



## Testing the Limits—What is An Understatement of Gross Income?

Podcast of June 22, 2007

Feed address for Podcast subscription:

<http://feeds.feedburner.com/EdZollarsTaxUpdate>

Home page for Podcast: <http://ezollars.libsyn.com>

©2007 Edward K. Zollars, CPA

*The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.*

*The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.*

*This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.*

## IRS Loses Case on Extended Statute of Limitations

After winning two cases dealing with the same issue regarding statute of limitation issues (*G-5 Investment Partnership*, 128 TC No. 15 and *Kligfeld Holdings*, 128 TC No. 16), the IRS found its winning streak on statute cases snapped in the next reported Tax Court opinion, that of *Bakersfield Energy Partners, LP*, 128 TC No. 17. In this case the question revolved around what constituted an omission of gross income that triggered the extended six year statute of limitations under §6629(c)(2) and the related provisions of §6501(e)(1)(A).

Specifically, the IRS was arguing that if a §1231 gain was understated due to the overstatement of the basis of the underlying asset, that the unreported amount of the gain constituted omitted gross income for purposes of invoking the extended statute of limitations. The Tax Court ultimately did not agree, relying on the basic logic found in

the 1958 US Supreme Court decision in the case of *Colony, Inc. v. Commissioner*, 357 U.S. 28.

## The Law

The general for assessing tax against an individual is found in §6501(a), which provides:

### §6501(a) General rule

Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period. For purposes of this chapter, the term "return" means the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit).

This general three year rule can be extended if a taxpayer runs afoul of §6501(e)(1)(A) and face a six year statute. That provision reads as follows:

### §6501(e) Substantial omission of items

Except as otherwise provided in subsection (c)--

#### (1) Income taxes

In the case of any tax imposed by subtitle A--

#### (A) General rule

*If the 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, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph--*

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return,

in a manner adequate to apprise the Secretary of the nature and amount of such item.

For assessments on partnership items, §6229 provides similar rules. The general statute rule is 3 years, as found in §6629(a) which provides:

§6629(a) General rule

Except as otherwise provided in this section, the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is 3 years after the later of--

- (1) the date on which the partnership return for such taxable year was filed, or
- (2) the last day for filing such return for such year (determined without regard to extensions).

Again, that statute can be extended to six years if there is an omission that triggers §6229(c)(2), which reads:

§6229(c) Special rule in case of fraud, etc....

(2) Substantial omission of income

If any partnership omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in its return, subsection (a) shall be applied by substituting "6 years" for "3 years".

While this is clearly a mechanical test, the issue of what exactly constitutes an item of "gross income" has to be resolved, and in this case we deal with the issue of interpreting how §1231 gains should be counted in terms of defining an item of gross income.

## The Facts

In this case, the key underlying issue relates to the basis of an asset sold by the partnership. The original return of the partnership reported the following items:

1.	a. Gross receipts or sales	0
	b. Less returns and allowances	0
2.	Cost of goods sold	0
3.	Gross profit	0
4.	Ordinary income (loss) from other partnerships	273,262
5.	Net farm profit (loss)	0

6.	Net gain (loss) from Form 4797	1,993,034
7.	Other income (loss)	0
8.	Total income (loss)	<hr/> <hr/> 2,266,296

On examination, the IRS adjusted the Section 1231 gain by denying the entire basis claimed against the sales proceeds, claiming that the transaction that supposedly established the basis under §743(b) was a sham transaction. The amount of disallowed basis was \$16,515,194—a rather substantial sum.

However, the IRS issued their Notice of Final Partnership Administrative Adjustment after the expiration of the three year statute of limitation—so, the question arises, regardless of whether the IRS is correct in their assertion about the transaction, is the matter moot since the IRS simply issued this assessment too late.

The IRS claims that, no, they actually are saved by the extended statute provisions noted above—the taxpayers had omitted from reported total income an amount that was far more than 25% of such total income by having reported too large an amount of basis. That is, the IRS claims, the proper amount to count in adding up gross income under the two provisions noted above is the net gain under §1231, in which case an overstatement of basis of a large enough amount, such as what the IRS alleges was true in this case, would trigger the extended statute.

