2010


Rose L. Bailey

Follow this and additional works at: http://scholarship.law.campbell.edu/clr

Part of the Business Organizations Law Commons, and the Tax Law Commons

Recommended Citation


This Article is brought to you for free and open access by Scholarly Repository @ Campbell University School of Law. It has been accepted for inclusion in Campbell Law Review by an authorized administrator of Scholarly Repository @ Campbell University School of Law.

ROSE L. BAILEY*

INTRODUCTION

As tax practitioners are well aware, today's world of Internal Revenue Code § 6694(a) preparer penalties¹ and Circular 230 sanctions² requires one to be well versed in tax pronouncement and tax litigation from various jurisdictions. In most cases, such penalties can be avoided where asserted tax positions are based on reasonable assumptions

* Rose L. Bailey LL.M, CPA, Esq. is an Assistant Professor at East Carolina University with a teaching/research focus in taxation and law. After a twenty-plus year career in legal/accounting practice with regional and national accounting and law firms, she entered academics. Her professional and research areas of emphasis include estate and income tax issues, with a particular interest in issues impacting closely-held entities and entrepreneurs.

1. I.R.C. § 6694(a) (LexisNexis 2010). Preparer penalties can be assessed on a preparer of a substantial portion of most tax returns, whether original or amended, or claims for refund where tax is understated due to an asserted tax position, which is not supported by substantial authority, and which is not otherwise adequately disclosed. E.g., Treas. Reg. §§ 1.6694-2(a)(1)(ii), (d) (2008). Alternatively, if the tax position is disclosed on the return, there must be a reasonable basis for the position asserted. Id. § 1.6694-2(a)(1)(iii). This standard increases to the requirement of a reasonable belief that the asserted tax position is "more likely than not" sustainable on its merits where a tax shelter or reportable transaction is involved. Id. § 1.6694-2(a)(1)(i).

2. Circular 230, 31 C.F.R. § 10 (2005). Circular 230 regulates those licensed to practice before the IRS, such as lawyers, CPAs and enrolled agents for an assembly of issues. 31 C.F.R. § 10.2(a)(4) (2009). Sanctions can be imposed under section 10.50 of Circular 230 for egregious behavior from failure to follow standards required of written opinions (section 10.34), failure to meet a due diligence obligation regarding the preparation of returns (section 10.22(a)(1)), improper use of contingent fees (section 10.27), and other deemed disreputable conduct offenses (sections 10.21, 10.23, 10.28, 10.29, and 10.31). See 31 C.F.R. §§ 10.21, .22(a)(1), .23, .27, .28, .29, .31, .34, .50; see also 31 C.F.R. §§ 10.51, .52(a)(1), .52(a)(2).
grounded in "substantial" primary authority. Substantial authority includes, among other items: Internal Revenue Code sections; proposed, temporary, and final regulations; revenue rulings; revenue procedures; and court cases. There is also no question that malpractice claims can follow where advice is offered for tax planning or Internal Revenue Service ("IRS") audit strategy, without a full review of this authority, both within, and without a client's geographic jurisdiction. As the practitioner considers options of appeal from an IRS administrative hearing, often the Tax Court appears the easiest alternative since its jurisdiction can be invoked without the payment of the disputed tax. Nonetheless, to make such a decision, without an understanding of the existing judicial authority of the Tax Court, could be quite a mistake. Yet, due to the court's status as a national court with jurisdiction over tax matters, one cannot stop with a mere review of Tax Court decisions. Any appeal of a Tax Court decision must be heard in the appropriate court of appeals circuit for the taxpayer's geographic region. Hence, a conundrum arises where circuits have decided issues differently. For example, if the Tax Court rules against a North Carolina resident, who then appeals to the United States Court of Appeals for the Fourth Circuit and successfully reverses the Tax Court decision, this precedent in the Fourth Circuit must be followed by the Tax Court in similar, non-distinguishable cases involving other North Carolina residents. Yet, there is no requirement that such precedent be followed by the Tax Court in a California taxpayer's similar litigation, unless the issue was similarly decided by the United States Court of Appeals for the Ninth Circuit. In fact, if the Ninth Circuit has ruled differently on the same issue, as presented in the Fourth Circuit, the Tax Court is required to follow the judicial precedent from the Ninth Circuit, since it is the

4. See generally Treas. Reg. § 1.6662-4(d)(3)(iii) (2008). A full list of such authorities includes: Internal Revenue Code sections; proposed, temporary, and final regulations; revenue rulings; revenue procedures; tax treaties and their regulations, as well as official explanations of such treaties; court cases; committee reports reflecting congressional intent; general explanations from the Joint Committee on Taxation regarding tax legislation; private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981; IRS information or press releases; and notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin.
5. I.R.C. § 6213(a) (petition to tax court); FED. R. APPL. P. 13(a).
6. I.R.C. § 6123(b).
7. Id. § 7482(b); see also Mary Ann Cohen, How to Read Tax Court Opinions, 1 HOUS. BUS. & TAX L.J. 1, 6 (2001).
appellate circuit with jurisdiction over the California taxpayer in that case.\textsuperscript{8}

In other words, the Tax Court may rule differently on similar facts, deciding similar legal issues, thereby creating one result under one circuit's precedent and a completely different result under another circuit's precedent. Now, consider a third case arising in Tax Court on this similar issue in yet a different circuit in which the issue has not yet been decided. The result may well be a third interpretation if the Tax Court chooses not to follow the rationale of other circuits and decides under its own rationale, disagreeing with both other circuits.\textsuperscript{9} So, one can conclude that, depending on the issue, the judicial precedent of your geographic district, the judicial precedent in prior Tax Court decisions that have not been reversed, and the judicial precedents that may offer supporting or opposition positions to your client from other circuits, your required review of tax litigation can become quite expansive in determining a position of substantial authority.

Reviewing tax litigation becomes an even greater challenge (or opportunity) when you consider the existence of the additional alternative appellate path from a negative IRS audit finding to the federal district court in your geographic area or the Federal Court of Claims. Similar to an appeal from Tax Court, any decision pursued in federal district court is appealable to the United States Court of Appeals circuit located in the taxpayer's geographic region.\textsuperscript{10} However, a decision pursued in the Federal Court of Claims is appealable to the Federal Circuit of the United States Court of Appeals.\textsuperscript{11} This presents a third appellate path around any undesirable judicial precedent that might exist in a taxpayer's geographic circuit in the United States Court of Appeals. Thus, this is yet another reason to consider carefully all judicial precedent as you determine the appropriate position of substantial authority.

When framing adequate tax advice to protect oneself from preparer penalties under sometimes ambiguous or unsettled tax law, or when

\begin{itemize}
\item \textsuperscript{8} See Golsen v. Comm'r (Golsen II), 445 F.2d 985, 988–89 (10th Cir. 1971), cert denied, 404 U.S. 940 (1971).
\item \textsuperscript{9} Id.; Golsen v. Comm'r (Golsen I), 54 T.C. 742, 757 (1970). The Tax Court in \textit{Golsen I} found that where an issue has not yet been decided in a circuit, the Tax Court can attempt to create uniform application of tax laws by applying its own judgment in the matter. \textit{Id}.
\item \textsuperscript{10} 28 U.S.C. § 1294(1) (2000); \textit{Id.} § 1346(a)(1) (stating that the original jurisdiction of United States district courts is concurrent with the United States Court of Federal Claims).
\item \textsuperscript{11} 28 U.S.C. § 1295(a)(3).
\end{itemize}
trying to affect your best appellate argument or direct a strategic audit litigation path, there can be no doubt of the importance of considering judicial precedent developments in all of these paths. To that end, under the discretion of this Author, a selection of relevant administrative regulations and rulings as well as judicial authority rendered in 2009 through spring 2010 are contained in this Article to cover significant income taxation developments impacting certain closely-held entities. Closely-held entities are considered, for purposes of this Article, "flow-through" entities regulated under two important subchapters of the Internal Revenue Code: (i) Subchapter K governing income taxation of partnerships,\(^\text{12}\) and (ii) Subchapter S governing income taxation of C corporations electing to be taxed as S corporations.\(^\text{13}\) The selected authority for emphasis is not intended to be a fully comprehensive review but rather a selection of those developments deemed most important for the tax practitioner advisor.

In order to ensure compliance with requirements imposed by the Internal Revenue Service, the author informs you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or tax-related matters addressed herein.

I. S CORPORATIONS

A. Capital Contributions from S Corporation Shareholders Not Characterized as "Tax Exempt" Income and Unavailable to Increase Tax Basis of S Corporation Shareholder Loans

_Nathel v. Commissioner (Nathel II),\(^\text{14}\)_ decided in the Second Circuit, provides an excellent opportunity to review basis calculation for shareholder loans to S Corporations.\(^\text{15}\) Let us review the facts of _Nathel II_ to determine how this issue ended up in Tax Court. Ira and Sheldon Nathel, brothers, were twenty-five percent shareholders of three S Corporations (referenced in this Article by the acronyms of, W & N

\(^\text{12}\) I.R.C. §§ 701-77.
\(^\text{13}\) Id. §§ 1361-79.
\(^\text{15}\) See I.R.C. § 1367.
New York, G & D Farms, Inc., and W & N California). Mr. Wishnatzki, who was not a party to the litigation, owned the remaining fifty-percent in each of these corporations. Following several years of losses in these corporations, it appears that the shareholders were in the midst of a "parting of the ways." In August 2001, the shareholders negotiated a reorganization plan to segregate their business relationships. The brothers' ownership in G & D Farms was redeemed, leaving Mr. Wishnatzki as the full owner. In a similar manner, the brothers obtained full ownership of W & N New York through the company's full redemption of Mr. Wishnatzki's ownership. Subsequently, W & N California was liquidated.

As part of their agreement to proceed with this reorganization, both the bank and Mr. Wishnatzki required the Nathel brothers to contribute capital of approximately $537,000 to G & D Farms and $181,396 to W & N California in August 2001. This capital was demanded consideration for the Nathel brothers' release from a prior guarantee of a $2.5 million bank loan. There was also a history of the Nathel brothers lending money to the corporation with repayments, which resulted in loans owed to each of the brothers from G&D Farms and W&N California of $649,775 and $161,250 respectively. The crux of this litigation centered on the brothers' desire to avoid ordinary income on the repayment of loans that they received from G&D Farms and W&N California, which had reduced bases.

It is well-settled law that pro-rated allocations of an S Corporation's income to a shareholder as described in I.R.C. § 1366(a)(1)(A) shall

17. Id.
18. Id.
19. Id. at *6–7.
20. Id.
21. Id. at *6.
22. Id. at *7.
23. Id. at *6–7.
24. Id. at *6.
25. Id. at *6–7. In December 2000, each of the Nathel brothers loaned G & D Farms $649,775. Id. at *6. At that time, the tax basis of their S Corporation stock in G & D Farms was zero and the tax basis of the loans had been reduced to $112,457 each. Id. In addition, W & N California owed each Nathel brother $161,250, in which each had a basis of only $3,603. Id. at *6–7. In February 2001, G & D Farms repaid both of these loans in full. Id. at *7. Subsequently, W & N California repaid its loans in full (at $161,250 each) prior to its liquidation. Id.
increase the shareholder's stock basis\textsuperscript{26} and allocations of pro-rated
losses or deductions similarly allocated shall reduce the shareholder's
stock basis.\textsuperscript{27} Further, where allocable deductions to a shareholder
decrease her stock basis to zero, any excess allocable deductions shall
only be allowed as tax deductions to the extent that sufficient basis still
exists for any loans from that shareholder to the S Corporation.\textsuperscript{28} The
application of these promulgated principles was not at issue in Nathel
II.\textsuperscript{29} Instead, the litigation arose over attempts by the taxpayer to classify
capital contributions as tax exempt income.\textsuperscript{30} The strategy was to
classify the capital contributions as items of tax-exempt income, thereby
qualifying the capital contributions as increased income, which would
increase basis.\textsuperscript{31} If one can successfully allege that the capital
contributions were characterized as tax-exempt income, then the general
rule would apply that any "increases to income" are first required to
restore any reduced basis of shareholder loans.\textsuperscript{32} Since the brothers'
loans to the S Corporations did have reduced bases from prior
allocations of prorated flow-through losses, the "increase to income" was
treated by the taxpayer as restoring such reduced basis of the loans.\textsuperscript{33}
Accordingly, $1.6 million of the 2001 loan repayments were not
reported as a taxable event but rather as a repayment of loans, which no
longer had reduced bases.\textsuperscript{34} Alas, the denied characterization of capital
contributions as tax-exempt income was the IRS' assessment generating
this litigation.\textsuperscript{35}

The Second Circuit appears to center its holding on a lengthy
analysis of how the courts have defined "income."\textsuperscript{36} Section 118(a)
specifically excludes a taxpayer's capital contributions from gross

\textsuperscript{26} I.R.C. § 1367(a)(1)(A) (2000).
\textsuperscript{27} See id. § 1367(a)(2)(B).
\textsuperscript{28} Id. § 1367(b)(2)(A).
\textsuperscript{29} Nathel v. Comm'r (Nathel II), No. 09-1955-ag, 2010 U.S. App. LEXIS 11244, at
*1 (2d Cir. June 2, 2010).
\textsuperscript{30} Id. at *8.
\textsuperscript{31} I.R.C. § 1367(a)(1).
\textsuperscript{32} Id. § 1367(b)(2)(B).
\textsuperscript{33} Nathel II, 2010 U.S. App. LEXIS 11244, at *8.
\textsuperscript{34} Id. at *7–8. For the 2001 tax year, the Nathel brothers made approximately
$1.437 million in capital contributions and received approximately $1.622 million in
loan repayments. Id.
\textsuperscript{35} Id. at *9 (noting that the IRS issued a notice of deficiency to both Nathel
brothers on June 21, 2006, asserting additional taxes of approximately $280,000).
\textsuperscript{36} I.R.C. § 61(a); Nathel II, 2010 U.S. App. LEXIS 11244, at *11–18.
income. The legislative history underlying § 118(a) further indicates it was enacted to codify pre-1954 judicial decisions in which payments by non-shareholders should be capital contributions, just as if they were from shareholders. Treas. Reg. § 1.118-1 also specifically states that “voluntary pro rata payments” by a shareholder for necessary business funding “do not constitute” corporate income.

