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Statute of Limitation: Congress Overrules Home Concrete and Retroactively Removes Some Taxpayer Defenses

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On July 31, 2015, President Barack Obama signed the ***Surface Transportation and Veterans Health Care Choice Improvement Act of 2015*** (H.R. 3236; Pub. Law No. 114-41) (the 2015 Act) into law. In addition to extending various federal highway programs funded by the Highway Trust Fund, and providing for the consolidation of certain programs administered by the U.S. Department of Veterans Affairs to improve veterans' access to care, the Act makes a significant change to Section 6501(e)(1) of the Internal Revenue Code (the Code), which provides for a special six-year period for assessment of tax where a taxpayer "omits from gross income" an amount greater than 25 percent of the gross income shown on its return. This change effectively overrules the Supreme Court of the United States' holdings in *The Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), and *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), that an overstatement of basis in a sold asset is not an "omission from gross income" for purposes of the six-year limitation period. In addition, the Act eliminates the "adequate disclosure" exception to the six-year rule in situations involving an overstatement of un-recovered cost or other basis. Under its effective date, the new provision may apply to tax returns filed several years ago and deprive taxpayers of a statutory disclosure defense that existed—and was relied upon—at the time those returns were filed.

Background

The ***Internal Revenue Service (the IRS)*** ordinarily has three years from the later of the filing of an income-tax return and the due date for the return in which to assess any tax for the year to which the return relates. In 1939, Congress enacted Section 275(c), which provided a special five-year limitation period when a taxpayer "omits from gross income an amount properly includible therein which is in excess of 25 *per centum* of the amount of gross income stated in the return." Litigation ensued over the meaning of "omits" and whether an item of income left out of the computations of gross income was to be considered omitted if that item was otherwise disclosed on the return.

While several cases were pending, Congress re-enacted Section 275(c) as Section 6501(e)(1)(A) of the 1954 Code. In virtually identical language to Section 275(c), Section 6501(e)(1)(A) gave the IRS six years in which to assess tax where a taxpayer had omitted more than 25 percent of its gross income. Congress resolved the disclosure controversy for later years by adding Section 6501(e)(1)(A)(ii)—now, Section 6501(e)(1)(B)(iii)—which excludes an omitted amount from the 25 percent computation if the omitted amount is adequately disclosed on the return or in a statement attached thereto. Congress also clarified that, with respect to sales of goods or services by a trade or business, the computation of gross income is to be based on gross receipts, un-reduced by cost of goods sold. Section 6501(e)(1)(B)(i).

The Supreme Court granted *certiorari* in *Colony* to resolve a circuit split regarding when the IRS is entitled to the special limitation period. The IRS argued that by overstating basis in a sold asset—and thereby reducing reported gain on the sale—a taxpayer had "omitted" gross income. Applying traditional tools of statutory construction, the Court rejected the IRS's argument, explaining that "omit" means to "leave out or unmentioned" and not something put in and overstated.

After *Colony*, the *basis-overstatement-as-omission-from-gross-income* issue was pretty much dormant until the turn of the century when the IRS began designating certain transactions as "listed transactions." However, the nature of these transactions, the manner in which they were reported on returns, and the time it typically took the IRS to gather information about them led the IRS to argue that it was at a serious disadvantage with respect to the three-year limitations period. In 2005, the IRS issued chief counsel advice taking the position that *Colony*'s holding was limited to the sale of goods or services by a trade or business, and, therefore, that a basis overstatement could, in other instances, result in an omission from gross income within the meaning of Section 6501(e)(1)(A).

This argument limiting *Colony*'s reach led to renewed litigation over the meaning of "omits from gross income." While the majority of cases involved listed transactions, some involved legitimate business transactions in which the dispute between the IRS and the taxpayer was over the basis of sold assets. Just as in the Section 275(c) cases, the IRS experienced mixed results, at both the trial and the appellate levels, in the cases addressing Section 6501(e)(1). To further complicate the issue, in September 2009 the IRS issued temporary and proposed regulations that provided that an understatement of gross income resulting from an overstatement of basis was an omission from gross income. The regulations applied "to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Importantly, the IRS interpreted the effective date provision to mean that the terms of the regulation should be applied in order to determine whether the limitation period was still open on that date and the regulation applied. The IRS promulgated final regulations in essentially the same form in December 2010. The regulations introduced the additional question of whether the IRS could issue regulations at odds with the Supreme Court's interpretation of the statutory language in *Colony.* The IRS's interpretation of the regulations' effective date provision also raised the specter of retroactive application.

