

May 14, 2012

## U.S. Supreme Court Holds That Extended Six-Year Statute of Limitations Is Not Triggered by an Overstatement of Basis

On April 25, 2012, a divided five-to-four U.S. Supreme Court held in *U.S. v. Home Concrete & Supply, LLC, et al.*, 566 U.S. \_\_\_, 2012 WL 1413964 (2012), that the extended six-year statute of limitations under IRC Section 6501(e)(1)(A) is not triggered by a taxpayer's overstatement of basis in property, even if the overstatement of basis results in an understatement of gain greater than 25% of the gross income stated on the taxpayer's return.<sup>1</sup> The case is important for its substantive tax holding because it limits the ability of the Internal Revenue Service (IRS) to extend the general statute of limitations, which requires that any tax imposed by the Code be assessed within three years after the return was filed. The case is also important for its analysis regarding what level of deference should be afforded to Treasury regulations, specifically regulations attempting to retroactively interpret a statute in a manner inconsistent with established case law.

### Majority Holds That *Colony* Must Be Followed

Section 6501(e)(1)(A) provides an exception to the general statute of limitations, extending it to six years if a "taxpayer omits from gross income an amount includible therein and . . . such amount is in excess of 25 percent of the amount of gross income stated in the return." The Supreme Court ruled that the doctrine of *stare decisis* required it to interpret this statute in accordance with the Court's holding in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which had reviewed the predecessor to Section 6501(e)(1)(A) and held that a taxpayer's overstatement of basis in property does not fall within the scope of the statute. The statute reviewed in *Colony*, however, was a provision of the Internal Revenue Code of 1939. The provision was recodified in the 1954 Code and two additional subsections were added.<sup>2</sup> The government asserted that the 1954 additions justified a different interpretation of the statute. The Court disagreed with the government, finding the statutory argument "too fragile to bear significant argumentative weight." *Home Concrete* at \*5.

### Regulation Not Entitled to *Chevron* Deference

On December 17, 2010, the IRS issued Treasury Regulation § 301.6501(e)-1, departing from *Colony* and interpreting retroactively the extended six-year statute of limitations provision of Section 6501(e)(1)(A) as being triggered when an omission of gross income results from an overstatement of basis in property sold by a taxpayer. Seizing on language in *Colony* that "it cannot be said that the language [in the statute] is unambiguous," 357 U.S. at 33, the government argued that the new regulation in effect superseded *Colony* because the statute at issue is ambiguous and under *Chevron, U.S.A., Inc. v. National Resources*

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<sup>1</sup> With regard to the same issue reviewed in *Home Concrete*, Sutherland was retained to file a petition for certiorari to the U.S. Supreme Court requesting a review of the U.S. Court of Appeals for the Seventh Circuit decision in *Beard v. Commissioner*, 633 F.3d 616 (7<sup>th</sup> Cir. 2011), *cert. granted and judgment vacated*, \_\_ S.Ct. \_\_, 2012 WL 1468526 (U.S. Apr. 30, 2012). Sutherland also represented taxpayers in one of the two appellate court cases in which taxpayers had prevailed on this issue. See *Burks v. U.S.*, 633 F.3d 347 (5<sup>th</sup> Cir. 2011), *cert. denied*, \_\_ S.Ct. \_\_, 2012 WL 1468574 (U.S. Apr. 30, 2012).

<sup>2</sup> The current Section 6501(e)(1)(B) was one of the new additions. Section 6501(e)(1)(B) limits the triggering of the extended statute of limitations with regard to a trade or business by defining "gross income" as the "total of the amounts received or accrued from the sale of goods or services . . . prior to diminution by the cost of such sales or services."

*Defense Council, Inc.*, 467 U.S. 837 (1984) (*Chevron*) and *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967 (2005) (*Brand X*), the reasonable interpretation of the ambiguous statute by the IRS should be given deference, even over prior U.S. Supreme Court case law. 545 U.S. at 982 (Holding that the deference entitled to an agency's reasonable interpretation promulgated in a regulation is so great that a "court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute . . ."); see also *Mayo Foundation for Medical Ed. And Research v. United States*, 562 U.S. \_\_\_ (2011).

The Court disagreed that the new regulation was entitled to *Chevron* deference, holding that "*Colony* has already interpreted the statute, and there is no longer any different construction that is consistent with *Colony* and available for adoption by the agency." *Home Concrete* at \*7. In support of the holding, a plurality of four justices seemed to take a step back from *Brand X*, concluding that before a regulation can receive *Brand X* authority to overturn a pre-*Chevron* case, that case must have determined that Congress left a statutory gap for the government agency to resolve, and such a gap does not exist merely because the earlier court described the statute as ambiguous. The plurality of justices then concluded that the Court in *Colony* had decided that there was no gap to fill in the statute, and thus the IRS regulation was invalid because it was contrary to *Colony*.

In a concurring opinion, Justice Scalia agreed with the decision of the Court but faulted the plurality opinion for holding that the Court in *Colony* had determined that there was no gap in the statute for the IRS to fill. He suggested that the plurality took a strained reading of *Colony* in a misguided effort to stand by both *Colony* and *Brand X*. Justice Scalia asserted that the plurality's position had created another confusing layer to the *Chevron* deference analysis. Justice Scalia suggested that the better course of action would have been to either hold that the Commissioner's interpretation was unreasonable or overturn *Brand X*, either of which would have resulted in no deference being accorded to the regulation.

The dissenting opinion, which included four justices, found enough differences between the statute at issue in *Colony* and the recodified statute to support the IRS's reading that an overstatement of basis can trigger the extension of the statute of limitations. The dissent concluded that the IRS had the authority to adopt its reasonable interpretation of the statute, and said that the Court "should be open to an agency's adoption of a different interpretation where, as here, Congress has given new instruction by an amended statute." *Home Concrete* at \*16.

**Sutherland Observation:** *Home Concrete* shows that the justices of the U.S. Supreme Court are not in agreement as to what level of deference should be accorded to a Treasury regulation when it purports to supersede prior case law. The plurality held that a subsequent agency regulation is entitled to *Chevron* deference only when Congress delegates "gap filling" authority to the agency, but it is unclear whether a majority of the Court would agree. Furthermore, while *Home Concrete* makes clear that there are real constraints on an agency's ability to overrule a Supreme Court case by regulation, it is unclear whether lower court cases provide a similar restraint.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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