Supreme Court: 'Omits' Means Omits

By Robert W. Wood

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In the discussion over the Supreme Court's *Home Concrete* decision, it seems easy to overlook what many clients may find most important. Wood discusses what he views as the case's most significant points, along with what the decision could mean for the future of tax administration.

All taxpayers and tax professionals care about the statute of limitations. We have all come to rely on the fact that in general, three years after a tax return is filed (or, if later, after its due date), the return is safe from audit. It matters to big and small taxpayers alike, business and nonbusiness ones. It may matter most in cases of significant events or transactions.

After all, suppose a taxpayer settles a large lawsuit, takes a company public, acquires a competitor, or expends a huge amount for environmental remediation. Some tax years are more important than others. Even so, the statute of limitations can figure into basic filing decisions.

Taxpayers who might not be required to file a return may do so anyway to start the statute of limitations running. A good example involves federal gift tax returns on which even annual exclusion gifts are sometimes reported. Thus, all taxpayers should care that on April 25, the Supreme Court issued its decision in *United States v. Home Concrete & Supply LLC*.[1]

Because the opinion resolves a significant split among the circuit courts, it should build confidence in taxpayers and their representatives. Three years means exactly three years, it seems to proclaim. The case also represents a significant blow to the IRS, although just how significant remains to be seen.

One big topic relates to Treasury's regulatory powers. How will regulations that attempt to go beyond a statute be evaluated, particularly when they attempt to do it retroactively? In that sense, the Supreme Court may be wearing a Cheshire cat grin, ignoring — to mix metaphors — the elephant in the room.

The opinion leaves us guessing at more thematic issues. The decision was not even close to unanimous. The Court was split five to four. The plurality opinion, penned by Justice Stephen G. Breyer, collected four votes. Justice Antonin Scalia wrote a concurring opinion that disagreed with important points. Justice Anthony M. Kennedy dissented, joined by three others.

Table Stakes

In the debate over when the IRS gets more than three years to audit, it is worth stressing that resort to the six-year statute is relatively 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. In that sense, it is possible to discount the practical importance of the decision to most taxpayers.

Nevertheless, it cannot be denied that the IRS has strayed from its traditional six-year practice. Invoking the six-year statute more frequently has ramped up focus on it, both judicially and administratively, leading eventually to Supreme Court review. All taxpayers should feel a little better post-*Home Concrete.*

The Supreme Court told us that the three-year statute of limitations is the baseline (we knew that); that the six-year statute is an exception (we knew that, too); and that the six-year statute does not apply to overstated basis. Put differently, when

[1]Sup. Ct. Dkt. No. 11-139 (2012), *Doc 2012-8781*, *2012 TNT 81-11*, *aff'g* 634 F.3d 249 (4th Cir. 2011), *Doc 2011-2674*, *2011 TNT 26-7*.

section 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 think further about this analysis. Why look a gift horse in the mouth?

While some people have argued that the opinion can be read as a victory to taxpayers doing questionable tax shelter deals, it is decidedly not that. Sure, some of the taxpayers involved in this and other six-year statute cases bought tax shelters. Admittedly, 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.[2] In any event, that argument was not before the Court.

Colonial View

Chief Justice John G. Roberts and Justices Breyer, Clarence Thomas, and Samuel A. Alito considered the language and intent of the six-year statute. Both were clear when the Court decided *Colony Inc. v. Commissioner* in 1958.[3] The taxpayer in *Colony* had reported the full proceeds from its real property sale but had overstated its basis, thus resulting in an underpayment of tax.

The Supreme Court in *Colony* 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. That is clear and unequivocal precedent, from the Supreme Court no less.

But with dogged determination, the IRS has sought to limit or even overturn *Colony*. For example, it has argued that *Colony*'s holding applies only to gains recognized in a trade or business.[4] Most notoriously, the IRS argued that a basis overstatement is an omission. On this, the IRS met with limited success.

The Tax Court, Ninth Circuit, and Federal Circuit 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.[5] ''Omits'' means omits. However, some courts agreed with the IRS that a basis overstatement can constitute an omission of income.[6] After losing one such basis case, *Intermountain Insurance Service of Vail LLC v. Commissioner*,[7] the IRS issued temporary regulations to ''clarify'' section 6501(e).

