



PREVIEW

OF UNITED STATES SUPREME COURT CASES

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Previewing the Court's Entire January Calendar of Cases, including ...

Perry v. Perez, Perry v. Davis, and Perry v. Perez
Texas adopted a congressional redistricting plan in response to population changes reflected in the 2010 census. Texas, a covered jurisdiction under the Voting Rights Act (VRA), sought preclearance for the plan. At the same time, a group of plaintiffs challenged the plan under the VRA in a federal court in Texas. When it became clear that the plan would not obtain preclearance before the start of the 2012 elections, the Texas court crafted and ordered an interim districting plan. Texas challenged the court's authority to issue this interim plan.

FCC v. Fox Television Stations, Inc.
This case comes back to the Supreme Court following a 2009 decision in which the Court upheld the Federal Communications Commission's indecency enforcement policy under the Administrative Procedure Act, but declined to reach the constitutional questions. The constitutional questions are now fully before the Court, which must decide whether the Commission's regulation of indecent, but not obscene, speech in broadcast media comports with the First and Fifth Amendments.

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Does an Overstatement of a Tax Basis by a Taxpayer Constitute an Omission That Might Extend the IRS Statute of Limitations for Review to Six Years?

CASE AT A GLANCE

The United States requests that the Supreme Court reverse the Fourth Circuit's determination, based on *The Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), that a taxpayer's overstatement of tax basis is not an omission from gross income that allows the IRS to assess a taxpayer within six years instead of the usually applicable three-year period. In addition, the United States asserts that the Court should permit application of the extended six-year period through application of a once-temporary, now final, Treasury Regulation that defines an omission from gross income to include an understatement of gross income resulting from an overstatement of basis and applies to pending litigation.

United States v. Home Concrete & Supply Docket No. 11-139

Argument Date: January 17, 2012
From: The Fourth Circuit

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INTRODUCTION

The Colony, Inc. v. Commissioner, 357 U.S. 28 (1958) (*Colony*) has long established the parameters for a determination of whether, under certain circumstances, a taxpayer can be subjected to a longer (in the case of *Colony*, five-year) statute of limitations on assessment by the Internal Revenue Service (IRS) instead of the typically applicable three-year period. *Colony* involved the IRS Commissioner's deficiency determination that the taxpayer, a seller of residential lots, had understated its gross income by overstating its basis in the lots by including unallowable items of development expense in cost. (Basis, as adjusted, is the taxpayer's unrecovered cost in his investment. Simply speaking, gain or loss for property disposed of by the taxpayer is computed by reducing the property's sales price by its adjusted basis.) The extended limitations period in that case, 26 U.S.C. § 275(c), a predecessor provision to 26 U.S.C. § 6501(e)(1)(A), provided that "[i]f the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed." In *Colony*, the Supreme Court held that an increase in basis that generates an understatement of income is not an omission from gross income within the meaning of § 275(c), so that the usual three-year statute of limitations applies. The *Colony* Court spoke to the rationale underlying § 275(c):

We think that in enacting § 275(c), Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some

taxable item, the Commissioner 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. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting "gross income" or one, such as overstated deductions, affecting other parts of the return. To accept the Commissioner's interpretation and to impose a five-year limitation when such errors affect "gross income," but a three-year limitation when they do not, not only would be to read § 275(c) more broadly than is justified by the evident reason for its enactment, but also to create a patent incongruity in the tax law.

This case reexamines *Colony* and addresses the applicability of Treasury Regulation § 301.6501(e) to these facts.

ISSUE

Does the United States Supreme Court's decision in *Colony* or Treasury Regulation § 301.6501(e) allow for application of the six-year limitations period on assessment set forth in 26 U.S.C. § 6501(e)(1)(A) where, according to the IRS, Home Concrete overstated its basis in certain assets sold in short sales?

FACTS

Two shareholders in a family enterprise, Home Oil & Coal Company, Inc., formed a partnership, Home Concrete & Supply, LLC, which sold the business in 1999 using a scheme known as a "Son-of-BOSS"

(Bond and Option Sales Strategy). That sale involved the formation of limited liability companies, the companies' short sales of United States Treasury Bonds, the transfer of the short sales proceeds to Home Concrete as capital contributions that created "outside basis" (partners' basis in the partnership), the transfer to Home Concrete of the obligations associated with the sales of the bonds to close them, the closing and covering of the short sales within a five-day period, and then the sale of the entirety of Home Concrete's assets to a third party. Home Concrete and its partners timely filed required tax returns in which they regarded the transfer of the obligation to Home Concrete to close the short sales as a nonliability, and elected to step up inside basis (the partnership's basis in its assets) to equal outside basis. Given that Home Concrete adjusted its inside basis to include the short sales proceeds, it reported a small taxable gain from the sale of the business because the proceeds were not offset by the liability consisting of the obligation to close the short sales. Had the liability been factored into computation of the assets' adjusted basis, taxable gains would have been substantially greater. Some things about these transactions were disclosed on plaintiffs' income and partnership returns. Thus, as the Fourth Circuit noted in its opinion, on its 1999 return, Home Concrete provided an itemized accounting of the basis for each asset, showed acquisition and sale costs and dates for the Treasury Bonds, and indicated the amount of gain. Returns filed by the individual taxpayers revealed the receipt of short sale proceeds on sales not closed by the taxpayers in 1999. *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011).

