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# ONLY TIME WILL TELL: THE GROWING IMPORTANCE OF THE STATUTE OF LIMITATIONS IN AN ERA OF SOPHISTICATED INTERNATIONAL TAX STRUCTURING

*Hale E. Sheppard\**

## I. INTRODUCTION

When pondering sexy legal issues, it is doubtful that tax law crosses the minds of many. It is also safe to assume that, even if one were to consider tax *law* intriguing, issues centered on tax *procedure* would not pique a great deal of interest. However, with the recent proliferation of complex international tax-avoidance schemes, attention to tax law in general, and tax procedure in particular, is on the rise.

Several issues have emerged from this increased focus on tax procedure, including the significance of the statute of limitations for assessing tax. There are two main problems in this area. First, due to the large amount of entities and transactions involved in many of the burgeoning tax-avoidance schemes, the U.S. Internal Revenue Service (IRS) has significant problems simply catching taxpayers who participate in such ploys. Second, even if the IRS manages to catch the non-compliant taxpayers, it has difficulty doing so in time to assess the tax.

Part II of this Article provides a general overview of a typical tax-avoidance scheme characterized by the use of multiple foreign entities and convoluted transactions among related parties. Part III then explains the considerable efforts made thus far by the U.S. government to identify abusive tax arrangements and the taxpayers who take advantage of them. Part IV describes the general three-year limit for assessing tax and the special six-year limit in cases where the taxpayer “omits” a substantial amount of income from her tax return. Part IV analyzes judicial interpretations of what constitutes “adequate dis-

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closure” of income by a taxpayer, placing particular emphasis on the willingness of certain courts to review individual tax returns in conjunction with returns of related entities. Based on the standards gleaned from relevant case law, this Article concludes in Part V that, despite all of its past and present efforts to combat abusive tax schemes, the U.S. government may continue to incur significant problems catching non-compliant taxpayers in time to assess the tax.

## II. DESCRIPTION OF A TYPICAL TAX-AVOIDANCE SCHEME

A typical tax-avoidance scheme involves the use of multiple flow-through entities such as partnerships and trusts.<sup>1</sup> Generally speaking, a “flow-through entity” is not a taxable entity itself; rather, it serves as a conduit through which its income, gains, losses, deductions, etc. pass directly through to its owners. Each owner then reports her share of the entity’s income on her individual tax return (Form 1040) and is taxed accordingly.

According to the IRS, many tax schemes in use today are highly complex and entail “multi-layer transactions for the purpose of concealing the true nature and ownership of taxable income and/or assets.”<sup>2</sup> In other words, instead of simply not reporting income to the IRS (which would raise red flags immediately), a taxpayer may create numerous entities and then cause such entities to enter into a multiplicity of transactions with each other in order to obfuscate the fact that the taxpayer is the true recipient of the income and should be taxed as such. Certain tax experts explain that this phenomenon of entity tiering, especially in the international context, presents a major obstacle for the IRS:

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1. See, e.g., PUB. NO. 4310, TAX FRAUD ALERT: ABUSIVE TAX SCHEMES 1 (2004) [hereinafter ABUSIVE TAX SCHEMES I], at <http://www.irs.gov/pub/irs-pdf/p4310.pdf> I.R.S.; ABUSIVE TRUST TAX EVASION SCHEMES [hereinafter ABUSIVE TRUST TAX EVASION SCHEMES], at <http://www.irs.gov/businesses/small/article/0,,id=106535,00.html>; Martin E. Needle et al., *Prosecution of Abusive Trust Cases*, U.S. ATT’YS BULL., July 2001, at 19–24, available at [http://www.usdoj.gov/usao/eousa/foia\\_reading\\_room/usab4904.pdf](http://www.usdoj.gov/usao/eousa/foia_reading_room/usab4904.pdf); I.R.S., *Certain Trust Arrangements*, 1997-16 I.R.B. 6 (R.14.52) [hereinafter *Certain Trust Arrangements*], available at <http://www.irs.gov/pub/irs-irbs/irb97-16.pdf>.

2. ABUSIVE TRUST TAX EVASION SCHEMES, *supra* note 1, at 1.

This may require the IRS to undertake the arduous task of poring through each of the tiered entities in order to find out what it needs to know about the lower-tier entity . . . This is not necessarily different from what happens domestically, but the work gets harder when the tiers of corporations cross national boundaries or consist of different types of entities created under foreign law, and information may not be readily available from all the entities involved, even if they are ultimately U.S.-owned.<sup>3</sup>

An abusive tax scheme ordinarily begins with a series of domestic trusts, which are designed to create the appearance that the taxpayer has relinquished her business to the trusts and, therefore, no longer has control over it. In reality, the taxpayer continues to indirectly control the business (and the income derived from that business) through strategically-placed trustees or through other entities that the taxpayer controls in some fashion.<sup>4</sup>

Common structures employed by taxpayers include the “business trust,” the “equipment trust,” and the “service trust.”<sup>5</sup> In simplified terms, the taxpayer first signs various documents that supposedly serve to transfer her business to a business trust.<sup>6</sup> The equipment trust then purports to lease equipment to the business trust at inflated rates.<sup>7</sup> Similarly, the service trust claims to supply the business trust with various services in exchange for sizable fees.<sup>8</sup> The business trust then takes hefty tax deductions for these alleged business expenses paid to the equipment trust and the service trust.<sup>9</sup> As a result, the an-

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3. THE CRISIS IN TAX ADMINISTRATION 45 (Henry J. Aaron & Joel Slemrod eds., 2004).

4. See, e.g., ABUSIVE TRUST TAX EVASION SCHEMES, *supra* note 1; Needle et al., *supra* note 1, at 19–24; *Certain Trust Arrangements*, *supra* note 1.

5. ABUSIVE TRUST TAX EVASION SCHEMES: FACTS (SECTION III) (2004) [hereinafter TRUST TAX EVASION SCHEMES: FACTS], available at <http://www.irs.gov/businesses/small/article/0,,id+106539,00.html> (last visited Feb. 17, 2005).

6. See I.R.S. CRIMINAL INVESTIGATION, TAX FRAUD ALERT, ABUSIVE TAX SCHEMES 1 (2004) [hereinafter I.R.S. CRIMINAL INVESTIGATION], available at [http://www.irs.gov/pub/irs-utl/abusive\\_tax\\_schemes.pdf](http://www.irs.gov/pub/irs-utl/abusive_tax_schemes.pdf) (last visited Feb. 17, 2005).

7. *Id.*

8. See, e.g., TRUST TAX EVASION SCHEMES: FACTS, *supra* note 5.

9. I.R.S. CRIMINAL INVESTIGATION, *supra* note 6, at 2.

nual income of the business trust is virtually eliminated, and its tax liability drops accordingly.<sup>10</sup>

Next, the equipment trust and the service trust transfer their income to another trust, which is established in a foreign country that imposes little or no income tax and has strong financial secrecy laws, i.e., a tax haven. This foreign trust subsequently distributes most or all of its income to a second foreign trust. Shortly thereafter, the second foreign trust opens a bank account and/or a securities-trading account in the tax haven and deposits the income. At the time the foreign accounts are opened, the taxpayer (often in the name of the second foreign trust) is issued a credit card. The funds located in the tax haven accounts earn tax-free interest, dividends and capital gains. When the taxpayer desires to access these offshore funds, she simply uses the credit card to withdraw cash or to make payments anywhere in the world. The records of such account activity are strictly maintained in the tax haven.<sup>11</sup>

### III. PROBLEM NUMBER ONE: CATCHING NON-COMPLIANT TAXPAYERS

The efforts by the U.S. government to identify abusive foreign tax schemes and taxpayers who participate in them have been laudable. For example, Congress has held at least four separate hearings in recent years to explore diverse aspects of abusive tax schemes.<sup>12</sup> These hearings featured lengthy testimony and written submissions by a variety of persons, including officials from the U.S. Treasury Department and the IRS, taxpayers

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10. *Id.*

11. *Id.*

12. See, e.g., *Tax Shelter—Who's Buying, Who's Selling, & What's the Government Doing About It?: Hearing before the U.S. Senate Comm. on Finance*, 108th Cong. (2003) [hereinafter *Who's Buying, Who's Selling?*], available at <http://finance.senate.gov/sitepages/hearing102103.htm>; *Schemes, Scams & Cons: The IRS Strikes Back: Hearing before the U.S. Senate Comm. on Finance*, 107th Cong. (2002) [hereinafter *Schemes, Scams & Cons*], available at <http://finance.senate.gov/sitepages/hearing041102.htm>; *Corporate Tax Shelters—Looking Under the Roof: Hearing before the U.S. Senate Comm. on Finance*, 107th Cong. (2002) [hereinafter *Looking Under the Roof*], available at <http://finance.senate.gov/sitepages/hearing032102.htm>; *Taxpayer Beware—Schemes, Scams & Cons: Hearing before the U.S. Senate Comm. on Finance*, 107th Cong. (2001) [hereinafter *Taxpayer Beware*], available at <http://finance.senate.gov/73551.pdf>.

