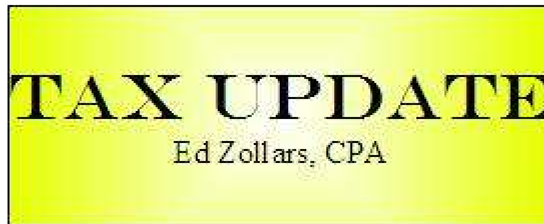

Adequate Disclosure and the Six Year Statute

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This week we consider the case of *Benson v. Commissioner,* TC Memo. 2006-55, where the Tax Court considers the issue of whether a taxpayer had met the adequate disclosure requirements of §6501(e)(1)(A)(ii) in disclosing transactions for which a tax was assessed after the expiration of the standard three year statute but before the expiration of the six year statute provided by §6501(e)(1)(A) for substantial understatements.

This case was being reconsidered by the Tax Court, which had previously ruled against the taxpayers on the merit of the tax itself (see *Benson v. Commissioner*, TC Memo 2004-272), but had ruled that the IRS had not carried the burden of showing fraud in order to hold the statute open indefinitely, and ruled that only if the unreported income exceeded the 25% test stated in §6501(e)(1)(A) would the assessment be deemed valid, once the ruling of the court was applied. The court noted:

> For respondent to prevail with respect to the 1988 taxable year, we must find fraud, which we do not. However, as discussed infra, we do find that respondent has proved substantial omissions of income in 1989, 1990, 1993, and 1994. The

> Bensons argue on brief that the only way respondent can show a 25-percent omission is by proving that they had constructive dividends. We have found that substantial constructive dividends were received. On brief, respondent refers to this matter as a computational issue. A recomputation of the Bensons' income under Rule 155 pursuant to our findings and holdings herein will control whether the Bensons omitted from gross income an amount which is in excess of 25 percent of the amount of gross income stated in the returns. If there was such an omission the period of limitations in section 6501(a) will not bar assessment for those years. See *Garden State Dev., Inc. v. Commissioner* [Dec. 22,952], 30 T.C. 135, 142 (1958); *Hulshart v. Commissioner* [Dec. 21,192(M)], T.C. Memo. 1955-231.

The court is reconsidering the case because it was determined there was a 25 omission, and now the taxpayer is arguing that they had not been able previously to present evidence of adequate disclosure under §6501(e)(1)(A)(ii). In the most recent opinion, the court explains:

> After our opinion at T.C. Memo. 2004-272, petitioners filed a motion for reconsideration. Petitioners now for the first time argue that the prior opinion did not provide a basis to resolve the question of whether petitioners Burton O. and Elizabeth C. Benson (the Bensons) disclosed the understatements of gross income on their returns. Petitioners argue that their failure to make this argument before our previous opinion was due to the complexities of the way the case was presented and briefed. On March 10, 2005, we granted petitioners' motion for reconsideration of findings and opinion pursuant to Rule 161 with respect to the application of section 6501(e).

General Rule

§6501(e)(1)(A) provides an extended six year period to assess tax under the following circumstances:

> **6501(e)(1)(A) GENERAL RULE.** --If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph --
>
> **6501(e)(1)(A)(i)** 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; and

> **6501(e)(1)(A)(ii)** In 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.

The Benson Case

Now we get to the application of these provisions to the disclosures on the Benson's returns.

The point of this provision is simple—taxpayers are to be "punished" for attempting to conceal the existence of a the potential for the IRS to challenge an item that is not reported on the return. As those of us trained in accounting and auditing were made aware back in our coursework years ago, finding that which is not in the documents but should be there is generally much more difficult than uncovering a problem with something that is there. The key question becomes what is disclosure in a manner adequate to apprise the Secretary of the nature and amount of the item in question.

As the Tax Court notes:

> The purpose of extending the period of limitations under section 6501(e) is to level the playing field when the taxpayer' omission of income places the Commissioner at a disadvantage in discovering errors. *Colony, Inc. v. Commissioner*, 357 U.S. 28, 36 (1958). Interpreting a prior version of section 6501(e), the Supreme Court stated that Congress extended the period of limitations to allow the Commissioner additional time "to investigate tax returns in cases where, because of a taxpayer' omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item." Id. To adequately apprise the Commissioner, "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. Commissioner*, 88 T.C. 1020, 1023 (1987). While a taxpayer' disclosure must be more substantial than supplying the Commissioner with "a 'clue' which would be sufficient to intrigue a Sherlock Holmes", the disclosure need not recite every underlying fact. *Quick' Trust v. Commissioner*, 54 T.C. 1336, 1347 (1970), *affd*. 444 F.2d 90 (8th Cir. 1971). Although a misleading statement may provide a "clue" to omitted gross income, it does not adequately apprise the Commissioner of the nature and amount of an item. *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968); *Estate of Fry v.*

> *Commissioner*, supra.