The Supreme Court granted *certiorari* in *Home Concrete* to resolve the conflict among the circuits on these issues. The Court's holding that "*Colony* determines the outcome of this case" seemed to resolve the question of what "omits from gross income" means with finality: it does not mean understating gross income by overstating un-recovered cost or other basis in a sold asset.

Congress Overrules *Home Concrete*

Having lost its definitional fight in the courts, the IRS went to Congress. In response, Congress made two significant changes to Section 6501(e)(1), actually going beyond what was at issue in the preceding litigation.

First—and most directly to the point—Congress added a new Section 6501(e)(1)(B)(ii) providing that "[a]n understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income." Congress thus removed any doubt under the statute that by overstating its basis in a sold asset a taxpayer has omitted an amount equal to the basis overstatement from its gross income, thereby making that amount part of the consideration as to whether the six-year limitation period applies.

The second change effected by Congress has nothing to do with the most recent spate of litigation over Section 6501(e)(1). In 1954, Congress added Section 6501(e)(1)(A)(ii) to the Code. It provided that "[i]n 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." Thus, "adequate disclosure" of an omitted item was a complete defense to the application of the six-year limitation period. The 2015 Act, however, amends this provision—now, Section 6501(e)(1)(B)(iii)—by inserting the phrase "(other than in the case of an overstatement of unrecovered cost or other basis)" after "In determining the amount omitted from gross income." As a result, "adequate disclosure" is no longer a defense to the imposition of the six-year limitation period with respect to any amount omitted from gross income by reason of an overstatement of basis.

The effect of these changes to the six-year limitation period rules is very broad. The amendments made to Section 6501(e)(1) by the 2015 Act are effective for returns filed after July 31, 2015, and, importantly, for "returns filed on or before such date if the period specified in Section 6501 of the Internal Revenue Code of 1986 (determined without regard to such amendments) for assessment of the taxes with respect to which such return relates has not expired as of such date." Thus, in addition to returns filed after the amendments were made, the revised Section 6501(e)(1) applies to (1) any return filed on or after July 31, 2012; (2) any return filed before July 31, 2012 that was open on July 31, 2015 for any reason under Section 6501 (*e.g.*, by execution of Form 872—Consent to Extend the Time to Assess Tax); and (3) any return for a tax year currently before the U.S. Tax Court (or on appeal from a decision of the Tax Court) that was docketed on or before July 31, 2015.

Conclusion

The 2015 Act makes significant changes to Section 6501(e)(1). It effectively overrules *Colony* and *Home Concrete* to include an overstatement of basis in the ambit of "omits from gross income." It also excludes an overstatement of basis from the "adequate disclosure" defense to the imposition of the six-year limitation period. These changes are effective for a very broad range of tax returns, including returns for years long before the enactment of the 2015 Act.

There is no question that Congress has the authority to change the statutory definition of "omits from gross income" and the parameters of the "adequate disclosure" defense on a prospective basis. It is less clear, however, whether the changes made to Section 6501(e)(1) can be applied retroactively to returns filed before the date of enactment, where taxpayers acted in reliance on the Supreme Court's interpretation of the statute in *Colony* and, most recently, *Home Concrete*. This is especially true with respect to the 2015 Act's exclusion of overstatements of basis from the "adequate disclosure" defense, something taxpayers have relied on for years based on the plain language of the statute. Although there is no constitutional bar to retroactive tax legislation and courts have been hesitant to strike down such legislation, due process concerns regarding the period of retroactivity and the reliance and lack of notice of the retroactive change are two factors that courts might consider. It remains to be seen whether such retroactive changes can be sustained in the face of what Justice Antonin Scalia, in his concurring opinion in *Home Concrete*, called "justifiable taxpayer reliance" on the Court's holdings and the plain words of the statue.

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