who participated in abusive tax schemes, former scheme promoters, academics, and tax attorneys.<sup>13</sup> Congress has further collaborated by examining during the last few years various legislative proposals addressing tax shelters.<sup>14</sup> The titles of many of these bills, such as the Abusive Tax Shelter Shutdown and Taxpayer Accountability Act, leave little ambiguity as to their purpose.<sup>15</sup>

Assorted governmental agencies such as the well-respected U.S. Government Accounting Office (GAO) have joined the cause by issuing reports analyzing the actions taken thus far to combat abusive tax schemes and identifying the challenges that still remain.<sup>16</sup> For its part, the U.S. Treasury Department is in the process of reforming Circular 230, which contains the rules governing the practice of attorneys, accountants, enrolled agents, and others before the IRS.<sup>17</sup> If all goes as planned, the revised Circular 230 will severely limit a taxpayer's ability to avoid penalties for participating in certain tax schemes since all

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13. See, e.g., *Who's Buying, Who's Selling?*, *supra* note 12; *Schemes, Scams & Cons*, *supra* note 12; *Looking Under the Roof*, *supra* note 12; *Taxpayer Beware*, *supra* note 12.

14. See, e.g., American Jobs Creation Act, H.R. 4520, 108th Cong. (2004), available at <http://thomas.loc.gov/cgi-bin/query/C?c108:/temp/~c1081c0vdl>; Tax Shelter Transparency and Enforcement Act, S. 1937, 108th Cong. (2003), available at <http://thomas.loc.gov/cgi-bin/query/C?c108:/temp/~c108Hune6u>; Jumpstart Our Business Strength Act, S. 1637, 108th Cong. (2003), available at <http://thomas.loc.gov/cgi-bin/query/C?c108:/temp/~c10821RMzO>; Abusive Tax Shelter Shutdown and Taxpayer Accountability Act, H.R. 1555, 108th Cong. (2003) [hereinafter Abusive Tax Shelter Shutdown and Taxpayer Accountability Act], available at <http://thomas.loc.gov/cgi-bin/query/C?c108:/temp/~c108S49HOJ>; American Competitiveness and Corporate Accountability Act, H.R. 5095, 107th Cong. (2002), available at <http://thomas.loc.gov/cgi-bin/query/D?c107:6:/temp/~c107hnF76L>; Tax Shelter Transparency Act, S. 2498, 107th Cong. (2002), available at H.R. 1555, available at <http://thomas.loc.gov/cgi-bin/query/D?c107:1:/temp/~c1076tBzP4>.

15. See generally Abusive Tax Shelter Shutdown and Taxpayer Accountability Act (articulating Congressional goals of preventing abusive tax shelters).

16. U.S. Gen. Accounting Office, *Challenges Remain in Combating Abusive Tax Schemes*, GAO-04-50 (Nov. 2003) (report to the Chairman and Ranking Minority Member, U.S. Senate Comm. on Finance) at 10–12 [hereinafter *Challenges Remain in Combating Abusive Tax Schemes*], available at <http://www.gao.gov/new.items/d0450.pdf>.

17. Regulations Governing Practices Before the Internal Revenue Service, 68 Fed. Reg. 75186-91 (Dec. 30, 2003) (to be codified at 31 C.F.R. pt. 10).

tax practitioners will be required to disclose whether they have certain types of compensation arrangements or referral agreements with any person who is engaged in promoting, marketing or recommending a particular tax scheme.<sup>18</sup>

The U.S. Department of Justice (DOJ) has also contributed by convincing courts to issue “John Doe” summonses to Visa International, American Express and MasterCard to acquire information regarding the identities and financial activities of U.S. taxpayers holding credit cards issued by banks in tax havens such as Antigua, Barbuda, the Bahamas, and the Cayman Islands.<sup>19</sup> Displaying its characteristic tenacity, the DOJ next directed its attention toward businesses where taxpayers used offshore credit cards and persuaded federal courts to allow the DOJ to serve John Doe summonses on more than 100 businesses, including airlines, hotels, car rental companies, and Internet retailers.<sup>20</sup> Further, the DOJ has initiated numerous legal actions to obtain lists of taxpayers who participated in potentially abusive tax schemes marketed by accountants,<sup>21</sup> law firms,<sup>22</sup> and banks.<sup>23</sup> The DOJ has also taken considerable steps to halt those who promote abusive tax schemes.<sup>24</sup> In terms of

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18. *Id.* For a detailed description of a variety of efforts made by the U.S. Treasury Department to combat abusive tax practices, see *Looking Under the Roof*, *supra* note 12 (statement of Mark A. Weinberger, Assistant Secretary of the Treasury for Tax Policy).

19. *IRS Issues Chronology on Credit Card Tax-Avoidance Schemes, John Doe Summonses*, TAX NOTES TODAY 10–12 (Jan. 15, 2003). See also *Challenges Remain in Combating Abusive Tax Schemes*, *supra* note 16, at 10–12.

20. *Id.*

21. See, e.g., *United States v. KPMG*, 316 F. Supp. 2d 30 (D.D.C. 2004); *United States v. BDO Seidman*, 2004 U.S. Dist. LEXIS 12145 (N.D. Ill. June 28, 2004); *United States v. Arthur Andersen*, 273 F. Supp. 2d 955 (N.D. Ill. 2003); *Justice Releases Documents in Grant Thornton Action – Petition for John Doe Summons for ESOP Information*, TAX NOTES TODAY, Nov. 5, 2003, at 7–8.

22. See, e.g., *United States v. Sidley Austin Brown & Wood*, No. 03 C 9355, 2004 U.S. Dist. LEXIS 6452 (N.D. Ill. Apr. 15, 2004); *United States v. Jenkens & Gilchrist*, No. 03 C 5693, 2004 U.S. Dist. LEXIS 6919 (N.D. Ill. Apr. 20, 2004).

23. See, e.g., *Doe v. Wachovia Corp.*, 268 F. Supp. 2d 627 (W.D.N.C. 2003).

24. See, e.g., *United States v. Cohen*, 222 F.R.D. 642 (W.D. Wash. 2004); *United States v. Stephenson*, 313 F. Supp. 2d 1054 (W.D. Wash. 2004); *United States v. Kahn*, 304 F. Supp. 2d 1353 (M.D. Fla. 2004); *United States v. Scott*, No. 4:03-CV-1410-A, 2004 U.S. Dist. LEXIS 2221 (N.D. Tex. Jan. 29, 2004);

numbers, in 2003 the DOJ filed 35 lawsuits, 28 of which resulted in injunctions.<sup>25</sup>

Other efforts to thwart abusive foreign tax schemes do not involve brandishing the tax-enforcement stick; rather, they offer cooperative taxpayers a carrot for their “voluntary” compliance. In particular, the IRS has recently introduced several tax-amnesty programs to induce non-compliant taxpayers to come forward in return for leniency from the IRS and the DOJ with respect to interest and penalties. Among these programs are the Offshore Voluntary Compliance Initiative,<sup>26</sup> the Last Chance Compliance Initiative,<sup>27</sup> and the Son of Boss Settlement Initiative.<sup>28</sup>

Enlisting state tax authorities is another technique employed by the U.S. government to foil abusive tax schemes. In September 2003, the IRS and nearly all 50 states signed a Memorandum of Understanding aimed at detecting and penalizing U.S. taxpayers involved in abusive tax avoidance transactions (ATAT Partnership).<sup>29</sup> Under the ATAT Partnership, the IRS and state tax authorities agreed to periodically exchange lists of participants in ATATs, share audit results from ATAT cases, inform one another regarding newly-discovered ATATs, jointly

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United States v. Graham, 92 A.F.R.R.2d (RIA) 7447 (S.D. Ohio Nov. 19, 2003); United States v. Sweet, 89 A.F.R.R.2d (RIA) 2189 (M.D. Fla. Feb. 20, 2002).

25. See Press Release, U.S. Dep’t of Justice, *Justice Department Notes Increase in Tax Enforcement—Civil and Criminal Enforcement Against Tax Cheats on the Rise* (Apr. 2004), available at [http://www.justice.gov/opa/pr/2004/April/04\\_tax\\_213.htm](http://www.justice.gov/opa/pr/2004/April/04_tax_213.htm).

