Another Federal Court of Appeals Weighs in on the Applicability of the Six-Year Statute of Limitations Period to an Overstatement of Basis

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The U.S. Court of Appeals for the D.C. Circuit recently reversed two U.S. Tax Court decisions and held that an overstatement of basis constitutes an omission from gross income that is subject to the six-year statute of limitations period under sections 6229(c)(2) and 6501(e)(1)(A). These decisions further the conflict among the appellate courts regarding the applicability of the extended limitations period.

On June 21, 2011, another U.S. Court of Appeals weighed in on the dispute between taxpayers and the Internal Revenue Service (IRS) as to whether an overstatement of basis constitutes an omission from gross income that triggers the six-year statute of limitations period under sections 6229(c)(2) and 6501(e)(1)(A) of the Internal Revenue Code. In *Intermountain Ins. Serv. of Vail, LLC v. Commissioner*, No. 10-1204 (D.C. Cir. 2011) (*Intermountain II*), *rev'g* T.C. Memo 2009-195 (*Intermountain I*), and *UTAM, Ltd. v. Commissioner*, No. 10-1262 (D.C. Cir. 2011), *rev'g* T.C. Memo 2009-253, the U.S. Court of Appeals for the District of Columbia reversed the U.S. Tax Court's decision and held that an overstatement of basis does constitute an omission from gross income that is subject to a six-year statute of limitations period.

The IRS generally has three years from the date the taxpayer filed its tax return to assess a tax against a taxpayer. However, if a taxpayer omits an item from gross income on its return that is in excess of 25 percent of the amount of gross income stated on the return, the period for assessment is extended from three years to six years. Various U.S. Courts of Appeals have issued decisions on the matter in 2011, and the results have been mixed.

Background

Disputes between taxpayers and the IRS regarding whether an overstatement of basis can subject a taxpayer to a six-year statute of limitations period have made their way through the courts since 2009. In that year, the U.S. Courts of Appeals for the Ninth Circuit and the Federal Circuit decided in *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009), *aff'g* 128 T.C. 207 (2007), and *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009), *rev'g* 79 Fed. Cl. 189 (2007) (*Salman Ranch I*), respectively, that an overstatement of basis does not constitute an omission from gross income that triggers a six-year statute of limitations period. The courts in *Bakersfield Energy* and *Salman Ranch I* relied on the Supreme Court of the United State's decision in *Colony Inc. v. Commissioner*, 357 U.S. 28 (1958), which had concluded that an overstatement of basis was not an omission from gross income under former section 275(c) of the Internal Revenue Code of 1939, the predecessor to section 6501(e)(1)(A).

The IRS and U.S. Department of Treasury disagreed with the Ninth and Federal Circuits' analyses and reliance on *Colony* in *Bakersfield Energy* and *Salman Ranch I*. The IRS and Treasury contended that, at the time of the enactment of section 6501(e) as part of the Internal Revenue Code of 1954, Congress was aware of the disagreements among the courts regarding the scope of former section 275(c), and the change resolved the issue for the future. Thus, they argued, the holding in *Colony* is limited only to cases subject to former section 275(c) and inapplicable to cases involving sections 6501(e)(1)(A) and 6229(c)(2).

In response to *Bakersfield Energy* and *Salman Ranch I*, the IRS and Treasury issued temporary regulations on September 24, 2009, asserting that an omission from gross income under section 6501(e)(1)(A) and section 6229(c)(2) includes an overstatement of basis. The temporary regulations further provided that the rules contained in them apply to taxable years with respect to which the six-year period for assessing tax did not expire before September 24, 2009.

Prior to the issuance of the temporary regulations, the Tax Court, relying on the Ninth Circuit's decision in *Bakersfield Energy*, concluded in *Intermountain I* that the IRS's final partnership administrative adjustment was untimely because the three-year, rather than the six-year, statute of limitations period applied to an overstatement of basis. After the issuance of the Temporary Regulations, the IRS filed motions with the Tax Court to reconsider and vacate its decision. The Tax Court denied the IRS's motion on May 6, 2010 (*see* 134 T.C. 211), and held that the temporary regulations were inapplicable because they were invalid and not entitled to deference.

