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In this article, the authors consider the implications of a recent IRS legal memorandum concerning the statute of limitations on assessments involving subpart F and how that could affect a taxpayer's overall return.

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In ILM 202142009, the IRS addressed the six-year extended statute of limitations on assessment that arises when a taxpayer omits subpart F income from a return.[1] The memorandum publicly announces the IRS's long-standing position that the six-year limitations period on assessments for specified omissions applies to all items of a return — not just the omitted items. In its broadest technical application, that interpretation would mean that any omission of subpart F income suffices to extend the statute for the taxpayer's entire return for three years beyond the regular rules. That is likely a surprise to many practitioners.

This article examines statutes of limitation on assessments generally and the development and current application of the six-year period for omissions of subpart F income, and notes areas in which those rules may create pitfalls for unsuspecting taxpayers with unreported controlled foreign corporation income inclusions.

Background

An assessment is the act of the IRS formally recording the liability of a taxpayer in its books and records, and the IRS cannot collect tax before making a valid and timely assessment. The code imposes time limits on the IRS to make those assessments. Generally, section 6501(a) provides that a tax assessment must be made within three years of the filing of a tax return. Other subsections of section 6501 provide multiple exceptions to the general three-year assessment period, including when:

- no return is filed, or a false or fraudulent return is filed, in which case the tax may be assessed at any time;

[1] *See* section 6501(e)(1)(C). Subpart F income is includable by some U.S. shareholders of controlled foreign corporations. *See generally* sections 951, 957, and 958.

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- the taxpayer consents to extend the limitations period;
- the taxpayer fails to provide information to the IRS on some foreign information filings,[2] in which case the assessment period for any tax will not expire before three years following the date the required information is provided (if the failure is the result of reasonable cause and not willful neglect, the extended assessment period applies only to the item or items related to that failure); and
- there is a substantial omission of gross income on a taxpayer's return, which extends the assessment period to six years from the filing date. An omission of gross income is substantial if:
  - it exceeds 25 percent of the amount of total positive gross income items stated in the return; or
  - it involves more than $5,000 in income from a foreign financial asset.

The word "omission" under section 6501 is not synonymous with the word "understatement." In general, an item is omitted if it is wholly missing from the return, and the return on its face provides no clue to the item's existence.[3] That is often distinguishable from an item that appears on the return but has been incorrectly calculated.

Six-Year Statute on Omissions of Subpart F

Section 6501(e)(1)(C) also authorizes a six-year assessment period when taxpayers omit constructive dividends from their returns. Since 2004 the definition of a constructive dividend has been an inclusion under section 951(a) — that is, the subpart F rules. The reference to section 951(a) captures both regular subpart F income inclusions under section 951(a)(1)(A), as well as section 956 inclusions under section 951(a)(1)(B). Since late 2017, income inclusions under the global intangible low-taxed income regime are treated equivalently, so a GILTI inclusion omission also can give rise to a six-year assessment period.[4]

Similar rules apply in the context of partnerships that omit subpart F (or GILTI) income.[5]

Before 2004, however, the special six-year period did not apply to subpart F income, but rather to omissions of inclusions under the former foreign personal holding company (FPHC) rules. When the FPHC rules were repealed as part of the American Jobs Creation Act of 2004, Congress — without any explanation — substituted subpart F inclusions for FPHC inclusions. The subpart F regime had been in effect for over 40 years, without any special extended statute, and there is no indication in the legislative history of why Congress decided to provide the IRS additional time to audit and assess subpart F liabilities.

Even so, the change in the provision is clear and operative. Further, by its plain language, it applies to any amount includable under section 951(a). That is in stark contrast to the primary "substantial omission" provision in section 6501(e)(1)(A), which, as noted, is implicated only when the taxpayer omits more than 25 percent of the positive income items due from its return.

The Memorandum

The IRS memorandum involved a taxpayer that filed an original return omitting subpart F income. It does not discuss the relative materiality of the omission compared with the taxpayer's taxable income generally.

The taxpayer filed an amended return reporting the omitted subpart F income after the three-year limitation period under section 6501(a) but before the expiration of the six-year limitation period under section 6501(e)(1)(C). While the IRS and taxpayer generally agreed that the six-year assessment period applied, the IRS took the position that the extended statute applied to all items on the return, including those unrelated to the subpart F omission. The taxpayer argued that the extended statute applied only to the omitted subpart F items.

The IRS primarily relied on *Colestock*[6] to support its position that the extended statute applied to the entire return. In *Colestock*, the U.S. Tax Court determined that the six-year statute of

[2] *E.g.*, forms 5471, 5472, 8858, and 8865.

[3] *Colony v. Commissioner*, 357 U.S. 28 (1958).

[4] *See* section 951A(f).

[5] *See* section 6235(c)(2).