26. See generally Rev. Proc. 2003-11, 2003-1 C.B. 311 (describes Offshore Voluntary Compliance Initiative).

27. See Thomas W. Ostrander, *The Offshore Credit Card and Financial Arrangement Probe: Fraught with Danger with Danger for Taxpayers*, 99 JOURNAL OF TAXATION 114 (2003) (explaining and distinguishing the Offshore Voluntary Compliance Initiative and the Last Chance Compliance Initiative); Steven Toscher & Michael R. Stein, *FBAR Enforcement is Coming!*, 5 JOURNAL OF TAX PRACTICE & PROCEDURE 27 (Dec. 2003–Jan. 2004) (describing the Last Chance Compliance Initiative and the potential hazards for those taxpayers participating in it).

28. See generally IRS Announcement 2004-46, 2004-21 I.R.B. 964, available at [http://www.irs.gov/irb/2004-21\\_IRB/ar19.html](http://www.irs.gov/irb/2004-21_IRB/ar19.html) (describing Son of Boss Settlement Initiative).

29. See IRS SB/SE Releases *Memo of Understanding on Abusive Transactions*, TAX NOTES TODAY, Sept. 17, 2003, at 180. See also *Federal and State Tax Authorities Initiate Partnership to Combat Tax Shelters: Pledge More Information Sharing*, IR-2003-111, Stand. Fed. Tax Rep. (CCH) 90(43) (2003).



participate in ongoing ATAT training and other educational activities, appoint members to the cross-functional ATAT council, and initiate communications on an as-needed basis in order to facilitate the purposes of the ATAT Partnership.<sup>30</sup> Based on the success of this federal-state alliance during the early stages, the IRS and the states expanded the ATAT Partnership in June 2004 by introducing three new joint initiatives: (i) the State Income Tax Reverse Filing Match, under which the IRS will compare the information provided by taxpayers on state income tax returns with federal data to identify non-filers and those taxpayers underreporting their income; (ii) the Federal-State Offshore Payment Card Matching Initiative, which contemplates increased use of state databases by the IRS to identify taxpayers who have participated in offshore credit/debit card abuses; and (iii) the Title 31 Money Servicing Businesses Memorandum of Understanding that establishes a framework for the federal-state information exchange to increase compliance by particular businesses in the financial services industry.<sup>31</sup>

In addition to acquiring the help of state tax authorities, the U.S. government has also procured assistance from other nations in its quest to eradicate abusive foreign tax schemes. Since 2001, the U.S. Treasury Department has entered into tax information exchange agreements with the Cayman Islands, Antigua and Barbuda, the Bahamas, the British Virgin Islands, the Netherlands Antilles, Guernsey, the Isle of Man, and Jersey.<sup>32</sup> In addition, the United States recently entered into an agreement with Switzerland under the existing bilateral income tax treaty to facilitate a more effective exchange of tax-related data between the two nations.<sup>33</sup> The United States is also in the

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30. See *IRS SB/SE Releases Memo of Understanding on Abusive Transactions*, *supra* note 29.

31. See, e.g., IRS, *IRS and State Partnership Moves Forward to Improve Compliance and Service*, IR-2004-77 (June 9, 2004), at <http://www.irs.gov/newsroom/article/0,,id=123817,00.html>; *IRS Announces Partnership with States Producing Early Results*, TAX NOTES TODAY, June 8, 2004, at 110-23; Allen Kenney, *IRS Commissioner: Service to Increase Information Sharing with States*, 2004 STATE TAX TODAY, June 9, 2004, at 111-13.

32. *Challenges Remain in Combating Abusive Tax Schemes*, *supra* note 16, at 12 n.4.

33. *U.S.-Switzerland Information Exchange Agreement*, TAX NOTES TODAY, Jan. 28, 2003, at 14-16.

process of negotiating tax information exchange agreements with several other nations, including Belize, El Salvador, Nicaragua and Panama.<sup>34</sup>

Finally, adhering to the time-honored theory that an ounce of prevention is worth a pound of cure, the IRS has recently released several publications designed to inform taxpayers of the nefarious nature of certain tax schemes. Among these publications are "Should Your Financial Portfolio Include Too-Good-to-be-True Trusts?,"<sup>35</sup> "Is It Too Good to Be True? Recognizing Illegal Tax Avoidance Schemes,"<sup>36</sup> and "Do You Have a Foreign Bank Account?"<sup>37</sup>

Despite these efforts, the U.S. government has encountered significant difficulties in reaching one of its primary goals in the tax arena; simply stated, the relevant authorities have discovered that catching non-compliant taxpayers is extremely challenging. According to a study by the General Accounting Office (GAO), the IRS recently estimated that approximately 740,000 taxpayers had participated in various abusive tax-avoidance schemes which resulted in a loss to the U.S. government of between \$20 billion and \$40 billion in tax revenue.<sup>38</sup> A separate report by the U.S. Treasury Department suggests that participation may even be more widespread. Indeed, it calculates that as many as one million taxpayers have unreported foreign bank accounts.<sup>39</sup>

The current situation is troubling and several factors indicate that it may get worse. For instance, the situation is exacerbated by the fact that abusive tax schemes are constantly evol-

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34. John Venuti et al., *Current Status of U.S. Tax Treaties and International Tax Agreements*, 33 TAX MGMT. INT'L J. 533, 538 (2004).

35. I.R.S. PUB. NO. 2193, SHOULD YOUR FINANCIAL PORTFOLIO INCLUDE TOO GOOD TO BE TRUE TRUSTS? (2002), available at <http://www.irs.gov/pub/irs-pdf/p2193.pdf> (last visited Feb. 3, 2005).

36. I.R.S. PUB. NO. 3995, IS IT TOO GOOD TO BE TRUE? RECOGNIZING ILLEGAL TAX AVOIDANCE SCHEMES (2003), available at <http://www.irs.gov/pub/irs-pdf/p3995.pdf> (last visited Feb. 3, 2005).

37. I.R.S. PUB. NO. 4261, DO YOU HAVE A FOREIGN BANK ACCOUNT? (2004), available at <http://www.irs.gov/pub/irs-pdf/p4261.pdf> (last visited Feb. 3, 2005).

38. *Challenges Remain in Combating Abusive Tax Schemes*, supra note 16, at 1.

39. U.S. Treasury Dep't, *A Report to Congress in Accordance with §361(b) of the USA Patriot Act*, 2002 TAX NOTES TODAY, April 26, 2002, at 84.

ing. In the words of one IRS official, “scheme promoters try to stay in the business of tax avoidance; when one type of scheme is discovered and addressed, another scheme will take its place.”<sup>40</sup> The task of catching those taxpayers involved in abusive foreign tax schemes is also hindered because the IRS has experienced troubles allocating its limited resources. A recent GAO study recognizes that the IRS has begun to shift its resources to address abusive tax schemes, but warns that “how future resources will actually be used remains to be seen [and] the future volume of cases [the] IRS will need to examine and the rate at which [the] IRS will be able to close examinations are unclear.”<sup>41</sup> Others are more alarmist and claim that “tax legislation, globalization, financial innovation, and budgetary parsimony have combined” to create a “crisis in tax administration.”<sup>42</sup>

#### IV. PROBLEM NUMBER TWO: CATCHING NON-COMPLIANT TAXPAYERS IN TIME

The preceding section establishes that, in spite of the commendable efforts by diverse segments of the U.S. government, catching taxpayers involved in abusive tax schemes has proven to be enormously challenging. Much has been written on this difficulty and it needs no further elaboration here.<sup>43</sup> However, legal analysis of a related problem is surprisingly scarce. Few articles or cases address an issue that is inextricably related to the first; that is, even if the IRS manages to catch a non-compliant taxpayer, can it do so in time to assess the tax? As explained in detail below, this is a formidable task in the case of modern tax-avoidance schemes that involve submitting to the IRS numerous tax and information returns regarding multi-layer entities engaged in multi-party transactions in an attempt to obfuscate the true source, amount and/or owner of the income.

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40. *Challenges Remain in Combating Abusive Tax Schemes*, *supra* note 16, at 6.

41. *Id.* at 19.

42. THE CRISIS IN TAX ADMINISTRATION 2, *supra* note 3, at 2.

43. See, e.g., Hale E. Sheppard, *You Can Catch More Flies with Honey: Debunking the Theory in the Context of International Tax Enforcement*, THE TAX MAGAZINE 29 (2005), available at <http://tax.cchgroup.com/primesrc/bin/highwire.dll>.

