

Capital Gain: Three-Year or Six-Year Statute of Limitations?

By Robert W. Wood

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In this column, Wood addresses the debate over the applicability of the six-year statute of limitations, and in particular whether lawsuit recoveries could be caught within it by virtue of capitalized legal fees. Concluding that capital gain character issues should not be considered basis overstatements even if the IRS's current basis position is upheld, Wood nevertheless concludes that caution is in order.

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Nearly everyone knows that the primary federal tax statute of limitations — the time the IRS has to audit and ask for more money — is three years following the filing of a tax return.¹ One other rule many people know is that there is no tax statute of limitations on fraud. In terms of the running of the statute of limitations, tax fraud is the equivalent of murder.

But specialized tax knowledge is generally required to appreciate the nuances of the statute of limitations beyond the extremes of three years versus never. The important and increasingly controversial exception to the normal three-year rule is that in some circumstances, the limitations period is extended to six years. A lot can happen in three years, so you'll want to know whether your return is hot for three years or six.

The six-year statute of limitations applies when a taxpayer has omitted 25 percent or more of his gross income.² That sounds simple enough. However, the IRS

¹Actually, the IRS may have additional time to assess tax from transferees, even if it is barred with respect to the taxpayer. Section 6901(c); *Bentley v. Commissioner*, T.C. Memo. 1997-119, Doc 97-6852, 97 TNT 47-11.

²Section 6501(e)(1)(A).

has sought to apply the six-year statute not merely to omissions of 25 percent or more of a taxpayer's income, but also when there is a tax effect sufficient to have the economic impact of such an omission. In fact, the IRS has begun aggressively seeking to expand the circumstances in which this six-year statute can be invoked.

The primary area in which the IRS tries to invoke the six-year statute (outside outright omissions of income) relates to overstated basis in assets. If the taxpayer in a capital transaction claims an overstated basis, the IRS argues that the extended limitations period should apply because the effect of overstating basis amounts to an omission.

Example: Jack sells for \$2 million a building he bought 10 years ago for \$100,000. He has a gain of \$1.9 million, and his limitations period runs in three years. But if Jack claimed a basis of \$1 million instead and therefore reported only a \$1 million gain, he overstated basis and therefore might face a six-year statute. Jack might have a fraud problem too, but I'll try to think positively and assume that he ramped up his basis with maintenance costs, painting, and other expenses that were claimed in good faith but legitimately should not have been added to basis if Jack were tax-savvy.

The basis overstatement in Jack's case seems clear. A significant legal question is whether that basis overstatement, regardless of its effects, should trigger the six-year statute. As we'll see, it's unclear whether the IRS has a proverbial leg to stand on in asserting that a basis overstatement yielding the same percentage effect as an omission from income actually triggers the six-year statute. Whether or not it is eventually held to do so, I want to posit a case even further along the continuum.

Example: Jill receives a lawsuit settlement (relating to her factory, which burned down). She reports it as a capital gain. Jill is aware that the IRS might take the position it is ordinary income. Her gross recovery is \$5 million. Her lawyer receives 40 percent, or \$2 million, so Jill keeps \$3 million. She reports the full \$5 million on Schedule D of her Form 1040, treating the \$2 million in fees as capitalized and thus added to basis. Is Jill's return subject to audit for three years or six?

The IRS could challenge the use of capitalized attorney fees on Schedule D of Jill's return to offset gain on her recovery. Technically, of course, she treats the attorney fees as basis, or as a selling expense in the year of sale which arguably amounts to the same thing. The IRS could argue that Jill's basis overstatement is the same as Jack's, thus triggering the requisite 25 percent omission. If it were successful in that assertion, the character of the item would presumably also be open to challenge.

Eye of the Beholder

As a general rule, additional federal income taxes must be assessed within three years after a tax return is filed.³ However, a six-year statute of limitations is triggered if a taxpayer “omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return.”⁴ The IRS has increasingly tried to expand the reach of this six-year statute.

Interestingly, the IRS does not appear to be inclined to argue that a question of the character of income as capital versus ordinary is an omission of income triggering the six-year statute. In a field service advice dated February 3, 1998, the IRS Office of Chief Counsel declared:

We think it is clear that a taxpayer must be given credit for the amounts reported on its return even if the Service takes the position that the characterization of such amounts is incorrect.⁵

In support, the field service advice cited *Davis v. Hightower*.⁶ In that case, the IRS unsuccessfully tried to use the extended limitations period to challenge the capital gain treatment of a sale of cotton. The gross proceeds from the sale were fully and accurately stated on the return, but under then prevailing tax law, only 50 percent of capital gains were included in net income.

