Tax Notes Today

FEBRUARY 10, 2011

Fifth Circuit Finds No Omission, Deepens Circuit Split

by Jeremiah Coder

Summary by taxanalysts

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"An overstatement of basis that adequately appraises the Commissioner of the nature of the item being reported does not constitute an 'omission from gross income' for purposes of [section] 6501(e)(1)(A)," wrote Judge Harold R. DeMoss Jr. in the consolidated cases of *Daniel S. Burks v. United States* (No. 09-11061) and *Commissioner v. MITA* (No. 09-60827). (For the decision, see *Doc 2011-2857*.) The Fifth Circuit's decision comes just days after a similar outcome in the Fourth Circuit. (For *Home Concrete & Supply LLC v. United States*, No. 09-2353 (4th Cir. Feb. 7, 2011), see *Doc 2011-2674* or *2011 TNT 26-7*. For prior coverage, see *Doc 2011-2673* or *2011 TNT 26-1*.)

Although prior circuit precedent, *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), had held that the six-year limitations period could be invoked when a taxpayer's return overstated the basis of an item, the Fifth Circuit in *Burks* said *Phinney* "involved a distinct fact pattern" that could be distinguished from the instant case. The court determined that *Phinney* did not limit the holding in *Colony Inc. v. Commissioner*, 357 U.S. 28 (1958) because both cases stand for the proposition that either an actual return omission, or a "fundamental misstatement of the nature of an item," has to occur for section 6501(e)(1)(A) to apply. Absent such circumstances, a mere misstatement of amount on a return does not put the IRS at a "special disadvantage in detecting errors"; concluding otherwise would render the general three-year limitations period "meaningless," the court wrote.

Revisions to section 6501(e)(1)(A) in the 1954 code that added two new subsections did not displace *Colony*'s applicability, the court held. While the IRS argued that the statutory additions were meant to confine *Colony*'s outcome to cases involving a trade or business, the court said the subsections were clarifications meant to provide an alternative definition to gross income when sales of goods and services were involved for purposes of determining the 25 percent threshold. "Subsection (i) is not rendered superfluous by application of *Colony* outside the context of a trade or business," the court held.

The court refused to give deference to Treasury regulations, finalized last year under section 6501(e)(1)(A), that adopted the government's litigating position, because the statute was unambiguous and controlled by *Colony*. The court found no authority on which to deem the regulations as "trump[ing]" established precedent, calling the government's retroactive application argument "circular." Because the regulations "are an unreasonable interpretation of settled law, we find that they are not applicable to the taxpayers in the present matters," the court said.

In a footnote, the court theorized that the Treasury regulations would not necessarily be subject to *Chevron* deference even if the statute was ambiguous and *Colony* didn't control. The Supreme Court's recent *Mayo* decision did not face "a situation where, during the pendency of the suit, the [T]reasury promulgated determinative retroactive regulations following prior adverse judicial decision on the identical legal issue," the court said in critcizing the government's position. The lack of notice and comment procedures in promulgating the temporary regulations were a cause for concern that might preclude *Mayo*'s applicability, and the eventual passage of final regulations was "not an acceptable substitute for pre-promulgation notice and comment," the court said.

Joel N. Crouch and David E. Colmenero of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP, who represented one of the taxpayers before the Fifth

Circuit, told Tax Analysts that they were pleased with the decision. In rejecting the regulations, the Fifth Circuit, along with similar outcomes in other circuits, "sent a clear message to the IRS that it is bound by the law and the statute of limitations in the same manner that taxpayers are," Crouch said. "The IRS does not have a carte blanche to rewrite the law for its benefit in a way that undermines established law and Congressional intent through the use of its rule making authority or by misconstruing case law," added Colmenero.

The Fifth Circuit's opinion calls into question a decision last month by the Seventh Circuit, the only circuit to side with the government so far. In *Beard v. Commissioner*, No. 09-3741 (7th Cir. Jan. 26, 2011), the Seventh Circuit relied heavily on the *Phinney* precedent to conclude that *Colony* did not control statutory interpretation of section 6501(e) following changes in the 1954 code. Some practitioners said the taxpayer in *Beard* may now have sufficient grounds to seek *en banc* review. (For prior coverage of *Beard*, see *Doc 2011-1726* or *2011 TNT 18-1*.)

Stuart J. Bassin of Baker & Hostetler LLP said that the *Burks* decision "shows the difficulty the IRS is having in selling the courts on its view" of how partnership rules operate under the 1982 Tax Equity and Fiscal Responsibility Act. The government has been fighting an uphill battle in litigation because "the rules weren't developed with these small partnerships in mind -- it's like trying to fit a square peg into a round hole," he said.

In reading *Chevron* and *Mayo*, "one could have thought that the Service had virtually unbridled regulation writing authority," Bassin said, "but now two circuits have shown us that there are limits, which is extremely important in a whole host of areas." In considering whether a grant of certiorari is likely if the government or a taxpayer appeals, the Supreme Court could be reluctant to take a case because it can only address part of the problem of fitting partnership audits into the overall scheme, he said. "Section 6501(e) is of interest to some people, but in the long run, I suspect both taxpayers and the Service can live with this group of decisions."

Alan I. Horowitz of Miller & Chevalier said the IRS no longer has the opportunity to resolve the section 6501(e) issue in its favor without Supreme Court review, following the Fourth and Fifth circuits' decisions this week. "After *Beard*, the government might have entertained the hope that it could turn the issue around in the other courts, but that's now gone," he said. The government could seek certiorari and might relish that opportunity because "the Supreme Court is likely to be freer to adopt a narrow construction of *Colony*," he said. Because the IRS only needed one appellate win to make a strong case for Supreme Court review, additional decisions going against the government's position won't necessarily be harmful to it in the long term, he said.

Asked to hazard a guess on the likelihood of certiorari being granted, Horowitz, a former assistant in the Office of the Solicitor General at the Justice Department, said that "the government has a lot of money at stake in these cases, which could be enough to attract the Supreme Court's attention."

Tax Analysts Information

Code Section: Section 6501 -- Limitations on Assessment
Jurisdiction: United States
Subject Areas: Litigation and appeals
Compliance
Partnership taxation
Information disclosure
Practice and procedure
Author: Jeremiah Coder
Institutional Author: Tax Analysts
Tax Analysts Document Number: Doc 2011-2861
Tax Analysts Electronic Citation: 2011 TNT 28-1

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