Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: **20082804F**

Release Date: 7/11/08
CC:LM:F:LI:DRMirabito
POSTF-103406-08

Via Regular Mail

date: March 18, 2008

to:

from: Theodore R. Leighton
Associate Area Counsel (Long Island)
(Large & Mid-Size Business)

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subject:

UIL 6501.08-00, 6012.05-01, 671.00-00

You requested advice on whether extensions of the statute of limitations should be secured from several grantor trusts that are shareholders in a S Corporation or from the individual grantors and whether potential audit adjustments should be protected via an extension of the statute of limitations on a Form 872 or on a Form 872-I.

Issues

1. Whether it is necessary to secure extensions of the statute of limitations from S Corporation shareholders that are grantor trusts or should extensions be obtained from the individual grantors.

2. Whether such extensions should be secured on Forms 872 or Forms 872-I.

Conclusions

1. Extensions of the statute of limitations should be secured from each of the individual grantors of the grantor trusts that are shareholders in the S Corporation. In addition, since it is possible that these trusts are not wholly-owned and therefore only partly grantor trusts, we recommend that you secure extensions of the statutes of limitations from each trust. Each trust's fiduciary is responsible for making a tax return.

2. Such extensions should be secured through Forms 872-I.

We have coordinated this advice with our National Office. The National Office has reviewed and agrees with this advice.

Facts:

You have advised us of the following facts:

filed its Form 1120S for the . A Form 872-S attached to this return shows that the statute of limitations has been extended until .

According to Schedules K-1 attached to this Form 1120S, the shareholders in are:

%

%

%

%

%

%

The Form K-1 for each shareholder above (collectively, the subject grantor trusts) attached to the Form 1120S reports or claims items of ordinary income, interest income, net section 1231 gain, charitable contributions, investment income, a depreciation adjustment, nondeductible expenses, and property distributions. We do not know whether the subject grantor trusts filed any Forms 1041, do not have copies of any such returns filed by the subject grantor trusts, or have any information on items reported on such returns.

On his joint Form 1040 filed for the [1], reported items from the and the . These items reported from the two Trusts included Interest Income, Short Term Capital Gain,

[1] It does not appear from either the Form 1040 or the Form 1120S that , is a shareholder in the S Corporation in her own right. Treas. Reg. § 1.671-4(b)(8) provides that a trust all of which is treated as owned by a husband and wife who make a joint return of income taxes for the taxable year under Internal Revenue Code § 6013 is considered to be owned by one grantor for purposes of paragraph (b). Therefore, this memorandum will consider as a grantor.

Income From Trusts, and Depreciation. On , requested an automatic extension of the time to file this return until ; the preparer signed the return on . From the above, we assume for purposes of this memorandum that is the grantor[2] of these two grantor trusts. Similarly, we assume that and are grantors of their respective grantor trusts. We do not have copies of any individual returns filed by or .

<u>Analysis</u>

<u>Issue 1: Extension of the statute of limitations</u>

<u>A. Return Filing Requirement Imposed on S Corporations and Trusts</u>

Internal Revenue Code § 1361(a) defines a S corporation as a small business corporation for which an election under § 1362(a) is in effect for any taxable year. Internal Revenue Code § 1361(b) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have more than 100 shareholders, have as a shareholder a person [other than a trust described in subsection (c)(2)] who is not an individual, have a nonresident alien as a shareholder, and have more than 1 class of stock. Section 1361(c)(2) states that a trust all of which is treated (under subpart E of part I of subchapter J) as owned by an individual who is a citizen or resident of the United States may be a shareholder. Subchapter J (§§ 641-692) includes Estates, Trusts, Beneficiaries, and Decedents; Part I pertains to Estates, Trusts, and Beneficiaries, and Subpart E includes §§ 671-679, rules for Grantors and Others Treated as Substantial Owners. Accordingly, based on the facts as we understand them, meets the requirements to be a small business corporation and is a S corporation for purposes of § 1361 et seq.

