M&A and the Three-Year Statute of Limitations

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Transactional lawyers and dealmakers probably care less about the IRS statute of limitations than many other taxpayers and professionals. In large transactions involving public companies that are audited every year, the assumption is likely to be that everything will be examined in any event. Even outside that rarified atmosphere, the pace of activity is often such that one is considering only the transactions that have not yet closed.

There is less time to worry about the deals that closed last year. There is even less time to worry about the transactions that closed two or even three years ago. Yet on some level, all taxpayers, even including M&A professionals, care about the IRS statute of limitations. When is a transaction safe from audit?

It may have been an earn-out or a reorganization, an asset sale or a stock deal. Whatever it was and however pristine you may think the reporting may have been, it is always good to know when it is truly safe. Unfortunately, knowing when it is safe can be difficult.

Six-Year Battles

With all of the fisticuffs over the three-year versus six-year statute in recent years, determining when a return is safe has become even more perplexing. Fortunately, on April 25, 2012, the Supreme Court issued its decision in *Home Concrete & Supply, LLC.* It resolved a significant split among the Circuit Courts. It was a significant blow to the IRS, though just how significant remains to be seen.

Some people have argued that the opinion can be read as a victory for taxpayers doing tax shelter deals. Sure, some of the taxpayers involved in this and other six-year statute cases bought tax shelters. Some of those shelters were bad.

But they were also not fraudulent, were claimed in good faith and were supported by legal opinions. Although some have suggested that the IRS could have used the unlimited statute of limitations for fraud, that seems a stretch. In any event, that argument was not before the court.

However, one topic that will not go away soon relates to the Treasury's regulatory powers. How will regulations that attempt to go beyond a statute be evaluated, particularly when they attempt to do it retroactively? The Supreme Court leaves many of us guessing at such thematic issues. The Court was split five to four, and the plurality opinion penned by Justice Breyer collected four votes.

Justice Scalia wrote a concurring opinion that disagreed with important points. Four justices dissented in an opinion by Justice Kennedy. The debates are not academic, but it is worth underscoring that resort to the six-year statute is rare. Usually, the IRS invokes it when an audit of one year (open under the three-year statute) extends to connected issues in earlier years.

Nevertheless, the IRS has strayed from this practice, ramping up resort to the six-year statute in court and administratively. All taxpayers should feel a little better post–*Home Concrete*. The Supreme Court told us that:

- the three-year statute of limitations is the base-line (we knew that);
- the six-year statute is an exception (we knew that too); and
- the six-year statute does not apply to overstated basis.

Put differently, when Code Sec. 6501(e)(1)(A) says the IRS gets six years to audit if the taxpayer omits 25 percent or more of his or its gross income, *omits* only means *omits*. Most taxpayers may not want to go further. This, after all, is a sweeping taxpayer victory.

Settled Law?

In *Colony, Inc.*, SCt, 58-2 USTC ¶9593, 357 US 28 (1958), the taxpayer reported the full sales proceeds of a real property sale. However, the taxpayer overstated its basis, thus resulting in a smaller amount of tax collected. In *Home Concrete,* Chief Justice Roberts and Justices Breyer, Thomas and Alito considered the language and intent of the six-year statute.

They found that language and legislative history to be clear when the Court decided *Colony, Inc.* in 1958. Moreover, that clarity hadn't changed, they said. 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. With dogged determination, though, the IRS has sought to limit or even overturn *Colony.* For example, the IRS argued that *Colony*'s holding applies only to gains recognized in a trade or business.

The IRS met with limited success. The Tax Court, the Ninth Circuit, and the Federal Circuit all rejected the IRS's attempts to limit *Colony* to its facts. These courts reasoned that the Supreme Court's holding was not limited to a trade or business context.

However, some courts agreed with the IRS that a basis overstatement *can* constitute an omission of income. After losing one such basis case, *Intermountain Insurance Service of Vail, LLC*, the IRS issued temporary regulations to "clarify" Code Sec. 6501(e). [*Intermountain Ins. Serv. of Vail, LLC*, 98 TCM 144, Dec. 57,918(M), TC Memo. 2009-195 (2009), *supplemented on denial of reconsideration*, 134 TC 211, Dec. 58,209 (2010), *rev'd and remanded*, CA-DC, 2011-2 USTC ¶50,468, 650 F3d 691 (2011), *vacated*, 2012 U.S. LEXIS 3401 (U.S. Apr. 30, 2012).

