OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Application of I.R.C. 6229(c)(4)

This Field Service Advice responds to your memorandum dated December 17, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:
LPX = Authorized representative

Z =

$A =
$B =
$C =
$D =
$E =

ISSUES:

1. How is “gross income” to be defined for purposes of measuring the 25% omission of gross income under I.R.C. § 6229(c)(2) where a TEFRA limited partnership sells its interests in other partnerships to a third party purchaser?

   A. May the Service apply the definition of “gross income” in I.R.C. § 6501(e)(1)(A)(i), using gross receipts . . . before diminution for cost of goods sold,” for purposes of I.R.C. § 6229(c)(2)?

   B. Do the exculpatory concepts of adequate disclosure, codified in I.R.C. § 6501(e)(1)(A)(ii), apply directly or by analogy in the application of I.R.C. § 6229(c)(2) to a TEFRA partnership?

2. Is a partnership that was formed for the exclusive purpose of being the vehicle to affect the sale of real estate parcels, each of which had been held as the sole asset of a related partnership, and terminated immediately after the sales, “in the trade or business” of selling partnership interests for purposes of I.R.C. § 6501(e)(1)(A)(i)?

CONCLUSIONS:

1. Inasmuch as the I.R.C. § 6229(a) supplements I.R.C. § 6501(a), the concept of gross income in I.R.C. § 6229(c)(2) should be interpreted in view of precedents under I.R.C. § 6501(e)(1)(A)(i). Likewise, the adequate disclosure provisions in I.R.C. § 6501(e)(1)(A)(ii) should be used in applying I.R.C. § 6229(c)(2).

2. A partnership formed solely to sell partnership interests is in the trade or business of selling partnership interests.

FACTS:

Using a group of limited partnerships, Z indirectly owned numerous parcels of real estate. Generally, Z and others were partners in a series of operating partnerships that, in turn, were controlling partners in another layer of real estate partnerships, which each held a single parcel of real estate. Third parties, such as lenders, sometimes held minority partnership interests in the real estate partnerships. The operating partnerships also owned undeveloped land and stock in a corporation that owned real estate. The core operations of the entire business group was real estate development and management.

The business group determined to pare its operations and negotiated a sale of some real estate to an unrelated third party. LPX, a limited partnership, was formed to facilitate the sale. In anticipation of the sale, operating partnerships transferred their controlling interest in some of the real estate limited partnerships and 100% of the stock in a corporation that owned another parcel of real estate to LPX, and transferred parcels of undeveloped land into newly created partnerships in which LPX was the majority limited partner. When the sale was closed, LPX transferred the corporate stock and its interests in the partnerships to the buyer. The sale also included some real estate partnership interests that were transferred directly by an operating partnership because the group could not get timely lender approvals for an interim transfer to LPX. Other property included in the initial contract was dropped from the sale before the closing.

LPX filed a timely Form 1065, under a filing extension, on which it reported $A of gross income from various sources, including $B from the sale of the stock and partnership interests. Claiming a $C basis in the stock and partnership interests, LPX reported a net loss. Information provided during an audit of Z led to a TEFRA audit of LPX that started more than three years after LPX filed its Form 1065. The Service issued a FPAA to LPX just before a six year limitation period on assessment under I.R.C § 6229(c)(2) would have expired.[1] The Service based its use of the six year limitations period upon LPX's alleged failure to report $D of gross income. Based upon documents from the sale, the gross income calculated by the Service included $E attributable to the sale of the stock and partnership interests. It appears that the difference in the gross income reported by LPX and calculated by the Service may result, at least in part, from varying treatment of encumbrances and loans paid off during the closing, but LPX has not yet provided any reconciliation of the amounts reported on its partnership return.

LAW AND ANALYSIS

1. Inasmuch as I.R.C. § 6229(a) supplements I.R.C § 6501(a), the concept of gross income in I.R.C. § 6229(c)(2) should be interpreted in view of precedents under I.R.C. § 6501(e)(1)(A)(i). Likewise, the adequate disclosure provisions in I.R.C. § 6501(e)(1)(A)(ii) should be used in applying I.R.C. § 6229(c)(2).