The Fifth Circuit held that the longer statute of limitations could not apply. The only way there could be a 25 percent omission of income, the court said, was if the taxpayer abandoned his claim to capital gain treatment. The court reasoned:

It cannot be thought that if a taxpayer accurately fills in every blank space provided for his use in the income tax form, giving every “gross” or maximum figure called for, and arrives at an incorrect computation of the tax only by reason of a difference between him and the Commissioner *as to the legal construction to be applied to a disclosed transaction*, the use of a smaller figure than that ultimately found to be correct in one stage of the computation amounts to an omission from “gross income” of the difference between the correct and incorrect item.⁷

A similar case dealing with the character of a disclosed item is *Slaff v. Commissioner*.⁸ There, the taxpayer reported the full amount of his income earned abroad on his tax return but (erroneously) claimed it was tax exempt. The court held the commissioner was barred from invoking the extended limitations period because there was no omission of income on the return.

Excess Basis

It is clear, of course, that the IRS likes its overstatement of basis theory. That is odd, since until recently the question whether an overstatement of basis constituted

an omission of income was thought to be conclusively answered in the negative by the Supreme Court in *Colony, Inc. v. Commissioner*.⁹ In that case, the IRS attempted to apply a five-year statute of limitations (the predecessor to today’s six-year period). The taxpayer had reported the full sales proceeds of real property but overstated its basis, thus resulting in a smaller amount of tax collected.

The Supreme Court held that the term “omission” did not mean a mere understatement of *net* income. An omission required leaving out specific income receipts from the computation of gross income on the return. This seems to be clear and unequivocal precedent, from the Supreme Court, no less. Yet the IRS has sought to limit or even overturn *Colony*.

For example, the IRS has argued that *Colony’s* holding applies only to gains recognized in a trade or business.¹⁰ By anyone’s measure, the IRS has so far met with limited success. The Tax Court, the Ninth Circuit, and the Federal Circuit have all rejected the IRS’s attempts to limit *Colony* to its facts, reasoning that the Supreme Court’s holding was not limited to a trade or business context.¹¹

However, a few district courts have agreed with the IRS that a basis overstatement can constitute an omission of income.¹² After losing one such basis case, *Intermountain*, the IRS issued temporary regulations in an attempt to bootstrap its way to victory. Those regulations purport to “clarify” section 6501(e). They provide that, except for the sale of goods and services in a trade or business, “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 Section 6501(e)(1)(A).”¹³

By their terms, these temporary regulations apply retroactively to all tax years that have not expired before September 24, 2009. The regulations themselves expire on September 24, 2012. However, talk of expiration may seem odd, since so far the IRS has been unsuccessful in enforcing them.

In fact, the Tax Court recently struck down the regulations as invalid, in a decision reviewed by the full

⁹357 U.S. 28 (1958).

¹⁰Subsections (i) and (ii) of section 6501(e)(1)(A) were added shortly before the *Colony* decision but did not apply to the tax year at issue. In the case of the sale of goods or services in a trade or business, subsection (i) now specifically defines “gross income” to mean gross receipts, without deduction for the costs of those goods or services.

¹¹*Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 2009), Doc 2009-13801, 2009 TNT 115-10; *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed Cir. 2009), Doc 2009-17311, 2009 TNT 145-13; *Intermountain Insurance Service of Vail, LLC v. Commissioner*, T.C. Memo. 2009-195, Doc 2009-19672, 2009 TNT 168-5.

¹²*Brandon Ridge Partners v. United States*, 2007-2 U.S.T.C. (CCH) 50,573 (M.D. Fla. 2007), Doc 2007-17831, 2007 TNT 148-14; *Home Concrete & Supply, LLC v. United States*, 599 F. Supp.2d 678 (E.D.N.C. 2008), Doc 2009-1548, 2009 TNT 15-14.

¹³Reg. section 301.6501(e)-1T(a)(1)(iii).

³Section 6501(a).

⁴Section 6501(e)(1)(A).

⁵1998 FSA LEXIS 217.

⁶230 F.2d 549 (5th Cir. 1956).

⁷*Id.* at 553 (emphasis added).

⁸220 F.2d 65 (9th Cir. 1955).

court.¹⁴ The Tax Court majority clearly disapproved of the IRS's attempt to reverse its loss in court by retroactively extending the limitations period. The court found the temporary regulations to be contrary to the Supreme Court's decision in *Colony*. They were not entitled to any deference, the Tax Court said.

However, this was not a unanimous Tax Court decision. Six of the 13 judges who considered the case would have dismissed the IRS's motion on narrower grounds. Whether a basis overstatement should be viewed as an omission of income continues to be controversial.

