Office of Chief Counsel
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Memorandum

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subject: Section 6501(e) and Forward Contracts

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

LEGEND

LLC X =
Member A =
Member B =
Member C =
Member D =
Year 1=
Date 1 =
Date 2=
Date 3=
Date 4 =
Date 5 =
Date 6=
Date 7=
Date 8=
Corporation=

Broker F=
Accountant E=
$x =
$v =
$y =
$z =
$a =
$b =
$c =

ISSUE

Whether LLC X adequately disclosed on its Year 1 return the amount omitted from gross income within the meaning of section 6501(e)(1)(A)(ii) to avoid the extended 6-year statute of limitations for a TEFRA partnership under section 6229(c)(2).

CONCLUSION

LLC X did not adequately disclose on its Year 1 return the omitted income within the meaning of section 6501(e)(1)(A)(ii). Therefore, the 6-year statute of limitations for assessment under section 6229(c)(2) applies, and LLC X's Year 1 tax year is open for examination.

FACTS

On Date 1, Member A formed LLC X for the purpose of engaging primarily in investment activities. Members A and B each held a 16.6667 percent interest in LLC X. Members C and D, the remaining members of LLC X, each held 33.3333 percent interests.

On Date 1, Member A contributed 20,000 shares of Corporation common stock to LLC X by delivering the shares to a Broker F brokerage account established by LLC X. The other members of LLC X also contributed a total of 100,000 shares of Corporation stock to the brokerage account.

On Date 2, the four members of LLC X transferred their interest in LLC X to individual annuity trusts (CRTs). Members A and B each retained a .5 percent interest in LLC X. The CRT trust agreements designated the respective individuals as the noncharitable beneficiaries, and different charities and schools as charitable beneficiaries. The CRTs had a term of two years and paid an annuity of 49.048 percent of the initial net fair market value of the trust assets valued as of Date 2.

On Dates 3, 4, and 5, Broker F and LLC X executed three prepaid forward contracts for the sale of shares of capital stock in certain companies on a forward basis. Section 1259(d)(1) defines a "forward contract" as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." A prepaid forward contract is one in which the purchaser prepays the sales price upon the execution of the contract.

The prepaid forward contracts specifically outlined the representations, warranties, and agreements for a prepaid equity forward transaction between Broker F and LLC X with respect to the common stock of Corporation. LLC X received prepayment proceeds from the sale of the forward contracts in the amount of 86.25 percent of Corporation's fair market value on the trade dates. Broker F disbursed a total of $v as prepayment proceeds to LLC in Year 1. The maturity dates for the contracts were on Date 6.

On Date 6, appraisers affiliated with Accountant E established the total value of the combined CRTs' 99 percent interests in LLC X as $y as of Date 2. For the period of Date 2 through Date 7, LLC X made total distributions of $z to all of the Members' CRTs. In Year 1, the CRTs in turn made distributions of $x to the four members.

LLC X filed its Year 1 return on Date 8. In Year 1, LLC X was treated as a partnership for federal tax purposes. Its Year 1 return was identified on its face as an "Initial Return." The balance sheet portion of the return contained no balance sheet for the beginning of the year. The principal business activity of the taxpayer was described as "Finance and Insurance," and its principal product or service was listed as "Other Financial Investment Activities." Schedule K-1s attached to LLC X's Year 1 return included, among others, K-1s identifying -- as LLC members -- the Member A Annuity Trust, the Member B Annuity Trust, the Member C Annuity Trust, and the Member D Annuity Trust.

In its Year 1 return, LLC X did not report any gross income. On the balance sheet for the close of the year (Schedule L) the taxpayer reported "Other Current Assets" in the amount of $a; "Other Liabilities" in the amount of $v (the amount of the prepayment proceeds received for the forward contracts); and "Partner's Capital Accounts" in the amount of $b. In its "Other Liabilities Schedule" attached to its Year 1 return, LLC X listed a "Forward Sale Contract" of $v.

The agent adjusted LLC X's Year 1 return in accordance with Revenue Ruling 2003-7 and pursuant to advice from Area Counsel on a similar case. For federal tax purposes, LLC X's execution of the forward contracts is treated as constructive sales deemed to have occurred in Year 1 on the dates that LLC X executed the three prepaid forward contracts with Broker F. LLC X's position is that such proceeds are not taxable when received, because the forward contract remains open until settlement, that is, until delivery of the stock.

The 3-year period under section 6229(a) for assessing any tax with respect to any person that is attributable to any partnership item (or affected item) on LLC's Year 1 return is closed. Should it be determined that LLC X has not adequately disclosed the transaction giving rise to the proceeds from the prepaid forward contracts, the 6-year period under section 6229(c)(2) would still be open.

LAW AND ANALYSIS

Section 6501(a) provides that tax must generally be assessed within 3 years after the return was filed, whether or not such return was filed on or after the date prescribed. As an exception to the general rule, section 6501(e)(1)(A) provides a 6-year statute of limitations if the taxpayer omits from gross income an amount properly includible therein that is in excess of 25 percent of the amount of gross income stated in the return. I.R.C. § 6501(e). Section 6501(e)(1)(A)(ii) states that "[i]n determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is 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." I.R.C. § 6501(e)(1)(A)(ii).

