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U.S. Supreme Court Takes Up Issue of Basis Overstatement in Tax Returns

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Normally, the Internal Revenue Service must assess any additional tax within three years after the taxpayer's income tax return is filed. Special rules apply, for example, the IRS can assess at any time when a return is false or fraudulent, or when no return is filed. Perhaps the most important special rule is the six year statute applicable if the taxpayer omits from his or her gross income an amount in excess of 25 percent of the amount stated in the return. (Internal Revenue Code Section 6501(e)(1)(A)(i)).

Does the extended statute of limitations for an omission from gross income apply when the taxpayer overstates the basis in assets being sold? This issue was addressed in *Colony Inc. v. Commissioner*, 357 U.S. 28 (1958). In *Colony*, the taxpayer, a real estate company, understated its business income by erroneously including unallowable development expenses in the basis of the lots sold. The U.S. Supreme Court held that the basis overstatement was not an omission from gross income that would extend the statute of limitations. It noted that Congress did not clearly address whether an overstated basis qualified as an omission from gross income.

The Court found that the legislative history indicated that Congress was addressing the specific situation where a taxpayer actually omitted an item from gross income, not where the taxpayer made computation errors. Congress' purpose was to provide the IRS extra time to investigate returns if, "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." In *dicta*, the Court also stated its conclusion was "in harmony with the unambiguous language of [Section] 6501(e)(1)(A)...."

The current statute, however, differs from the version in *Colony*. First, in the case of a trade or business, gross income means the total received or accrued from the sale of goods or services (if required to be shown on the return) before reduction by the cost of the sales or services. Second, any amount disclosed in the return or in a statement attached to it "in a manner adequate to apprise the Secretary of the nature and amount of such item" is ignored. (Internal Revenue Code Section 6501(e)(1)(B)). To what extent do these additions impact the application of *Colony*?

In *Phinney v. Chambers*, 392 F. 2nd 680 (5th Circuit 1968), a surviving spouse reported as a sale of stock, which would have received a basis increase at her husband's death, what was actually an installment note, which was not entitled to a basis increase. The court held that the basis overstatement was an omission because the IRS had inadequate notice of the item.

SPECIAL REPORT

Top Women Lawyers

Our annual list of the Top Women lawyers in the state.



Thursday, May 12, 2011

Discipline

Receiver Sues Sedgwick For Malpractice

Sedgwick LLP has been hit with a \$200 million malpractice suit over its work for accused fraudulent investment company Medical Capital Holdings Inc.

Health Care & Hospital Law

Former Biotech GC Acquitted

A U.S. judge acquitted former GlaxoSmithKline general counsel Lauren Stevens on Tuesday of all six charges against her in an investigation of the company's marketing practices for an anti-depressant.

Zoning, Planning and Use

The Curse of Chavez Ravine

Are the Dodgers' financial problems a case of delayed retribution for how Dodger Stadium came about? By **Gideon Kanner** of Loyola Law School

International

The Benefits of Bilateral Investment Treaties When Investing in China

Bilateral investment treaties operate as "free insurance" with its minimal costs and direct benefits. By **Allan Marson, Grant Hanessian,** and **Michiel Kloes** of Baker & McKenzie

Construction

What to Do With a Busted Project

Distressed real estate projects are getting a shot of much needed adrenaline from preferred equity. By **Anita F. Sabine** of O'Melveny & Myers LLP

Letter to the Editor

America Is a Fair Country

Leon Snaid responds to "Death of Osama bin Laden: Could There Have Been a Trial?"

Criminal

Panel Lawyers Could Be Curtailed

A committee of federal judges is considering whether to create a new "alternate" public defender's office in the Central District of California that would be independent of the existing institution.

Judge Bars Gang Injunction Enforcement

A federal judge has approved an unusual permanent injunction against the Orange County district attorney, barring him from enforcing a gang injunction won in state court against 48 people.

Does the extended statute of limitations for an omission from gross income apply when the taxpayer overstates the basis in assets being sold?

Following *Phinney* there were few "overstatement of basis" cases until the Son-of-BOSS (Bond and Option Sales Strategy) tax shelters made their way to the courts. This shelter used a short sale mechanism to artificially increase the basis in a partnership interest, thereby limiting the capital gains tax on the sale. Some Son-of-BOSS cases found *Colony* inapplicable and an overstatement of basis to be an omission of gross income. (*Brandon Ridge Partners v. U.S.*, 100 AFTR 2d 2007-5347 (M.D. Fla. July 30, 2007)). Others including the 9th U.S. Circuit Court of Appeals in *Bakersfield Energy Partners L.P. v. Commissioner*, 568 F. 3d 767 (9th Cir. 2009), found *Colony* controlling and an overstatement of basis not to be an omission of gross income. And in the past two months, three federal appeals courts have decided such cases, with two favoring the taxpayers.

On Jan. 26, *Beard v. Commissioner*, 107 AFTR 2d 2011-552 (7th Circuit) held that *Colony* was not controlling and that "a plain reading of [the statute] would include an inflation of basis as an omission of gross income in non-trade or business situations." The court also addressed a temporary Treasury regulation issued, without a notice and comment period, during the pendency of the Son-Of-BOSS cases, designed to confirm the IRS' omission of gross income position. The court did not have to determine the level of deference due the regulation because it found that *Colony* was not controlling. However, the court indicated that it would have been inclined to grant the regulation controlling deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984). Though the 7th U.S. Circuit Court of Appeals did not cite the Supreme Court's 15-day old decision in *Mayo Foundation for Medical Education and Research et al. v. U.S.*, No. 09-837 (Jan. 11), its view is consistent with *Mayo's* deferential tone.

On Feb. 7, *Home Concrete & Supply LLC v. U.S.*, 107 AFTR 2d 2011-768 (4th Circuit) held that "omits from gross income" is not dependent upon whether a taxpayer is in a trade or business. It also rejected deference to the IRS' regulation because the Supreme Court in *Colony* had declared the statute "unambiguous."

Two days later, the 5th U.S. Circuit Court of Appeals weighed in. (*Burks v. U.S.*, Case no. 09-11061 and 09-60827 (Feb. 9)). This was especially noteworthy because it had ruled 33 years earlier in *Phinney* that an overstatement of basis is an omission from gross income. The Court distinguished the *Phinney* fact situation as "a fundamental misstatement of the nature of an item reported in a tax return that places the Commissioner at a disadvantage in detecting the error...." The Court decided to "join the Fourth, Ninth and Federal Circuits by finding that *Colony's* holding with respect to the definition of 'omits from gross income' remains applicable in light of the revisions to the Code." It also refused to give deference to the regulation for the same reason as the 4th U.S. Circuit Court of Appeals: The statute is unambiguous.

The history and mystery of the meaning of "omission from gross income" for the last half century is finally headed to the Supreme Court. The Court's decision is likely to cast new light on its recent *Mayo* decision and the level of deference due IRS regulations.

Judicial Profile

Making Her Mark

A framed reproduction of Botticelli's *Calumny of Apelles* hangs in U.S. Magistrate Judge Jennifer L. Thurston's chambers. The colorful painting, rich in allegory, depicts Slander dragging Innocence - the victim of false accusations by Envy,

Intellectual Property

Nevada Newspaper Pursues Copyright Cases

Despite some recent unfavorable court rulings, a Nevada company appears to be doubling down on its bet that suing hundreds of defendants for infringing the copyright of a Las Vegas newspaper is a winning strategy.