Harlan v. Commissioner, 116 T. C. 31 (2001)

In Harlan v. Commissioner, the U. S. Tax Court ruled that second-tier partnership income must be included in calculating the gross income stated on a taxpayer's return for the purpose of the six-year statute of limitations under IRC §6501(e)(1)(A). This decision expands the scope of information considered part of a taxpayer's return, impacting how the IRS and taxpayers assess the timeliness of deficiency notices.

Parties

Ridge L. Harlan and Marjory C. Harlan, and Theodore S. Ockels and Rosemarie G. Ockels, as petitioners, were the taxpayers. The Commissioner of Internal Revenue was the respondent. The case involved multiple tiers of partnerships, with the Harlans and Ockels as direct partners in first-tier partnerships and indirectly connected to second-tier partnerships through their first-tier partnerships.

Facts

The Harlans and Ockels were partners in various partnerships, some of which were themselves partners in other partnerships, creating a multi-tiered partnership structure. The Commissioner issued notices of deficiency in 1992 for the tax year 1985, which was beyond the three-year statute of limitations but within the six-year period allowed under IRC §6501(e)(1)(A) if more than 25% of gross income was omitted from the taxpayers' returns. The taxpayers argued that the gross income stated on their returns should include the gross income from second-tier partnerships, which would reduce the percentage of omitted income below the 25% threshold, thereby applying the shorter three-year statute of limitations.

Procedural History

The taxpayers filed their 1985 tax returns in 1986. The Commissioner issued notices of deficiency in 1992. The taxpayers contested the timeliness of these notices, arguing the applicability of the three-year statute of limitations. The Tax Court reviewed the case under a de novo standard to determine whether the six-year statute of limitations applied based on the inclusion of second-tier partnership income in the calculation of gross income stated on the taxpayers' returns.

Issue(s)

Whether, in determining the amount of "gross income stated in the return" under IRC §6501(e)(1)(A), the information returns of second-tier partnerships must be treated as adjuncts to, and parts of, the information returns of first-tier partnerships, which in turn are treated as adjuncts to, and parts of, the taxpayer's tax return?

Rule(s) of Law

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IRC §6501(e)(1)(A) extends the statute of limitations from three to six years if the taxpayer omits from gross income an amount properly includible that is in excess of 25% of the amount of gross income stated in the return. The gross income of a partner includes their distributive share of the partnership's gross income under IRC §702(c). Treas. Reg. §1. 702-1(c)(2) further explains that in determining the applicability of the six-year statute of limitations, a partner's gross income includes their distributive share of partnership gross income as described in IRC §6501(e)(1)(A)(i).

Holding

Yes, because the Court held that the information returns of second-tier partnerships must be treated as adjuncts to, and parts of, the information returns of first-tier partnerships, which in turn are treated as adjuncts to, and parts of, the taxpayer's tax return, thereby including the second-tier partnership's gross income in the denominator of the 25% calculation under IRC §6501(e)(1)(A).

Reasoning

The Court reasoned that the taxpayer's return does not typically state gross income directly, requiring the consideration of attached schedules and partnership returns. The Court established that partnership returns are treated as adjuncts to the taxpayer's return for the purpose of determining gross income under IRC §6501(e)(1)(A). The same logic applies to second-tier partnerships, as their information returns are necessary to fully determine the gross income of first-tier partnerships, which are then included in the taxpayer's gross income calculation. The Court rejected the Commissioner's argument that considering second-tier partnerships would impose an excessive administrative burden, as the record did not support this claim and the principle of treating partnership returns as part of the taxpayer's return had been established for first-tier partnerships without such concerns. The Court also noted that the statutory and regulatory texts did not explicitly address second-tier partnerships but found that the established practice of looking through to partnership income logically extended to second-tier partnerships.

Disposition

The Tax Court held that the information returns of second-tier partnerships must be included in determining the gross income stated on the taxpayer's return for purposes of IRC §6501(e)(1)(A). This holding was to be incorporated into the final decision of the case once all other issues were resolved.

Significance/Impact

The Harlan decision expands the scope of what constitutes the gross income stated on a taxpayer's return for statute of limitations purposes, particularly in the context

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of multi-tiered partnerships. It requires the IRS to consider income from second-tier partnerships when determining the applicability of the six-year statute of limitations, potentially affecting the timeliness of deficiency notices in complex partnership structures. This ruling aligns with the principle that partnership income flows through to partners and should be considered when calculating their gross income for tax purposes. Subsequent courts have applied this decision in similar contexts, and it has implications for tax planning and compliance in partnerships with multiple tiers.

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