In its Year 1 return, LLC X did not report any gross income. According to the agent, however, LLC X should have reported on its Year 1 return a long-term capital gain of $c for the prepayment proceeds received from the execution of the forward contracts. Thus, LLC X omitted from gross income an amount in excess of 25 percent of the amount of gross income stated in the return. It thus must be determined whether LLC X adequately disclosed the amount omitted from gross income to avoid the 6-year statute of limitations. Whether LLC X's listing of the forward sale contract as a liability adequately disclosed the omitted income is a factual question. University Country Club, Inc.,v. Commissioner, 64 T.C. 460, 468 (1975), acq. 1976-3 C.B. 3. The Service has the initial burden to establish the 25 percent omission from gross income but the taxpayer has the burden to establish that the return contains an adequate disclosure. See Hines v. Commissioner, T.C. Memo. 1989-17, aff'd without opinion, 893 F.2d 1330 (3d Cir. 1989).

While the 6-year period under section 6229(c)(2)[1] applies here, we look to the law as developed under section 6501(e) to apply that TEFRA provision. See Rhone-Poulenc Surfactants & Specialties, Ltd. P'ship v. Commissioner, 114 T.C. 533, 542 (2000), appeal dismissed and remanded, 249 F.2d 175 (3d Cir. 2001) (discussing the interplay between sections 6229 and 6501).

Adequate Disclosure

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 v. Commissioner, T.C. Memo. 1989-17, aff'd without opinion, 893 F.2d 1330 (3d Cir.

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[1] Section 6229(a) provides that the period for assessing tax which is attributable to any partnership item (or affected item) shall not expire before 3 years after the later of the date the partnership files its return, or the last day for filing the return for such year (determined without regard to extensions). If a partnership omits from gross income an amount in excess of 25 percent of the amount of gross income stated on its partnership return, then section 6229(a) is applied by substituting "6 years" for "3 years." I.R.C. § 6229(c)(2).

1989). See also University Country Club, Inc, 64 T.C. at 471. The Tax Court explains further as follows:

> The statement must, however, be sufficiently detailed to apprise the Commissioner and her agents as to the nature and amount of the transaction so that 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 (1955), 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, 1022 (1987). In addition, we believe that CC&F Western Operations Ltd. P'ship v. Commissioner, 273 F.3d 402 (1st Cir. 2001), is particularly applicable to the subject case. CC&F Western Operations shows that the return must give a revenue agent 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 CC&F Western Operations, the partnership omitted from the Form 1065 items of gross income arising from being relieved of a share of partnership liabilities upon the sale of several partnership interests. CC&F Western O attached the Schedule K-1 of the partnerships, which showed its share of their liabilities. The court, however, found that nothing in CC&F Western's Form 1065 indicated the allocation of debt or other sales terms. Rejecting CC&F Western's contention that if the Service had combined the amounts reported on the twelve K-1's attached to the return, 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. . . .

CC&F Western Operations, 273 F.3d at 408.

An example of a return providing a reason to investigate further regarding the omitted income is shown in University Country Club, Inc. In that case, the Service determined that receipts from the sale of class B stock represented taxable income to petitioner because, in substance, the stock was a license for the privilege of using petitioner's facilities; that taxpayer treated the receipts as nontaxable contributions to capital from the sale of that stock. The taxpayer attached a balance sheet that showed a capital stock account comprised of two classes of common stock and a capital surplus account; a reconciliation schedule of the capital surplus account showed the account to be comprised of general membership for pool and golf. The Tax Court found that "reporting the dollar value of class B stock on the balance sheet of the initial return rather than classifying the proceeds from the sale of stock as income is a type of disclosure described by the Supreme Court." University Country Club, Inc., 64 T.C. at 469-70.

It has been said that “[t]he touchstone in cases of this type is whether respondent has been furnished with a ‘clue’ as to the existence of the error.” George Edward Quick Trust v. Commissioner, 54 T.C. 1336, 1347 (1970), aff’d per curiam, 444. F.2d 90 (8th Cir. 1971). The origin of this “clue” test is Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), and it is routinely referenced in opinions of the Tax Court and other courts; See e.g. University Country Club, Inc., 64 T.C. 460, 470 (1975); Rhone-Poulenc, 114 T.C. at 557-58. The First Circuit in CC&F Western Operations, however, rejected the notion that Colony established an independent clue test based on statutory language. The First Circuit speculated that post-1953 judicial decisions had erroneously incorporated that ideology out of an “[i]mpulse to create a sense of continuity” between Colony and Section 6501(e)(1)(A)(ii)'s adequate disclosure test. Id. The court further indicated that the adequate disclosure standard in section 6501(e)(1)(A)(ii) establishes a “much stiffer test than a mere clue.” Id. CC&F Western Operations represents the best statement of our current view of the law.

Here, LLC X failed to report as gross income the proceeds received in Year 1 from the forward sale contracts. LLC X instead reported the proceeds on Schedule L as a liability of $v and directed the IRS to review the attached Statement 2. Statement 2 described the $v amount as a current liability attributable to a “forward sale contract.” LLC X, however, did not indicate anywhere on the return that the forward sale contract was prepaid. That is, that it had in fact already received the proceeds. Thus, the IRS was not made aware from the return of any connection between the specific transaction and the CRTs. Nor did LLC X give the agent any other reason to further investigate the nature of the forward sale contracts. By omitting any reference to prepayment proceeds, LLC X failed to disclose in substance the particular omitted income item. See CC&F Western Operations, 273 F.3d at 408. The 6-year statute of limitations under section 6229(c)(2) thus applies, because LLC X did not adequately disclose the amount omitted from gross income within the meaning of section 6501(e)(1)(A)(ii).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call (202) 622-7800 if you have any further questions.