Despite this clear statutory and regulatory direction, the Second Circuit nonetheless patiently analyzed each petitioner assertion, still reaching the same conclusion. One of the lengthiest premises asserted by the taxpayer was based on authority developed in the Supreme Court case Gitlitz v. Commissioner. In Gitlitz, a discharge of indebtedness originating from the cancellation of a debt converted to a creditor’s capital contribution was not excluded from taxation as a capital contribution under I.R.C. § 118. Yet, it was excluded from income under the insolvency exception of § 108(a)(1)(B) and § 108(d)(7)(A). Most importantly, the excluded income was deemed to be an income item increasing basis under § 1366(a)(1)(A). Therefore, in Gitlitz, the taxpayer successfully increased its S Corporation stock basis by his pro-rata share of discharge of indebtedness income, which had been excluded from taxable income under the insolvency exception. The key distinguishing fact in Gitlitz, as compared to Nathel II, is simply that despite the § 108(a) exclusion of debt discharge income from gross income during insolvency, the debt discharge income in Gitlitz was still fundamentally an item of income under § 61(a)(12). Nathel II distinguished Gitlitz due to the long-standing judicial precedent that capital contributions in the normal course of business, unlike discharge of indebtedness, are distinctly different as an item excluded from income. Comparison to the Nathel II facts was found to be flawed.

After holding that capital contributions are not income, and therefore do not increase basis in debt under § 1367(b)(2)(B), the

37. See I.R.C. § 118(a).
39. Id. at *18 (quoting 26 C.F.R. § 1.118-1 (2010)).
41. Id. at 213–15.
42. Id.
43. Id.
44. Id. at 218–20.
45. Id. at 216.
47. Id.
Second Circuit addressed the taxpayer's alternative argument. That is, failing to achieve classification of the capital contributions as tax exempt income, the Nathel brothers asserted alternatively that contributions made to G & D Farms were deductible under § 165(c)(2) as loss transactions entered into for profit. It appears to this Author that this argument was the stronger of the two. Authority was cited by which § 165(c)(2) can be the basis to deduct losses for negotiated payments to release a loan guarantee as long as such release was the primary motive for the transaction. The Second Circuit agreed with the lower Tax Court decision that the taxpayer failed to prove that the guarantee release was the primary purpose of the capital contributions. Instead, the court identified three purposes motivating the Nathel brothers' agreement to make the capital contributions: (i) the release of the guarantee by the bank; (ii) the agreement of Mr. Wishnatzki to release the Nathel brothers from the guarantee; and (iii) the agreement of Mr. Wishnatzki to the re-organization of ownership of the companies. The Second Circuit declined to follow argued authority, distinguishing both cases in which payments for the release of a guarantee were upheld as a deductible loss under § 165(c)(2), despite multiple objectives for the payment. The court ultimately held that the Nathel brothers did not meet the burden of proving that their capital contributions were primarily motivated to acquire a release from the bank loan guarantees.

B. Availability of Retroactive S Corporation Election Following a "Check the Box" Conversion of a Partnership to a Corporation in Revenue Ruling 2009-15

Revenue Ruling 2009-15 offers an “escape hatch” from even one day's status as a C Corporation prior to conversion to an S Corporation.
One might ask, why is this important? Simply review the mechanics of one of the two taxes assessed against an S Corporation and you will understand this issue. Generally, I.R.C. § 1374 applies an income tax on any net recognized "built-in" gain within an S Corporation's recognition period, if it was a C Corporation prior to making the S election after 1986. This ruling considers how to avoid C Corporation status for even one day by avoiding the question of whether a gain might exist at the date of conversion to S Corporation status.

Revenue Ruling 2009-15 considers two common scenarios involving "check the box" conversions accompanied by an S Election. In scenario one, an unincorporated entity classified as a partnership elects under the "check the box" regulations to be taxed as an association as of the first day of its tax year. One month later, the association properly files an election for the association to be taxed as an S Corporation, requesting that the first day of the tax year be the effective date. All persons deemed to be holding stock on the first day of the tax year are also holding stock on the date of the election in this scenario. The ruling indicates that on the day preceding the effective date, December 31 for a calendar year partnership, the partnership is "deemed" to have exchanged all its assets and related debt for the stock. Immediately after this deemed exchange, that same day, a fictional liquidation of the partnership is considered to occur through which the stock is distributed to the partners in their individual capacities. The result is that the next day, January 1, the first day of the new tax year, only individual partners will be shareholders of the corporation. This creates the required eligibility for a retroactive S Corporation election. The authority for these deemed facts can be found in § 301.7701-3(g)(1)(i) and § 301.7701-3(g)(3)(i). Without these fictional assumptions the corporation would not be in compliance with Treas. Reg. § 1.1362-6(a)(2)(ii)(B). Specifically, the retroactive application in the year of the S election is permitted since the electing corporation qualifies as a small business corporation with the requisite shareholders for the entire year.
portion of the tax year. Since the partnership is converting in the same year of the election, the deemed conversion on the day preceding the first day of the tax year satisfies this condition. Retroactive application, to the first day of the electing tax year, is achieved, and any intervening short tax year as a C Corporation is avoided.

In scenario two, an unincorporated entity, classified as a partnership for tax purposes, institutes a conversion to a corporate form as required under the applicable state law, to be effective as of the first day of its tax year. One month later, it also files an election to be taxed as an S Corporation effective on the first day of the tax year. Similarly to scenario one, after a deemed contribution of all net assets from the partnership to the corporation on December 31, the partnership is deemed liquidated on that same date. Simultaneously, the corporate stock is deemed distributed in liquidation to its partners. This reaches the same result as found in scenario one by which the resulting corporation qualifies as a small business corporation for the entire tax year and any intervening short tax year as a C Corporation is avoided.

C. Developments Impacting the Calculation of S Corporation Built-In Gains Tax

The American Recovery and Reinvestment Tax Act of 2009 ("ARRTA of 2009") amended I.R.C. § 1374's built-in gain recognition period for tax years 2009 and 2010.64 When a qualifying corporation elects S Corporation status, its shareholders report a pro-rata share of its income and loss.65 The S Corporation is not subject to corporate tax with the exception of two distinct tax assessments, one of which is the built-in gains tax.66 As discussed above, liability for the built-in gains tax generally only applies to some S Corporations that elected such status after 1986 and existed as a regular C corporation before the election.67 For an S Corporation to be subject to the built-in gains tax, it must have a "net recognized built-in gain" during the "recognition period."68 Generally, a net recognized built-in gain includes any gain during the recognition period from the sale of any corporate asset owned at the

65. I.R.C. § 1361(b) (delineating the requirements needed to qualify as a "small business corporation" eligible for an S Corporation election); id. § 1366 (pass-thru of items to shareholders).
66. Id. § 1374 (tax imposed on certain built-in gains).
67. Id. §§ 1374(a), (c)(1).
68. Id. § 1374(a).
effective date of the S Corporation election, if it equals, or is less than, the inherent gain existing in that asset at the effective date of the election. For the built-in gains tax to apply, the net recognized built in gain must occur during the recognition period. Prior to ARRTA of 2009, the recognition period normally was ten years following the first effective date of the S Corporation election. For example, ignoring the revisions in ARRTA of 2009, if the effective date of the first S Corporation year is January 1, 2001, then the recognition period will not expire until December 31, 2011. However, under the modifications of ARRTA of 2009, if the eighth, ninth, or tenth year of the ten-year recognition period falls in tax years beginning in 2009 or 2010, any net recognized built in gains occurring in those years will not be subject to the built-in gain tax. Therefore, in my example with the first day of S Corporation status effective on January 1, 2001, a net unrecognized built in gain recognized in the tax year beginning in 2009 would not be subject to the built-in gain tax since it is the ninth tax year of the ten-year recognition period.

1. Valuation Considerations with Built-In Gain Tax in Sales Among Shareholders

The taxpayer in Ringgold Telephone Co. v. Commissioner owned one-fourth of Cellular Radio of Chattanooga ("CRC") as well as a 7.385 percent effective interest in an entity, Chattanooga MSA Limited Partnership ("CHAT"). This interest was derived through the taxpayer's ownership of CRC, which owned a 29.54 percent limited partnership interest in CHAT. Ringgold elected S Corporation status subsequent to being taxed as a C Corporation (effective on January 1, 2000). In early 2000, based on a revised valuation report from Ringgold's CPA, the one-fourth ownership of CRC was valued at $2.6 million. However, an investment banker marketing the CRC interest

69. Id. § 1374(d)(3). A gain inherent as of the effective date of the election follows a traditional calculation of the fair market value of the relevant asset as of the effective date of the S election, reduced by the basis of that asset as of that date. Id.
70. Id.
71. Id. § 1374(d)(7)(A).
72. Id. § 1374(d)(7)(B).
74. Id.
75. Id. at *2.
76. Id. at *4–5.
valued it at approximately $7 million.\textsuperscript{77} Having failed to enlist any offers, BellSouth, a 25% owner of CRC and an effective owner of 62.695% of CHAT, agreed to purchase the taxpayer’s one-fourth interest in CRC in early July of 2000.\textsuperscript{78} The sales transaction was negotiated in July and completed in November of 2000 for approximately $5 million.\textsuperscript{79} All parties agreed that a built-in gain tax was properly owed by Ringgold and should be calculated using the valuation of the CRC interest as of the effective date of the S Corporation election (January 1, 2000).\textsuperscript{80} The amount of this valuation ultimately created the dispute in this case. The taxpayer’s 2000 tax return calculated the built-in gain tax using the CPA’s January 2000 valuation of $2.98 million.\textsuperscript{81} The IRS asserted that the tax was properly calculated using a valuation of $5.22 million, which was ultimately the sales’ price paid by BellSouth for the CRC interest six months later.\textsuperscript{82} The deficiency assessed was approximately $925,000, with an additional I.R.C. § 6662(a) penalty of approximately $185,000.\textsuperscript{83}

The “fair market value” standard examined by the court considered the classic definition of fair market value to be the price to which a willing buyer and a willing seller would agree when both parties are motivated to obtain the best economic transaction and are aware of all relevant facts while operating without any particular “compulsion to buy or sell.”\textsuperscript{84} Although a full analysis of the methodology of both parties’ experts, in arriving at respective asserted fair market values, is beyond the scope of this Article, a good review of this material can be found in the decision.\textsuperscript{85} In assessing the importance of the actual sales price of the CRC interest, as a measurement of the appropriate fair market value for the built-in gains tax, the court considered several factors. First, the court found that there should be no distinction in the values based on the amount of time between the two valuation dates, since only six months had expired and neither party presented evidence of intervening events impacting the reliability of the January 2000 valuation.\textsuperscript{86} Second, the court quickly concluded that as BellSouth was an unrelated buyer,
and neither party contested the arm’s length nature of the negotiations, the valuation was acquired through an “arm’s-length” arrangement between the parties.\textsuperscript{87}

Ringgold argued it was entitled to a “lack of control” discount as a matter of law in determining the appropriate fair market value of CRC.\textsuperscript{88} The premise was that BellSouth would be inclined to pay a higher price than actual fair market value to acquire Ringgold's minority interest in CRC to preserve greater control of not only CRC, but also of CHAT, particularly since BellSouth already had a controlling interest in CHAT.\textsuperscript{89} The Court rejected all asserted judicial precedent for this premise, finding no incentive for BellSouth to pay a premium for the minority interest in CRC, since BellSouth possessed majority control of CHAT without any acquisition of the CRC interest from the taxpayer.\textsuperscript{90}

Next, Ringgold asserted through expert testimony that BellSouth’s track record was to consistently offer the highest bid to forego the likelihood of another owner exercising a right of first refusal.\textsuperscript{91} Arguably, this should impact the conclusive consideration of the sales prices as the relevant fair market value between two parties under no special compulsion to buy. This was considered relevant by the court as a special circumstance possibly creating a higher fair market value than might otherwise be negotiated between an objective buyer and seller.\textsuperscript{92} Mr. King, the taxpayer’s expert witness, carried much weight in this conclusion with his experience in telecommunication industry valuations, his involvement in numerous transactions involving BellSouth, and his specific testimony that “once BellSouth determines that a transaction is strategic it will ‘do whatever it takes to win’ including submitting high bids to discourage exercises of any outstanding right of first refusal.”\textsuperscript{93} Since the other minority owners in CRC (Bledsoe Telephone Company and Trenton Telephone Company) had an enforceable first right of refusal, the court reviewed the sales price not as a conclusive value, but rather as a value to be weighed with all the other evidence.\textsuperscript{94} Other evidence considered by the court included Mr. King's detailed valuation methodologies and testimony, the

\textsuperscript{87} Id. at *20.
\textsuperscript{88} Id. at *22.
\textsuperscript{89} Id.
\textsuperscript{90} Id. at *21–26.
\textsuperscript{91} Id. at *21.
\textsuperscript{92} Id. at *27–28.
\textsuperscript{93} Id.
\textsuperscript{94} Id. at *28.
relevant business climate, the partnership structure, CRC's dividend and capital call history, as well as an average of Mr. King's estimated CRC values from a distribution yield analysis, a business enterprise analysis and BellSouth's actual purchase price. The result was a finding of fair market value at January 1, 2000 of $3.727 million. The court further abated the assessment of § 6662(d) accuracy related penalties, finding Ringgold had acted in good faith with reasonable reliance on its CPA's advice and valuation for the built-in gains tax.