The disclosure can include a reference to certain other returns:

> When taxpayers' individual returns contain references to other documents or returns, those references provide a clue or serve as notice to the Commissioner. Reuter v. Commissioner [Dec. 42,536(M)], 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. Commissioner*, 991 F.2d 657, 661 (10th Cir. 1993), *affg*. T.C. Memo. 1991-552; see also Hoffman v. Commissioner, supra at 147. Similarly, when taxpayers' returns include 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*, supra at 135; see also *Roschuni v. Commissioner*, supra.

However, for the Bensons the return in question was their C corporation return—not a return that would have flowed through to their personal return. The Bensons were arguing that since the issue at hand was, in their view, a "reallocation" of income from the corporation to the individual, the corporate return disclosure should have given them protection. The court disagreed noting:

> Neither section 6501(e)(1)(A)(ii) nor the caselaw interpreting that section requires respondent to examine the corporate returns of ERG in search of "clues" that disclose income. The Bensons have not cited any authority to support their contention that the returns of a taxable subchapter C corporation serve as an adjunct to an individual taxpayer' return for purposes of section 6501(e)(1)(A)(ii). Instead, the Bensons rely on *Benderoff v. United States*, 398 F.2d 132 (8th Cir. 1968), and *Roschuni v. Commissioner*, 44 T.C. 80 (1965), which involve the returns of subchapter S corporations. This Court has explained that the returns of subchapter S corporations and partnerships should be examined in conjunction with the individual taxpayer' return because these entities are passthrough entities. See *Harlan v. Commissioner*, 116 T.C. at 54 ("when the taxpayers' tax returns stated taxable income from partnerships or S corporations, we declared that the information returns of these pass-through entities would be treated as adjuncts to, and part of, the taxpayers' tax returns"); *Roschuni v. Commissioner*, supra at 85-86. As a subchapter C corporation, ERG is a taxable entity, it does not have the passthrough aspects of an S corporation, and it files income tax returns, not information returns. Therefore, the rationale for treating the returns of passthrough entities as adjuncts to an individual' returns is not present in the case of a subchapter C corporation' income tax return. Respondent was not required to

> examine the returns of ERG, a subchapter C corporation, to determine whether the Bensons disclosed items of gross income.

This presents an issue where there has been a "shifting" of income among related entities, something taxpayers are known to do for various reasons.

Amended returns also fail to work to solve a case where the original return did not have adequate disclosure. As the court notes:

> In section 6501(e)(1)(A), the word "return" does not include amended returns. See *Houston v. Commissioner*, 38 T.C. 486, 489 (1962); *Goldring v. Commissioner*, 20 T.C. 79, 81 (1953) (interpreting similar language in section 275(c), the predecessor to section 6501(e)). The period of limitations starts to run with the filing of the original return, and the filing of an amended return does not affect the period of limitations. *Insulglass Corp. v. Commissioner*, 84 T.C. at 207; *Goldring v. Commissioner*, supra at 82.

In the Benson's case, they had amended an S corporation return and claimed the amended return had adequate disclosure. The court noted "Amended returns do not correct the omission of income from an original return. *Houston v. Commissioner*, supra; *Goldring v. Commissioner*, supra. Section 6501(e)(1)(A)(ii) requires respondent to examine only the Bensons' original returns and the original returns of the passthrough entities listed on their returns. Any "clues" to omitted gross income on the amended returns of NPI will not prevent the 6-year period of limitations of section 6501(e) from applying to the Bensons' 1989, 1990, 1993, and 1994 tax years."

A disclosure that is misleading will not be sufficient to apprise the IRS of the existence of an issue, and this was a problem with the disclosure of related party royalties on the S corporation return was misleading and defective. The court noted:

> We find that the disclosures of royalties on NPI' returns were misleading. The returns of NPI failed to disclose that it received the royalties from a related corporation, ERG, or that Burton Benson acted on behalf of both corporations involved in the transaction. The returns of NPI failed to disclose that ERG sold patent rights to NPI and simultaneously licensed those rights back from NPI in the exclusive licensing agreement. Also, the "royalties" label listed on the returns of NPI was misleading and inadequate to apprise respondent that the transactions constituted a tax planning tool completely lacking in economic substance. Because the royalties disclosures in the returns of NPI were misleading, they fail to satisfy section 6501(e)(1)(A)(ii).