*A. The Statute of Limitations for Assessing Tax*

Section 6501(a) provides the general rule that the IRS has three years from the date that a taxpayer files a return to assess a tax related to that return.<sup>44</sup> If the IRS reviews a return and believes that the taxpayer owes additional amounts, then it ordinarily “assesses” the tax by issuing a notice of deficiency to the taxpayer. There are several exceptions to the general three-year rule. For example, Section 6501(e)(1)(A) provides that if a taxpayer “omits” from gross income an amount that should have been included and the amount “omitted” exceeds 25 percent of gross income that the taxpayer actually reported on her tax return, then the IRS may assess tax at any time within six years after the taxpayer files the return.<sup>45</sup> In other words, if there is a “substantial omission” of gross income from the tax return, then the time frame during which the IRS may assess tax increases from *three* years to *six* years. A key issue, therefore, is whether income is “omitted.”

The amount of income a taxpayer omitted under Section 6501(e)(1)(A)(ii) does not include the amount that is disclosed either on the tax return itself or in a statement attached to the return in a manner that is “adequate to apprise the [IRS] of the nature and amount of such item.”<sup>46</sup> Likewise, regulations under Section 6501 provide that an item of income shall not be considered omitted if information that is “sufficient to apprise the [IRS] of the nature and amount of such item is disclosed in the return or in any schedule or statement attached to the return.”<sup>47</sup>

In summary, if the taxpayer adequately discloses particular items of income to the IRS either directly on her tax return or on any schedule or statement attached to the tax return, then the taxpayer has not “omitted” such income. It follows that if the taxpayer has not “omitted” these items from gross income, then the six-year assessment period under Section 6501(e) does

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44. Unless otherwise stated, all references in this article to “Section” are to the Internal Revenue Code of 1986, as amended. Section 6501(a) clarifies that the tax must be assessed within three years after the taxpayer files the return, regardless of whether the return was filed on or after the filing deadline. I.R.C. § 6501(a) (2000).

45. Section 61(a) generally defines the term “gross income” as “all income from whatever source derived.” I.R.C. § 61(a).

46. § 6501(e)(1)(A)(ii).

47. Treas. Reg. § 301.6501(e)-1(a)(1)(ii) (2001).

not apply, and the IRS must assess tax by issuing a notice of deficiency within three years after the taxpayer files her tax return. If the IRS fails to do so, it may permanently lose the opportunity to collect this tax revenue.<sup>48</sup> The magnitude of this matter has not escaped certain tax practitioners, who explain that

[t]he significance of the SOL [statute of limitations] as an issue cannot be overemphasized. It may provide a complete and total victory to the taxpayer if the IRS violates it. Its importance is evident by the fact that it can be raised at any time prior to . . . a decision on the merits in a litigated case. Consequently, one should consider the SOL's applicability in each and every case.<sup>49</sup>

### B. *Judicial Interpretation of Adequate Disclosure*

Whether a taxpayer's disclosure is adequate has been addressed in numerous cases and certain general standards have developed. The following sections address these standards.

#### 1. The Taxpayer Must Give the IRS a "Sufficient Clue"

In *Colony v. Commissioner*,<sup>50</sup> the sole issue was whether the ordinary three-year statute of limitations or the five-year statute of limitations applied under Section 275(c) (the predecessor to Section 6501(e)).<sup>51</sup> In reaching its decision, the court made the following statement, which has become the benchmark in cases applying Section 6501(e):

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48. Under Section 6501(c)(1), the IRS may assess tax at any time (i.e., there is no statute of limitations) where a taxpayer submits a "false or fraudulent" return with the "intent to evade tax." I.R.C. § 6501(c)(1). Likewise, Section 6501(c)(2) provides that the IRS may assess tax at any time in the case of a "willful attempt in any manner to defeat or evade tax." I.R.C. § 6501(c)(2). From a practical point of view, meeting the civil fraud or tax evasion exception is often difficult for the IRS since it must prove that the taxpayer intended to engage in tax evasion. Meeting this standard may entail the challenging task of providing sufficient evidence to demonstrate that a taxpayer acted in "bad faith" and with a "sinister motive." See, e.g., *Payne v. Commissioner*, 224 F.3d 415 (5th Cir. 2000); *Neely v. Commissioner*, 116 T.C. 79 (2001).

49. EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE "NEW" IRS 1240 (Jerome Borison ed., 3d ed. 2004).

50. See generally *Colony v. Commissioner*, 357 U.S. 28 (1958) (court articulated "sufficient clue" requirement for Section 6501(e)).

51. See *id.*

We think that in enacting § 275(c) Congress manifested no broader purpose than to give the [IRS] an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the [IRS] 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.*<sup>52</sup>

This “clue” standard was subsequently refined in *Quick Trust v. Commissioner*,<sup>53</sup> where the court found that the taxpayer had adequately disclosed a particular item of income to the IRS, explaining that

[t]he touchstone in cases of this type is whether [the IRS] has been furnished with a “clue” to the existence of the error. Concededly, this does not mean simply a “clue” which would be sufficient to intrigue a Sherlock Holmes. But neither does it mean a detailed revelation of each and every underlying fact.<sup>54</sup>

## 2. The Taxpayer Must Not Be Stingy or Misleading

Satisfying *Colony* and *Quick Trust* may appear relatively undemanding at first glance; however, courts have clarified that supplying a sufficient “clue” requires the taxpayer to exhibit a certain degree of forthrightness.

*Estate of Fry v. Commissioner*<sup>55</sup> addressed whether the information provided in Schedule D to the taxpayers' Form 1040 apprised the IRS of the nature and amount of an item of income. The taxpayers' Schedule D, on which a taxpayer reports her capital gains and losses, showed that the taxpayer received \$150,000 in a transaction described as “a sale.” Based on this description, the court held that a reasonable IRS examiner would have assumed that the payment in question was made in cash and that the transaction involved a sale of stock to an un-

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52. *Id.* at 36–37 (emphasis added). *But see* CC&F Western Operations v. Comm'r, 273 F.3d 402 (2001) (criticizing the broad interpretation of *Colony* in several U.S. Tax Court decisions).

53. *See generally* *Quick Trust v. Commissioner*, 54 T.C. 1336 (1970) (court refined “clue” standard).

54. *Id.* at 1347 (citations omitted).

55. *See generally* *Estate of Fry v. Commissioner*, 88 T.C. 1020 (1987) (court held that taxpayer's description of transaction as cash sale on Schedule D was materially misleading).

related party.<sup>56</sup> Schedule D failed to show that the transaction actually involved the exchange of stock for property (rather than for cash) and that it was a stock redemption (rather than a stock sale).<sup>57</sup> The court stated that any transaction between a closely-held corporation and one of its shareholders necessitates special scrutiny.<sup>58</sup> Moreover, explained the court, a stock redemption may require determining which amounts constitute “dividends” and may involve the stock attribution rules.<sup>59</sup> As a result, the court held that the taxpayer’s description of the transaction on Schedule D as a cash sale, presumably to an unrelated party, was “materially misleading” and insufficient disclosure for purposes of Section 6501(e).<sup>60</sup>

The courts also demanded a certain degree of candor from taxpayers in earlier cases. For instance, in *Thomas v. Commissioner*,<sup>61</sup> the taxpayers were waiters and waitresses who failed to maintain formal records regarding their tip income. After auditing their tax returns for the 1963-1965 tax years, the IRS issued a notice of deficiency in March 1970.<sup>62</sup> The taxpayers argued that the tax assessment was barred because the three-year limit under Section 6501(a) had expired.<sup>63</sup> The IRS, on the other hand, argued that the notice of deficiency was timely because the six-year limit under Section 6501(e) governed.<sup>64</sup> The taxpayers argued that (i) they described their occupations as waiters/waitresses on their Forms 1040, (ii) they reported their tips in “round figures,” and (iii) it was common knowledge that tip income was frequently understated.<sup>65</sup> The court summarily dismissed the taxpayers’ arguments, labeling them “too slim a justification.”<sup>66</sup> As for the contention that there is adequate disclosure if merely the type (and not the amount) of income is re-

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56. *Id.* at 1023.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *See generally* *Thomas v. Commissioner*, T.C.M. (P-H) 1973-261 (court declined to include description of type of income within adequate disclosure required by Section 6501).

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

vealed on Form 1040, the court explained that accepting this position would “emasculate” Section 6501, and thus refused to do so.<sup>67</sup>

### 3. The Taxpayer Cannot Solely Rely on Disclosures by Others

In addition to determining that taxpayers who are miserly or misleading in their disclosures are not entitled to benefit from the shorter three-year limit under Section 6501(a), the courts have held that a taxpayer cannot depend entirely on disclosures made by third parties.