Internal Revenue Code § 6011 contains the general requirement of making a return. Specifically, this statute provides that when required by regulations, any person made liable for any tax imposed by this title, shall make a return or statement according to the forms and regulations prescribed by the Secretary of the Treasury or his delegate. Section 6012(a)(4) requires every trust having for the taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income to make a return with respect to income taxes under subtitle A. Given the amounts on the Forms K-1 noted above, we conclude under § 6012(a)(4)that each of the grantor trusts are required to make a return for the items received from . However, see the discussion on Internal Revenue Code § 671 below. Pursuant to Internal Revenue Code § 6012(b)(4), a trust's fiduciary must make the return.

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[2] Internal Revenue Code § 671 and Treas. Reg. § 1.671-4 refer to trusts owned by the grantor or another person. This memorandum will use the term "grantor" to refer to the owner of a grantor trust and includes "another person".

Internal Revenue Code § 6037(a) requires every Subchapter S Corporation to make a return for each taxable year. However, pursuant to the provisions of § 1363(a), in general, an S corporation shall not be subject to the taxes imposed by Chapter 1. Thus, § 6037(a) is primarily concerned with describing the contents of the corporation's return. In contrast, the plain language of § 6501 starts the period for determining any deficiency in tax due from items passed through a Subchapter S corporation from the filing date of the shareholder's return. Bufferd v. Commissioner, 506 U.S. 523 (1993). In addition, IRM section 25.6.22.4.3 states that for flow through items on a non-TEFRA Form 1120S, the shareholder's statute should be extended.

B. Extension of the Statute of Limitations

In general, the amount of any tax imposed by the Internal Revenue Code shall be assessed within 3 years after the return was filed. No proceeding in Court without such assessment of the collection of tax shall begin after the expiration of such period. The term "return" means "the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deductions, or credit)." Internal Revenue Code § 6501(a).

Under § 6501(c)(4)(a), where the Secretary of the Treasury or his delegate and the taxpayer both consent in writing to assessment of any tax before the expiration of the 3-year period, the tax may be assessed at any time prior to the expiration of the period agreed upon. The agreed upon period may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon. See also § 6501(c)(4)(B) regarding notice to the taxpayer of its right to refuse or limit such extension. To our knowledge, no other exception to the 3-year period of § 6501(a) exists here.

Internal Revenue Code § 641 imposes income tax under § 1(e) on any kind of property held in trust. Thus, although a trust acts as a conduit for distribution to its owner(s), the trust itself is subject to income tax. Internal Revenue Code § 671 states that where the grantor or another person shall be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or other person, those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D.

Treas. Reg. §1.671-4(a), effective for taxable years beginning on or after January 1, 1996, provides that in general, items of income, deduction, and credit attributable to any portion of a trust which is treated as owned by the grantor or another person are not reported by the trust on Form 1041, but are shown on a separate statement to be attached to that form. Accordingly, since the grantor trust is not a taxable entity, generally a grantor trust only files a blank return with a statement that shows the items of income, deduction, and credit of the trust of the taxable year that are attributable to the grantor. Per Treas. Reg. § 1.671-4(b)(2)(B), the trustee need not file any type of return in the case of a trust all of which is owned by one grantor or one other person, where the trustee furnishes certain information to payors and furnishes to the grantor or other person treated as the owner of the trust with a statement that: (1) shows all items of income, deduction, and credit of the trust for the taxable year; (2) identifies the payor of each item of income; (3) provides information necessary to take the items into account in computing the grantor's or other person's taxable year; and (4) informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

Litigation of grantor trust issues has occurred in the Tax Court; see Lardas v. Commissioner, 99 T.C. 490 (1992). In that case, the Court held that the relevant return for determining when the statute of limitations is triggered is the return of the grantor, not the grantor trust. Thus, the Court held that "section 6501(a) refers to the taxpayer's return [in the case, husbands and wives], and not that of the source entity, where such source entity is a grantor trust." Id., at 499. The Tax Court has consistently maintained this position without regard to the source entity involved; see cases cited in Olson v. Commissioner, T.C. Memo. 1992-711. We have no reason to think that the Tax Court would take a different position in regard to and to and and their respective spouses, if any.