The court continues on to discuss payments for "engineering services" that were at issue

as well:

> Similarly, the Bensons argue that the NPI returns disclosed engineering services paid by ERG to NPI. In our prior opinion, we found:
>
> ERG transferred millions of dollars to NPI for payment of supposed "engineering services". However, there is no evidence of what services Burton performed on behalf of NPI other than his testimony that he provided ERG with engineering "know how". No third party testified as to what Burton specifically did. There is no evidence of how much time he devoted to this endeavor and whether the amounts charged were reasonable and customary. In fact, we infer from the evidence that in conjunction with the exclusive licensing agreement, the label "engineering services" was created to achieve Burton' goal of having ERG show a consistent paper profit of approximately $75,000. * * *
>
> After reviewing the NPI returns, we find that these returns lack any specific reference to engineering services. Additionally, like the royalties that NPI purportedly received from ERG, we find that any characterization of the ERG transfers to NPI as payments for engineering services was misleading. Burton Benson caused ERG to make these transfers to NPI for the purpose of maintaining ERG' profits at $75,000. He used the "engineering services" explanation to justify these payments. We find that this label does not reflect the true nature of these transfers. For purposes of section 6501(e)(1)(A)(ii), we hold that the NPI returns failed to adequately disclose the nature and amounts of these transfers.

The court takes note of the “goal” of maintaining the C corporation at a $75,000 profit level through the use of these payments for vaguely defined services.

Similarly, the court had problems with disclosure involving rents when the returns provided no clue that the rental income paid was in excess of the amounts the tenant was legally obligated to make:

> We found that the Lowell rent payments constituted constructive dividends to the Bensons because ERG made payments that it had no contractual obligation to make. We further found that the payment of "rents" by ERG constituted constructive dividends to the Bensons. The returns of NPI do not provide any clues that suggest that ERG' payments for the Lowell plant exceeded ERG' legal obligation to make those payments. These disclosures did not adequately reveal the nature of these transfers. Therefore, we hold that the Bensons failed to disclose the constructive dividends received in the form of purported rent payments for the Lowell plant.

> While the returns of NPI disclosed the receipt of rent for the Stanford plant, these disclosures were misleading because they did not inform respondent that the payments exceeded ERG' contractual rent obligation. In Benson v. Commissioner, supra, we stated:
>
> The maximum monthly lease amount listed in the unbundling agreement apparently reflected the product of an arm'-length negotiation between the two warring brothers. Under these circumstances, this is the best indication of the intent of the parties and the value of the use of the property at that time. * * * [Fn. ref. omitted.]
>
> The actual payments exceeded the monthly lease payments as agreed upon in the unbundling agreement. We think that the disclosure of the rental payments is misleading because an examiner would expect that these payments reflected the monthly payments agreed to during the arm'-length negotiation. Nothing in the returns of NPI informed respondent that NPI received rent payments from ERG that exceeded the amounts that the parties agreed upon in the unbundling agreement. We hold that the Bensons did not adequately apprise respondent of the nature of these transactions for purposes of section 6501(e)(1)(A)(ii).

Conclusions

Tax practitioners involved in the preparation of returns have a potential trap here, one rendered more dangerous during the rush to finalize returns before a deadline (like the one rapidly approaching). Clients are naturally reluctant to lay out the roadmap for a potential IRS challenge on the return itself. However, the matter could involve a potential understatement of income issue under §6501(e)(1)(A), preparers need to warn clients of the risks of leaving the disclosure off the return.

What you have is a trade-off between the risk of the disclosure triggering a battle that would not have taken place had the disclosure not been there, a battle that even if the taxpayer prevails will be an expensive and stressful undertaking, vs. the risk that an agent down the road raises the issue and then opens up six years for assessment under the mechanical application of §6501(e)(1)(A) in the absence of disclosure.

And, as the Benson court made clear, brief titles for line items on a return are not generally going to count as adequate disclosure, especially when the real challenge will be on whether those items are really what they purported to be. As well, if items come from related parties, that fact is generally going to be considered a relevant issue for purposes of adequate disclosure.

As well, the original Benson case is instructive as a warning about the dangers involved when you have related entities and an attempt to “manage” income among those

entities. Advisers may have forgotten about the potential application of §6501(e)(1)(A) to open up years based on the understatement of gross income that may arguably result from such transactions. In this case, many of the payments were reclassified as deemed dividends to the shareholder when they were disallowed as payments. Such deemed dividends were "omitted income" for these purposes (and, coindentally, the court ruled that you couldn't "look through" the S corporation for gross income when doing your totals).