    A. Gross income for purposes of I.R.C. § 6229(c)(2) includes the definition of gross income in § 6501(e)(1)(A)(i).

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[1] You have advised us that the computation of the six year period of limitations is not at issue in this case.

The fundamental limitation period on assessment of tax by the Service is found in I.R.C. § 6501(a), which provides that, unless otherwise provided, any assessment must be made within three years from the date on which the return was filed. Section 6501(e)(1) provides otherwise "if the taxpayer omits from gross income an amount properly includible therein which is in excess of the 25 of the amount of gross income stated in the return."

For this purpose, section 6501(e)(1)(A)(i) provides its own definition of gross income:

> 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; . . ..

In the Tax Court, the Service has the burden of proving that the six-year statute of limitations based upon the substantial omission of gross income exception applies. See Rules 39 and 142 of the Tax Court Rules of Practice and Procedure. The Service must show that the amounts of income that were not reported were properly included in gross income and that the excluded amounts exceeded 25% of the amount shown on the return. Rhombar v. Commissioner, 47 T.C. 75, 85 (1966), aff'd, 386 F.2d 510 (2d Cir. 1967) and acq., 1967-2 C.B. 3.

The language in section 6501(e)(1)(A)(i) was first added to the Internal Revenue Code in 1954 when Congress sought to clear up a controversy among courts applying a predecessor of section 6501 over whether the term "gross income" meant "gross receipts," i.e., the "total amount received or accrued before diminution by the cost of sales", or "gross profits," being the excess realized over the unrecovered cost or other basis for the property." H.R. Rept. No. 1337, 83rd Cong. 2d Sess., A414 (1954); compare Upgrove Lumber Co. Commissioner, 204 F.2d 570, 572-573 (3d Cir.1953) with Carew v. Commissioner, 215 F.2d 58, 61-62 (6th Cir. 1954); cf. Colony, Inc. v. Commissioner, 357 U.S. 28 (1958) (applying pre-1954 law after adoption of section 6501(e)(1)(A)(i)). For "trade or business" income, Congress adopted the "gross receipts" test for use in determining the amount of unreported gross income. Thus, to the extent LPX generated its income from the trade or business of selling partnership interests and stock, application of the section 6501 definition of gross income would require the partnership to report at least 80% of its gross receipts from the sales to avoid the six year limitations period.

In 1982, Congress enacted the TEFRA unified audit and litigation procedures to substitute a simplified and streamlined entity-level partnership audit, litigation, and assessment process in lieu of instituting multiple separate proceedings with the partners. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248;

Cong. Rep. No. 97-248 at 600 (1982), 1982-2 C.B. 462. The TEFRA procedures provide rules for the examination of a partnership entity that parallel and supplement the existing rules and procedures in the Code for the examination of a taxpayer's return.

The TEFRA procedural rules supplement the rules for making a tax assessment by inserting the audit of a TEFRA entity into the examination process before an assessment of taxes can be made against a partner based upon the partnership return. Although the audit is of an entity, such as a partnership, the tax can only be assessed against the taxpayers who are partners in that entity. Thus, to supplement section 6501, Congress enacted a minimum assessment period during which assessments could be made against all the partners in a TEFRA partnership for tax attributable to partnership items. First, I.R.C. § 6501(n)(2) was added to amend the general limitations on assessments in section 6501 by expressly providing: "For an extension of period in the case of partnership items (as defined in section 6231(a)(3)), see section 6229." Section 6229, in turn, sets forth provisions that enhance the limitations periods in section 6501 for partnership items of a taxpayer. These include:

--- a minimal period in section 6229(a) for assessing tax attributable to partnership items, which will not expire before the date that is three years from the later date on which the partnership return was filed or due to be filed (without regard to extensions);

--- a provision allowing a partner, on his own behalf, or the TMP, acting with respect to all partners, to agree to extend the three year limitations period set under section 6229(a);

--- a special rule, not necessary under section 6501, establishing a one year period for making assessments of tax attributable to items that become nonpartnership items before the assessment period for tax on partnership items expires;

--- the suspension of the minimum period for assessment once an FPAA is issued that is similar to that provided in section 6503 when a notice of deficiency is issued; and

--- a longer assessment period in special circumstances, such as fraud or the substantial omission of income.