In *Hess v. United States*,<sup>68</sup> the taxpayers timely filed Forms 1040 for the 1983 and 1984 tax years and left most lines blank or stating “\$0.” The IRS later determined that the taxpayers’ gross income was approximately \$56,000 in 1983 and \$64,000 in 1984.<sup>69</sup> Therefore, the IRS issued a notice of deficiency in June 1988, more than three years after the taxpayers filed the relevant returns.<sup>70</sup> The taxpayers argued that the IRS notice was untimely because the three-year period under Section 6501(a) had expired.<sup>71</sup> The IRS, not surprisingly, claimed that the assessment period remained open because the six-year period under Section 6501(e) applied.<sup>72</sup>

The court recognized that the taxpayers presented the “rather ingenious argument” that a tax return should consist not only of Form 1040 and the schedules attached thereto, but also of all the information provided by others “on behalf of, or with respect to” a taxpayer.<sup>73</sup> Under Section 6103(b)(1), the term “return” is defined as “any tax or information return . . . which is filed with the [IRS] by, or on behalf of, or with respect to any person, and any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return.”<sup>74</sup> Following this logic, the taxpayers

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67. *Id.*

68. *See generally* *Hess v. United States*, 785 F. Supp. 137 (E.D. Wash. 1991) (court declined to expand Section 6501’s definition of “return” to include information provided by others on behalf of taxpayers).

69. *Id.* at 138.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.* at 139.

74. 26 U.S.C.A. §6103(b)(1).



claimed that Form W-2 (which an employer is required to provide to the IRS annually to report the wages it paid to, and the taxes it withheld from, each of its employees), Form 1099 (which certain institutions are required to provide to the IRS annually to report the interest, dividends, etc. earned by each of their investors), and other information-returns all become part of the taxpayers' return.<sup>75</sup> Since the taxpayers' employers filed the necessary Forms W-2 and their banks filed the mandatory Forms 1099, the taxpayers maintained that the IRS had been given "adequate disclosure."<sup>76</sup>

The court rejected the taxpayers' argument and declined to apply Section 6103. In particular, the court explained that the prefatory language in Section 6103(b)(1) clearly states that the definition of "return" set forth therein is for purposes of Section 6103 only.<sup>77</sup> The court concluded that if it were to hold otherwise "no one would ever be required to file a return at all so long as employers and banks submitted information returns on the taxpayer's behalf."<sup>78</sup>

A few years later, the U.S. Tax Court again recognized the principle that a taxpayer cannot depend entirely on disclosures about the taxpayer made by third parties. In *Edelson v. Commissioner*,<sup>79</sup> the taxpayer and her husband lived in California, which is a community property state.<sup>80</sup> The husband was a longstanding tax protester, as a result of which the IRS maintained special files on him.<sup>81</sup> During the tax years at issue, the taxpayer timely filed her Form 1040, but she failed to report her share of the community income earned by her husband.<sup>82</sup> For each year in question, the amount that the taxpayer omitted from her Form 1040 far exceeded 25 percent of gross income

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75. See *Hess*, 785 F. Supp. at 139.

76. *Id.* at 137.

77. §6103(b)(1).

78. *Hess*, 785 F. Supp. at 139.

79. See generally *Edelson v. Commissioner*, 66 T.C.M. (CCH) 1210 (1993) (court held that Section 6501 requires taxpayers to disclose on tax returns or attached statements).

80. *Id.* For an explanation of the tax effects of living in a community property state, see PUB. NO. 555, COMMUNITY PROPERTY (2002), available at <http://www.irs.gov/pub/irs-pdf/p555.pdf> (last visited Mar. 6, 2005).

81. *Edelson*, 66 T.C.M. 1210.

82. *Id.*

that she actually reported.<sup>83</sup> The IRS issued a notice of deficiency.<sup>84</sup>

The taxpayer argued that the notice of deficiency was invalid since it was issued more than three years after she submitted her Form 1040.<sup>85</sup> The taxpayer contended, in essence, that the three-year limit under Section 6501(a) should apply because the IRS already had in its possession information related to her husband's income.<sup>86</sup> Specifically, she emphasized the fact that the IRS maintained special files concerning her husband due to his tax-protestor status and received Forms W-2 from her husband's employer reporting his income.<sup>87</sup> The court quickly rebuffed the taxpayer's assertion by explaining that Section 6501 and its corresponding regulations require that the disclosure be made on the tax return itself or on a statement attached to the return.<sup>88</sup> The court concluded that "[t]he possibility or even the fact that information may have been furnished to [the IRS] in connection with other returns is not enough to comply with these explicit requirements."<sup>89</sup>

#### 4. The Taxpayer Cannot Benefit from the Toil of the IRS

Logic dictates that if the courts are unwilling to allow a taxpayer to rely on the efforts of third parties to satisfy the disclosure requirement in Section 6501(e), then they would be loath to allow a taxpayer to benefit from the labors of the IRS. This principle has been verified in several cases, among them *Insulglass v. Commissioner*.<sup>90</sup> In this case, the taxpayers omitted substantial amounts of income from their Forms 1040 for the 1976 and 1977 tax years.<sup>91</sup> The IRS initiated an audit of the taxpayers and discovered these omissions before the three-year

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83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *See generally* *Insulglass v. Commissioner*, 84 T.C. 203 (1985) (court held that Section 6501 expressly refers to amount disclosed in return or statement attached to return).

91. *Id.* at 205.

limit under Section 6501(a) had expired.<sup>92</sup> These discoveries notwithstanding, the IRS did not issue a notice of deficiency until April 2003, nearly six years after the taxpayers had filed Form 1040 for the 1976 tax year.<sup>93</sup>

In their defense, the taxpayers contended that the six-year limit was inapplicable because the rationale behind enacting Section 6501(e) was to give the IRS additional time to investigate tax returns in situations where a taxpayer's omission places the IRS at a disadvantage in detecting errors.<sup>94</sup> Since the IRS discovered the substantial omissions during an audit before the three-year limit had expired, the taxpayers claimed that the IRS was not placed at a disadvantage and thus did not need an additional three-year period to assess the tax.<sup>95</sup> Noting the fact that the taxpayers failed to cite any cases in support of their position, the court reviewed the language of Section 6501(e) and concluded that it expressly refers to an amount disclosed in the return or in a statement attached to the return.<sup>96</sup> It does not, held the court, mention the knowledge of omitted income that an IRS agent obtains during an audit.<sup>97</sup>

#### 5. Individual Returns Considered Together with Other Returns

As explained above, flow-through entities are not taxable entities; rather, they serve as conduits through which their income, gains, losses, deductions, etc. pass directly through to their owners.<sup>98</sup> Each owner then reports her share of the entity's income on her individual tax return (i.e., Form 1040) and is taxed accordingly.<sup>99</sup> As flow-through entities, partnerships, S corporations and trusts generally pass any income that they earn directly through to their owners, that is, to the partners,

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92. *Id.* at 206.

93. *Id.*

94. *Id.*

95. *Id.* at 207.

96. *Id.*

97. *Id.*

98. Peter R. Orszag, *Small Businesses and Flow Through Entities*, TAX NOTES, Apr. 12, 2004, at 239, available at [http://taxpolicycenter.org/UploadedPDF/1000637\\_TaxFacts\\_041204.pdf](http://taxpolicycenter.org/UploadedPDF/1000637_TaxFacts_041204.pdf) (last visited March 6, 2005).

99. *Id.* See also ABUSIVE TRUST TAX EVASION SCHEMES: FACTS (SECTION II) [hereinafter ABUSIVE TRUST TAX EVASION SCHEMES II], available at <http://www.irs.gov/businesses/small/article/0,,id+106538,00.html> (last visited Feb. 17, 2005).

the shareholders, or the beneficiaries, as the case may be.<sup>100</sup> Although these entities are not taxed, they are required to comply with certain IRS filing requirements: a partnership files Form 1065 (U.S. Return of Partnership Income), an S corporation files Form 1120-S (U.S. Income Tax Return for an S Corporation), and a trust files Form 1041 (U.S. Income Tax Return for Estates and Trusts).<sup>101</sup> Among other things, each of these three forms must describe any income that flowed from the entity to the owner.<sup>102</sup> In this manner, the IRS is able to cross-check the amounts reported (as income received) by the owners of the entities on their Forms 1040 with the amounts reported (as income distributed or allocated) by the entities on their Form 1065, Form 1120-S or Form 1041.

Having a basic understanding of flow-through entities and the relevant IRS forms is important in grasping the significance of the following cases where the courts have been amenable to considering the tax returns of the owners along with the returns of the entities in deciding whether the taxpayer/owner omitted income for purposes of Section 6501(e).