[6] *Colestock v. Commissioner*, 102 T.C. 380 (1994).

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limitations under section 6501(e)(1)(A) opens all items on a taxpayer's return for the determination of a deficiency, not just those items omitted from the return. The court based its conclusion on the prefatory language appearing before section 6501(e)(1)(A), which applies the exception to "any tax imposed by subtitle A." In doing so, the court acknowledged that there was an ambiguity in the statute but found that the legislative history of section 6501(e)(1)(A) supported (or at least did not clearly contradict) its interpretation of the statutory language.

The memorandum concluded that because section 6501(e)(1)(C) shares the same prefatory language as section 6501(e)(1)(A), the extended statute should apply to all items of the return, consistent with the *Colestock* interpretation. The IRS also concluded that the legislative history of section 6501(e)(1)(C) did not provide any other guidance on the matter. In doing so, the memorandum referenced only the (lack of) discussion regarding the swap-in of subpart F inclusions for FPHC inclusions in the 2004 change. The memorandum did not fully trace back the history of the provision to when it was first enacted as part of the FPHC rules in the 1930s. Our review of that old history suggests that while it is questionable whether Congress really meant for the extended statute that was triggered by an omitted FPHC inclusion to apply to the entire return, there is no clear "smoking gun" statement that would persuasively contradict the memorandum's *Colestock*-based analysis.

Implications

Structuring and Operations

Under sections 951(a) and 951A, U.S. shareholders of CFCs must currently include their pro rata share of subpart F and GILTI inclusions in their income. Generally, subpart F income is taxed as ordinary income at the full relevant U.S. corporate tax rate, and GILTI is taxed at a preferred corporate tax rate via the section 250 deduction.

Before the enactment of the Tax Cuts and Jobs Act, taxpayers generally tried to avoid structuring into subpart F inclusions. After the TCJA, however, many more taxpayers are subject to CFC income inclusions, either through the GILTI provisions or by structuring into the traditional subpart F provisions to better use tax attributes such as foreign tax credits. Because more international tax planning involves recognizing GILTI or subpart F inclusions, those planning strategies should consider the collateral risks that section 6501(e)(1)(c) could present. An example would be determining whether CFC income from goods produced offshore, perhaps after a supply chain restructuring, is properly categorized as foreign base company sales income or qualifies for one of the exceptions thereto. This area has gotten significant recent attention in light of the Tax Court and Sixth Circuit's decisions in *Whirlpool*.[7]

Tax Compliance and Income Tax Accounting

Professionals should carefully ensure that all subpart F income, including GILTI, is properly reported on federal tax returns.

Tax professionals working on accounting for income taxes should consider whether section 6501(e)(1)(C) affects the timing of recognition of previously unrecognized tax benefits under ASC 740.

Mergers and Acquisitions

As the three-year statute of limitations begins to close in 2022 for 2018 tax years, mergers and acquisitions teams performing due diligence should question whether section 6501(e)(1)(C) applies and requires ongoing consideration of tax positions with uncertainty.

Transition Tax

Although the IRS memorandum does not discuss this issue, taxpayers with section 965 transition tax inclusion year returns under examination should consider whether the six-year statute of limitations on assessment in section 965(k) displaces section 6501(e)(1)(C) or whether the two provisions could be read together to create exposure on other items on the transition tax return.

[7] *Whirlpool Financial Corp. v. Commissioner*, No. 20-1899 (6th Cir. 2021), *aff'g* 154 T.C. No. 9 (2020).

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Conclusion

As noted, there is no explicit materiality threshold in the statute, so a broad technical reading of the provision suggests that any omitted item of subpart F income is sufficient to expose the taxpayer to a six-year statute of limitations on assessment. Experience, however, teaches that IRS auditors generally focus on whether a tax return is materially correct.[8] Further, if the IRS wants to use section 6501(e) to assess tax outside the ordinary three-year limitations period, it bears the burden of proving that a longer limitations period applies.[9]

Striking a proper operational balance between the technical and practical perspectives depends on the facts and circumstances of each situation. We note that the IRS is ramping up the overall enforcement environment — especially for international items — so old assumptions about materiality and risk may be outdated.[10] ■

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[8] *See, e.g.*, Internal Revenue Manual 4.46.4.10.6 ("Materiality and compliance considerations will be evaluated when conducting the risk analysis for each issue. As soon as a determination is made, the issue team will timely inform the taxpayer whether an issue is being added, continued, expanded, narrowed, or dropped.").

[9] *Dillingham v. Commissioner*, 903 F.2d 760, 762 (10th Cir. 1990), *citing Weikel v. Commissioner*, 51 T.C.M. (CCH) 432 (1986), and *Reis v. Commissioner*, 1 T.C. 9 (1942).

[10] The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

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