Larry's Tax Law

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part XIII – What Happens to a Shareholder's Return When There Is an Error on the S Corporation Return?

By Larry Brant on 11.13.24 | Posted in Internal Revenue Code, Tax Laws, Tax Planning

Basic Rules

IRC § 6501(a) generally requires the IRS to assess tax within three (3) years after a tax return is filed by the taxpayer.

There are two (2) notable exceptions to this rule under IRC § 6501(c) and (e), namely:

1. Under IRC § 6501(c), an unlimited assessment period exists in the case of a false or fraudulent return where the taxpayer has the intent to evade tax; and
2. Under IRC § 6501(e), a six (6) year period for assessment exists in the case where the taxpayer understates gross income by more than 25 percent, unless there is adequate disclosure on the taxpayer's original tax return.

In the case of a shareholder of an S corporation, the analysis is generally conducted at the shareholder level. In other words, the focus is on the shareholder's tax return, and the issue is whether there is a problem with that return that would extend the limitation period for assessment.

As we know from the basic rules, absent fraud or an undisclosed substantial understatement of gross income, the limitation period for assessment is three (3) years. Likewise, absent fraud, an undisclosed substantial understatement of gross income extends the limitation period for assessment to six (6) years.

Six (6) Year Assessment Period

As stated above, under IRC § 6501(c), a six (6) year period for assessment exists in the case where the taxpayer understates gross income by more than 25 percent, unless there is adequate disclosure on the taxpayer's original tax return. In accordance with IRC § 6501(e)(1)(B)(iii), the amount of omitted gross income (for purposes of the six (6) year assessment period) does not include any amount that "is disclosed on the return, or on a statement attached to the return, in a manner adequate to appraise the Secretary of the nature and amount of such item."

Disclosure is often adequate if the tax return provides evidence of the existence, nature and amount of the omitted income, and the disclosed income would be apparent to a reasonable person. When an individual tax return refers to another tax return, such as an IRS Form 1120S, the information on that return must also be considered when determining whether adequate disclosure exists.

The U.S. Tax Court, in *Manashi v. Commissioner*, T.C. Memo. 2018-106 (2008), recognized the carve-out for amounts of income adequately disclosed on a return and any statement attached to the return, including information disclosed on another return (e.g., IRS Form 1120S) referenced on the return. In *Manashi*, the taxpayers argued that they had provided adequate disclosure to the IRS because the S corporation had reported some (not all) of the gross income that they omitted, and that the corporation's banks and clients likely filed IRS Forms 1099 that should have made the IRS aware of the remainder of the omitted income.

The Tax Court held that the six (6) year statute of limitations for assessment applied because the omitted income was not adequately disclosed to the IRS. The court rejected the taxpayers' assertion that reporting some of the gross income provides adequate disclosure, concluding that reporting some of the gross income provides "no clue" that other income was not reported. The court also flatly rejected the taxpayers' argument that the IRS Forms 1099 filed (or that should have been filed) by banks and clients should have made the IRS aware of the unreported income because those forms, if they were filed, were not attached to the taxpayers' tax returns.

In *Estate of Fry*, 88 T.C. 1020 (1987), the U.S. Tax Court pronounced that, to constitute proper disclosure, "[t]he statement must be sufficiently detailed to alert the [Service] to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one."

The Eighth Circuit in *Benderoff*, 398 F.2d 132 (Eighth Cir. 1968), concluded that "the corporate information return on [IRS] Form 1120S must be considered along with the taxpayers' individual returns in resolving the issue of adequate disclosure." However, if an IRS Form 1120S has not been filed with the IRS at or before the filing of the individual return or the omitted is disclosed on an amended IRS Form 1120S, adequate disclosure will not be considered to have been made.

Further, the U.S. Tax Court in *Insulglass Corp.*, 84 T.C. 203 (1985), ruled in the situation where a late IRS Form 1120S is not filed until after the taxpayer files his or her IRS Form 1040, the late IRS Form 1120S is treated as an amended return and is ignored for purposes of disclosure under IRC § 6501(e).

Affirming the conclusion of the Eighth Circuit, Chief Counsel, in CCA 201333008, pronounced that information on a late-filed IRS Form 1120S, "should be treated like information found in an amended return and disregarded" for purposes of determining the individual's disclosure of income on the timely filed IRS Form 1040, even though the IRS Form 1120S is referenced in the IRS Form 1040. Only the amount of S corporation income reported on the timely filed original corporate return is considered for this purpose. Accordingly, any gross income from the S corporation (as reflected on its late, amended or non-yet filed IRS Form 1120S as of the date of the shareholder's filing) not reported on the face of the shareholder's IRS Form 1040 (or referenced in a document contemporaneously in the IRS's possession) is an omission.