These temporary regulations provided 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)(i)."

By their terms, these temporary regulations applied retroactively to all tax years that have not expired before September 24, 2009. The temporary regulations themselves were to expire on September 24, 2012, but in 2010, quite quickly by IRS standards, the IRS finalized them.

Nevertheless, the Tax Court in *Intermountain* struck them down as invalid, a decision reviewed by the court. The Tax Court found the temporary regulations to be contrary to the Supreme Court's decision in *Colony*. Yet this was not a unanimous Tax Court decision. Six of the 13 judges would have dismissed the IRS's motion on narrower grounds.

The Supreme Court followed *Colony, Inc., supra,* holding that the six-year statute does not apply to a basis overstatement. True, a basis overstatement wrongly understates a taxpayer's income. However, the "omits" wording limits the statute to situations where specific receipts are *left out* of computing gross income.

The *Colony* Court believed the history of the statute showed Congress did not intend the six-year statute to apply to overstatements of basis. Without effectively overruling *Colony,* the Court *said* no other interpretation seemed possible. Although there were large questions about how much deference Treasury Regulations should receive, the Supreme Court said *Colony* had interpreted the statute and that no different construction consistent with *Colony* could be adopted.

Regulatory Deference?

What does this important case say about regulations, particularly retroactive ones?

The Supreme Court doesn't actually criticize the adoption of the temporary and then final regulations that plainly conflict with the wording of the statute. The Court doesn't even say that they might have been okay had they not been imposed retroactively. In fact, the Court mentions a number of important cases that, some might say, muddy the waters even more.

In *National Cable & Telecommunications Assn. v. Brand X Internet Services*, SCt, 545 US 967 (2005), the Court ruled six-to-three that a law regarding the distinction between telecommunication services and information services was vague, and that the FCC has the authority to make the decision. There has been much debate in the tax world about whether the IRS and the Treasury can interpret the tax law however they want, or only do so if the statute is ambiguous.

That debate is not ended by *Home Concrete*, although it gets a workout in Justice Scalia's romping concurrence. Justice Scalia argues persuasively that the Court should abandon the *Brand X* notion. *Colony* decided *Home Concrete*, he urges, and *Brand X* is wrong.

In stark contrast, the four dissenting justices did not think *Colony* applied at all! They found that the language of Internal Revenue Code Section ("Code Sec.") 6501(e) was not clear but was ambiguous. That meant regulations on such a provision were permissible and even appropriate. The Supreme Court agreed that the regulatory process exists so that statutory gaps are filled in by the respective agencies and not by the courts.

However, the narrowly victorious view of the case is that where there is no ambiguity, there is no gap. If a statute is unambiguous, that means Congress did not delegate gap-filling authority to an agency. The question of retroactivity—a huge point that seems to deserve attention—is not discussed. The Tax Court stated in *Intermountain* that these retroactive temporary regulations violated the Administrative Procedure Act.

However, the various Circuit Courts disagreed over the handling of the retroactivity point, whether the notice and comment period could cure any defects, and other matters. The fact that the Supreme Court did not explain what analysis applies leaves us at least partially in the dark.

Nevertheless, the IRS and the Treasury should feel chastised for having written regulations that were temporary, that conflicted with a Supreme Court decision, and that were retroactive. Yet it is unclear if this subliminal message was even intended by the Supreme Court, much less received. Although the retroactivity point seems the biggest omission in the case, taxpayer reliance is also ignored.

How important was the fact that taxpayers rely on the law and expect changes to be prospective? It isn't clear. The dissent suggested that taxpayer reliance deserves respect. However, this particular law was sufficiently unsettled that they would not allow taxpayer reliance to carry the day in *Home Concrete*.

Set in Concrete?

Home Concrete is a huge decision, one that makes clear that taxpayer contests—while in some respects stacked in favor of the government—can be productive. This is so even when the taxpayer takes on a regulation. Unfortunately, the Court does not lay out a template for how regulatory contests will be refereed.

With all these shortcomings, the Court did at least hold that the six-year statute simply does not apply to basis overstatements. That's no small accomplishment.