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100. "S Corporations" are incorporated entities whose shareholders file an election with the IRS to be taxed primarily under Subchapter S of Chapter 1 of the Internal Revenue Code (i.e., Sections 1361 to 1379), as opposed to under the normal rules in Subchapter C. For a corporation to be eligible to make an "S" election, it must qualify as a "small business corporation." This means that (i) it must be a domestic corporation, (ii) it must have a limited number of shareholders, (iii) all of the shareholders must be individuals, estates, trusts and/or certain tax-exempt organizations, (iv) none of the shareholders may be nonresident aliens, (v) it has only one class of stock, and (vi) it is not one of several "ineligible corporations." The main tax effect of making an "S" election is that the corporation's income, deductions, gains and losses are generally not subject to tax at the entity level. Rather, these items pass through to the shareholders of the S Corporation, who each report their share of these items on their individual income tax returns, i.e., Forms 1040. See LEANDRA LEDERMAN, UNDERSTANDING CORPORATE TAXATION 179-98 (2002).

101. See, e.g., Instructions for Form 1065, available at <http://www.irs.gov/instructions/i1065/ch01.html#d0e216> (last visited Feb. 17, 2005). See also ABUSIVE TRUST TAX EVASION SCHEMES II, *supra* note 99, at 1.

102. See, e.g., Instructions for Form 1065, *supra* note 101 ("Form 1065 is an information return used to report the income, deductions, gains, losses, etc., from the operation of a partnership. A partnership does not pay tax on its income but "passes through" any profits or losses to its partners. Partners must include partnership items on their tax returns.").

*a. Individual Returns and Partnership Returns*

On several occasions courts have considered Forms 1040 and Forms 1065 together in determining whether the taxpayer, who is a partner in a partnership, made an adequate disclosure under Section 6501(e) of partnership income.

In *Rose v. Commissioner*,<sup>103</sup> the taxpayers received a notice of deficiency more than three years after they filed their Form 1040 for the tax year at issue. The IRS argued that the appropriate statute of limitations was five years under the predecessor to Section 6501(e).<sup>104</sup> The taxpayers, on the other hand, contended that the general three-year statute of limitations was applicable because their Forms 1040 suggested the existence of a partnership return, which, in turn, disclosed the relevant income.<sup>105</sup>

The taxpayers operated two clothing stores, one of which was located in Ventura, California.<sup>106</sup> The court found that the Ventura store was part of the taxpayers' community property and that any income derived from the Ventura store was therefore community income.<sup>107</sup> Accordingly, each of the taxpayers should have reported one-half of the income from the Ventura store on his or her respective Form 1040.<sup>108</sup> Forms 1065 were filed for the Ventura store for the relevant tax years.<sup>109</sup> Each year, one-half of the income reported on the Ventura store's Form 1065 was transferred to each of the taxpayers' Form 1040.<sup>110</sup> Specifically, each Form 1040 expressly reported certain "Income from partnerships."<sup>111</sup> It later turned out that the Ventura store was not actually operating as a partnership.<sup>112</sup>

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103. See generally *Rose v. Commissioner*, 24 T.C. 755 (1955) (IRS attempt to assess tax barred by statute of limitations because one-half of gross income in Form 1065 should have been imputed to Form 1040).

104. *Id.* at 767.

105. *Id.* at 768.

106. *Id.* at 771.

107. *Id.* at 768.

108. *Id.*

109. *Id.* at 769.

110. *Id.*

111. *Id.* at 759.

112. *Id.* at 768.

The IRS argued that the taxpayers had omitted from their Forms 1040 the income derived from the Ventura store.<sup>113</sup> Rejecting this argument, the court held that “we think it is unrealistic to say that the [taxpayers] did not report the gross income from the Ventura store” because they did so on Form 1065.<sup>114</sup> Although no partnership actually existed with respect to the Ventura store, the taxpayers filed Form 1065 for the relevant tax years pursuant to the suggestion of an IRS agent, who informed the taxpayers (albeit incorrectly) that filing Form 1065 would facilitate reporting community income from the Ventura store.<sup>115</sup>

Based on this, the court held that “the so-called partnership return filed for the Ventura store was merely an adjunct to the individual returns of [the taxpayers] and must be considered together with such individual returns and treated as part of them.”<sup>116</sup> Thus, one-half of the gross income appearing in Form 1065 for the Ventura store should have been imputed to the Form 1040 filed by each of the taxpayers in determining the amount of gross income omitted.<sup>117</sup> The court found that when it considered jointly the Ventura store’s Form 1065 and the taxpayers’ Forms 1040 the amount of income omitted was not in excess of 25 percent of the gross income reported.<sup>118</sup> The court therefore held that the IRS’s attempt to assess tax was barred by the three-year statute of limitations.<sup>119</sup>

The courts have reached similar results in several other cases.<sup>120</sup> More importantly, the courts have recently extended

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113. *Id.* at 769.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 770.

120. *See, e.g.,* Estate of Klein v. Commissioner, 537 F.2d 701 (2d Cir. 1976) (“Congress could not have intended that the statute of limitations be extended against a taxpayer when that taxpayer has properly reported all of his items of gross income [y]et that would be the technical result if the partnership return were to be isolated from examination in determining what gross income was ‘disclosed’ in the partner’s return for the purposes of § 6501(e)(1)(A)(ii).”); Davenport v. Commissioner, 48 T.C. 921 (1967) (“[T]his court has recognized that a partnership return is to be considered together with an individual return in determining the total gross income stated in the individual return for the purpose of determining whether the 6-year statute of limitations is appli-

*Rose* to situations involving not just one partnership, but rather multi-layer partnerships. In *Harlan v. Commissioner*,<sup>121</sup> the taxpayers were two couples, the Harlans and the Ockels. The Harlans filed their joint Form 1040 for the 1985 tax year in August 1986.<sup>122</sup> The IRS issued a notice of deficiency to the Harlans regarding the 1985 tax year in June 1992, which was more than three, but fewer than six, years after the Harlans filed their Form 1040.<sup>123</sup>

The Harlans' Form 1040 showed an ordinary loss from several partnerships, which were all identified by name, address, and tax identification number (TIN).<sup>124</sup> During the 1985 tax year, Mr. Harlan was a partner in two multiple-tier partnerships, namely Pacific Real Estate Investors Partnership (Pacific) and Carlyle Real Estate Limited Partnership VI (Carlyle).<sup>125</sup> Pacific was a partner in another partnership.<sup>126</sup> Pacific's Form 1065 showed an ordinary loss from the partnership in which it was a partner, and identified this partnership by name and TIN.<sup>127</sup> Carlyle was a partner in four other partnerships.<sup>128</sup> Carlyle's Form 1065 for the 1985 tax year showed ordinary income from the four partnerships, and identified each partnership by name and TIN.<sup>129</sup>

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cable."); *Hoffman v. Commissioner*, 119 T.C. 140 (2002) ("It is well established in this Court that for purposes of section 6501(e), a taxpayer-partner's return includes the information returns of partnerships of which the taxpayer was a member and that were identified on the taxpayer-partner's return."); *Walker v. Commissioner*, 46 T.C. 630, 637-638 (1966) ("The [IRS] concedes in the stipulation and on brief, and we think properly so, that information contained in the partnership return should be taken into consideration in determining whether any omitted income was disclosed in the return in a manner adequate to apprise [the IRS] of the nature and amount of such item.").

121. See generally *Harlan v. Commissioner*, 116 T.C. 31 (2001) (court held that it must consider other forms, schedules, and statements attached to Form 1065 of first-tier partnerships to determine gross income). The parties to this case agreed that, although the issue raised in this case has existed since 1934 when the predecessor to Section 6501(e) was enacted, this is a matter of first impression. *Id.* at 39.

122. *Id.* at 33.

123. *Id.*

124. *Id.* at 34.

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

The Ockels' Form 1040 for the 1985 tax year showed ordinary income from several partnerships identified by name and TIN.<sup>130</sup> During the 1985 tax year, Mr. Ockels was a partner in one multiple-tier partnership, Mission Resources Development Drilling Program – Belridge II (Mission).<sup>131</sup> Mission was a partner in another partnership.<sup>132</sup> Mission's Form 1065 showed ordinary income from the other partnership, which it identified by name.<sup>133</sup>

The IRS argued that the six-year statute of limitations under Section 6501(e) was applicable because the Harlans and the Ockels omitted from their gross incomes more than 25 percent of the amount of gross income reported.<sup>134</sup> The Harlans and Ockels countered that the normal three-year statute of limitations under Section 6501(a) applied because (i) their Forms 1040 should be treated as having disclosed their shares of gross income that were disclosed on the Forms 1065 of Pacific, Carlyle, and Mission (i.e., the first-tier partnerships) and, (ii) the Forms 1065 of Pacific, Carlyle and Mission should be treated as having disclosed their shares of gross income that were disclosed in the Forms 1065 of the partnerships in which they were partners (i.e., the second-tier partnerships).<sup>135</sup>

The court explained that although the key term in Section 6501(e)(1)(A) is "gross income," a taxpayer does not state this amount anywhere on her Form 1040.<sup>136</sup> Instead, one must review various schedules and statements attached to a taxpayer's Form 1040 to identify the components of gross income.<sup>137</sup> The court then explained that

[i]t has long been accepted that, for these purposes, the information return of the taxpayer's properly identified 1st-tier partnership is treated as part of the taxpayer's tax return. But the 1st-tier partnership's information return suffers from the same "defect" in that we must look through the various forms, etc., attached to the 1st-tier partnership's information

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130. *Id.* at 35.