The taxpayer obviously disagrees. In the taxpayers' viewpoint, the total amount of gross income is the same on the original return and a return prepared in line with the IRS's assessment. The total sales price of the asset was properly reported on the return, so this is fundamentally different from a case where a taxpayer omits income entirely, sending the IRS on a "hide and seek" game to find the unreported item. In the taxpayer's view, the IRS is simply out of luck regardless of the validity of their underlying assertion—they waited too long to raise the issue.

## **The Court Speaks**

The question before the Court is whether to grant the partnership's request for a summary judgment in their favor based on the fact that the statute of limitations has run. Judge Cohen notes:

If the period of limitations is open with respect to any partner in the partnership, the adjustments made in the FPAA in issue would have to be examined on the merits. However, the parties have stipulated that they know of no other exceptions to the normal 3-year period with respect to the individual partners, and respondent has conceded that, if the Court determines that petitioners' failure to include net

gain from the sale of property does not constitute an omission from gross income, the Court should grant petitioners' motion for summary judgment.

So the question becomes simple—is there any point in looking at this case, or was the IRS simply too late?

The Court goes on to note that, as the parties have agreed, the same principles apply in evaluating the matter under §6229 as under §6501 for the six year statute. She also noted that the IRS is arguing that an interpretation of a similar issue by the United States Supreme Court in *Colony Inc. v. Commissioner* under the 1939 Code should not be used to interpret the provisions under the current 1986 Code.

The IRS is particularly interested in the language found in §6501(e)(1)(A)(i), which provides the following special definition:

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services;

In the IRS's view, this is a "special" definition that suggests that, in computing gross income from other transactions where costs are "netted" that gross income should be computed by looking at the net gain/loss reported. That is, for all other items, the proper computation would be *after* diminution by the cost of such sales or services.

In *Colony, Inc.*, the Supreme Court held that an entity in the business of selling land that had overstated basis but properly reported the sales price did not run afoul of the predecessor of §6501 under the 1939 Code (then §275(c)). The Tax Court quotes the following from the Supreme Court's opinion:

In determining the correct interpretation of sec. 275(c) [now sec. 6501(e)] we start with the critical statutory language, "omits from gross income an amount properly includible therein." The Commissioner states that the draftsman's use of the word "amount" (instead of, for example, "item") suggests a concentration on the quantitative aspect of the error—that is, whether or not gross income was understated by as much as 25%. This view is somewhat reinforced if, in reading the above-quoted phrase, one touches lightly on the word "omits" and bears down hard on the words "gross income," for where a cost item is overstated, as in the case before us, gross income is affected to the same degree as when a gross-receipt item of the same amount is completely omitted from a tax return.

On the other hand, the taxpayer contends that the Commissioner's reading fails to take full account of the word "omits," which Congress selected when it could have chosen another verb such as "reduces" or "understates," either of which would have pointed significantly in the Commissioner's direction. The taxpayer

also points out that normally “statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them.” *De Ganay v. Lederer*, 250 U.S. 376, 381. “Omit” is defined in Webster's New International Dictionary (2d ed. 1939) as “To leave out or unmentioned; not to insert, include, or name,” and the Court of Appeals for the Sixth Circuit has elsewhere similarly defined the word. *Ewald v. Commissioner*, 141 F.2d 750, 753. Relying on this definition, the taxpayer says that the statute is limited to situations in which specific receipts or accruals of income items are *left out* of the computation of gross income. For reasons stated below we agree with the taxpayer's position. [*Id.* at 32-33.]

The Supreme Court ultimately concluded the following, cited by the Tax Court:

We think that in enacting section 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two years [now three] to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. \* \* \* [*Id.* at 36.]

The key question is whether anything would change the result when applied outside of the sale of a taxpayer's inventory or when applying the current law as opposed to the law as it existed in the 1939 Code §275(c).

Ultimately Judge Cohen sees no reason to arrive at a different result. As she notes:

We are unpersuaded by respondent's attempt to distinguish and diminish the Supreme Court's holding in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). We do not believe that either the language or the rationale of *Colony, Inc.* can be limited to the sale of goods or services by a trade or business. As petitioners point out, the Supreme Court held that “omits” means something “left out” and not something put in and overstated.

Thus, the IRS is simply out of luck as nothing was “left off” the return—they issued their notice after the statute had run, and therefore there is no reason to look beyond that fact. The taxpayers cannot face continued liability under a statute that deals with omitting an item when, in fact, nothing was omitted (if anything, something was included that arguably shouldn't have been there at all).