And more fodder appears to be headed our way. The IRS has invoked its temporary regulations in several other cases, including appeals pending before the Fourth, Fifth, Seventh, and Tenth circuits.¹⁵ The IRS seems determined to get what it believes is the "right answer."¹⁶ But commentators have questioned whether the temporary regulations will ultimately be upheld.¹⁷ One article noted that the Service's aggressive action:

could add a new dimension to the ongoing debate over the level of judicial deference to IRS guidance, and it pits two Supreme Court decisions against each other. While *Colony* stands for the proposition that overstated basis does not constitute gross omission from income under the tax code, *Brand X* supports the notion that the IRS can issue a regulation at odds with judicial precedent. Which opinion prevails?¹⁸

The Tax Court answered this question by quoting *Chevron U.S.A. v. Natural Resources Defense Council*: "The judiciary is the final authority on issues of statutory construction."¹⁹

¹⁴*Intermountain Insurance Service of Vail, LLC v. Commissioner*, 134 T.C. No. 11 (2010), Doc 2010-10163, 2010 TNT 88-12. Tax Court judges submit all draft opinions to the chief judge of the Tax Court. The chief judge often directs that decisions dealing with high-profile issues, such as the proposed invalidation of a regulation, be reviewed by the full court (that is, all presidentially appointed judges of the Tax Court). See section 7460(b). The Tax Court considers reviewed decisions to be binding precedent. See *Nico v. Commissioner*, 67 T.C. 647, 654 (1977), *aff'd in part, rev'd in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977): "we consider neither revenue rulings nor Memorandum Opinions of this Court to be controlling precedent."

¹⁵See Brief for the Appellee at 13, *Home Concrete & Supply, LLC v. United States*, No. 09-2353 (4th Cir. 2010); Brief for the Petitioner at 17-18, *Commissioner v. M.I.T.A.*, No. 09-60827 (5th Cir. 2010), Doc 2010-14405, 2010 TNT 126-12; Brief for the Appellant at 9, *Commissioner v. Beard*, No. 09-3741 (7th Cir. 2010); Brief for the Appellant at 14, *Salman Ranch, Ltd. v. Commissioner*, No. 09-9015 (10th Cir. 2010), Doc 2010-14404, 2010 TNT 125-20.

¹⁶See Jeremiah Coder, "IRS Undeterred After Tax Court's Intermountain Decision," *Tax Notes*, May 17, 2010, p. 729, Doc 2010-10721, or 2010 TNT 94-6 (quoting Deborah Butler, IRS associate chief counsel (procedure and administration)).

¹⁷See Coder, "IRS Strikes Back Against Judicial Losses in Overstated Basis Cases," *Tax Notes*, Oct. 5, 2009, p. 19, Doc 2009-21733, or 2009 TNT 190-4; and Coder, *supra* note 16.

¹⁸Coder, *supra* note 17, at 21.

¹⁹467 U.S. 837, 843 n.9 (1984).

Summing Up

To return to our examples, Jack and Jill seem to have similar fact patterns. After all, in each case there is no omission of gross proceeds, and — at first glance — each appears to have a potential basis overstatement problem. The IRS could certainly assert in both cases that the effect is a more than 25 percent omission.

Yet there is a fundamental distinction between Jack and Jill. In Jack's case, there is no question about the character of his income from the sale of the building. The sole issue is the amount of his gain. Reaching the conclusion that the six-year statute of limitations applies thus requires a simple, single-step application of the statute. Jack made a clear basis overstatement. Consequently, the IRS can argue the extended statute of limitations should apply.

In Jill's case, the real issue is the capital versus ordinary character of the transaction itself. There is no question about the amount of legal fees Jill reported as her basis, only their placement on her return. If her recovery is properly capital, her legal fees should surely be claimed on Schedule D. If Jill's recovery is ordinary, she would be entitled to a deduction of some sort.

In contrast to Jack's case, Jill's situation thus requires the IRS to take the preliminary step of overturning her claim to capital gain treatment before it can argue she overstated her basis or otherwise omitted income. This is *Davis v. Hightower* all over again.

Even under the temporary regulations, it would be a significant stretch for the Service to try to treat Jack and Jill in the same fashion. Indeed, those regulations don't seem to change the result of *Davis v. Hightower*, since they define the term "omission" only in reference to overstated basis in the disposition of property.²⁰ If the IRS is having a hard time enforcing its position against Jack, Jill should prove to be tougher still.

Basis overstatements are clearly to be decried. Yet given the reaction most courts have had to the IRS's claims, basis overstatements do not appear to trigger the six-year statute of limitations. The Tax Court went so far as to strike down the temporary regulations as invalid. The battle may not yet be over, but the interim results suggest that Jack should be governed by the three-year statute. If Jack is, so clearly is Jill.

But if the IRS eventually prevails against Jack, does Jill too land within the six-year soup? Plainly, that answer should be no. Even if the IRS's basis putsch is upheld, if it attempts to expand Jill's statute to six years, it should be unsuccessful. Still, that doesn't mean it won't try.

²⁰See Mark Allison, "The New Battle in an Old War: Omissions From Gross Income," *Tax Notes*, Mar. 8, 2010, p. 1227, Doc 2010-3180, or 2010 TNT 45-4.