpayers are required to attach a disclosure statement (currently, Form 8886) to their tax return next filed after the date the transaction is listed. Id.

Temp. Treas. Reg. § 1.6011-4T (T.D. 8877, 2000-1 C.B. 727), was published on February 29, 2000. The regulation by its own terms was limited to "corporate tax shelters." The regulation applied to corporate income tax returns filed after February 28, 2000. Since the regulation applies to only corporate returns filed after February 28, 2000, the regulation did not impose a duty on the taxpayer involved in this case. The above temporary regulation was amended on August 11, 2000 (T.D. 8896, 2000-2 C.B. 249) and August 2, 2001 (T.D. 8961, 2001-2 C.B. 194), but the amendments still only applied to corporate income tax returns.

However, the above regulation was amended again on June 14, 2002 (T.D. 9000, 2002-2 C.B. 87) to include within its reach individuals, trusts, partnerships and S corporations who have directly or indirectly participated in a reportable transaction. These regulations are effective for transactions entered into after January 1, 2001, unless such transaction is reported on a tax return filed by the taxpayer on or before June 14, 2002. In this case, the transactions for the years 2 and 3 were entered into prior to January 1, 2001. Thus, there is no duty to disclose imposed with respect to the tax years. However, there may be a duty to disclose with respect to the years , as these transactions may have been entered into after January 1, 2001 and we do not know if they were reported on a return filed on or before June 14, 2002. Temp. Treas. Reg. § 1.6011-4T(d)(1) sets forth the requirements for post-filing listed transactions, which, similar to the current rules cited above, requires taxpayers to disclose these transactions on their next filed return.

Temp. Treas. Reg. § 1.6011-4T was amended again on October 17, 2002 (T.D. 9017, 2002-2 C.B. 815). These regulations are effective for transactions entered into after January 1, 2003. Thus, these regulations may apply with respect to the taxable year, as the transactions at issue for that year may have been entered into after January 1, 2003. Unlike the previous years, the taxpayer should have filed her return for this year after the transaction was listed, as the transaction was listed in 2003. Under Temp. Treas. Reg. § 1.6011-4T(e)(1), taxpayers must disclose these transactions on their return for the year in which they participated in the transaction.

The regulation became final on February 28, 2003 (T.D. 9046, 2003-1 C.B. 614) and (T.D. 9108, 2004-1 C.B. 429). As mentioned above, Treas. Reg. § 1.6011-4(e)(1) sets forth the general disclosure requirements and Treas. Reg. § 1.6011-4(e)(2)(i) sets forth the requirements with respect to post-filing listed transactions.

As we understand the facts, the taxpayer would allegedly enter into similar agreements with Corporation B at the start of each taxable year. Therefore, there appears to be a duty to disclose under the applicable regulations for the taxable years 4, 5, and 6. If so, since the transaction involved herein may have become a listed transaction in May, 2003, the taxpayer should have disclosed by attaching a completed Form 8886 for each year 4, 5, and 6 that she participated in the transaction on her Year 65 income tax return.

Failure to Disclose Requirement:

As we understand the facts, the taxpayer for each year simply reported as income the amount of the "wages" paid by her Subchapter S corporation. In addition, we understand that the Form 1120S simply reported as income the amount of money deposited into its bank account from Corporation A. There is no indication on the tax returns that the taxpayer entered into this type of transaction.

Since we have not reviewed the tax returns filed by the taxpayer, we would advise that the returns for the years 4, 5, and 6 be reviewed to see if the taxpayer attached a disclosure statement to any of those returns. As the period of limitations on assessment was still open for each year in 2004 under section 6501(a) when the return for the year would have been due, any failure to disclose would have occurred while the period of limitations on assessment for the year(s) at issue was still open.

It is also necessary to see if the taxpayer made any late disclosures in accordance with section 4 of Rev. Proc. 2005-26 that would start the running of the one-year period provided in section 6501(c)(10). In addition, you must determine whether the taxpayer's "Material Advisor" (probably) provided any lists in response to a request by the Service under section 6112 that would start the one-year period under section 6501(c)(10) running, as discussed in section 5 of Rev. Proc. 2005-26.

If you need further assistance (e.g., in the actual calculation of the omission of income), please feel free to contact me at (.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Associate Area Counsel
(Small Business/Self-Employed)

By: _____

General Attorney (, Group 2)
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