2. Calculation of Built-In Gain Tax with I.R.C. § 481 Change in Accounting Method

In MMC Corp. v Commissioner, Tax Court precedent interprets how positive adjustments under an I.R.C. § 481 change in accounting method impact calculation of § 1374 built-in gain tax. Following the amendment of § 475(c)(4) to eliminate a mark-to-market valuation of accounts receivable, MMC Corp. was forced to convert to face-value accounts receivable valuation and institute a $5.3 million § 481 positive income adjustment to eliminate the duplication of prior deductions. At the time of its conversion from a C Corporation to an S Corporation on January 1, 2000, two years remained for completion of the pro-rata amortization of the § 481 positive adjustment. The annual increase to income for 2000 and 2001 was approximately $1.337 million. After the conversion, these adjustments were made in 2000 and 2001, increasing flow-through taxable income to the S Corporation shareholders. MMC Corp. did not consider these amounts to be subject to built-in gains tax. The IRS assessed deficiencies, asserting that this income was a net recognized built-in gain under § 1374(d)(5)(A). Under this authority, income recognized during the ten-year recognition period attributable to tax years prior to the effective

95. Id. at *28–29.
96. Id. at *30.
97. Id. at *28–30.
98. MMC Corp. v. Comm'r, 551 F.3d 1218, 1218 (10th Cir. 2009).
99. Id. at 1218, 1219–20.
100. Id. at 1219–20.
101. Id. at 1221.
102. Id. at 1220.
103. Id.
104. Id.
date of an S Corporation will be classified as built-in gain subject to the tax. The court's analysis first considered Treas. Reg. § 1.1374-4(d), through which one must determine the item driving the I.R.C. § 481 positive income adjustment. In this case, the taxpayer had previously deducted $5.3 million of previously accrued income under the then permissible mark-to-market valuation method of accounts receivable. With the amendment of § 475(c)(4), requiring conversion to fair value valuation, this deduction had to be recaptured as income. Under the § 481 amendments, as incorporated into the IRS Restructuring and Reform Act of 1998, all such adjustments must be recognized over a four-year period. To determine whether the ratable income adjustments in 2000 and 2001 pertained to the period preceding the S Corporation election, the court considered the test imposed under Treas. Reg. § 1.1374-4(b). Specifically, if MMC Corp., as an accrual method taxpayer, would otherwise have been required to include the recaptured 1997 conversion deduction in a tax year prior to its S Corporation election, but for the legislated ratable allocation, then the recognized income pertains to a pre-S corporation election period and is subject to the tax. In this case, MMC Corp. would otherwise have been required to accrue the $5.349 million deduction as income in 1998, prior to the S corporation election, as this was the year the I.R.C. § 481(a) conversion was legislated. Based on the test provided under the regulations and prior Tax Court judicial precedents for similar treatment of § 481 income adjustments, recognized in the recognition period for built-in gains, the Tenth Circuit upheld the Tax Court's decision.

105. Id. at 1220-21. The deficiency for MMC for 2000 was $357,534 and for 2001 was $468,068. Id. at 1220.
107. MMC Corp., 551 F.3d at 1221-23.
108. Id. at 1219.
109. Id. at 1220.
111. MMC Corp., 551 F.3d at 1221.
112. MMC Corp., 551 F.3d at 1220-23.
D. Final Regulations Impacting Classification and Tax Basis of S Corporation “Open Account” Debt to a Shareholder

Final regulations were issued governing the definition of open account debt, which significantly impact basis adjustments to debt owed by an S Corporation to a shareholder under I.R.C. § 1367(b)(2). Revisions to the regulations were designed to prevent further Tax Court decisions in which ambiguities of the definition of open account debt produced results by which taxpayers appeared to be manipulating classifications to avoid income recognition.

1. Historical Development Preceding Final Regulations

I.R.C. § 1367(a) for S corporations allows the pass-through taxation of income and loss to the shareholder. This creates the regime by which such owner's basis is increased for her proportionate share of income or decreased for any such allocated loss. When the pass-through character is that of a net loss, for such loss to be fully tax-deductible, Subchapter S requires the shareholder to possess sufficient basis in her stock or in any debt obligations owed to such shareholder by the S Corporation to equal or exceed the amount of the allocated loss. The ordering scheme of § 1367 requires the shareholder to first reduce the basis of her S Corporation stock to zero in claiming allocated losses. Then, any remaining allocated loss will only be deductible to the extent of the available basis of loans from the shareholder to the corporation. Once the basis of the debt owed to the shareholder is reduced by allocated losses, basis restoration up to the original face value of the debt will occur through priority allocation of “excess positive flow-through” items. Basis restoration for excess positive flow-through items is

114. Id.
117. Id. § 1366(d)(1). Subchapter S also requires that flow-through loss not only meet the basis testing under § 1366(d)(1) to be deductible, but also meet the testing parameters of § 469 (at-risk limitations) and § 465 (passive loss limitations). Id.
118. Id. § 1367(b)(2).
119. Id.
120. See id. "Excess positive flow-through items" is defined for purposes of this article as the netted impact of the year's flow through items of taxable and nontaxable income and gain, less nondeductible and deductible losses and deductions which create a net increase. Id. § 1367(b)(2)(B). One significant difference between stock basis
always first applied to any "reduced-basis" debt owed to the shareholder at the beginning of the tax year.\textsuperscript{121} Then, remaining unallocated excess positive flow-through items can be used to restore the reduced basis of S Corporation stock.\textsuperscript{122}

This regulatory development addresses the determination of when open-account debt exists. The significance of classification of debt as "open-account" relates to the methodology by which the basis of such debt is calculated, thereby impacting income recognition with the repayment of the debt. Historically, this methodology differed depending on whether the debt is an open-account debt, as compared to a debt evidenced by a separate written instrument. This issue is relevant for S corporations experiencing flow-through losses so large that they reduce the shareholder basis in stock to zero, yet still have excess losses which require additional basis from shareholder loans for such excess losses to be deductible.

Debt used to establish basis has historically been derived from two forms. One form is for debt to be formalized as an obligation which is substantiated by a written promissory note. Alternatively, such debt might be created as an "open account." The "open account" concept was introduced in the 1994 regulations, defined simply as "shareholder advances not evidenced by separate written instruments."\textsuperscript{123} Since the 1994 regulations were issued, it has been very common for owners of S Corporations to delay income recognition on repayments of "reduced-basis" open account debt. This occurred under the regulatory methodology by which basis is calculated for such debt. Essentially, the regulations authorized a "netting" of repayments, advances and "excess positive flow through items" to arrive at a net increase or decrease of the debt basis adjusted only at the end of the entity's tax year.\textsuperscript{124} This allowed manipulation of the transactions to assure that any repayment of reduced basis debt would be offset by increases in basis during the same tax year through either additional advances or positive adjustments. For example, if on January 1, the open account debt has a face value of $1 million, yet a basis of zero, after use of such basis to deduct flow-through losses, any repayment could be fully taxable. Yet, with open-

---

\textsuperscript{121} Id.
\textsuperscript{122} Treas. Reg. § 1.1367-2(c)(1) (LexisNexis 2010).
\textsuperscript{123} Id. § 1.1367-2(a)(2).
\textsuperscript{124} Id.
account debt, any later advances in that tax year could supplement annual positive income adjustments to net in total as an offset of the repayment. This methodology allowed avoidance of income recognition with repayments on reduced basis debt. For example, consider the facts in Table 1 which are modeled after an example in the final regulations under § 1367(a)(2). These facts are modified slightly to reflect the impact of complete repayment of the shareholder debt. Table 1 applies the regulatory basis calculations for shareholder debt illustrating income recognition when open-account debt is used prior to the issuance of the final regulations. As you will see from Table 1, prior regulations applying the annual advance and repayment netting methodology produced income recognition in two tax years ($1,500 in 2010 and $16,500 in 2013).

**Table 1 - Example from Final Regulations**
Calculation of Tax Consequences of Open Account Debt with Reduced Basis

PRIOR TO FINAL REGULATIONS
[Assuming Facts for Illustration Purposes from Cited Regulations]

<table>
<thead>
<tr>
<th><strong>Open Account Transactions</strong></th>
<th><strong>Taxpayer A</strong></th>
<th><strong>Impact to Basis Under Reg. 1.1367-2(e) BEFORE MODIFIED BY FINAL REGS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transactions occur when Stock Basis Zero</strong></td>
<td><strong>Face Value</strong></td>
<td><strong>Tax Basis</strong></td>
</tr>
<tr>
<td>Beginning Balances</td>
<td>$16,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>Loss allocation 2009 - Basis of Debt Reduced</td>
<td>Basis Reduction to 50% of Face Value</td>
<td></td>
</tr>
<tr>
<td>End of 2009</td>
<td>$16,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>4/1/2010 Repayment</td>
<td>-4,000</td>
<td></td>
</tr>
<tr>
<td>5/1/2010 Advance</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Netted Decrease 2010</td>
<td>-3,000</td>
<td>-1,500</td>
</tr>
<tr>
<td>Ending Balance 2010</td>
<td>$13,000</td>
<td>$6,500</td>
</tr>
</tbody>
</table>

---

2/1/2011 – Netted Increase in Note’s Face Value
Repayment $ -5,000
3/2011 - Advance
No formal note - 20,000
Adjusted Balance - 12/31/2011 $28,000
Net Increase - 15,000
Repayment increases tax basis by net increase - No
Gain triggered with $5,000 repayment
since transactions are netted
Basis set at 76.786% of face value

2/1/2012 – Netted Increase in Note’s Face Value
Repayment $ -5,000
6/1 - Advance
$50,000 50,000
9/1 - Advance
$10,000 10,000
Netted Increase - 2012 55,000 55,000
12/31 - Loss
Allocation -10,000
Adjusted Balance - 12/31/2012 $83,000 $66,500
Netted increase in note’s face value
Increases tax basis while loss
Allocation decreases basis basis Basis at
80.12% of face value

2/1/2013 – Repayment Triggers Gain @ 19.88% of
ENDING BALANCE $ -83,000 $ -66,500 $16,500
$83,000 - $66,500

SUMMARY – GAIN RECOGNITION WITH DEBT REPAYMENT:

Tax Year – 2010 $ 1,500
Tax Year – 2013 $16,500
TOTAL GAIN RECOGNIZED $18,000

Alas, however, let’s review the impact of the final regulations.

2. Final Regulations Effective for Advances Occurring AFTER the Effective Date of these Final Regulations under I.R.C. § 1367(A)(2), October 20, 2008

Final regulations under I.R.C. § 1367(a)(2) establish a “bright-line” rule as to what type of debt will qualify as an “open-account” debt.126

126. Treas. Reg. §§ 1.1367-2(a), (c)(2), (e). These regulations are effective for advances occurring after October 20, 2008. However, if elected by the S Corporation
Specifically, if the principal balance of an open account debt is greater than $25,000 at the end of a tax year, the balance of that open account debt is deemed a debt evidenced by a written instrument at the end of the tax year and is no longer afforded the same basis adjustment treatment as applied to an “open-account” debt. This occurs despite the fact that it is not actually evidenced by a debt instrument of any kind. The debt remains classified as such until it is repaid and subsequent advances are considered to create a second debt. The second debt shall be classified as open-account unless evidenced by a written instrument or until it ultimately exceeds threshold amounts of $25,000 at the end of the S Corporation’s tax year. The regulations establish an alternative testing date effective when a shareholder surrenders ownership of the S Corporation, or at such time a disposal occurs of the open account debt. Here the testing date is at the occurrence of either of these two events.

Table 2 summarized in this Article, illustrates the tax consequences of the facts of Table 1 as applied under these final regulations. As you will see from Table 2, these same facts using the new threshold amount limitations for open-account debt classification produced income recognition with a shorter deferral period. In Table 2, income was recognized in three tax years as follows: $1,161 in tax year 2012; and then in 2013 with full repayment of both debts, $8570 on debt #1 and $11,589 on debt #2.

Table 2 – Ex-Table 1 Illustrating Revised Results Under Final Regulations

<table>
<thead>
<tr>
<th>Open Account Transactions</th>
<th>Taxpayer A</th>
<th>Impact to Basis Under FINAL Reg. 1.1367-2(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>** Transactions occur when Stock Value Basis is Zero**</td>
<td>Face Value</td>
<td>Tax Basis</td>
</tr>
<tr>
<td>Beginning Balances</td>
<td>$16,000</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

shareholders, the new regulations can apply to repayments on existing advances as of October 20, 2008.

127. Id. § 1.1367-2(a)(2).
128. Id.
129. Id.
130. Id. § 1.1367-2(b)(2).
131. Id. § 1.1367-2(a)(3).
### 2010 [TAX DEVELOPMENTS IMPACTING CLOSELY-HELD ENTITIES]

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
<th>Basis Reduction to 50% of Face Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/1/2010</td>
<td>Repayment</td>
<td>Netted decrease in note of $3,000 triggers net gain of $1,500 since basis of debt an End of 2009 =50% of Note's Face Value.</td>
</tr>
<tr>
<td>5/1/2010</td>
<td>Advance</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2/1/2011</td>
<td>Repayment</td>
<td></td>
</tr>
<tr>
<td>3/2011</td>
<td>Advance</td>
<td></td>
</tr>
<tr>
<td>12/31/2011</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### DEBT #1 FACE TAX VALUE BASIS

<table>
<thead>
<tr>
<th>Date</th>
<th>DEBT #1 FACE TAX VALUE BASIS</th>
<th>DEBT #2 FACE TAX VALUE BASIS</th>
<th>Impact to Basis Under Reg. 1.1367-2(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>OPEN ACCOUNT</td>
<td>$28,000</td>
<td>$21,500</td>
<td>Since &gt; 25,000 at end of tax year segregated as single debt</td>
</tr>
<tr>
<td>2/1/2012</td>
<td>-5,000</td>
<td>-3,839</td>
<td>Basis Reduced at 76.786% allocation Triggers Gain of $1,161</td>
</tr>
<tr>
<td>ENDING BALANCE 2012</td>
<td>$23,000</td>
<td>$17,661</td>
<td></td>
</tr>
<tr>
<td>6/1/2012</td>
<td>Advance of $50,000</td>
<td></td>
<td>Immediately treated as Separate Debt SINCE Debt #1 Now DEEMED substantiated by written instrument</td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
<td>$50,000</td>
<td></td>
</tr>
</tbody>
</table>
In summary, the implications of these revisions are an increased administrative burden, although somewhat improved from the proposed regulations, and likely to result in increased income recognition absent thoughtful planning prior to the end of the tax year.