In September 2006, well after the three-year statute of limitations on assessment prescribed in § 6501(a), the IRS issued a Final Partnership Administrative Adjustment (FPAA) to Home Concrete, alleging that it had overstated the assets' basis and that an adjustment to the partnership return was warranted. Home Concrete and its partners brought suit in federal district court requesting a declaration that the IRS was prohibited from adjusting the partnership return because the three-year limitations period on assessment had expired. The IRS asserted that the six-year limitation period instead applied so that its adjustment was timely.

The district court entertained the parties' respective motions for summary judgment and ultimately granted summary judgment in favor of the United States with respect to several issues. Initially, the court determined that the United States Supreme Court's holding in *Colony* did not preclude application of the six-year statute of limitations to a taxpayer when the taxpayer overstates basis and resultantly omits an item of gross income. *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678 (E.D. N.C. 2008). In supplemental proceedings, the court considered whether plaintiffs, Home Concrete and its partners, sufficiently disclosed information on their tax returns to bring them within the safe harbor provision of § 6501(e)(1)(A)(ii), which forestalls application of the expanded six-year period in instances in which the taxpayer has disclosed the "nature and amount" of the item. (Although the court had identified certain other issues for its consideration, plaintiffs stipulated, only for purposes of the motions, that they overstated the basis of the assets resulting in an omission from gross income in excess of 25 percent of the stated gross income amount, thereby leaving the disclosure/safe harbor issue the sole supplemental issue before the court for decision on partial summary judgment.) The court ruled that mere disclosure of a step-up in basis coupled with other disclosures relating to the asset sale constituted an insufficient disclosure so that the safe harbor provision of

§ 6501(e)(1)(A)(ii) did not render the FPAA untimely. *Home Concrete & Supply, LLC v. United States*, 2009 U.S. Dist. LEXIS 127250 (2009).

Thereafter, the Treasury promulgated a regulation, Temporary Treasury Regulation § 301.6501(e)-1T (since replaced by a nearly identical final regulation), stating that "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6501(e)(1)(A)." The regulation also included language making it applicable to pending litigation.

Home Concrete and its partners appealed to the Fourth Circuit, which reversed on grounds that *Colony* absolutely precludes an argument that an overstatement of basis in reporting the proceeds of a short sale constitutes an omission from gross income allowing for expansion of the limitations period on assessment from three to six years. In response to other assertions offered by the government in support of application of the six-year period, the Fourth Circuit declined to apply the Treasury Regulation retroactively. *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011).

The solicitor general filed a petition for writ of certiorari identifying two issues: "(1) Whether an understatement of gross income attributable to an overstatement of basis in sold property is an 'omission' from gross income that can trigger the extended six-year assessment period; and (2) Whether a final regulation promulgated by the Department of the Treasury, which reflects the IRS's view that an understatement of gross income attributable to an overstatement of basis can trigger the extended six-year assessment period, is entitled to judicial deference." *United States v. Home Concrete & Supply, LLC*, 2011 U.S. S. Ct. Briefs LEXIS 1329 (2011). The Supreme Court granted the solicitor general's petition for writ of certiorari on September 27, 2011, *United States v. Home Concrete & Supply, LLC*, 189 L. Ed. 2d 940 (2011).

CASE ANALYSIS

In straightforwardly applying *Colony*, the Fourth Circuit examined the facts in *Colony* and the Supreme Court's focus on the legislative history underlying former § 275(c). According to the Fourth Circuit, this history revealed "persuasive evidence that Congress was addressing itself to 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."

Although the district court in this case had looked to certain language in § 6501(e)(1)(A) defining "gross income" in the context of a trade or business—thereby prompting the lower court to hold that *Colony* applies only to taxpayers selling goods and services—the Fourth Circuit disagreed, aligning its ruling with those of the Ninth and Federal Circuits in *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009) and *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009). The Fourth Circuit found no language in *Colony* linking its holding to cases involving the sales of goods and services, and viewed the operative language of the predecessor provision, § 275(c), as indistinguishable from the governing language of the current § 6501(e)(1)(A).