131. *Id.*

132. *Id.* at 36.

133. *Id.* at 37.

134. *Id.*

135. *Id.* at 37–38.

136. *Id.* at 38.

137. *Id.*



return in order to identify the components of gross income that must be added together in order to determine the total amount of gross income stated in the 1st-tier partnership's information return. *Every explanation that has been drawn to our attention, or that we have discovered, as to why we must treat the properly identified 1st-tier partnership's information return as part of the taxpayer's tax return applies with equal force to treating the properly identified 2d-tier partnership's information return as part of the 1st-tier partnership's information return.*<sup>138</sup>

The court explained that Forms 1065 for the first-tier partnerships for the 1985 tax year did not provide for disclosure of gross income.<sup>139</sup> Forms 1065 contained a line for *total* income, but several components of this amount were *net* figures.<sup>140</sup> In such situations, the court said that it must consider other forms, schedules, and statements that are attached to the Forms 1065 of the first-tier partnerships in order to determine the amount of gross income.<sup>141</sup> This amount, in turn, is necessary to determine the amount of a partner's gross income on Form 1040.<sup>142</sup> Continuing this analysis, the court explained that if the first-tier partnerships' Forms 1065 disclose net income from a second-tier partnership, then the court should consider the second-tier partnership's Form 1065 as merely another document that is an adjunct to, and part of, the partner's Form 1040.<sup>143</sup>

*b. Individual Returns and S Corporation Returns*

Just as the courts have recognized the appropriateness of viewing a partner's Form 1040 in conjunction with the partnership's Form 1065, they have also accepted the need to consider together a shareholder's Form 1040 and the S corporation's Form 1120-S.

The taxpayers in *Roschuni v. Commissioner*<sup>144</sup> were shareholders in an S corporation (Gilbert Hotel). In 1958, Gilbert

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138. *Id.* at 37–38 (emphasis added).

139. *Id.* at 38.

140. *Id.*

141. *Id.*

142. *Id.* at 56.

143. *Id.* at 56–57.

144. *See Roschuni v. Commissioner*, 44 T.C. 80, 81 (1965).

Hotel was sold, which generated significant capital gains. Gilbert Hotel duly filed Form 1120-S for the 1958 tax year and disclosed in a statement attached thereto all the data concerning the sale, including the selling price, adjusted basis for determining gain or loss, expenses, profit, and mortgages assumed by the buyer.<sup>145</sup> Lest there be any ambiguity, the statement was entitled “COMPUTATIONS FOR INSTALLMENT REPORTING OF GAIN ON SALE OF [GILBERT] HOTEL.”<sup>146</sup> The taxpayers duly filed Form 1040 for the 1958 tax year.<sup>147</sup> In Schedule D to Form 1040, the taxpayers reported the capital gain from the property sale and stated “See – Gilbert Hotel, Inc. (Schedule D, Form 1120-S), \$34,190.00”<sup>148</sup> Claiming that the taxpayers had underpaid their taxes, the IRS issued a notice of deficiency for the 1958 tax year. Since this notice was issued more than three years after the taxpayers’ Form 1040 was filed, the taxpayers alleged that the proposed assessment was barred by the three-year statute of limitations under Section 6501(a).<sup>149</sup> The IRS, for its part, argued that the six-year statute of limitations under Section 6501(e)(1)(A) applied because there was a substantial omission from gross income.<sup>150</sup>

The court held that the Schedule D of the taxpayers’ Form 1040, together with the statement attached to Gilbert Hotel’s Form 1120-S, were adequate to apprise the IRS of the nature and amount of the income.<sup>151</sup> In reaching this conclusion, the court explained that

the so-called omitted amount is due entirely to including the gain from the sale of [the property] on a completed basis rather than on the installment basis. All the facts for either basis were shown “in a statement attached to the return” filed by [Gilbert Hotel] and incorporated by reference in [the taxpayers’] individual return.<sup>152</sup>

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145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.* at 84.

149. *Id.* at 83.

150. *Id.* at 82.

151. *Id.* at 84.

152. *Id.*

A similar conclusion was reached in *Benderoff v. United States*.<sup>153</sup> In this case, the taxpayers were shareholders in an S corporation (Benderoff Company), whose taxable year ended on March 31.<sup>154</sup> In May 1959, the Benderoff Company made a distribution of cash to the taxpayers in the amount of \$45,207.<sup>155</sup> The trial court held that the taxpayers should be taxed on this cash distribution.<sup>156</sup> However, since the IRS did not attempt to assess this tax until April 1964, the taxpayers claimed that the IRS was prohibited from doing so because the three-year limit under Section 6501(a) had elapsed.<sup>157</sup> The IRS countered that the six-year limit under Section 6501(e) applied since the cash distribution made in May 1959 was not adequately disclosed.<sup>158</sup>

One of the schedules attached to the taxpayers' Forms 1040 stated the following: "tax option corporation – V.C. Benderoff Co. Inc.," followed by the proper amount of their share of undistributed income from the Benderoff Company.<sup>159</sup> The balance sheet attached to the Benderoff Company's Form 1120-S for the taxable year ended March 31, 1959 showed \$45,207 of undistributed taxable income, which was precisely the amount of cash distributed to the taxpayers in May 1959.<sup>160</sup> The balance sheet attached to Form 1120-S for the following year (i.e., that ending March 31, 1960) showed \$45,207 of undistributed taxable income at the beginning of the year and \$49,782 at the end of the year.<sup>161</sup> The \$49,782 amount was also shown on directly on the Benderoff Company's Form 1120-S as "taxable income."<sup>162</sup>

Based on these disclosures, the court held that it should have been "obvious to a competent examiner" that the only undistributed income that the Benderoff Company had on hand at the end of the tax year ending March 31, 1960 was the income

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153. See generally *Benderoff v. United States*, 398 F.2d 132 (8th Cir. 1968) (court held that taxpayers' Forms 1040, supplemented by Form 1120-S and attached balance sheet, provided the IRS with an adequate clue).

154. *Id.* at 134.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.* at 137.

161. *Id.*

162. *Id.*

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that the corporation earned during that year.<sup>163</sup> Indeed, explained the court, if there was neither an actual distribution of cash to the taxpayers nor an allocation of undistributed income to the taxpayers, then the balance sheet attached to Form 1120-S would have shown the \$45,207 on hand at the beginning of the year, plus the \$49,782 of undistributed income earned during the year, for a total of \$94,990.<sup>164</sup> This was not the case. In holding that the taxpayers' Forms 1040, supplemented by the Benderoff Company's Form 1120-S and the attached balance sheet, provided the IRS with an adequate clue, the court explained that:

[t]he clue provided by the undistributed taxable income item was there for the [IRS] to observe, heed and investigate and a reasonable follow-up on such clue would have confirmed the fact that a distribution had been made of undistributed taxable income in the same manner that such fact was established in the belated investigation.<sup>165</sup>

While *Roschuni* and *Benderoff* demonstrate courts' willingness to concurrently examine Forms 1040 and Forms 1120-S in determining the amount of gross income disclosed by a taxpayer, these holdings have been limited by later cases. For example, in *Taylor v. United States*,<sup>166</sup> the taxpayers timely filed a Form 1040 for the 1961 tax year reporting as income only the wages that they received from working as teachers. One of the taxpayers owned 25 percent of the stock of an S corporation (Huxford). During the tax year at issue, Huxford earned \$100,000 of income, which it properly reported on its Form 1120-S.<sup>167</sup> The taxpayers mistakenly believed that the distributions from Huxford were not reportable as gross income on their Form 1040.<sup>168</sup> Accordingly, their Form 1040 contained no reference to Huxford or the income received from Huxford.<sup>169</sup>

The IRS argued that it was given neither an indication of the existence, nature, or amount of the omitted income nor a refer-

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163. *Id.*

164. *Id.*

165. *Id.*

166. *See Taylor v. United States*, 417 F.2d 991, 992 (5th Cir. 1969).

167. *Id.* at 992.

