Harlan v. Commissioner, T.C. Memo. 2002-28

For the purpose of applying the extended 6-year statute of limitations under Section 6501(e)(1)(A) for substantial omission of gross income, the "gross income stated in the return" includes a taxpayer's share of gross income from second-tier partnerships, in addition to first-tier partnerships.

Summary

The Tax Court addressed whether the 6-year statute of limitations for substantial omission of gross income applies when a taxpayer's income is derived from tiered partnerships. The IRS argued that only the gross income from first-tier partnerships should be considered when calculating the "gross income stated in the return." The court held that the "gross income stated in the return" includes the taxpayer's share of gross income from both first-tier and second-tier partnerships. This decision allows for a more comprehensive view of a taxpayer's gross income for statute of limitations purposes when partnership structures are involved, preventing premature closure of audits where income is indirectly held.

Facts

1. Petitioners Harlan and Ockels were partners in first-tier partnerships.
2. These first-tier partnerships were, in turn, partners in second-tier partnerships.
3. On their 1985 tax returns, Petitioners reported income from the first-tier partnerships but did not explicitly include gross income from the second-tier partnerships.
4. The IRS issued notices of deficiency to Petitioners for 1985 more than three years, but less than six years, after they filed their returns, asserting a substantial omission of gross income due to stock conversion income.
5. The IRS sought to apply the 6-year statute of limitations under Section 6501(e)(1)(A), which applies if a taxpayer omits more than 25% of the gross income stated in their return.
6. Petitioners argued that the omitted income was less than 25% of their stated gross income if second-tier partnership gross income is included in the calculation of "gross income stated in the return."

Procedural History

1. The IRS issued notices of deficiency to Petitioners Harlan and Ockels for the 1985 tax year.
2. Petitioners contested the deficiencies in Tax Court, raising the statute of limitations as an affirmative defense.
3. The cases were severed for opinion on the issue of whether gross income from second-tier partnerships should be included in the "gross income stated in the return" for purposes of the extended statute of limitations.
4. The issue was submitted fully stipulated to the Tax Court.

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Issue(s)

1. Whether, in applying the 6-year period of limitations under Section 6501(e)(1)(A), the phrase "gross income stated in the return" includes a taxpayer's distributive share of gross income from second-tier partnerships, when the taxpayer receives income from a first-tier partnership that is a partner in a second-tier partnership.

Holding

1. Yes. The "gross income stated in the return" for purposes of Section 6501(e)(1)(A) includes the taxpayer's share of gross income from second-tier partnerships, in addition to first-tier partnerships, because the information returns of both tiers are considered adjuncts to the individual partner's return.

Court's Reasoning

– The court reasoned that the statutory language "gross income stated in the return" is not explicitly defined in the Code for partnership scenarios.
– Prior case law has established that for first-tier partnerships, the partnership information return (Form 1065) is considered an adjunct to the individual partner's return when determining "gross income stated in the return." Cases like *Davenport v. Commissioner* and *Rose v. Commissioner* support this principle.
– The court extended this logic to second-tier partnerships, stating, "Every explanation that has been drawn to our attention, or that we have discovered, as to why we must treat the properly identified first-tier partnership's information return as part of the taxpayer's tax return applies with equal force to treating the properly identified second-tier partnership's information return as part of the first-tier partnership's information return."
– The court rejected the IRS's argument that considering second-tier partnership income would create an excessive administrative burden. The court noted that the IRS already examines first-tier partnership returns and extending this to second-tier partnerships does not represent a fundamentally different or unmanageable burden in principle.
– The court emphasized the purpose of Section 6501(e) is to provide the IRS with sufficient time to audit returns with substantial omissions of gross income. Limiting the "gross income stated in the return" to only first-tier partnership income would frustrate this purpose in complex partnership structures.
– The court quoted *Estate of Klein v. Commissioner*, 537 F.2d at 704, stating that gross income is not "stated in the return" in the case of a taxpayer with partnership income unless one looks at the partnership return as being a part of the personal income tax return.

Practical Implications

– This case clarifies that when determining whether the extended 6-year statute of limitations applies to partners, the IRS and taxpayers must consider gross income

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from all tiers of partnerships, not just first-tier partnerships.
– Legal professionals should ensure that when advising clients on statute of limitations issues involving partnerships, especially tiered partnerships, the calculation of "gross income stated in the return" includes income from all partnership levels.
– This decision prevents the statute of limitations from prematurely barring audits in cases where taxpayers have structured their businesses through multiple layers of partnerships, ensuring the IRS has adequate time to review complex returns.
– It reinforces the principle that partnership information returns are integral to the individual partner's tax return for purposes of determining "gross income stated in the return" under Section 6501(e)(1)(A).
– Later cases will likely cite *Harlan* to support the inclusion of income from pass-through entities beyond just the immediately connected entity when calculating the denominator for the 25% omission test.

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