Each section 6229 provision applies the basic statute of limitations rule as set forth in section 6501 to the special circumstances involved when the determination of a taxpayer's liability is subject to the special partnership audit process. Rather than providing a separate statute of limitations rule that applies exclusively to the partners' tax adjustments from a partnership that would necessarily repeat all the definitions and terms already present in section 6501, section 6229 simply addresses the special circumstances under which the section 6501 rules will be applied for the partners' tax adjustments resulting from the audit of the partnership entity. For example, in supplementing section 6501, section 6229 does not repeat the details from section 6501 such as the need for a written agreement to extend the limitations period in section 6501(c)(4) or the definition of gross income in section 6501(e)(1)(A).

Thus, when section 6229(c)(2) states that "6 years" will be substituted for "3 years" if "any partnership omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in its return" a further definition of "gross income" or how gross income is to be determined need not be provided. The section 6501(e)(1)(a)(i) definition is the one to be used in section 6229(c)(2) if the gross income is from a trade or business.[2]

B. The adequate disclosure provisions in I.R.C. § 6501(e)(1)(A)(ii) should be used in applying I.R.C. § 6229(c)(2).

Once the Service argues that the section 6501(e)(1)(A)(i) definition of "gross income" should be used in interpreting section 6229(c)(2) based upon treating section 6229 as a extension of section 6501, inherent factors of equity and logic preclude the Service from asserting that the adequate disclosure provisions of section 6501(e)(1)(A)(i) are not also encompassed in section 6229(c)(2). LPX should be given an opportunity to demonstrate that its partnership return adequately disclosed in gross income from the sale of stock and partnership interests.

We would assert that the disclosure, to be adequate, must be apparent from the return itself, including sufficient detail to alert the Service as to the nature of the transaction and enable it to make a reasonably informed decision on whether to select the return for audit. Mariani Frozen Foods, Inc. v. Commissioner, 81 T.C. 448 (1983) aff'd. sub nom., Gee v.Commissioner, 761 F.2d 1410 (9th Cir. 1985); Benderoff v. United States, 398 F.2d 132 (8th Cir. 1968).

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[2] Note that LPX's interests in other partnerships must be considered in determining the gross income shown on its return for purposes of section 6501(e)(1). The Service will need to consider whether these partnerships filed returns and the amount of gross income shown on the partnership returns. See Davenport v. Commissioner, 48 T.C. 921 (1967), acq., 1968-2 C.B. 2; Rose v. Commisisoner, 24 T.C. 755 (1955), acq., 1956-2 C.B. 8 (partnership return was an adjunct to the individual returns and must be considered together with such individual return); Rev. Rul. 55-415, 1955-1 C.B. 412.

In considering whether disclosure is adequate in the context of multiple return-filing entities, the return of each entity should meet the adequate disclosure needs on its own without the Service being compelled to search through myriad documents that may be in its possession with respect to another entity or taxpayer. One exception is that any disclosures made on a partnership return must be considered in connection with the return of a partner in that partnership. Walker v. Commissioner, 46 T.C. 630 (1966), acq.,1967-2 C.B. 4. In determining whether LPX made adequate disclosure, the returns filed by the partnerships that LPX transferred, or by any other partnership in which LPX was a partner, should be considered.

In contrast, a partnership cannot satisfy its adequate disclosure responsibilities by relying upon returns filed by its partners or related entities. The Service cannot be expected to untangle information scattered over multiple returns before determining whether possible adjustments should be proposed. In cases such as the one presented, where the Service belated discovered LPX's underreporting of gross income only through its extended audit of another taxpayer, a six year assessment period is appropriate.

3. A partnership that was formed for the exclusive purpose of being the vehicle to effect the sale of real estate parcels, each of which had been held as the sole asset of a related partnership, and terminated immediately after the sales, should be treated as being "in the trade or business" of selling partnership interests for purposes of I.R.C. § 6501(e)(1)(A)(i).