On several grounds, the Fourth Circuit also rejected the IRS's efforts to sidestep *Colony* through promulgation of its regulation, which the

government contended is entitled to deference under *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837 (1984). First, the court noted that the regulation, by its own terms, “applies to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009.” Treas. Reg. § 301.6501(e)-1(a)(1)(iii). Because the relevant tax returns in this case were due by April 2000, and the period for assessing tax would have expired on September 14, 2006 (according to the district court’s finding), the Fourth Circuit concluded that the regulation does not apply by its own terms. Nor did the court agree with the government’s contention that the six-year limitations period remained open pursuant to the regulation because this litigation had not become final on or after September 24, 2009. According to the court, the Treasury’s efforts in creating a regulation that allows for reopening an assessment period so long as litigation is pending as a redraft of § 6501 clearly contravenes Congress’s express intent that, in the absence of fraud, there be closure to the IRS’s ability to assess a taxpayer. The court also refused to accord the regulation deference under *Chevron* because such deference is warranted only when the regulation interprets an ambiguous statute. Because *Colony* declared the operative language here “unambiguous,” the Fourth Circuit determined congressional intent to be clear and *Chevron* deference unwarranted. Finally, the court saw no reason to retroactively apply the regulation as a clarification of *Colony*; the regulation was no mere clarification of *Colony*, but instead a substantive rewrite of the law to enable the government to assess plaintiffs more than ten years after they filed their returns.

In its Supreme Court brief, the United States asserts that “the most natural reading of the disputed language” reveals that an understatement of gross income that is the result of an overstatement of basis constitutes an “omission from gross income” that can call into play § 6501(e)(1)(A). *Colony* does not require a different result because it was based on the language of a predecessor statute and its pertinence is belied by subsequent statutory amendments. According to the United States, the *Colony* Court did not address the 1954 amendments to § 275(c), which clarify the meaning of the words “omits from gross income an amount properly includible therein.” *Colony* described the operative statutory language as ambiguous, allowing Treasury to adopt a regulation imparting a different interpretation, asserts the United States. Further, the reasons Congress identified for amplifying the usual three-year period to six years supports inclusion of a basis overstatement within the meaning of an understatement of gross income. And, according to the government, the recently promulgated final Treasury Regulation ends the dispute. The United States claims that the recent regulation is controlling, is a permissible interpretation, and applies to cases such as this one in which litigation is pending. The Fourth Circuit’s conclusion that the final regulation was inapplicable because the limitations period for tax year 1999 had expired long before the regulation’s self-stated effective date reflects a misunderstanding. Certain events—such as the issuance of the FPAA in this case—suspend the running of the limitations period, contends the government. To the extent the language of § 6501(e)(1)(A) is ambiguous, the regulation fully resolves the ambiguity—it represents a reasonable interpretation entitled to deference under *Chevron*. There is no difficulty with impermissible retroactive application here because the regulation simply clarifies existing law and does not change it. Moreover, asserts the United States, the regulation is rightfully viewed as a procedural rule that may be applied to conduct that occurred before it was promulgated. Even if

the regulation is properly characterized as retroactive, retroactive application is not impermissible because Treasury has the authority to implement retroactive rules.

Before the Supreme Court, plaintiffs offer *Colony* as controlling authority, focusing on pre-*Colony* cases that supported the Supreme Court’s decision in that case, the amendments that are now part of the pertinent statute, and *Colony*’s declaration about the unambiguous language of § 6501(e)(1)(A). According to plaintiffs, *Colony*’s holding is not restricted to taxpayers in the trade or business of selling goods or services. Contrary to the government’s assertions, the 1954 amendments to the statute are not rendered superfluous if *Colony* is applied without restriction. The plaintiffs assert that the Treasury Regulation does not apply by its own terms, is an abuse of executive power, alters settled law, and constitutes a violation of due process. *Chevron* deference cannot be extended to the regulation because it conflicts with unambiguous statutory language and this Court’s construction of that language in *Colony* concludes the plaintiffs.

SIGNIFICANCE

Although plaintiffs attempt to downplay the significance of this case (“[t]his case is one that is important for the parties involved, but its resolution is not important for the public at large”), taxpayers need to know—with as relative certainty as possible—what events will trigger an enhancement to the ordinarily applicable three-year statute of limitations on assessment. It is unlikely that “Son-of-BOSS” tax shelters such as that here will represent the only setting in which basis adjustments call into question whether there has been omission from gross income for purposes of application of the six-year statute of limitations. Therefore, a determination of the continued viability of *Colony* is jurisprudentially significant and will serve to enhance taxpayers’ understanding of what limitations period potentially applies to them.

Even more important in this context is the question of application of the Treasury Regulation, which the Treasury scrambled to promulgate after it was beset with litigation losses—whether it is an impermissible retroactive application of the law, whether it fails the first step in *Chevron* as an effort to interpret unambiguous statutory language, whether it reflects an end-run around clear congressional intent, and whether the Fourth Circuit correctly decided that it is inapplicable to this case by its own terms. Certainly, the regulation, with its retroactive implications, will not be the only one of its type offered by the Treasury over time. An analysis of the permissible extent of the Treasury’s reach in this case will inform future regulations and cases interpreting them.

Finally, a host of cases have decided one or more of these issues in favor of the government or the taxpayer, see, e.g., *Beard v. Commissioner*, 633 F.3d 616 (7th Cir. 2011); *Grapevine Imports, Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011); *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011); *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009); *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009); and *Intermountain Insur. Servs. of Vail, LLC v. Commissioner*, 650 F.3d 691 (D.C. Cir. 2011). Resolution of this case will resolve any conflicts and provide a measure of certainty to the questions presented.

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