T.C. Memo. 1985-15

Disclosure on a tax return is sufficient to avoid the extended six-year statute of limitations for substantial omissions of income only if it adequately apprises the IRS of the nature and amount of the omitted item; misleading or incomplete disclosures do not suffice.

Summary

In *Fry v. Commissioner*, the Tax Court addressed whether the taxpayer's disclosure of a stock sale on his tax return was sufficient to prevent the application of the six-year statute of limitations for substantial omissions of income. Fry, a CPA and shareholder, sold stock back to his closely held corporation in a redemption transaction. On his tax return, he described it as a sale of stock but failed to disclose it was a redemption or that part of the payment was in the form of property. The IRS audited beyond the typical three-year limit but within six years, asserting a deficiency based on a significantly higher valuation of the property received. The Tax Court held that Fry's disclosure was insufficient and misleading because it did not adequately apprise the IRS of the nature of the transaction, particularly its character as a redemption from a related party and the non-cash consideration, thus the six-year statute of limitations applied.

Facts

William F.L. Fry, a CPA and shareholder of Smith Land & Improvement Corp. (Land), sold his stock back to Land in a redemption transaction. On his 1976 tax return, Fry reported the transaction as a sale of stock, stating a selling price of $1,150,000, with $150,000 received in 1976. However, the $150,000 payment was in the form of a parcel of land, not cash, and the return did not explicitly disclose that the transaction was a redemption from the corporation. The IRS later determined the land was worth significantly more than $150,000, leading to a notice of deficiency issued more than three years after the return was filed but within six years.

Procedural History

The taxpayers petitioned the Tax Court challenging the deficiency notice as untimely, arguing the three-year statute of limitations had expired. The IRS contended the six-year statute of limitations under Section 6501(e)(1)(A) of the Internal Revenue Code applied due to a substantial omission of income and that the disclosure on the return was inadequate to trigger the exception under Section 6501(e)(1)(A)(ii). The case came before the Tax Court on the taxpayers' motion for partial summary judgment regarding the statute of limitations issue.

Issue(s)

1. Whether the disclosure on the taxpayer's 1976 income tax return regarding the

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stock sale was “adequate to apprise the Secretary of the nature and amount of such item” omitted from gross income, as provided in Section 6501(e)(1)(A)(ii) of the Internal Revenue Code.

Holding

1. No. The Tax Court held that the disclosure was not adequate because it was misleading and did not sufficiently inform the IRS of the nature of the transaction as a stock redemption from a closely held corporation, nor did it clearly indicate that the initial payment was in property rather than cash. Therefore, the six-year statute of limitations applied because the exception for adequate disclosure was not met.

Court’s Reasoning

The Tax Court relied on *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), emphasizing that the purpose of the six-year statute of limitations is to address situations where “the return on its face provides no clue to the existence of the omitted item.” The court stated the disclosure must be sufficiently detailed to alert the Commissioner to the nature of the transaction, enabling a “reasonably informed” decision on whether to audit. The court found Fry’s disclosure insufficient and misleading because it described a “sale” without indicating it was a redemption from a related corporation. The court reasoned:

“In the instant case, the statement clearly shows the receipt of $150,000 in 1976 and describes the transaction as a sale. We think it reasonable for an examining agent to have assumed that this payment was made in cash, rather than in property, and that it was received in a sale of the shares of stock from an unrelated person. The schedule failed to show that the transaction was a redemption; i.e., a payment to a shareholder or that the payment was in fact a transfer of real property valued at $150,000. Any transaction between a corporation and one of its two equal shareholders warrants special scrutiny. Also distributions in redemption of stock may have dividend consequences (sections 301 and 302) and may involve the attribution rules of section 318. Therefore, disclosure of a redemption transaction by a closely held corporation is a significant audit clue, and describing such a transaction as a cash sale presumably to an unrelated party is materially misleading.”

The court concluded that taxpayers seeking to benefit from the disclosure exception must be transparent and not misleading in their return statements.

Practical Implications

Fry v. Commissioner underscores the importance of full and accurate disclosure on tax returns, especially concerning transactions with related parties and non-cash consideration. For tax practitioners, this case serves as a reminder that simply mentioning an item is not enough to trigger the adequate disclosure exception to the

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six-year statute of limitations. Disclosures must be sufficiently detailed and clear to reasonably apprise the IRS of the nature and amount of potentially omitted income. Describing a stock redemption as a simple “sale,” particularly without disclosing payment in property, can be considered misleading and will not protect taxpayers from the extended statute of limitations. This case informs tax return preparation by emphasizing the need to clearly identify related-party transactions, specify the nature of consideration received, and avoid ambiguity that could mislead the IRS during an audit selection process.

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