This is where the plot truly thickens — and what ultimately landed the issue in the Supreme Court. These 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).''[8] By their terms, the temporary regulations applied retroactively to all tax years that did not expire before September 24, 2009.

The temporary regulations were set to expire on September 24, 2012, but the Service finalized them in 2010 (quite quickly by IRS standards).[9] To the IRS's chagrin, however, the Tax Court (in a reviewed decision) struck them down as invalid.[10] This was not a unanimous Tax Court decision. Six of the 13 judges would have dismissed the IRS's motion on narrower grounds. Nevertheless, the Tax Court found the temporary regulations to be contrary to the Supreme Court's decision in *Colony*.

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[2]Jack Townsend, ''The Supreme Court Blesses Taxpayers Sheltering and Hiding Income from Six-Year Statute of Limitations,'' Federal Tax Crimes (Apr. 25, 2012), *available at* http://federaltaxcrimes.blogspot.com/2012/04/supreme-court-blesses-taxpayers.html.

[3]357 U.S. 28 (1958).

[4]Subsections (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. For 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.

[5]*See Home Concrete*, 634 F.3d 249; *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), *Doc 2011-2857*, *2011 TNT 28-12*; *Equip. Holding Co. v. Commissioner*, 439 Fed. Appx. 368 (5th Cir. 2011) (unpublished), *Doc 2011-18401*, *2011 TNT 168-14*; *Bakersfield Energy Partners LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009), *Doc 2009-13801*, *2009 TNT 115-10*.

[6]*See Beard v. Commissioner*, 633 F.3d 616 (7th Cir. 2011), *Doc 2011-1764*, *2011 TNT 18-10*; *Grapevine Imps. Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011), *Doc 2011-5233*, *2011 TNT 49-14*; *Salman Ranch Ltd. v. Commissioner*, 647 F.3d 929 (10th Cir. 2011), *Doc 2011-11714*, *2011 TNT 105-16*; *Intermountain Ins. Serv. of Vail LLC v. Commissioner*, 650 F.3d 691 (D.C. Cir. 2011), *Doc 2011-18052*, *2011 TNT 164-10*.

[7]T.C. Memo. 2009-195 (2009), *Doc 2009-19672*, *2009 TNT 168-5*, *supplemented on denial of reconsideration*, 134 T.C. 211 (2010), *Doc 2010-10163*, *2010 TNT 88-12*, *rev'd and remanded*, 650 F.3d 691, *vacated*, 2012 U.S. LEXIS 3401 (U.S. Apr. 30, 2012).

[8]Reg. section 301.6501(e)-1T(a)(1)(iii).

[9]Reg. section 301.6501(e)-1(e)(1).

[10]*Intermountain*, 134 T.C. 211 (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) (''We consider neither revenue rulings nor Memorandum Opinions of this Court to be controlling precedent''), *aff'd in part, rev'd in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977).

Rule of Law

Faced with a deep split in the circuit courts, the Supreme Court in *Home Concrete* followed *Colony*, 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 cases in which specific receipts are *left out* of computing gross income.

Although the statute's language was not unambiguous, the *Colony* Court noted that the history of the statute showed that Congress intended to restrict the six-year statute to situations that did not include 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.

What About the Regulations?

The biggest question facing taxpayers and their advisers is what this important case says about regulations, particularly retroactive ones. The Supreme Court avoided actually criticizing the adoption of temporary and then final regulations that plainly conflict with the wording of the statute. The Court didn't even say that it might have been acceptable had the regulations not been imposed on taxpayers retroactively. Yet the retroactivity point is what seemed to bother the Tax Court in *Intermountain.*

What the Supreme Court did do is mention several important cases that might muddy the waters even more. Take *National Cable & Telecommunications Assn. v. Brand X Internet Services*.[11] In *Brand X*, the Court held six to three that a law regarding the distinction between telecommunication services and information services was vague, and that the Federal Communications Commission has the authority to make the decision. What does the FCC have to do with tax?

There has been much debate in the tax world about whether the IRS and Treasury can interpret the tax law to fill in statutory gaps, or if they can do so only if the statute is ambiguous. That debate is not set to rest by *Home Concrete*, although it does get a workout in Scalia's romping concurrence. Scalia argues persuasively that the Court should abandon the *Brand X* notion. *Colony* decided *Home Concrete*, he said, and *Brand X* is wrong.