### E. Impact of Shareholder Guarantees on S Corporation Basis

If it has been a while since you studied basis calculation rules for S Corporations you may want to review the simple Tax Court memorandum case *Weisberg v. Commissioner.*

the taxpayer expended the funds to litigate this case as the rules of tax law applicable here are long settled. Nonetheless, he did and Weisberg offers us a good review of the basics. Mr. Weisberg was the sole owner of an S Corporation in which he ran his law practice. In early 2000, the corporation obtained a $200,000 line of credit with the assistance of Weisberg's personal guarantee. In 2003 the corporation experienced losses, which approximated $199,000 that were deducted on Mr. Weisberg's individual return. Without providing the specific details, we are left to assume from the opinion that Mr. Weisberg had no basis remaining in his S Corporation stock as of the 2003 tax year. The flow-through loss from the S Corporation was claimed on Weisberg's individual income tax return, then promptly denied by the IRS who alleged that he had no tax basis for claiming such loss. Citing the Tax Court's language in a 1998 case later affirmed by the Eleventh Circuit, the court reminds us (in the unlikely event we forget) that guarantees of loans made by a non-shareholder creditor to the corporation do not provide basis under I.R.C. § 1366(d)(1)(B). As stated artfully in the 1998 decision, there must be an economic outlay by the shareholder with a "direct indebtedness between the corporation and its shareholders" for the creation of basis. Obviously, once the shareholder is called to satisfy the promised guarantee, as occurred in this case when Mr. Weisberg's guarantee was called in 2004, the economic outlay then has occurred, with the corporation owing the shareholder the liability paid on the corporation's behalf. Unfortunately for Mr. Weisberg, that occurred in 2004, not in 2003 (the year in which he needed sufficient basis to fully claim his prorated share of losses). His mere status as a guarantor on the line of credit did not create such basis. Lacking substantial authority to support his deduction for these allocated losses and since the law was well settled in this area, the court upheld the assessment of a twenty-percent accuracy penalty on the 2003 deficiency under § 6662(a).

133. Id. at *3.
134. Id. at *4.
135. Id. at *3–4.
136. Id.
137. Id. at *5.
138. Id. at *7.
139. Id. at *7; Spencer v. Comm'r, 110 T.C. 62, 83–84 (1998), aff'd, 194 F.3d 1324 (11th Cir. 1999).
141. Id. at *9–11.
II. PARTNERSHIP ISSUES

A. Tax Court Interpretation of the “Per Se” Passive Classification of Limited Partners Followed by Similar Precedential Authority in the Federal Circuit of the United States Court of Appeals

A 2009 Tax Court decision, Garnett v. Commissioner,142 offers an excellent planning opportunity for many advisors of entrepreneurs. In tax years 2000 through 2002, the Garnetts were owners of various agribusiness entities selling primarily poultry, eggs and hogs.143 These entities were registered LLPs or LLCs, organized and operated under Iowa law.144 In summary, the Garnetts owned directly 16.66% of Fremont Farms, 11.11% of Quality Poultry & Eggs, as well as Garnett Family Farms LLC and Garnett Family Farms LLC I through IV (“GFF I – IV”).145 Each of the Garnett Family Farms LLCs owned minority interests in other LLPs and LLCs.146 Mr. Garnett was managing member of GFF I and GFF II, however the case reflects no evidence of who managed the other LLCs.147 The partnership agreements allowed all partners to participate in the active control and management of the LLP businesses.148 Iowa law provided that such partnerships would not bear personal liability for LLP liabilities based on the statutory characteristics of their role as a limited liability partner.149 The IRS record reflects that Mr. Garnett managed two of the three holding company LLCs, but not the LLCs owned through the LLPs.150

For the tax years in question, the IRS disallowed deductible flow-through losses, arguing that the ownership of these entities as partners with limited liability, either through the LLCs or through the limited liability partnerships, made Garnett a “per se” passive partner under I.R.C. § 469(h)(2).151 As such, the Garnett’s participation did not meet § 469-5T(e) requirements for active participation.152 Specifically, a “per

143. Id. at *3.
144. Id. at *3–4.
145. Id. at *3–5.
146. Id. at *4–5.
147. Id. at *6.
148. Id. at *5.
149. Id.
150. Id. at *2–7.
151. Id. at *10.
152. Id. at *10–12.
The crux of the case rested on the court's interpretation of the applicability of § 469(h)(2) (the "per se" passive rule) to limited liability partners and limited liability company members. Generally, § 469(a)(1) restricts the ability to deduct losses attributable to activities deemed to be passive based on a determination that the taxpayer has not materially participated in the activity under six objective tests promulgated in § 469 regulations. Specifically, the regulations under § 469 promulgate threshold objective tests by which it is determined whether or not material participation has occurred. Generally, the individual owner can satisfy the threshold test for active classification of income or loss through meeting one of the following six tests: (i) whether there is participation in the business activity of over five hundred hours in a year; (ii) whether the actual participation in the business activity amounts to substantially all of such actual participation of any person during the year; (iii) whether there is at least over one hundred hours of participation in the tax year by the taxpayer and it exceeds any other person's activity during that period; (iv) whether the taxpayer's total activity in all "significant participation activities" is over five hundred hours and the activity in question is a significant participation activity; (v) whether the taxpayer has materially participated in such activity for at least five of the prior ten tax years; or (vi) whether the taxpayer has materially participated for any three of the prior tax years if such activity is a personal service activity. In addition, there is a subjective facts and circumstances threshold, by which the material participation threshold can be met with evidence demonstrating there is regular, substantial and continuous participation by the individual.
Since the Garnetts owned their interests, as is common today via a limited liability company or a limited liability partnership, the IRS argued that the literal meaning of § 469(h)(2) controlled instead of the broader material participation requirement defined as "regular, continuous and substantial" participation under § 469(a)(1), as determined under the application of the previously stated seven material participation tests.\textsuperscript{160} Regulations interpreting this statute only allow a limited partner the ability to trump the "per se" rule and establish material participation for classifying income or loss as active income under limited tests.\textsuperscript{161} Specifically, once the "per se" passive status is deemed to apply, the partner can only avoid passive classification where he/she has participated for at least five hundred hours in the activity or has materially participated in five of the ten last prior years.\textsuperscript{162} If it is a personal service activity the five year requirement drops to a three consecutive prior tax year requirement to meet the material participation threshold.\textsuperscript{163}

The rationale behind the "per se" passive rule is grounded in the fact that when the passive rules were promulgated in 1986, limited partnerships were the only form of flow-through limited liability entities outside of S corporations and general partnerships. Since limited partners were restricted from active involvement, yet limited liability company members are not similarly restricted, the court considered that Congress could not have considered the role of limited partners in limited liability partnerships and members in limited liability companies when § 469 was enacted.\textsuperscript{164} However, the court did not base its decision in favor of the taxpayer on this premise.\textsuperscript{165} Instead, the court looked at the "general partner exception" as defined in § 1.469-5T(e)(3)(ii) as an exception to the "per se" rule of § 469(h)(2).\textsuperscript{166} By doing so, the court actually incorporated the substance of the historical differences in these entities.\textsuperscript{167} Under the general partner exception, the passive "per se" rule of § 469(h)(2) is not applicable where a person holds a general partner

\textsuperscript{160} Garnett, 2009 U.S. Tax Ct. LEXIS 18, at *19.
\textsuperscript{161} Treas. Reg. § 1.469-5T(e)(2); 53 Fed. Reg. 5726 (Feb. 25, 1988).
\textsuperscript{162} Treas. Reg. § 1.469-5T(a); 53 Fed. Reg. 5726.
\textsuperscript{163} Treas. Reg. § 1.469-5T(e)(2).
\textsuperscript{165} Id. at *14–23.
\textsuperscript{166} Id. at *23.
\textsuperscript{167} See id. at *22–23.
interest throughout the year as well as a limited partnership interest.\textsuperscript{168} The actual statutory language of this regulation reads as follows:

(ii) Limited Partner Holding General Partner Interest - A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).\textsuperscript{169}

The Tax Court concluded that the "general partner exception" applied inherently to entities in which the legal structure allowed the partner or member to actively manage the business without loss of their limited liability.\textsuperscript{170} In essence it considered the general partner exception to be both a general partner rule and a limited partner rule.\textsuperscript{171} This judicial precedent in the Tax Court now provides substantial authority for a broader classification of material participation. For example, certain limited liability partners and LLC members owning multiple interests, whose active participation was spread throughout their various entities, were often denied the ability under prior interpretations of the "per se" passive rule to classify their entity activities as significant participation activities. Without the application of the general partner exception, these partners and members were considered limited partners and confined to only three of the material participation tests listed above. Now, with the broader application of the general partner exception by the Tax Court, there is a much wider possibility that the partner's activities will qualify as materially participating if the "significant participation activity" test is met.\textsuperscript{172} To meet this test, the core business of such entities must be a trade or business, the partner must participate at least one hundred hours in each entity, and the partner's total participation in all such entities must be more than five hundred hours.\textsuperscript{173} This has a broader impact on entrepreneurs who are actively involved in many businesses when compared with those who spend more time in each.

The breadth of Garnett's judicial precedent has been expanded by the Federal Circuit's decision to apply the Tax Court's narrow

\begin{itemize}
\item \textsuperscript{168} I.R.C. §1.469-5T(e)(3)(ii) (2000).
\item \textsuperscript{169} Id.
\item \textsuperscript{170} Garnett, 2009 U.S. Tax Ct. LEXIS 18, at *22–30.
\item \textsuperscript{171} See id. at *29–30.
\item \textsuperscript{172} Id. at *9 (citing Temp. Treas. Reg. § 1.469-5T(a)(4) (1988)).
\item \textsuperscript{173} Id. at *8.
\end{itemize}
application of the "per se" passive loss rule. Just a month after Garnett was decided, a United States Court of Federal Claims decision, Thompson v. United States, followed Garnett's rationale by determining that a member in an LLC formed under Texas law should not be considered akin to a "limited partner" where the taxpayer's interest in the entity is analogous to that of a general partner. The IRS acquiesced, in result only, in Thompson that a membership interest in a limited liability company is not a limited partnership interest as defined in Temp. Treas. Reg. § 1.469-5T(e)(3). Between these two decisions, the North Carolina tax practitioner can certainly be guided through the Tax Court precedent, as well as the Federal Circuit, with confidence under similar facts.

B. Planning in the Worst of Times is Essential . . . A Key Example of the Need for the Tax Practitioner Guiding Clients Through Debt Restructuring to be Aware of the Definition of a "Partnership Item" Under TEFRA

When facing the nightmare of debt workouts, either now, or back in the 1990's, there are pitfalls at every turn. Bassing v. United States is a classic example of how procedural rules can save the day where followed carefully. 1110 Bonifant LP was a Maryland limited partnership formed in 1985 for construction of a Silver Spring office facility. Although it had several limited partners, the two general partners (Charles Bassing and Richard Cohen) were the taxpayers. The partnership agreement included all the necessary deficit restoration obligations, which became a relevant point as the partnership encountered financial difficulty in the late 1980's. A settlement agreement was negotiated with the lender, in which the creditor obtained the building in lieu of foreclosure accompanied by a payment from one of the general partners (Mr. Cohen). Subsequently, the partnership was liquidated, leaving Bassing with a deficit capital account

175. Id. at 738.
177. Bassing v. United States, 563 F.3d 1280, 1284–85 (Fed. Cir. 2009) (holding that an action by Mr. Bassing to treat his release from a partnership as a cancellation of debt, rather than a sale of his interest, was prohibited).
178. Id. at 1281.
179. Id.
180. Id.
181. Id.
of approximately $883,000. As part of that settlement agreement, the other general partner (Mr. Cohen) and the limited partners, in conjunction with the creditor, agreed to give Bassing a full release of the deficit restoration owed in February 1991 of $883,000. The taxpayer's original 1991 individual income tax return, as filed on April 15, 1992, reported a long term capital gain of the deficit amount, treating his release from the obligation as a deemed sale of his partnership interest. Only later did the taxpayer consider that due to his insolvency at the time of the settlement, he should have characterized the release of this obligation as cancellation of debt income under the insolvency exclusion. The taxpayer filed an amended tax return, asserting this position in late 2002, which would have re-characterized the income, yet excluded most of it from taxation. However, the claim was denied by the IRS.

This case does not consider the substantive merits of how the deficit obligation should have been characterized. However, it does illustrate how a failure to understand the partnership procedures as instituted under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") can foreclose one's ability to resolve such possible mischaracterizations for the benefit of the partners. In this decision, the Federal Circuit was in agreement with the Federal Court of Claims that the taxpayer's refund claim was barred under I.R.C. § 7422(h), since the taxpayer's refund claim centered on a partnership item as defined in § 6231(a)(3). Specifically, Bassing's deficit capital balance of approximately $883,000 must be calculated under an adopted accounting policy applying the capital account maintenance rules. Accordingly, under Treas. Reg. § 301.6231(a)(3)-1(b) a partnership item includes: "[T]he accounting practices and the legal and factual determinations that underlie the determination of the amount, timing and characterization of items of income, credit, gain, loss, deduction, etc . . . ." As a partnership item,
TEFRA instituted regulatory procedures assuring that partnership items, such as this one, impact the partnership, therefore impacting its partners and requiring handling at the partnership level for consistency. Accordingly, the court found that Mr. Bassing's release of his deficit restoration obligation was a partnership item requiring the partnership, acting through its tax matters partner, not Mr. Bassing, to classify the deficit and the settlement agreement's related impact pertaining to its tax characterization. What occurred here was a failure to follow the procedures afforded the taxpayer under I.R.C. § 7422. Accordingly, any action for a refund of taxes related to partnership items would be handled under the authority of § 6228(b)(2). Had the partnership's tax matters partner filed an administrative adjustment request under § 6227(a) no later than three years after the date the partnership return was filed, or the normal April 15 deadline, Bassing would have been led down a happier path. It appears, in this scenario, that this deadline could have been met at least through April 15, 1995, under the procedures required of the tax matters partner under § 6227. Here, the taxpayer (of course) was too late in figuring this out.