Despite the Tax Court's opinion in *Intermountain I*, the IRS and Treasury issued final regulations on December 14, 2010, which followed the temporary regulations. The final regulations provide 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 sections 6229(c)(2) and 6501(e)(1)(A). However, the final regulations provide that "[a]n amount shall not be considered as omitted from gross income if information sufficient to apprise the [IRS] of the nature and amount of the item is disclosed in the return, including any schedule or statement attached to the return." The final regulations provide that they apply to "taxable years with respect to which the period for assessing tax was open on or after September 24, 2009."

Intermountain II and Other Developments in 2011

Since the issuance of the Final Regulations in December 2010, a number of courts have reached conflicting conclusions regarding whether an overstatement of basis is an omission from gross income that triggers the six-year statute of limitations period under sections 6229(c)(2) and 6501(e)(1)(A) and whether the final regulations are entitled to deference.

Courts in favor of the IRS

As noted above, on June 21, 2011, the D.C. Circuit in *Intermountain II* reversed the Tax Court's 2009 decision in *Intermountain I*, holding that an overstatement of basis is an omission from gross income that triggers the extended six-year statute of limitations period. In its decision, the D.C. Circuit concluded that *Colony* was inapplicable to sections 6229(c)(2) and 6501(e)(1)(A), and that the final regulations were entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), stating "[the regulations] were validly promulgated, apply to the case, qualify for *Chevron* deference, and pass muster under the traditional *Chevron* two-step framework." In a companion case to *Intermountain II*, the D.C. Circuit stated that its decision in *Intermountain II* also reverses the Tax Court's 2009 decision in *UTAM*.

In addition to the D.C. Circuit's decision in *Intermountain II* and *UTAM*, the Seventh, Tenth and Federal Circuits decided cases in 2011 all holding that an overstatement of basis is an omission from gross income that is subject to the six-year statute of limitations period. See *Beard v. Commissioner*, 633 F.3d 616 (7th Cir. 2011); *Grapevine Imports, Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011); and *Salman Ranch Ltd. v. Commissioner*, No. 09-9015 (10th Cir. 2011) (*Salman Ranch II*). In *Beard*, the Seventh Circuit rejected the application of *Colony*, but did not address whether the final regulations are entitled to deference under *Chevron*. Although the Federal Circuit held in favor of the taxpayer in *Salman Ranch I*, the court reversed course and held in favor of the IRS in *Grapevine*. The Federal and Tenth Circuits in *Grapevine* and *Salman Ranch II*, respectively, concluded that the final regulations are entitled to deference under *Chevron*. The Tenth Circuit in *Salman Ranch II* also determined that the final regulations are not impermissibly retroactive.

Courts in favor of the taxpayer

In addition to the Ninth Circuit's decision in *Bakersfield Energy* in 2009, the Fourth and Fifth Circuits decided cases in 2011 in favor of the taxpayer, holding that an overstatement of basis is not an omission from gross income that is subject to the six-year statute of limitations period. See *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011), and *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011). The Tax Court has continued to affirm its decision in *Intermountain I* in invalidating the final regulations, concluding in *Carpenter Family Investments LLC v. Commissioner*, 136 T.C. 17 (2011), that the six-year statute of limitations period is inapplicable to an overstatement of basis.

What Does this Mean?

As it stands, there is a clear split in the circuits regarding whether an overstatement of basis is an omission from gross income that is subject to the six-year statute of limitations period under sections 6229(c)(2) and 6501(e)(1)(A) and whether the final regulations should be given *Chevron* deference. More appeals are docketed and future trial-level and appellate decisions on this issue are expected. However, taxpayers should review their returns to determine whether the IRS can assess additional tax under the extended statute of limitations period. Furthermore, due to the conflicting decisions of the courts, taxpayers litigating this issue should be aware of the jurisdiction to which their case would be appealed.

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