

Does an Overstatement of Basis Constitute an Omission From Gross Income?

The Tax Court holds invalid the IRS Temporary Regulations that an overstated basis constitutes an omission from gross income potentially triggering the extended statute of limitations are invalid.

Originally published in *the AICPA Tax Insider Newsletter*
Reproduced with permission

Written By:
Thomas R. Wechter

For the last 50 years the Internal Revenue Service (IRS) has argued that an overstatement of basis constitutes an omission from gross income in determining if the six year statute of limitations applies. In response to the IRS's lack of success with respect to this issue, temporary regulations were promulgated in September, 2009, providing that an overstatement of basis constitutes an omission from gross income. Following the issuance of the temporary regulations, the IRS filed notices for rehearing and to vacate the prior decisions in those cases that had held against the IRS on the issue. The first of the cases to consider the temporary regulations was *Intermountain Insurance Service of Vail LLC v. Commissioner*, 134 T.C. No. 11, in which the Tax Court, refusing to reconsider its earlier decision finding that the six-year statute of limitations did not apply, held the temporary regulations invalid. In several other cases the IRS's motion in reliance upon the temporary regulations has met with a similar fate. Despite the continued rejection of the temporary regulations, the IRS has publicly announced that it is not going to back down on the issue.

Statute of Limitations

Code Section 6501(e)(1)(A) provides that if the taxpayer "omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return," the IRS has six years, rather than three years, from the date on which the return was filed to assess a deficiency. In addition, the section defines "gross income" in the context of a trade or business as the total amount received or accrued from the sale of goods or services without consideration of the cost of such sales or services and excludes items of gross income if properly disclosed in the return. Code Section 6229(c)(2) mirrors code Section 6501(e)(1)(A) with respect to partnerships subject to the *Tax Equity and Fiscal Responsibility Act* of 1982 (TEFRA) procedures.

The language of the statute leaves unanswered a number of questions: Does "to omit" from gross income mean to leave off or exclude?" Does an "amount" of gross income mean a specific item of gross income or does it mean a miscalculation? Does "gross income" mean proceeds or receipts as in the case of a trade or business? Or does it mean net profits or gain? And does the definition of gross income for purposes of a trade or business mean that gross income is defined differently otherwise?

The Landscape at the Time of the Issuance of the Temporary Regulations

The seminal case in the area is *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), where the Supreme Court, dealing with the predecessor of Code Section 6501(e)(1)(A), held that the extended statute of limitations was applicable only in "the specific situation where a taxpayer actually omitted some income receipt or accrual in his computation of gross income and not more generally to errors in that computation arising from other causes." The IRS has argued that *Colony* is not controlling because the statute applied by the Supreme Court was effectively the trade or business provisions added to the 1954 Code by Section 6501(e)(1)(A)(i) in which the basis determination is irrelevant. The IRS has found some success with that argument, most notably in the First Circuit and a number of lower courts, but the over whelming weight of authority, principally in the Federal Circuit, the Ninth Circuit

and the Tax Court, is that *Colony* is not limited to trade or business cases and that an overstatement of basis is not an omission from gross income.

Temporary Regulations

To bolster its litigation position, the IRS issued temporary regulations to clarify the term “gross income” outside the context of a trade or business and to provide that an overstatement of basis in determining gain constitutes an omission from gross income. The temporary regulations provide that the term gross income in a non-trade or business context has the same meaning as provided in Code Section 61(a) which defines “gross income” as “all income from whatever source derived” and explicitly includes in gross income “gains derived from dealings in property.” In accordance with the effective date provisions, the temporary regulations are “applicable to all cases with respect to which the period for assessing tax under the applicable provisions has not expired before September 24, 2009.” In determining whether the applicable provisions have not expired, the IRS has argued that the determination is to be made by applying the temporary regulations on a hypothetical basis.

Intermountain Case

The first case to consider the temporary regulations was *Intermountain* in which the Tax Court had held in a prior decision that the final partnership administrative adjustment was untimely. Relying upon the temporary regulations the IRS filed an untimely motion with the Tax Court to reconsider and vacate its prior decision.

In a reviewed opinion with a seven judge majority, the IRS’s motions were denied. The court first found that the temporary regulations did not apply to this case since the period for assessing tax had expired before September 24, 2009, the effective date in the temporary regulations. The IRS had argued that in determining whether the statute of limitations had expired prior to September 24, 2009, the temporary regulations are to be applied on a hypothetical basis. The majority opinion rebuked the IRS for “advancing a notably convoluted interpretation” of the effective date of the temporary regulations that assumed applicability to any year that would be an open year by applying the regulations themselves. The court found the IRS’s interpretation of the effective date provisions were “irreparably marred by circular, result driven logic and the wishful notion that the temporary regulations should apply to this case.”

Further, the court found that the temporary regulations did not deserve judicial deference because the decision in *Colony* was based upon the determination that the statute was unambiguous. Since the temporary regulations did not interpret an ambiguous statute, they could not displace the Supreme Court’s decision in *Colony* and therefore were invalid.

Four judges concurred in the result, but would have reached the same result on the narrower ground that the motion to vacate was untimely filed. Two other judges concurred with the result, but on the basis that the temporary regulations did not comply with the Administrative Procedure Act, which required notice and comment before publication.

Despite the set back in *Intermountain*, the IRS has publicly announced that it will continue to rely upon the temporary regulations. Since *Intermountain*, the Tax Court has denied the IRS's motion to vacate and reconsider in two other Tax Court cases and has yet to rule on the IRS's motion with respect to two other cases.

Conclusion

In light of the public statements made by the IRS, the battle is not over. The IRS can always remedy the failure to follow the Administrative Act, but cannot remedy the impression by the Tax Court that the temporary regulations were purely a bootstrap action to support its litigation position and are an overly aggressive use of the regulatory process. In all likelihood, the IRS will appeal the *Intermountain* case to clear the air with respect to the deference to be shown to the temporary regulations.

This publication has been prepared for the general information of clients and friends of the firm. It is not intended to provide legal advice with respect to any specific matter. Under rules applicable to the professional conduct of attorneys in various jurisdictions, it may be considered advertising material. The advice contained in this article is not intended or written to be used, and cannot be used by a taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under law.

For more information visit our Web site at www.schiffhardin.com.

© 2010 Schiff Hardin LLP