C. Unique Case with a Partner Determined Not to be the Beneficial Owner of his Partnership Interest & Therefore Not Subject to Tax on His Distributive Share

Windheim v. Commissioner sets the scene for a family conflict of unusual proportions in which the taxpayer was found not to be the beneficial owner of his distributive share of partnership income from an 18.879-percent limited partnership interest in Martinique. Martinique, a partnership owning New York real estate, was transferred to the taxpayer from his father (Joseph Windheim) in 1976. Later in 1981, shortly before his death, the father transferred his complete ownership in another separate family business, Les Promotions Taillon Limitée (“Taillon”), to the taxpayer and the taxpayer's sister. The siblings'
joint management of the business was a disaster, resulting in the taxpayer suing his sister in Canada, in the hope of a court-ordered liquidation of Taillon to divide the assets between the two parties. Following the sister's allegations that the taxpayer misappropriated assets, the court denied the liquidation request. Instead, the court decided to divide the asset management responsibilities within Taillon between the two parties. The taxpayer was to manage the securities portfolio, while the sister was given the task of managing the real estate. Needless to say, the disputes continued and the security portfolio became worthless under the taxpayer's management. Allegedly, the sister as well as the siblings' mother continued to use Taillon's funds as a personal banking account, leaving the accounts virtually devoid of any funds.

The next skirmish among the siblings occurred when the taxpayer learned distributions attributable to his ownership of Martinique were made payable to him, but were issued to him in care of his mother. These checks had been issued in such a manner in the past as well, and were consistently delivered to his mother's address. In 1998 the taxpayer sued the Toronto bank for honoring the prior endorsements of these checks by his sister, who deposited the funds into Taillon's account and immediately thereafter withdrew the funds. This led to the mother instituting a lawsuit in New York to enjoin Martinique from making distributions directly to the taxpayer. As a result, the New York court held in December 2000, that the original transfer of the Martinique partnership interest to the taxpayer was solely for the convenience of the father. Further, it held that the mother and sister had an interest in the taxpayer's distribution checks. Yet, there was no finding from the court as to who had a beneficial interest in the Martinique partnership interest. However, the New York orders did

198. Id. at *3.
199. Id. at *3–4.
200. Id. at *3.
201. Id.
202. Id.
203. Id. at *2–4.
204. Id. at *4–5.
205. Id. at *4.
206. Id.
207. Id. at *5.
208. Id.
209. Id.
direct Martinique to comply with the ultimate findings of the Canadian judgment regarding the ultimate disposition of distributions from the partnership.210

Finally in 2001, the Canadian court found the Toronto bank negligent in honoring the forged endorsements that named the taxpayer as owner of the distributions.211 The court ordered the Toronto bank to pay the taxpayer, and directed the mother and sister to pay the Toronto bank.212 The Canadian appellate court disagreed, based on a finding that the sister had the authority to authorize the bank's actions.213 It reversed the lower court, yet still did not address who was the beneficial owner of the Martinique partnership, as it was not a question raised by the nature of the original pleadings in the negligence suit against the bank.214 Attempts to take further action to recover the funds from the sister were considered barred by the statute of limitations.215

As if this conflict was not enough, the taxpayer had yet to face the IRS. Windheim had been issued a Schedule K-1 (partner's share of income, credits, deductions) for the four tax years in question (2000 through 2003), for which he did not even file tax returns.216 In defending his failure to report this income, the taxpayer argued that despite his legal title over the Martinique partnership interest, he was not the beneficial owner of the partnership interest as he had no control over it.217 The court considered various precedents to determine the extent of his beneficial ownership, considering the extent of his control over economic benefits, his inability to dispose of the asset, the assignment of obligations, the risk attached to him with respect to the asset, and the extent to which he could handle or be involved with the asset.218 Considering these factors, the Tax Court found that the

210. Id.
211. Id. at *6.
212. Id.
213. Id.
214. Id. at *6–7.
215. Id. at *6–7.
216. Id. at *7.
217. Id. at *8.
218. See id. at *8 (citing Hang v. Comm'r, 95 T.C. 74, 80 (1990) (actual command or enjoyment from economic benefits); Ragghianti v. Comm'r, 71 T.C. 346, 349 (1978), aff'd, 652 F.2d 65 (9th Cir. 1981) (determining ownership based on the person having the largest amount of possession); Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1237–38 (1981) (looking to all relevant factors, including receipt of economic benefits, control over selling assets, impact of obligations and risks associated with assets, and how the parties involved handle the particular asset)).
taxpayer had no ability to direct or control the disposition of the partnership interest. The taxpayer was effectively restrained from transferring his partnership interest due to the continuing New York order, by which a constructive trust was created over the Martinique distribution checks until the Canadian lawsuit was resolved. It also influenced the Tax Court that the Canadian judgment was overturned in favor of the mother and sister, and that the taxpayer was forced to abandon any further attempts to win control over the Martinique distributions. This succession of events, through which the taxpayer tried to recover beneficial ownership, were the only times the court considered him to have any inkling of beneficial ownership. Yet virtually no economic benefit accrued to him during all the years in question. After a finding that he was not the beneficial owner of the interest, the taxpayer was not required to report his distributive share of partnership earnings. Good result for the taxpayer, but quite a rocky path to victory against the IRS!

D. Review of the Methodology of Income Characterization for Liquidating Partners from a Service Partnership

In Wallis v. Commissioner, the taxpayer was a retiring tax lawyer from Holland & Knight, a Florida limited partnership. Having served as a Class B principal equity partner in the firm for twelve years, the taxpayer converted to a Class C (non-ownership) partner and shortly thereafter retired from the firm. The firm provided Wallis with a schedule of benefits to be paid, consisting of approximately $98,000 of Schedule B regular capital withdrawal benefits and $240,000 of Schedule C unit benefits. Schedule C units were awarded to the Class B capital partners annually regardless of firm profits, yet these amounts were not reserved to the partner's benefits and they were forfeited generally with a departure from the firm. The partnership had reported these payments through Form 1099-MISC in the following increments: 2003 - $60,000; 2004 - $80,000; 2005 - $80,000; and 2006 - $20,000; for a total

219. Id. at *9.
220. Id. at *9-10.
221. Id. at *9-10.
222. Id. at *13-14.
224. Id. at *6-7.
225. Id. at *7.
226. Id. at *5.
of $240,000 reported through Form 1099s over the four year period of benefit payout.\footnote{227} Additionally, Mr. Wallis was paid the following amounts for liquidation of his capital account according to the benefit schedule from the firm: 2003 - $24,540; 2004 - $32,720; 2005 - $32,720; and 2006 - $8,180; for a total of $98,160.\footnote{228} Reviewing the Schedule K-1s, reported through the partnership for Mr. Wallis for his entire employment as a Class B equity partner, the IRS calculated his partnership basis at the time of his withdrawal to be $399.\footnote{229}

Originally failing to report any of the 2005 payments as income, Wallis conceded for the 2005 tax year audit (which is the only year in question in this case) that the $80,000 receipt of Schedule C unit payments should be reported as income.\footnote{230} What he did contest, however, was the characterization of such Schedule C payments. Wallis asserted that they were not properly classified by the IRS as ordinary income, but instead should be considered liquidating payments taxable as consideration for the sale or exchange of a capital asset.\footnote{231} The court considered statutory authority by which payments to retired partners are classified either as: (i) distributive shares of income;\footnote{232} (ii) guaranteed payments;\footnote{233} or (iii) payments received in exchange for partnership interests.\footnote{234} Considering the 1992 elimination of the firm's retirement plan and the evidence that Schedule C units were not considered an allocated portion of partnership income or property, nor derived from the taxpayer's capital account, the court interpreted these payments to be paid from future earnings of the partnership after the partner's retirement.\footnote{235} With classification as partner retirement benefits, the court relied on precedential authority in Sloan v. Commissioner\footnote{236} and Treas. Reg. §1.736-1(a)(2) to determine that retirement payments to a

\begin{itemize}
  \item \footnote{227} Id. at *12.
  \item \footnote{228} Id. at *9–13, *25.
  \item \footnote{229} Id. at *25. The basis calculated by the IRS simply followed the Schedule K-1 reporting, with total capital contributions of $111,756 increased by Wallis's total distributive share of taxable income of $2,780,394 and of tax-exempt income of $422, which was then reduced by total distributions to Wallis of $2,892,173. \textit{Id.} The sum of these values equals $399.
  \item \footnote{230} Id. at *2.
  \item \footnote{231} Id. at *15.
  \item \footnote{232} I.R.C. § 736(a)(1) (2000).
  \item \footnote{233} Id. § 736(a)(2).
  \item \footnote{234} Id. § 736(b).
  \item \footnote{235} Wallis, 2009 Tax Ct. Memo LEXIS 245, at *18.
  \item \footnote{236} Wallis, 2009 Tax Ct. Memo LEXIS 245, at *18; \textit{see also} Sloan v. Comm'r, 42 T.C.M. (CCH) 1606 (1981).
\end{itemize}
liquidating partner are deemed guaranteed payments.\textsuperscript{237} The taxpayer relied on language from the partnership agreement by which the partner's interest value is the combination of the Schedule C units and the capital account.\textsuperscript{238} Accordingly, the taxpayer asserted that the Schedule C units were amounts received in exchange for his partnership interest to be taxed as a capital gain,\textsuperscript{239} asserting that the regulations consider an arm's length agreement as to valuation of a partnership interest to be correct.\textsuperscript{240} The court rejected this argument, asserting further regulatory interpretation that payments to partners who are withdrawing can constitute several items.\textsuperscript{241} As such, allocations must be characterized distinguishing among payments for different types of partnership assets, as well as other payments.\textsuperscript{242} With the firm's schedule of benefits allocating between Schedule C unit payments and the capital account payments, combined with the firm's reporting of the Schedule C unit payments on Form 1099, as well as the regulatory characterization of liquidating payments to include guaranteed payments, and the judicial precedent finding partner retirement benefits analogous to guaranteed payments, the court held that the Schedule C unit payments were taxable as guaranteed payments.\textsuperscript{243}

The IRS also alleged that the 2005 capital liquidation payments of $32,720 were fully taxable as capital gains, since such payments exceeded their calculated partner's basis of $399.\textsuperscript{244} The success of this assertion hinged on the court's acceptance of this basis as determined from the cumulative Schedule K-1 reporting.\textsuperscript{245} Given the taxpayer's submission of partnership schedules used by the firm to establish the partner's capital eligible for liquidation payments, which support the taxpayer's assertion of a total basis of $98,162 and its conflict with the Schedule K-1 tax reporting by the firm, the court considered the benefit

\begin{itemize}
  \item \textsuperscript{237} Wallis, 2009 Tax Ct. Memo LEXIS 245, at *19.
  \item \textsuperscript{238} Id. at *20--21.
  \item \textsuperscript{239} Id. at *24--25.
  \item \textsuperscript{240} Treas. Reg. § 1.736-1(b)(1) (2009).
  \item \textsuperscript{241} Wallis, 2009 Tax Ct. Memo LEXIS 245, at *21--22.
  \item \textsuperscript{242} Id. at *22; Treas. Reg. § 1.736-1(a)(2).
  \item \textsuperscript{243} Wallis, 2009 Tax Ct. Memo LEXIS 245, at *21--22.
  \item \textsuperscript{244} Id. at *24--25.
  \item \textsuperscript{245} Id. at *15; see also Sloan v. Comm'\r, 42 T.C.M. (CCH) 1606 (1981). Gain or loss on partnership dispositions is recognized to the recipient where cash distributions exceed such partner's basis prior to the distribution. I.R.C. § 731(a)(1) (2000). Generally, no gain will be recognized until the basis is fully reduced by total payments, except where the partner receiving fixed payments elects to pro-rate basis among all payments. Treas. Reg. § 1.736-1(b)(6) (2009).
\end{itemize}
payment schedule likely to have been prepared more carefully given the firm’s interest in its correctness. Further, the court emphasized the IRS’s failure to address the discrepancies with a rationale to support their assertions, as the basis to hold that the IRS had failed to meet the preponderance of evidence burden of proof. The result to Wallis was the avoidance of capital gains tax on the capital equity payments for 2005, as they were treated as return of the greater basis, as reflected on the partnership schedules, instead of the IRS calculations from cumulative Schedule K-1’s.

As an interesting final note with respect to the assessment of I.R.C. § 6662(a) accuracy related penalties, Wallis was forced to pay this penalty on underpaid tax attributable to the IRS reclassification of Schedule C unit payments as guaranteed payments from this decision. This Author finds it hard to disagree with the court on this point. Specifically, the partnership reported the Schedule C unit payments on Form 1099-MISC, giving notice to the taxpayer, a tax lawyer, of a treatment inconsistent from what he reported on his tax return. There just is not a more classic example illustrating when Form 8082 should be filed for notification to the IRS of inconsistent return reporting to avoid the § 6662(a) accuracy related penalty. Needless to say, Mr. Wallis learned the hard way!