The definition of "gross income" for a "trade or business" in section 6501(e)(1)(A)(i) as "the total amount received or accrued before diminution by the cost of sales" differs from the definition of "gross income" under I.R.C. § 61 for those who sell or dispose of property other than through a "trade or business." When property is sold other than through a trade or business, the gross profits, being the net gain (or loss) on a sale, rather than the gross proceeds of the sale, is used as the measure of gross income. Insulglass Corporation v. Commissioner, 84 T.C. 203 (1985); cf. Burbage v. Commissioner, 82 T.C. 546 (1984), aff'd, 774 F.2d 644 (4th Cir. 1985) (taxpayer's long-term lease recharacterized as a sale with substantial long-term capital gain income). Thus, to the extent LPX generated its income from the trade or business of selling partnership interests and stock, application of the section 6501 definition of gross income would require the partnership to report at least 80% of its gross receipts from the sales to avoid the six year limitations period. If the section 6501(e)(1)(A)(i) definition does not apply, the test is of LPX's gross profits from the sale, measured after any reduction for LPX's basis in the property and the costs of the sale. Since the partnership return reports a net loss, any net gain on the sales would produce more than a 25% omission of the gross profits.

As you note, there are few cases decided under section 6501(e) in which the issue was whether the taxpayer was engaged in a trade or business. In Schneider v. Commissioner, T.C. Memo.1985-139, 49 TCM (CCH) 1032 (1985), the Tax Court denied the taxpayers the use of the section 6501(e)(1)(A)(i) definition because the parties had stipulated that their sale was a casual sale of a capital asset. In Insulglass Corporation v. Commissioner, 84 T.C. 203 (1985), the taxpayer unsuccessfully argued that he was entitled to use the section 6501(e)(1)(A)(i) gross receipts test even though he was an investor and not in the trade or business of selling commodities.

In Connelly v. Commissioner, T.C. Memo. 1982-644, 45 TCM (CCH) 49 (1982), an innocent spouse case based upon the omission of income under I.R.C. § 6013(e), the court determined that the taxpayer's spouse was engaged in the trade or business of selling securities before using the section 6501(e)(1)(A)(i) gross income test to determine the amount of the omitted income. [3] The court relied upon cases in substantive tax areas in deciding that whether a taxpayer was engaged in a trade or business is a factual question requiring an examination of the surrounding facts and circumstances. Cf. Higgins v. Commissioner, 312 U.S. 212 (1941) (business or nonbusiness bad loans); Main Line Distributors, Inc. v. Commissioner, 321 F.2d 562 (6th Cir. 1963) (deductibility of trading expenses).

The facts and circumstances concerning LPX's creation and activities present a compelling case that it was in the trade or business of selling real estate embodied in partnerships and corporations. It was created to facilitate such sales and quickly acted to complete the single sale of the assets that had been transferred to it for purposes of the sale. It then conducted no other business.

We note that Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), a case involving facts that LPX claims are similarly to its own, was decided against the Service because the Service, before the enactment of section 6501(e)(1)(A)(i), tried to use a gross profits test in determining the omission of gross income. Finding that Colony, Inc. had properly reported its gross receipts, the Court rejected the use of the gross profits test because, in that case, gross profits reflected the overstatement of expenses rather than the taxpayer's "omission" of income. Thus, the Supreme Court decided the case based upon the same theory used by Congress four years earlier in enacting section 6501(e)(1)(A)(i). The Court agreed with Congress that gross receipts is a better measure of the omission of gross income than gross profits for purposes of section 6501(e)(1)(A) because, in computing gross profits, income is reduced by basis and other costs that can be

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[3] The court's use of the section 6501(e)(1(A)(i) gross income test for a trade or business in interpreting section 6013(e) supplies a second argument in favor of using the same definition in interpreting section 6229(c)(2).

overstated. With facts and circumstances similar to those in Colony, Inc., LPX should be treated as a trade or business for purposes of section 6501(e)(1)(A), and gross income should be computed, as in Colony, Inc., using gross receipts.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any questions.

By: ______________________________

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