

Seventh Circuit Overturns Tax Court on Gross Income Omission

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The first federal appeals court to issue a decision in one of several government appeals from the Tax Court on whether the IRS can invoke a six-year statute of limitations period when basis has been overstated on a tax return has held that the extended statute of limitations applies.

The U.S. Court of Appeals for the Seventh Circuit held January 26 in *Beard v. Commissioner* that the Supreme Court's decision in *Colony Inc. v. Commissioner*, 357 U.S. 28 (1958), was factually distinguishable and did not have to be followed. "The plain meaning of the Code and a close reading of *Colony* lead us to the conclusion that, given the changes to Section 6501(e)(1)(A), *Colony* does not control here and an overstatement of basis can be treated as an omission from gross income under the 1954 code," it wrote. (For *Beard v. Commissioner*, No. 09-3741 (7th Cir. Jan. 26, 2011), see *Doc 2011-1764* or *2011 TNT 18-10*.)

The government has taken a litigating position that it will assert a six-year statute of limitations in cases in which taxpayers report overstated property items on their tax returns. The extended period of limitations is in contrast to the general three-year limitations period for issuing a deficiency notice. Treasury recently issued final regulations that adopt that position in administrative form. (For T.D. 9511, see *Doc 2010-26662* or *2010 TNT 240-11*. For the temporary regs (T.D. 9466), see *Doc 2009-21297* or *2009 TNT 184-9*. For prior coverage, see *Tax Notes*, Jan. 17, 2011, p. 257, *Doc 2011-744*, or *2011 TNT 9-2*; and *Tax Notes*, Aug. 24, 2009, p. 758, *Doc 2009-18720*, or *2009 TNT 161-5*.)

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The Seventh Circuit agreed that the government's take on the statute was correct. Freed from the constraints of *Colony*, the court wrote that "the clear, dry line from the language to the plain meaning of section 6501(e)(1)(A) is preferable."

Although the statutory text "omits from gross income" remained the same in both the 1939 and 1954 codes, the court said the inclusion of two new subsections added to section 6501(e)(1)(A) in the 1954 code served to remake the overall meaning of

the law. The court held that Congress was addressing the same perceived deficiencies in the statute that *Colony* itself tried to address and that the statutory changes were meant to "clarify a plain reading of the statute and quell [any] confusion." According to the court, subsection (i) was not a calculation clarification; instead, it was intended to ensure that "an inflation of basis should be considered an omission from gross income such that it triggers the extended six-year statute of limitations."

The court chose to focus on the phrase "gross income" in the statute, deciding that because no specific definition of the term is available, the general meaning assigned to it encompassed "an inflation of basis as an omission of gross income in non-trade or business situations." The court held that omissions from gross income is a broad concept that includes more than just specific items listed on a return.

Given the court's position on the plain meaning of the statute, it did not decide whether the temporary regulations under section 6501(e) were valid. However, it wrote that "we would have been inclined to grant the temporary regulation *Chevron* deference."

Robert E. McKenzie of Arnstein & Lehr LLP, who represented the taxpayers in the case, told Tax Analysts, "We are very disappointed. I was surprised by the decision, because it took the position that the 1954 code amendments allowed a reading of the [statute of limitations] law contrary to *Colony* when it reviewed the 1939 code." McKenzie added, "This decision is far-reaching in that it would essentially extend the [statute of limitations] for all significant capital transactions. The IRS will be able to review basis in each capital transaction in light of the new 1099B reporting of basis required for this year."

Emily A. Parker, a partner with Thompson & Knight LLP in Dallas, said the Seventh Circuit's opinion adopting the government's interpretation of section 6501(e) "renders all arguments over the regulation's retroactivity irrelevant." The court was intent on looking at the statutory text, she said. "If the Supreme Court were to apply this same approach, it would say *Colony* is overread by taxpayers," she said.

Parker said she believes that "courts generally look for interpretations of statute of limitations provisions that protect the government." But even when unsympathetic taxpayers are under consideration, as in *Beard*, "courts should interpret the statute as it exists," she said.

Kevin Johnson, a shareholder at Chamberlain, Hrdlicka, White, Williams & Martin, said that "the government's argument was overreaching, and the

circuit got it wrong in following that rationale." The court probably reached its conclusion in part because it considered the taxpayer to be involved in a tax shelter, he said.

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Patrick J. Smith of Ivins Phillips & Barker said that "the way the court reached its result is surprising," adding, "I think few practitioners would have expected the court to say that not only should *Colony* be limited to the 1939 code and thus not controlling, but that the IRS's position was right under the plain meaning of the statute, without any need to resort to the regulations." He also noted that the *Beard* decision makes the Seventh Circuit the first appellate court to consider both the section 6501(e) issue and the two-year innocent spouse filing period regulation under section 6015(f), both of which involve situations in which the IRS has issued regulations related to time limits.

Beard is unlikely to be the last word on the issue, Smith said. "Even if the IRS wins some of the other outstanding cases, I don't think those circuits are likely to follow the same analytical path," he said. Although the circuit's decision arguably sets up a conflict with the Ninth and Federal circuits that could be taken up by the Supreme Court, a grant of certiorari is unlikely until at least some of the other appeals have been resolved, he said. (For Smith's article on the gross income omission issue, "Omissions From Gross Income and the *Chenery* Rule," see *Tax Notes*, Aug. 16, 2010, p. 763, Doc 2010-16074, or 2010 TNT 158-3.)

Josh O. Ungerman of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP said that "instead of flat-out refusing to follow the Supreme Court precedent in *Colony*, the Seventh Circuit merely decided that the Supreme Court's decision in *Colony* did not control in the Seventh Circuit" on the basis that "the omission in the Seventh Circuit case was not in the course of a trade or business."

The Seventh Circuit is the first circuit court, when faced with a late-1990s overstated basis case, "to fail to rein in the government's expansive statute of limitations grab to extend the traditional three-year statute of limitations to six years," Ungerman said. The *Beard* decision "leaves little room for doubt that a split in the circuits now exists, and the issue will definitely make its way back to the Supreme Court," he said.

Other circuits that have heard appeals so far include *Home Concrete & Supply LLC v. United States*,

No. 09-2353 (4th Cir. Oct. 27, 2010); *Burks v. United States*, No. 09-11061 (5th Cir. Oct. 27, 2010); *Salman Ranch Ltd. v. United States*, No. 09-9015 (10th Cir. Sept. 22, 2010); and *Grapevine Imports Ltd. v. United States*, No. 2008-5090 (Fed. Cir. Jan. 12, 2011). ■