III. EXTENSIONS OF THREE-YEAR STATUTE OF LIMITATIONS TO SIX YEARS WHEN BASIS OVERSTATEMENTS UNDERSTATE INCOME OF PARTNERSHIPS OR S CORPORATIONS

A. Introductory Comments for the Practitioner

I.R.C. § 6501(a) requires that the IRS assess income tax deficiencies against a taxpayer within a three-year period after the filing of an income tax return. There are ten statutory exceptions to the application of the three-year statute of limitations, with the four most relevant ones including: (i) when the IRS and the taxpayer agree to extend the time for

247. Id. at *27.
248. Id. at *25.
249. I.R.C. § 6662 (imposing a 20% penalty on tax underpayments that are deemed substantial, because they are greater than the larger of $5,000 or 10% of the tax required to be reported on a tax return with the tax underpayment).
assessment;\textsuperscript{252} (ii) when no return is filed;\textsuperscript{253} (iii) when a fraudulent return is filed by a taxpayer intending to avoid tax;\textsuperscript{254} and (iv) when required information regarding a listed transaction has not been included in the filing of a return.\textsuperscript{255} Section 6501(e)(1)(B) is another statutory mechanism by which the IRS can extend the normal three-year statute of limitations period for assessing income tax deficiencies to a six-year period if certain omissions of gross income occur on a return.\textsuperscript{256} The extended period is triggered when a taxpayer omits gross income equal to or greater than 25 percent of the gross income actually reported on the return.\textsuperscript{257} Simply applied, if a taxpayer’s return reports $500,000 of gross income, yet omits $150,000 of gross income, 25\% of gross income reported ($125,000) has been exceeded and the three-year statute is extended to six years.

Currently, § 6501(e)(1)(B) offers two exceptions from the trigger extension of the statute of limitations with certain omissions of income.\textsuperscript{258} The first exception applies where the taxpayer is reporting gross income derived from the sale of goods or services generated in a trade or business. Specifically, in such a trade or business the statute classifies a “gross income” omission to be solely an omission of “gross receipts” and not an omission of “gross income” (as derived when reducing gross receipts or sales by cost of goods sold).\textsuperscript{259} This statute clearly indicates that the extended six-year statute of limitations shall not apply where the gross income omission is derived from the overstatement of cost of goods sold, thereby creating an understatement of reported gross income from the trade or business.\textsuperscript{260} Yet, where gross

\begin{itemize}
\item \textsuperscript{252} Id. § 6501(c)(4).
\item \textsuperscript{253} Id. § 6501(c)(3).
\item \textsuperscript{254} Id. § 6501(c)(1).
\item \textsuperscript{255} Id. § 6501(c)(10). This section is effective for tax years with respect to which the period for assessing a deficiency did not expire before October 22, 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified at 26 U.S.C. § 6501(c)(10)).
\item \textsuperscript{256} I.R.C. § 6501(e)(1)(B) was the successor to I.R.C. § 6501(e)(1)(A), as the statute was reordered by the 2010 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147. The cases discussed in Section III refer to the prior statute (I.R.C. § 6501(e)(1)(A)), which now is I.R.C. § 6501(e)(1)(B).
\item \textsuperscript{257} I.R.C. § 6501(e)(1)(A)(i).
\item \textsuperscript{258} Id. § 6501(e)(1)(B).
\item \textsuperscript{259} Id. § 6501(e)(1)(B)(i); Colony Inc. v. Comm’r, 357 U.S. 28, 30 (1958). See Form 1040, Schedule C for reporting profit or loss from a business by which “gross receipts” as reported on Part 1, Line 1 is reduced by returns and allowances as well as by cost of goods sold to calculate “gross income” on Part 1, Line 7.
\item \textsuperscript{260} I.R.C. § 6501(e)(1)(B)(i).
\end{itemize}
receipts are sufficiently understated and cost of goods sold is properly reported, this omission of reported income can result in the application of the six year statute of limitations where the 25% omission threshold is met.261 A second exception from the extended statute period is granted where the tax position generating the omission of gross income has been adequately disclosed either in the tax return or in an attachment.262 Whether the return adequately discloses the position by which an omission of gross income occurs depends on whether the disclosures are reasonably sufficient for the IRS to be aware of the “nature and amount” of the omitted item.263 This will vary on a case-by-case basis and is best considered under the relevant facts and circumstances.

Since 2008, there have been a significant number of judicial decisions issued interpreting when the exception to the three-year statute triggered by an omission of income applies under § 6501(e)(1) as codified in those relevant tax years prior to 2010. It is important at this juncture to point out to the reader that § 6501(e)(1)(A), (e)(1)(A)(i), and (e)(1)(B) were re-ordered under the 2010 Hiring Incentives to Restore Employment Act to accommodate an addition to § 6501(e). For the purposes of issues discussed in Section III, the same provisions found in the predecessor § 6501(e)(1)(A) in 2009 will be used to reference these topics in discussing the cases to allow the reader consistency in reviewing the case citations. See Appendix I to this Article for a comparison of § 6501(e) as applied in the cases to § 6501(e) as amended in 2010.264

The cases discussed in this Article have occurred in Tax Court, in the Federal Circuit, and in various other circuits, including the Fourth Circuit. As one might expect, the proliferation of these cases can be attributed to litigation winding through the audit process involving the various iterations of tax shelter strategies which incorporate the use of artificially high basis for tax avoidance.265 These judicial developments

261. Id. § 6501(e)(1)(A)(i).
262. Id. § 6501(e)(1)(A)(ii).
263. Id.
264. 2010 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147. The re-ordering of the statute was to accommodate the addition of a definition of omitted gross income from one or more assets to which information reporting is required for reporting foreign financial information under I.R.C. § 6038(d). The cases discussed in Section III refer to the prior statute (I.R.C. § 6501(e)(1)(A)), which now is I.R.C. § 6501(e)(1)(B).
illustrate the impact of these types of transactions on the application of the six-year extended statute of limitations under § 6501(e)(1)(B). 266 But, more importantly, they emphasize the zeal with which the IRS is attacking egregious tax planning in its attempt to recover significant tax deficiencies. The IRS has chased these transactions with arguments that they represent sham transactions without economic substance, business purpose, nor economic effect.267 Exhibiting the fury of “Roman soldiers,” the IRS attempted to topple these transactions as different forms of the abusive “Son-of-Boss” tax avoidance structures. Yet, for the last eighteen months, what has been relevant in the actual case development in this area is that, often, the IRS’s dogmatic pursuit begins too late under the statute of limitations assessment restrictions of § 6501(a).268 Suffice it to say that, in most of these cases, what appeared to be possibly substantial arguments against the economic substance of “inflated basis” technical wizardry became moot. Moot simply because, without interpretation of § 6501(e)(1)(A) in light of the “tax wizardry” of the new millennium, the old standards used to define “omissions of income” and allow an even-playing field between the IRS and the cunning tax practitioner appear insufficient. As you will see in the strategies challenged in these cases, the IRS uncovered deficiencies created through the use of partnerships too late to assess deficiencies of income items on the reporting partnerships under a final partnership administrative adjustment (“FPAA”), without an extended statute period.269 This set the stage for a plethora of cases, several of which are discussed herein, in which the substantive technical issues were not dissected under the focus of appellate analysis. Rather, the analysis focused on whether jurisdiction existed to assess the tax deficiency within an extended statute of limitations period. The IRS has consistently (albeit with a few exceptions) failed in its arguments to broaden the interpretations of what constitutes an “omission of income” under § 6501(e)(1)(A) to extend the three-year statute to six years.270

\[\text{References}\]

266. I.R.C. § 6501(e)(1)(B).
267. Salman Ranch III, 573 F.3d at 1365.
268. I.R.C. § 6501(a).
269. Bakersfield II, 568 F.3d at 767; HCS I, 599 F. Supp. 2d at 678.
270. I.R.C. §§ 6501(e)(1)(A), 6229(c)(2); see AD Global Fund, LLC ex rel. N. Hills Holding, Inc. v. United States, 481 F.3d 1351, 1352 (Fed. Cir. 2007). I.R.C. § 6229(c)(2) in conjunction with I.R.C. § 6501(e)(1)(A) asserts a period for assessing tax
Considering the arguments from the courts as discussed in this Article, one cannot help but realize that the policy issues in the 1950's, used to decide when the statute of limitations should be extended under § 6501(e)(1)(A), are quite antiquated in light of today's sophisticated tax strategies. Just as the "sword" of Circular 230 had to be sharpened to enforce the ethical challenges of today's tax practice,\textsuperscript{271} so too does the underlying policy asserted for § 6501(e)(1)(A), as originally premised on section 275(c) from the Revenue Act of 1934, appear to need "sharpening."\textsuperscript{272} Reading Colony, which is cited in all of the inflated basis cases, the review of the legislative history of the predecessor statute for § 6501(e)(1)(A) feels like a review of a time capsule. That is... long ago and far away in another galaxy... our Senate Finance Committee members could never have dreamed of short-sale transactions, in conjunction with manipulation of ambiguous Subchapter K basis rules, governing basis reduction, with a partner's "contribution" of assets subject to contingent liabilities, followed by entity restructuring under a § 754 election used primarily to inflate the inside basis of partnership assets about to be sold for millions.\textsuperscript{273} Yes, as considered by the senators in the 73rd Congressional Session and considered as relevant legislative history in Colony, the senators expressed concern that section 276's extension of the statute of limitations "not be kept open indefinitely in the case of an honest but negligent taxpayer," as it was believed that "a taxpayer who makes an honest mistake" would be treated unfairly where the statute was held open "indefinitely," such as when a "taxpayer failed to report a dividend because he was erroneously advised by the officers on the partners, which is attributable to any reported partnership item that expires on the later of three years after the partnership return is filed or three years after the last day for filing the tax return without considering extensions. Given the complexity of these transactions, absent extension of this assessment period by agreement of the parties under I.R.C. § 6229(b), or absent the ability to prove that a partner has, with the intent to evade tax, signed or participated directly or indirectly in preparation of the partnership return, including a false or fraudulent item under I.R.C. § 6229(c), an omission from gross income as described in I.R.C. § 6501(e)(1)(A) (25% or more of the gross income as reported) is the primary way in which the IRS could successfully assert an extended six-year statute for assertion of the assessment on the individual partners in the tax years in question.


\textsuperscript{272} Colony Inc. v. Comm'r, 357 U.S. 28, 35 (1958).

\textsuperscript{273} Bakersfield II, 568 F.3d at 769; HCS I, 599 F. Supp. 2d at 682.
of the corporation that it was paid out of capital[,] or he might report as
income for one year an item of income which properly belonged in
another year."274 Oh, but if that was only the biggest worry of today.

As you review this section's judicial case developments, which are
lining up in all possible appellate paths a tax practitioner might choose,
consider the issue of the extension of the statute of limitations as highly
relevant both in and outside the context of an abusive tax shelter. Let us
be clear, the IRS will continue to chase recovery of "tax gap"275 dollars.
Specifically, given the number of cases lost by the IRS on this procedural
issue, they boldly issued retroactive temporary regulations in late 2009,
attempting to override the decisions of the Tax Court and several of the
United States Court of Appeals. Rumblings from the professional world
quickly surfaced as to the validity of these regulations, alluding to the
use of improper procedures. One case has already considered the issue
and is discussed in this Article. The likelihood of further litigation
seems assured, if only to determine the enforceability of the regulations
in light of the IRS's "never-give-up" attitude to recover significant tax
dollars evaporating in these "inflated basis" planning transactions.

B. Tax Court's Dispute with the IRS over Interpretation of I.R.C. §
6501(e)(1)(A)'s Extension of the Three-Year Statute of Limitations to
Six Years with a Tax Basis Understatement

As we begin a review of two Tax Court cases, Beard v. Commissioner276 and UTAM, Ltd. v. Commissioner,277 interpreting the
applicability of an extended statute of limitations involving inflated basis
transactions, we will consider the Tax Court's interpretation of legal
precedent applying the extended statute of limitation under I.R.C. §
6501(e)(1)(A) in contrast to the IRS's broader interpretation. The crux
of both positions begins with the 1958 Supreme Court decision in

274. Colony, 357 U.S. at 35.
0,,id=137246,00.html (last visited June 30, 2010). Based on FS-2005-14, the tax gap
widely discussed by the IRS is defined to include unpaid tax liabilities derived from: (i)
failure to file tax returns; (ii) failure to completely report all taxable income, the
overstatement of taxable deductions and the improper claiming of tax credits, all of
which lead to the underreporting of tax liabilities; and (iii) failure to pay tax liabilities
reflected on filed tax returns at all, or at least on a timely basis. Id. As reported on
March 29, 2005, the gross tax gap estimated on 2001 data approximates $353 billion.
276. Beard v. Comm'r, No. 13372-06, 2009 Tax Ct. Memo LEXIS 185 (Aug. 11,
2009).
Colony, which interprets the predecessor section to § 6501(e)(1)(A). The Court's interpretation of Colony permeates all these cases. Both Beard and UTAM, Ltd. also incorporate the rationale of Bakersfield I, a Tax Court decision upheld in the Ninth Circuit in June 2009. Since Beard is on appeal to the Seventh Circuit, and UTAM, Ltd. is still appealable to the D.C. Circuit at the time of submission of this Article, there is a potential for disagreement with the Bakersfield II Ninth Circuit on the horizon, which will likely surface along with the debate over validity of the IRS's newly issued retroactive regulations.

In Beard, the taxpayer acquired treasury notes from a short sale and sold them to an unrelated third party to generate $12.16 million. Shortly thereafter, Beard acquired more treasury notes in amounts of $5.7 million and $6.46 million, which were immediately transferred into his two S Corporations of which he owned a seventy-six percent majority control. Also transferred in with the investments were his short positions, thereby obligating the S Corporation to close the original short sale through acquiring replacements of the borrowed securities. Ultimately, the S Corporations closed the positions and only four days later did the taxpayer sell his interests in the S Corporations to an unrelated party for $6.6 million and $7.6 million. The IRS's notice of deficiency alleged that the taxpayer overstated his basis in the S corporations by increasing the basis for the contributed treasury stock, yet failing to reduce such basis by the obligation assumed by the S Corporation to close the stockholder's short position. The alleged inflated basis was $5.7 million and $6.46 million respectively for a total increase to the reported $1.4 million gain on the S Corporations' sales of $12.16 million. The issue decided in this decision was not a
debate on the merits of the deficiency. Instead, the taxpayer challenged the issuance of the deficiency notice in 2006 after the expiration of the three-year statute of limitations. On a motion for summary judgment, the essence of Beard's assertion was that the three-year statute had expired prior to the deficiency assessment and the six-year extended statute was not applicable since there had been no omission from gross income as required for § 6501(e)(1)(A) to apply to extend the statute.