[11]545 U.S. 967 (2005).

In stark contrast, the four dissenting justices did not think *Colony* applied at all. They found that the language of section 6501(e) was not clear but ambiguous. That meant regulations on that provision were permissible and even appropriate. The messages for the IRS and Treasury are therefore mixed.

Chevron USA Inc. v. Natural Resources Defense Council Inc.[12] requires courts to defer to an administrative interpretation of a statute unless the statute is unambiguous (step 1). But *Chevron* also says if the statute *is* ambiguous, the courts should defer to the administrative interpretation unless that interpretation is not a permissible interpretation of the statute (step 2). There was some question whether the *Chevron* two-step analysis would apply to tax regulations. Yet the Court in *Mayo Foundation for Medical Education and Research v. United States*[13] said that it did.

Finally, in *Brand X*, the Supreme Court held that an administrative pronouncement could actually *override* a prior judicial interpretation of a statute. That, one can well imagine, was of keen interest to the IRS and Treasury. A key qualifier to the rule was that the administrative pronouncement would need to (itself) pass the *Chevron* test. But if it did, the agency could — via administrative law — supersede a court decision.

Beyond the important and interesting six-year statute question, these administrative versus judicial trump cards were at the heart of *Home Concrete*. Indeed, perhaps those trump cards will have a longer lasting and greater impact than anything else. They may not have been of the biggest concern to the taxpayers in *Home Concrete*, who wanted to know only that the IRS was too late. Yet these issues are clearly facing taxpayers, tax practitioners, and the government.

The Supreme Court in *Home Concrete* agreed that the regulatory process exists so that statutory gaps are filled by the appropriate agencies and not by the courts. However, the narrowly drawn view of the case is that when there is no ambiguity, there is no gap. It follows that an agency seeking to fill the nonexistent gap would be overstepping. If a statute is unambiguous, as it was here, Congress did not delegate gap-filling authority to an agency.[14]

Are Tax Regulations Different?

All tax lawyers know it is difficult to take on any Treasury regulation. That is still true post-*Home Concrete*. In fact, these particular regulations may have been a little *easier* to take on than most,

[12]467 U.S. 837 (1984).
[13]131 S. Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*.
[14]*See Chevron*, 467 U.S. 837.

because their history (it seems fair to say) was tortured. The retroactivity question — a huge point that seems to deserve its own discussion — is largely ignored in the case.

The Tax Court had said in *Intermountain* that these retroactive temporary regulations violated the Administrative Procedure Act.[15] However, the various circuit courts disagreed over the handling of the retroactivity point. The appeals courts disagreed over the ensuing notice and comment period and whether they could cure any defects.

The courts disagreed over other matters, too. The Supreme Court's failure to explain what analysis applies leaves us at least partially in the dark, yet it makes sense that the Court did not say more than it had to.

Tax Regulation Retroactivity?

In one sense, it seems clear that the IRS and Treasury should feel chastised for having written regulations that were temporary, that conflicted with a Supreme Court decision, and that were retroactive to boot. Yet the Court never said that, and it is unclear if that subliminal message was intended, much less received. Of all the elephants in the room, that one takes the cake.

Taxpayers and the Service will want to know how regulations are to be treated. Although the retroactivity point seems a big omission in the case, taxpayer reliance also is ignored. How important was the fact that taxpayers may rely on the law and expect changes to be prospective? That may be another side of the retroactivity coin, but that topic, too, is given short shrift.

The dissent in *Home Concrete* suggests that taxpayer reliance deserves respect. Even so, it also suggests that this particular law is sufficiently unsettled that taxpayer reliance is not an appropriate basis of decision. Scalia's concurring opinion reveals greater interest in the reliance question generally.

Last Words

Neither taxpayers nor advisers should look this gift horse in the mouth. *Home Concrete* is a huge decision. It makes clear that taxpayer contests — while in some respects stacked in favor of the government — can be productive indeed.

What's more, it is possible for tax contests to be productive even when the taxpayer is forced to challenge a regulation. We may not know *exactly* how future regulatory contests will be judged. It is true that the Court does not lay out a template for how regulatory contests will be refereed.

Nevertheless, more is clear than is unclear. Besides, the Court did not fudge the holding that the six-year statute simply does not apply to basis overstatements. That's no small accomplishment.

[15]P.L. 79-404.