Consequently, when the IRS Form 1120S is not filed until after the shareholder's IRS Form 1040 is filed, a morass of issues follows. In CCA 201333008, the taxpayer filed IRS Form 1040 and reported an amount as his share of an S corporation's income. When the S corporation filed its IRS Form 1120S more than three (3) years later, it reported that the taxpayer's actual share of the S corporation's income was more than 125 percent of the amount reported on the shareholder's IRS Form 1040. The Service concluded that the omitted income was more than 25 percent of actual gross receipts. As discussed above, when an individual's return contains a reference to other documents or returns, it can, in some cases, serve as notice to the IRS sufficient to constitute an adequate disclosure. However, before an IRS Form 1120S can be incorporated by reference into a taxpayer's return, the IRS Form 1120S must exist and be in the IRS's hands. In the case presented in CCA 201333008, the IRS Form 1120S had not been filed when the shareholder filed his return; so, any reference to it was insufficient to constitute adequate disclosure as required by IRC § 6501(e)(1)(B)(iii). Put another way, the information on a late filed IRS Form 1120S is not considered to be disclosed on a shareholder's IRS Form 1040 even if it references the S corporation return.

In the S corporation context, IRC § 6501 generally controls the statute of limitations for assessment relative to the income tax return of the shareholder. Consequently, the statute of limitations under both IRC § 6501(a) (the three-year statute) and IRC § 6501(e) (the six-year statute) commences upon the filing of a shareholder's tax return. That conclusion was a subject of debate.

In numerous cases, taxpayers have challenged when the statute of limitations for assessment commences with respect to the passthrough income of a shareholder from an S corporation. Based upon the U.S. Supreme Court decision in *Bufferd v. Commissioner, 506 U.S. 523 (1993)*, it appears to be well settled that the period for assessment commences upon the shareholder's filing of his or her return, reporting the passthrough income. To the contrary, the filing of the S corporation's IRS Form 1120S does not start the period for assessment with respect to the shareholder's IRS Form 1040 (as it does not contain all of the needed information to compute the shareholder's taxable income).

EXAMPLE 1: Shareholder X is the sole shareholder of ABC, an S corporation. Both ABC and X report for tax purposes on a calendar year basis. For tax year 2020, both X and ABC file their respective tax returns on a timely basis without extension. The IRS audits ABC for tax year 2020 in June 2024. It ultimately determines ABC omitted more than 25 percent of gross receipts. There is no fraud. For X, the omission of the passthrough income understated by ABC does not represent more than 25 percent of his gross receipts for tax year 2020. Because there is no fraud, no substantial understatement, and it is beyond the 3-year period of assessment, in accordance with *Bufferd*, there should be no adjustment to X's 2020 IRS Form 1040.

EXAMPLE 2: Same facts as Example 1, but the audit occurred in June 2023. Since the 3-year statute of limitations for assessment relative to X is open until April 15, 2024, X will be subject to an assessment with respect to his share of the income omitted by ABC.

In determining what constitutes a substantial omission from gross income for purposes of the 6-year statute, the applicable treasury regulations state that a shareholder's gross income includes the shareholder's proportionate share of the S corporation's gross income.

EXAMPLE 3: Shareholder X's proportionate share of the gross income of ABC, an S corporation, is $100,000, and X's proportionate share of ABC's taxable income is $25,000. X, however, only reported on his tax return $10,000 of ABC's taxable income. Accordingly, X is deemed to only have reported $40,000 (40 percent of $100,000) of his proportionate share of ABC's gross income. Assuming no other income items appear on X's IRS Form 1040, he has a substantial omission of gross income under IRC § 6501(e), which triggers the 6-year statute of limitations for assessment. However, if ABC's return was timely filed by the time X filed his return, X could assert that he adequately disclosed the income and that the three-year period of assessment applies.

Fraudulent IRS Form 1120S

If a shareholder of an S corporation, like any taxpayer, files a false or fraudulent tax return with the intent to evade tax, the limitation period for assessment is extended indefinitely.

The issue that follows is whether the period of limitation for assessment at the shareholder level is extended indefinitely when the IRS Form 1120S is fraudulent. The IRS, in Chief Counsel Advice 201238026, addressed this issue.