Specifically, Beard asserted that § 6501(e)(1)(A) should be construed by its specific language, which requires an omission of gross income which was not applicable since amounts received for the sale of corporate stock had not been omitted. Rather, there had been an overstatement of the basis used to reduce the amounts received to the gain from the sale. Relying then on language contained within an exception to § 6501(e)(1)(A), Beard argued that without an omission of amounts received or accrued from the sale then, the overstatement of basis did not constitute an omission of gross income.

The Tax Court in Beard reviewed the underlying legal issues interpreting § 6501(e), beginning with the 1958 Supreme Court precedent in Colony, as it interpreted § 275(c) in the 1939 Internal Revenue Code (the predecessor statute to § 6501(e)(1)(A)). Colony held that specific income receipts or accrued income must have been “left out” in computing gross income for an “omission of income” to trigger measurement of the amount of the omission for possible extension of the statute of limitations. The transaction in Colony involved the taxpayer's sale of inventory of subdivision lots. The IRS has consistently argued that the Supreme Court's 1958 decision in Colony should only apply to cases with taxpayers generating gross income.
receipts from sales or services in the course of a trade or business.\textsuperscript{298} Since \textit{Beard} involves the overstatement of basis in the sale of corporate stock, it is the IRS's position that the \textit{Colony} holding is not controlling.\textsuperscript{299}

The crux of the IRS argument was centered on the premise that \textit{Colony}’s analysis of section 275(c) of the 1939 Internal Revenue Code is to be distinguished from interpretations of § 6501(e) as codified in the 1954 code, as the latter is materially different.\textsuperscript{300} In examining the 1958 \textit{Colony} decision, only two references are made to the 1954 codified § 6501(e)(1)(A). First, the court simply references the existence at the time of the decision of a new codification of this statute, followed by only one further reference in the last sentence of the decision, stating that \textit{Colony}’s holding is in congruence with the unambiguous language of the newly codified § 6501(e)(1)(A), as codified in the 1954 Internal Revenue Code.\textsuperscript{301} It is clear that \textit{Colony} did not attempt to construe the 1954 codification in any manner.\textsuperscript{302} However, the IRS argued its premise as follows:

1. § 6501(e)(1)(A) of the 1954 code (“the 25% omission rule”), labeled “general rule,” is just that, a broad general rule that an omission of gross income, properly includible in the return, which exceeds 25 percent of gross income stated on the return, will extend the statute of limitations to six years.

2. Clause (i) of § 6501(e)(1)(A) of the 1954 code\textsuperscript{303} (“the trade or business gross receipts test”) defines how to calculate gross income used for the 25% omission rule in subparagraph A. Specifically, the clause provides that gross income derived from a trade or business is defined as amounts received or accrued from the sale of goods or services without reduction for the cost of such goods or services.

3. Even though § 275(c) of the 1939 code, as interpreted in \textit{Colony}, has identical language to the 25% omission rule, \textit{Colony} essentially applied the rule embodied in the trade or business gross receipts test to the \textit{Colony} facts - facts involving taxpayers receiving gross receipts for

\textsuperscript{298} Beard, 2009 Tax Ct. Memo LEXIS 185, at *9; see also Bakersfield Energy Partners, LP v. Comm’r (Bakersfield II), 568 F.3d 767, 773 (9th Cir. 2009); Home Concrete & Supply, LLC v. United States (HCS I), 599 F. Supp. 2d 678, 683 (E.D.N.C. 2008); Salman Ranch Ltd v. United States (Salman Ranch III), 573 F.3d 1362, 1367 (Fed. Cir. 2009); Highwood Partners v. Comm’r, 133 T.C. 1 (Aug. 13, 2009).

\textsuperscript{299} Beard, 2009 Tax Ct. Memo LEXIS 185, at *8–11.

\textsuperscript{300} Id. at *10.

\textsuperscript{301} Id.

\textsuperscript{302} Id.

\textsuperscript{303} I.R.C. § 6501(e)(1)(B)(i) (1954) (including the “trade or business gross receipts exception”).
residential lots sold in the trade or business. Therefore, the IRS argues that Colony's holding should be limited in application as a special definition of gross income only applicable as stated in the trade or business gross receipts test.304

(4) Since the 1954 codification of the trade or business gross receipts test would therefore be the exception to the general 25% omission rule, the IRS argues this is proof that Congress in its 1954 codification intended the general rule of the 25% omission rule to be broader in its application.305 That is, it would include: (i) omissions of receipts and accruals of sales of products or services in the course of a trade or business; and (ii) omissions of other types of gross income as defined under § 61, such as gains from the sale or exchange of capital assets as defined under § 1001(a).306 The IRS asserts further that finding Colony to apply to the broader full definition, instead of limiting its application, constitutes an omission from gross income, rendering the 1954 addition of § 6501(e)(1)(A)(i) superfluous.

(5) Hence, the IRS asserts that in calculation of gains from the sale of investments, such as the sale of S Corporation stock in Beard, basis overstatement which leads to the understatement of the § 1001(a) gain would not be controlled by the definition of gross income under the trade or business gross receipts test. Accordingly, the special rule of that test - that only omissions of gross receipts or accruals of income are measured omissions - would not apply. Instead, the understatement of the gain from the sale of investment property, due to a basis overstatement, would rightfully be included as an omission.307

In reaching its conclusion, the Tax Court in Beard leaned heavily on the rationale of the June 2009 Ninth Circuit ruling in Bakersfield II.308 The facts of Bakersfield II present another IRS argument that the taxpayer pursued a sham transaction to create inflated basis, which

305. Id. at *6, *9-10; see also CC & FW Operations Ltd. v. Comm'r, 273 F.3d 402, 406 n.2 (1st Cir. 2001).
306. I.R.C. § 1001(a) (LexisNexis 2000) (defining a gain from a sale or disposition to be calculated as the amount realized less the basis). In a case such as Beard, the overstatement of basis in the S Corporation stock would create an understatement of the net gain under I.R.C. § 1001(a).
307. Beard, 2009 Tax Ct. Memo LEXIS 185, at *6; see also CC & FW. Operations, 273 F.3d at 406 (expressing skepticism that Colony's holding should be applied to interpret the "sales of goods and services" as a rule ignoring basis overstatements as omissions of gross income). But see Salman Ranch Ltd v. United States, 573 F.3d 1362, 1372–73 (Fed Cir. 2009).
308. Bakersfield Energy Partners, LP v. Comm'r (Bakersfield II), 568 F.3d 767, 771–76 (9th Cir. 2009).
substantially reduced a reported capital gain. The taxpayer's first line of defense was a motion for summary judgment to dismiss the case due to the tax deficiency assessment occurring after the expiration of the three-year statute of limitations. The IRS defended, arguing the applicability of § 6501(e) to extend the limitations period from three to six years due to an alleged substantial omission of income.

The IRS similarly argued the third interpretative premise discussed above. The Ninth Circuit rejected the IRS's argument to interpret Colony as applying to the trade or business gross receipts test as an exception to a broader definition of gross income. The identical verbiage of § 275(c), as interpreted in Colony, appeared word for word identically in the 1954 codification of § 6501(e)(1)(A). Judicial precedent for statutory interpretation convinced the court that new statutes should be interpreted identically to the meaning attributed to

309. Id. at 770.
310. Bakersfield Energy Partners, LP v. Comm'r (Bakersfield I), 128 T.C. 207, 208–10 (2007), aff'd, 568 F.3d 767 (9th Cir. 2009). Four partners of Bakersfield Energy Partners ("BEP"), a limited partnership, owning oil and gas property, failed to successfully complete a sale of the properties to an unrelated party and then decided to restructure the partnership. 128 T.C. at 208. They formed a new entity, Bakersfield Resources, LLC ("BRLLC"), through the sale by four partners of their 76.3% ownership to BRLLC on April 1, 1988 for 19.9 million (the gain from which was reported by the partners under the installment method). Id. With this sale of more than 50 percent of BEP in a twelve month period, I.R.C. § 708(b)(1)(B) was triggered, through which there was a technical termination of the partnership for tax purposes. Id. at 209. This created a deemed formation, for tax purposes, of a new partnership, to which BEP was deemed to contribute all assets tax free under I.R.C. § 721, followed by the deemed termination of the "old" BEP through distribution to its partners of proportionate shares of interests in the "new" BEP (this was not a "legal" termination, but merely a "tax" termination). Id. at 209–10. The new BEP retained its employer identification number, but now consisted of a new partnership, of which BRLLC was a 76.3% owner, with the remaining partners of the "old" BEP owning their proportionate share of the "old" BEP. 568 F.3d at 769. Because BEP had elected under I.R.C. § 754, BRLLC was permitted to allocate its outside basis in the "new" BEP of $19.9 million to its assets under I.R.C. § 743(b). Id. This resulted in allocations of an additional $16.515 million to the zero bases of the oil and gas properties. Id. When the oil and gas properties were sold to an unrelated party in 1998 for $23.898 million, the gain reported was $7.38 million, instead of $23.898 million. Id. Although not clear from the opinions, since the partners did individually continue to report their installment sale gains on sales to BRLLC, the tax benefits of this transaction appear derived through deferred reporting on at least 69 percent of the proceeds, allowing for other possible planning for gain offsets in later years.

311. Bakersfield II, 568 F.3d at 775.
312. Id.
313. Id.
identical language from a predecessor statute.\textsuperscript{314} Hence, \textit{Colony}'s interpretation of § 275(c) must be applied to § 6501(e)(1)(A), according to the Ninth Circuit.\textsuperscript{315} Additionally, the Ninth Circuit demonstrated some creative speculation as to the legislative intent of the congressional motivations for this addition. Specifically, the addition of the trade or business gross receipts test in § 6501(e)(1)(A)(i) was considered a clarification of what Congress \textit{apparently believed} to be disputed interpretations.\textsuperscript{316}

The Ninth Circuit also rejected the convention that following \textit{Colony}'s interpretation of the considerations for assessing what is an omission of gross income would render the addition of § 6501(e)(1)(A)(i) superfluous in quite creative logic.\textsuperscript{317} The court determined that \textit{Colony} solely interprets what constitutes an "omission of gross income" under the then language of § 275(c), which is exactly analogous to § 6501(e)(1)(A), in calculating whether there has been a greater than 25 percent omission.\textsuperscript{318} In its opinion, the \textit{Colony} court only interprets how to calculate what amount of income is "omitted" from gross income. Specifically, \textit{Colony} rejects the traditional gross income definition found in § 61 in which gains from property are classified as gross income under the § 1001(a) definition of amount realized less basis solely for purposes of calculating what is an omission from gross income.\textsuperscript{319} The Ninth Circuit accordingly interpreted \textit{Colony} as maintaining the definition of "gross income" actually reported on the return under the traditional gross income definition. The Ninth Circuit rushes to the grand interpretation that only with the 1954 codified addition of § 6501(e)(1)(A)(i) did we gain consistency in the definitions of gross income as omitted as it is compared to total gross income reported on the return.\textsuperscript{320} Therefore, \textit{magically}, § 6501(e)(1)(A)(i) is \textit{not} rendered superfluous as asserted by the IRS.

Just to be clear, consider this illustration: a tax return reports $300,000 of wage income and a gain from the sale of stock of $80,000; the gain is calculated as a gross sales price of $180,000, reduced by basis of $100,000 for an $80,000 gain; the omission of gross income is $100,000. Under \textit{Colony}'s sole interpretation, without considering any

\textsuperscript{314} Id. at 775–76.
\textsuperscript{315} Id. at 776.
\textsuperscript{316} Id.
\textsuperscript{317} Id.
\textsuperscript{318} Id.
\textsuperscript{319} Id.
\textsuperscript{320} Id.
statutory additions in the 1954 codification, the application of § 275(c) would produce $100,000, divided by gross income determined under the traditional § 61 concepts. Accordingly, $300,000 of wages and the net gain from the sale of stock of $80,000 would create $380,000 of gross income reported on the return. Applying the 25% omission rule, the amount of gross income omitted would be $100,000, divided by $380,000, for a 26.3% omission of gross income. Since this exceeds the 25% threshold, the taxpayer would be subject to a six-year extended statute of limitations. But, lo & behold, with the magic of the addition of the trade or business receipts test to the 1954 codification of § 6501(e)(1)(A)(i), a different result occurs. Here, the definition of gross income found in § 6501(e)(1)(A)(i) defines gross income in the 25% omission rule of § 6501(e)(1)(A) to apply to the amount of the omission as well as the amount of gross income reported on the return. That is, now the $300,000 of wage income would be increased by the gross receipts received or accrued from the sale of products or services in a trade or business. Forget for now that the Ninth Circuit did not take the time to consider whether the sale of stock was the sale of a product or service in this magic proposition. Simply increase $300,000 by the gross receipts from the sale of $180,000 without any reduction for the cost of the stock of $80,000. The result is the division of the $100,000 omission of other income divided by $480,000 for a 20.8% omission, well under the 25% of income reported threshold. Obviously these different positions do produce different results.