168. *Id.*

169. *Id.* at 993.

ence to any other source of such information.<sup>170</sup> In response, the taxpayers argued that the information necessary to determine their tax liability was contained in Huxford's Form 1120-S; therefore, there was adequate disclosure.<sup>171</sup> In rejecting the taxpayers' argument, the court stated that the "obvious flaw" in that theory was that the Forms 1040 did not refer to Huxford or to Huxford's Form 1120-S.<sup>172</sup> According to the court, since the taxpayers' Form 1040 contained "no suggestion or inference that relevant information may have been contained elsewhere, it cannot be seriously contended that the 'adequate disclosure' referred to in section 6501(e)(1)(A)(ii) was made."<sup>173</sup>

*c. Individual Returns and Trust Returns*

In an attempt to build on the decisions in earlier cases involving partnerships and S corporations, taxpayers have urged the IRS to examine jointly a beneficiary's Form 1040 and a trust's Form 1041 in deciding whether there was adequate disclosure under Section 6501(e). Although the decisions have been largely unfavorable to taxpayers in these scenarios, they demonstrate that courts are willing to consider the argument.

In *Sampson v. Commissioner*,<sup>174</sup> the taxpayers were husband and wife. During the tax years at issue, the husband provided medical services through a corporation (Corporation).<sup>175</sup> In April 1975, the wife, as the grantor, executed a trust agreement to create a so-called pure equity trust (Trust).<sup>176</sup> The husband, the wife and their two children served as both the trustees and beneficiaries of the Trust during the relevant tax years.<sup>177</sup> Later

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170. *Id.*

171. *Id.* at 994.

172. *Id.* at 993.

173. *Id.* at 994. *See also* Reuter v. Commissioner of Internal Revenue, 51 T.C.M. (CCH) 99 (1985) (holding that "the receipt of a Form W-2 from [the taxpayer], reporting wages paid, from a corporation, without more, does not provide a sufficient clue to the existence of an omission from income.").

174. *See generally* *Sampson v. Commissioner*, 51 T.C.M. (CCH) 1148 (1986) (court held that IRS did not have sufficient clue concerning income and, thus, six-year statute of limitations applied under Section 6501(e)).

175. *Id.*

176. *Id.*

177. *Id.* (court noted that the use of the term "trust" did not necessarily indicate a holding that the trust was a valid trust for either federal tax or state law purposes).

in April 1975, the husband executed an agreement with the Trust, which dictated that the husband would provide medical services to the Trust in exchange for (i) use of the Trust property (including the taxpayers' home), (ii) unlimited use of the Trust telephone, and (iii) use of a leased car for purposes other than Trust business.<sup>178</sup> In September 1975, the Trust executed an agreement with the Corporation, whereby the Trust would furnish the husband's medical services to the Corporation in return for a fee that was essentially equal to the annual income earned by the husband for the Corporation.<sup>179</sup>

The Corporation filed Forms 1120 for the 1975 through 1978 tax years and reported certain deductions for "professional fees," "professional services," and "cost of goods sold."<sup>180</sup> The Corporation did not report any taxable income during these tax years.<sup>181</sup> The Trust filed Forms 1041 for the same years, reporting certain income, deductions, and distributions to the taxpayers and their children.<sup>182</sup> Like the Corporation, the Trust did not report any taxable income.<sup>183</sup> The taxpayers filed joint Forms 1040 for the relevant tax years reporting thereon the income from Trust distributions that matched the amounts shown in the Trust's Forms 1041.<sup>184</sup>

In January 1981, the IRS issued a notice of deficiency to the taxpayers, who argued that the notice was barred for the 1975 and 1976 tax years by the three-year limit under Section 6501(a).<sup>185</sup> The court rejected the taxpayers' argument, holding that

[the taxpayers'] disclosure of the fact of income from the Trust was not sufficient to give [the IRS] a clue as to the existence of additional omitted income. Neither the Trust returns nor [the taxpayers'] individual returns disclosed the fact that [the husband] was purportedly employed by the Trust as an independent contractor. The Trust returns did state that the Trust was engaged in a business, but did not identify which business it

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178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.*

was engaged in. The only hint which [the IRS] had that [the taxpayers] had omitted items of gross income was the fact that [the husband's] profession was listed as osteopath on [the taxpayers'] 1976 income tax return and yet there was no entry for income from salary or wages or trade or business income. We decline to find that this was a sufficient "clue" as to the existence of the omitted income.<sup>186</sup>

Since the IRS did not have a sufficient clue as to the income, the court concluded that the six-year statute of limitations under Section 6501(e) applied, and upheld the notice of deficiency for the 1975 and 1976 tax years.<sup>187</sup>

Courts have entertained similar arguments and rendered comparable decisions in recent cases. In *Connell Business Co. v. Commissioner*,<sup>188</sup> the taxpayers were involved with four trusts: the Connell Business Company, the Connell Vehicle Company, the Connell Vehicle Company #101, and the Connell Family Trust.<sup>189</sup> Each of the four trusts timely filed its Forms 1041 for the 1995, 1996 and 1997 tax years.<sup>190</sup> Forms 1041 for the Connell Business Company, the Connell Vehicle Company, and the Connell Vehicle Company #101 each identified the Connell Family Trust as the beneficiary.<sup>191</sup> The Connell Family Trust's Form 1041, in turn, identified the taxpayers as the beneficiaries and reported distributions of \$6,068 to each of the taxpayers during the 1996 tax year.<sup>192</sup>

The taxpayers timely filed their Form 1040 for the 1995, 1996 and 1997 tax years; however, they made no reference to the four trusts or in any way indicated that they were associated with, beneficiaries of, or recipients of income from, the four trusts.<sup>193</sup> With respect to the \$6,068 of income allocated to each of the taxpayers on the Connell Family Trust's Form 1041, the taxpayers reported that income on Schedule C to their Form 1040

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186. *Id.*

187. *Id.*

188. *See generally* *Connell Business Co. v. Commissioner*, 87 T.C.M. (CCH) 1384 (2004) (court held that taxpayers could not rely on Forms 1041 to demonstrate adequate disclosure under Section 6501(e) because the forms did not refer to trusts).

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

as “gross receipts or sales.”<sup>194</sup> However, Schedule C contained no information suggesting that the Connell Family Trust was the source of that income.<sup>195</sup>

The taxpayers argued that the income they received from the Connell Family Trust was not “omitted” because it was adequately disclosed.<sup>196</sup> Accordingly, the taxpayers claimed that the IRS was barred from assessing deficiencies for the 1995 and 1996 tax years because the three-year limit under Section 6501(a) had passed.<sup>197</sup> The court rejected this argument, holding that the taxpayers could not rely on the Forms 1041 to demonstrate that there was adequate disclosure for purposes of Section 6501(e) because the taxpayers’ Forms 1040 “made no reference” to the four trusts.<sup>198</sup>

#### V. CONCLUSION

The following general rules emerge from the cases examined above. A taxpayer will be deemed to have adequately disclosed an item of income to the IRS if the tax return on its face provides a sufficient “clue.” Providing the requisite clue means that the taxpayer may not be stingy or misleading, but it does not obligate her to make a “detailed revelation of each and every underlying fact.” The taxpayer may not rely solely on disclosures made to the IRS by third parties and may not benefit from the toil of the IRS in cases where an audit uncovers income that the taxpayer previously omitted. Individual tax returns may be considered together with returns of related flow-through entities (such as partnerships, S corporations and trusts) in determining whether the taxpayer omitted a particular item of income, provided that the taxpayer makes a reference to the entity in her Form 1040. This consideration-of-various-returns-at-the-same-time rule also applies in the context of multi-tiered flow-through entities, such as when a taxpayer is a partner in a partnership, which, in turn, is a partner in another partnership.

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194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*



Analyzed in a vacuum, these legal principles may mean little. However, when examined in the context of modern international tax-avoidance schemes, these broad judicial interpretations of Section 6501(e) take on considerable importance. As discussed earlier, many tax schemes utilized today are tremendously complex, involving multiple foreign entities, offshore financial accounts, and related-party transactions. Participants in such structures do not simply fail to report income or refuse to submit returns; rather, they tend to inundate the IRS with numerous tax and information returns in an attempt to muddle the real source, amount and/or owner of the income.

As the IRS gradually identifies more of the estimated one million U.S. taxpayers involved in such schemes, a key issue will be whether the returns filed with respect to the tiered foreign entities and the related-party transactions provide the IRS with a sufficient “clue” as to the income. If so, many taxes may go unassessed due to the three-year limit under Section 6501(a). Based on the standards derived from *Colony*, *Quick Trust*, *Rose*, *Harlan*, *Roschuni*, *Benderoff* and the rest, this prophecy may become a reality. But, only time will tell—literally.