Given the addresses of and , should any litigation of this issue occur, any such decision would be appealable to the Court of Appeals, Second Circuit.[3] That Circuit, in Rothstein v. United States, 735 F.2d 704, 709 (2d Cir. 1984), held that although the grantor must include items of income, deduction, and credit attributable to the trust in computing the grantor's taxable income and credits, the trust must continue to be viewed as a separate taxpayer for purposes of sales transactions. Conceivably, one could conclude from this decision that the pertinent statute of limitations related to the trust, rather than to the grantors. However, the issue before the Court was not whether the statute of limitations had expired; rather, the case involved whether a purchase of stock in exchange for the taxpayer's promissory note involved a "loan" under Internal Revenue Code § 675(3) and whether the taxpayer or the trust was entitled to an interest deduction. Please note that no other Second Circuit decision cites Rothstein. In response to this decision, the Service issued Rev. Rul. 85-13, 1985-1 C.B. 184, which states that the Service will not follow Rothstein to the extent that it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor.

[3] We do not have the address of either or . For purposes of this advice, we assume that any litigation involving or would also be appealable to the Second Circuit.

Other courts have found that the “return” of a passthrough entity such as a grantor trust does not start the statute of limitations running because the statute of limitations should apply to the person who pays the tax. That position is articulated in Siben v. Commissioner, 930 F.2d 1034, 1035 (2d Cir.), cert. denied, 112 S. Ct. 429 (1991), where the Court states, in a partnership context, that “it appears to us that the ‘return’ that starts the running of the limitations period at issue is that of the taxpayer whose liability is being assessed and not that of a[n] … entity whose return might also report the transaction that gives rise to the liability.” Ultimately, the Court held that the controlling return was the individual income tax return. See also, § 6501(c)(4) requiring the “taxpayer” to consent to the extension of the period allowed for assessment. We recognize that the Siben Court based its decision, in part, on the fact that a partnership does not itself report any tax imposed by the Code. In addition, the Court noted that the partnership return does not furnish information necessary to calculate the individual partner’s income tax, such as income, losses, deductions or credits derived from third party sources. Thus, the facts in Siben are not identical to the facts here. However, we conclude that the general principle articulated, that it is the return of the taxpayer whose liability is in issue that triggers the statute of limitations for assessment, applies in this grantor trust context.

Thus, if it is the individual grantors against whom you seek to assess tax, it is the individual grantors that should extend their individual statute of limitations. To the extent that you propose to adjust items reported on each of the Forms 1041 filed by any of the subject grantor trusts, if any, the fiduciary for each trust should extend the statute of limitations. However, the safest approach is to get all the individual grantors and the fiduciaries for each of the grantor trusts to extend their respective statutes of limitations.

Issue 2: Which Form 872 Should be Used to Extend the Statute of Limitations

IRM section 25.6.22.4.1 states that a Form 872 or Form 872-A are the appropriate forms to extend the statute of limitations for income tax. However, you have asked whether Forms 872-I should be secured. We understand that that Form is intended to be used to extend the statute of limitations on partnership items under both Internal Revenue Code §§ 6229 and 6501. In our opinion, a Form 872-I does not appear to prohibit extending the individual grantor’s statute of limitations under § 6501 where the Form states, "Without otherwise limiting the applicability of this agreement, this agreement also extends the period of limitation ... attributable to any partnership items (see section 6231(a)(3)) ...." Therefore, we think the best practice is to have the grantors extend their individual statute of limitations under § 6501 by executing a Form 872-I. Similarly, the trust fiduciaries should be asked to execute Forms 872-I.

Please note that our conclusions are based on the following assumptions:

1. The subject grantor trusts are not electing small business trusts under § 641 (c).

2. None of the subject grantor trusts are partners in any TEFRA partnerships.

3. The named individuals ( )
are the grantors and/or owners of their respective grantor trusts.

If you have information showing any of these assumptions to be incorrect, you should provide us with that information and should not rely on the conclusions in this memorandum until we have reviewed that information and advised you of our opinion on how that information impacts the conclusions herein.

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary please contact this office for our views.

Please call Diane Mirabito at (516) 688-1709 if you have any further questions.

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By: ______________________________
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