Chief Counsel, reviewing the case law, concluded the mere act of a shareholder reporting fraudulently understated income from an S corporation on his or her personal return does not automatically make the shareholder guilty of fraud and extend the period of assessment with respect to his or her tax return. Rather, to determine whether an indefinite assessment period under IRC § 6501(c) is appropriate, the Service must examine the activities of the shareholder.

Additionally, in the case of spouses, the fraud of one spouse holds the assessment period open for the other spouse if and only if the spouses file a joint return – not when they file separate returns (provided the separate filing spouse is innocent of the fraud).

Last, if the S corporation's tax return preparer committed the fraud with the intent to evade taxes, such taint automatically carries over to the shareholder. If, however, the preparer did not intend the S corporation and its shareholders to evade taxes (e.g., the preparer made false returns to cover-up his or her embezzlement from the corporation), the taint does <u>not</u> automatically carry through to the shareholder.

The take-aways from CCA 201238026 are as follows:

- A fraudulent IRS Form 1120S does <u>not</u> automatically extend the period of limitations on assessment under IRC § 6501(c)(1) for the personal tax liability of a shareholder who did <u>not</u> participate in the fraud.
- When the taxpayer is the spouse of a shareholder who is a bad actor, and the spouses file their income tax returns separately, the period of limitations on assessment under IRC § 6501(c)(1) for the personal tax liability of the spouse, provided he or she is innocent of the fraud, is <u>not</u> extended;
- When the shareholder is the bad actor, the period of limitations on assessment under IRC § 6501(c)(1) for the personal tax liability of the shareholder is extended;
- When the taxpayer is the spouse of a shareholder who is a bad actor, and the spouses file their income tax returns jointly, the period of limitations on assessment under IRC § 6501 (c)(1) for the personal tax liability of the shareholder and his or her innocent spouse is extended; and

- When the S corporation's return preparer is the bad actor and he or she intended that taxes be evaded, the period of limitations on assessment under IRC § 6501(c)(1) for the personal tax liability of a shareholder is extended.

Absent the last three (3) bullets above, an otherwise innocent shareholder's period of limitations on assessment should not be extended due to a fraudulent S corporation income tax return.

EXAMPLE 1: A and B are the sole shareholders of the AB Corporation, an S corporation. D is the corporation's controller and tax return preparer. He fraudulently prepares and files the corporation's IRS Form 1120S for tax year 2023. D omits income on the return with the goal of hiding his embezzlement from the corporation. A and B are unaware and not involved in the bad act. A and B timely file their IRS Form 1040s for tax year 2023. The statute of limitations for assessment will not be extended relative to A and B's individual 2023 income tax returns.

EXAMPLE 2: Same facts as Example 1, but A is involved in the embezzlement and fraudulently prepared IRS Form 1120S. As long as B is not involved in the bad act and does not file his or her personal income tax returns jointly with A (i.e., A and B are not spouses), the statute of limitations for assessment will not be extended on B's individual 2023 income tax return.

EXAMPLE 3: A is the sole shareholder of X corporation, an S corporation. The corporation's accountant, at the insistence of A, omits a significant amount of income from X's 2023 IRS Form 1120S. A is married and files his 2023 IRS Form 1040 jointly with his spouse. The spouse is aware of the omission of income. The statute of limitations for assessment relative to A and his spouse's 2023 IRS Form 1040 is extended indefinitely due to the fraud of the preparer. A is a bad actor and his spouse is caught in the web as she joined in the filing of a joint 2023 IRS Form 1040.

EXAMPLE 4: Same facts as Example 3, except A's spouse is unaware of the omission of income. Unfortunately, the answer is the same. Because the 2023 IRS Form 1040 is filed jointly by A and his spouse, the period of assessment for the return is extended indefinitely due to the fraud of A.

EXAMPLE 5: Same facts as Example 2, except A's spouse files her 2023 IRS Form 1040 separately from A. The period of assessment on the spouse's 2023 IRS Form 1040 is not extended.

Conclusion

As illustrated by the discussion set forth above, the rules relating to the period of limitation for assessment are not always intuitive. This is especially true in the case of an S corporation and its shareholders.

I hope this Part XIII in my multi-part series on S corporations was enlightening. Stay tuned for more posts in our *Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary*.

Tags: A Journey Through Subchapter S, gross income, income tax, IRS, limitation period for assessment, S corporation, shareholders, tax return fraud