321. Id.

322. Hoffman v. Comm'r, No. 16028-99L, 2002 U.S. Tax Ct. LEXIS 44, at *17–22 (Sept. 24, 2002). Hoffman offers interesting precedential authority for Bakersfield’s analysis of the varied definitions of “gross income” in I.R.C. § 6501. Hoffman involves a taxpayer (trying to do the right thing) who amended a return outside the three year statute period to report omitted cancellation of indebtedness income and promptly paid the additional tax. Id. at *5–6. As to be expected, the IRS assessed interest and penalties. Id. at *6. Once the notice of intent to levy appeared, at a hearing on the matter, the taxpayer essentially said, I made a mistake in amending the return, since it was filed outside the three year statute of limitation... give me my money back! Id. at *6–7. Of course, the IRS said no and this case is what resulted. Id. at *7–9. Hoffman also gave the Tax Court an opportunity to point out in 2002 that the Supreme Court’s rationale in Colony, which solely applied to the definition of an omission of gross income, had been expanded in the 1954 codification of I.R.C. § 6501(e)(1)(A)(i). Id. at *17–18. Specifically, they interpreted the definition of gross income in the trade or business gross receipts test to apply to determine not only the amount of gross income omitted, but also to determine the amount of gross income shown on the return as well. Id. The impact here was that the partnership flow through income on the taxpayer’s return required increasing by any possible reduction of gross receipts that might have occurred by the cost of sales of products or services. Id. at *18–19. However, the IRS
evidence in Bakersfield II that this was truly the intent of the drafters of the 1954 codification. One might also argue at this juncture that in light of the very different tax planning world that exists in today's sophisticated tax world, Congress might want to reconsider what the right interpretation should be and make it so!

In Bakersfield II, the Ninth Circuit also revisits the considerations addressed in Colony through which the Supreme Court emphasized the critical choice of words that § 275(c) (currently § 6501(e)) used when considering whether the taxpayer “omits from gross income an amount properly includible therein which is in excess of 25% of the amount of gross income stated in the return.” The Circuit again emphasizes the Colony statements recognizing prior taxpayer's arguments 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 significantly supported the IRS position.”323 Finally, the Ninth Circuit in Bakersfield II did not find any specific limiting language in Colony that might imply it was limited to factual patterns where the taxpayer was actually engaged in a trade or business. Since Beard involved investment transactions outside the context of a trade or business, this IRS argument, if successful, could have saved their position. Alas, it did not. Accordingly, the three-year statute was found to apply in Bakersfield I.324 The taxpayer's motion for summary judgment was granted, finding that the notice of deficiency sent by the IRS was not timely submitted since it was not issued within the three-year statute of limitations period.325

Bakersfield II represents just one more huge loss to the IRS in the inflated basis cases, which have plagued them in this first decade of the new millennium. Unfortunately, it is not even a loss after a significant debate, not on the technical merits of the transaction, but instead a loss on the procedural issues to simply “get up to bat.” In the next subsection discussing developments in this area, another such loss is delivered in the Federal Circuit appellate path.

Before moving to consider the Federal Circuit developments, the practitioner should consider briefly a similar inflated basis case which

---

323. Bakersfield II, 568 F.3d at 773.
324. Id. at 778.
325. Id.
moved through the Tax Court recently, UTAM, Ltd.\textsuperscript{326} This case was
decided under the same rational as Beard, with a heavy emphasis on the
precedential authority of Bakersfield II. The case involves an alleged
inflated basis transaction created with a transactional structure involving
the combined use of an S Corporation and a limited partnership
interest.\textsuperscript{327} David Morgan, the primary owner of the entities, merged a
successful life insurance business into his wholly owned S Corporation
UTA Management.\textsuperscript{328} Shortly thereafter, attempting to avoid the Texas
franchise tax, the business assets of UTA Management were transferred
into a newly created limited partnership UTAM, Ltd. in exchange for a
partnership interest.\textsuperscript{329} UTAM, Ltd. was then owned primarily by UTA
Management with the remaining 1.24% owned by DDM Management
Inc., another S Corporation owned by Mr. Morgan and other family
members.\textsuperscript{330} Shortly after the formation of UTAM, Ltd., an offer to buy
the insurance business assets was received from an unrelated third
party.\textsuperscript{331} Prior to the culmination of this sale, UTA Management entered
into a short sale of borrowed United States treasury notes for $38
million.\textsuperscript{332} The cash from the sale and its related short sale obligation
was transferred to UTAM, Ltd.\textsuperscript{333} As in Beard and Salman Ranch III,\textsuperscript{334}
the cash was considered an asset contributed to UTAM, Ltd. thereby
increasing UTA Management's basis in UTAM, Ltd. by $38 million.\textsuperscript{335}
However, the taxpayer asserted the position that the related short sale
obligation assumed by UTAM, Ltd. was not considered a Treas. Reg. §
752 liability as it was deemed undeterminable due to the uncertainty of
the cost of replacement treasury notes.\textsuperscript{336} The partnership interest was

\begin{footnotes}
\footnote{326. UTAM, Ltd. v. Comm'r, No. 24762-06, 2009 Tax Ct. Memo LEXIS 258 (Nov. 9, 2009). Respondent's motion for the court to reconsider was denied on May 19, 2010, triggering the ninety-day period in which an appeal can be filed. Id. at *10. The status of the appeal was unknown at time of this Article's submission.}
\footnote{327. Id. at *2–3.}
\footnote{328. Id. at *2.}
\footnote{329. Id.}
\footnote{330. Id.}
\footnote{331. UTAM, 2009 Tax Ct. Memo LEXIS 258, at *2–3.}
\footnote{332. Id. at *3.}
\footnote{333. Id.}
\footnote{334. Salman Ranch Ltd v. United States (Salman Ranch III), 573 F.3d 1362, 1378 (Fed. Cir. 2009).}
\footnote{335. I.R.C. § 723 (2000).}
\footnote{336. The 1999 transaction preceded the issuance of Treas. Reg. § 1.752-7 (2003). Treas. Reg. § 1.752-7 replaced Temp. Reg. § 1T.752-6 (effective regarding partnership liabilities for transactions between October 18, 1999 and June 24, 2003). Under transactions affected by Temp. Reg. § 1T.752-6, the actual amount required to close the

http://scholarship.law.campbell.edu/clr/vol33/iss1/2
sold shortly thereafter with the reported gain challenged. The IRS challenged the transaction as a sham transaction, lacking economic substance, designed solely to inflate the basis in light of the likelihood that the short sale positions were primarily risk-less due to the nature of treasury notes. Therefore, the IRS asserted a deficiency attributable to the alleged gain understatement of $41.1 million basis for UTAM, Ltd.'s failure to reduce the outside basis of the partnership after its increase from the contributed $38 million for the related short sale obligation assumed by UTAM, Ltd. with the cash contribution. Since the tax assessment did not occur within the three-year statute, again, as in Beard, the taxpayer sought a motion for summary judgment to dismiss the assessment. Again, the dismissal request was premised on the argument that I.R.C. § 6501 did not apply to extend the statute of limitations to six years and the assessment was therefore not timely. The taxpayer here, just as in Beard, was successful as the Tax Court applied the precedent of the cases discussed above - Colony, Bakersfield II, Salmon Ranch III, and Beard.

C. The United States Court of Appeals for the Federal Circuit Weighs in on Debate Over I.R.C. § 6501(e)(1)(A)

Salman Ranch III, a 2009 decision in the United States Court of Appeals for the Federal Circuit, was released shortly after the Ninth Circuit's decision in Bakersfield II. The Federal Circuit reversed the Court of Federal Claims decision in favor of the taxpayer, rejecting the short sale was considered undeterminable until the assets, such as the United States treasury notes in UTAM, were re-acquired to replace the sold borrowed assets. In UTAM, the partner argued that the actual obligation was contingent, thereby avoiding the reduction of the basis already increased by the cash contributed from the short sale of $38 million. UTAM, 2009 Tax Ct. Memo LEXIS 258, at *3–4. Nonetheless, this "disregarded" liability was still paid by the partnership; yet the amount was not used to reduce the contributing partner's basis. Id. The overstatement of the partner's outside basis ultimately created the overstated basis at issue in UTAM. Id. at *1.

337. Id. at *2–3.  
338. Id. at *4.  
339. Id.  
340. Id.  
341. Id.  
344. Bakersfield II, 568 F.3d at 767.
lower court's decision that I.R.C. § 6501 applied to extend the statute of limitations to six years.\footnote{Salman Ranch Ltd v. United States (Salman Ranch I), 79 Fed. Cl. 189, 190 (2007).} Salman Ranch started with the transfer in 1987 of a ranch by the owners into a partnership formed as Salman Ranch Ltd.\footnote{Id.} On October 8, 1999, the partners of Salman Ranch Ltd., in their individual capacities, entered into short sales of borrowed treasury notes, generating $10.98 million in sales proceeds.\footnote{Id.} Five days later, these proceeds, with the short sale obligations requiring the repurchase of replacement treasury notes, were contributed to Salman Ranch Ltd. by the individual partners.\footnote{Id.} Then, sometime between the transfer to the partnership, but before November 30, 1999, the partnership closed the short sale transaction, acquiring the replacement treasury notes for $10.981 million.\footnote{Id.}

Now, let us consider the impact of these steps so far. Attendant to the transfer of the proceeds from the sale of the borrowed treasury notes was the related increase to each partner's outside basis in Salman Ranch Ltd. under § 723\footnote{Treas. Reg. § 1.752-7 (2003). The asserted position by many taxpayers in these cases was that the related short sale obligation to acquire replacement investments to cover the short sale was not properly a liability under I.R.C. § 752, which generally required a basis reduction to a partner's outside basis when the partner transferred the liability potential to the partnership. This question was resolved through Treas. Reg. § 1.752-7. See Treas. Reg. § 1.752-7. Under this regulation, where a contingent obligation is transferred into the partnership, at the time of such transfer it still is not treated as a liability, such that it reduces the transferor partner's outside basis at transfer. Id. Instead, it is considered an I.R.C. § 704(c) built-in loss to the transferor partner. Id. Therefore, when the contingent liability is actually paid by the partnership, it is treated as a built-in loss allocable to the transferor partner at the value estimated at the time of the transfer. Alternatively, if the transferor partner disposes of the partnership interest before the liability is paid, such partner's outside basis must be reduced by the liability amount that remains unsatisfied in accordance with Treas. Reg. § 1.752-7(e)(1). See id. § 1.752-7(e)(1).} from the contribution each partner's proportionate share of the $10.98 million sales proceeds. At this point in these transactions, and prior to the promulgation of the son-of-BOSS regulations,\footnote{I.R.C. § 704 (2000).} the impact of contingent liabilities on each partner's outside basis was somewhat unsettled. The partners apparently treated

\begin{thebibliography}{99}
\footnotetext[345]{Salman Ranch Ltd v. United States (Salman Ranch I), 79 Fed. Cl. 189, 190 (2007).}
\footnotetext[346]{Id.}
\footnotetext[347]{Id.}
\footnotetext[348]{Id.}
\footnotetext[349]{Id.}
\footnotetext[350]{Treas. Reg. § 1.752-7 (2003). The asserted position by many taxpayers in these cases was that the related short sale obligation to acquire replacement investments to cover the short sale was not properly a liability under I.R.C. § 752, which generally required a basis reduction to a partner's outside basis when the partner transferred the liability potential to the partnership. This question was resolved through Treas. Reg. § 1.752-7. See Treas. Reg. § 1.752-7. Under this regulation, where a contingent obligation is transferred into the partnership, at the time of such transfer it still is not treated as a liability, such that it reduces the transferor partner's outside basis at transfer. Id. Instead, it is considered an I.R.C. § 704(c) built-in loss to the transferor partner. Id. Therefore, when the contingent liability is actually paid by the partnership, it is treated as a built-in loss allocable to the transferor partner at the value estimated at the time of the transfer. Alternatively, if the transferor partner disposes of the partnership interest before the liability is paid, such partner's outside basis must be reduced by the liability amount that remains unsatisfied in accordance with Treas. Reg. § 1.752-7(e)(1). See id. § 1.752-7(e)(1). However, these regulations were not in effect to be used in resolving the substantive issues in these "inflated basis" cases and are beyond the scope of a full discussion in this Article.

http://scholarship.law.campbell.edu/clr/vol33/iss1/2
the short sale obligations as contingent liabilities, arguing that the impact of assuming contingent liabilities can be disregarded since the amount of the liability that the partnership actually owed to acquire the replacement treasury notes is supposedly "undeterminable." Had the liabilities assumed been determinable, such as a value of $10 million, then the amount of the liabilities assumed by the partnership from the partner's transfer would, without question, be treated as deemed cash distributions to the partners under § 752. The impact would have been a fairer reflection of the true net increase in worth from the contribution to the partnership of the short sale proceeds with the attendant obligation to replace the sold treasury notes. For example, had the amount of the obligation to close the short sale been determined to be $10 million, then it would reduce the $10.98 million in sales proceeds, resulting in a total net increase in the partner's outside basis in Salman Ranch Ltd. of $0.98 million. Instead, in Salman Ranch the impact of the contingent liability was not considered in determining the partner's outside basis. Accordingly, there was an increase to the partner's outside basis in the ranch of $10.98 million due to the cash proceeds contributed, yet there was not any reduction in the partner's outside basis for the liability the partnership assumed to close the short sale obligation.

Now that the nature of the "inflated basis" in this case has been revealed, let's review the end of the "hat trick" through which the inflated basis is used to significantly reduce the gain from an obviously pre-planned sale of Salman Ranch Ltd. As has been the case in these

352. Salman Ranch Ltd v. United States (Salman Ranch I), 79 Fed. Cl. 189, 192 (2007). So the theory goes, yet of course the IRS asserted that Treasury Notes are virtually riskless from market fluctuations, so there is a question technically as to the appropriateness of the position that these liabilities qualified as contingent. See id.
353. I.R.C. § 752(b).
354. Id. Liabilities transferred by a partner to a partnership are considered a deemed distribution of money, thereby triggering a decrease in the partner's basis by the amount of the liability transferred from the partner to the partnership. See id.
356. The absence of economic substance in this "magic" basis calculation has been widely attacked with varied facts under "Son-of-BOSS." So, you can understand IRS's fervor to win these cases and the likely frustration when such attempts are thwarted through operation of the three-year statute of limitations.
"inflated basis" partnership transactions, on November 30, 1999, after the basis of each partner's interest had allegedly been "inflated," each partner then contributed his partnership interest in Salman Ranch Ltd. to a newly created respective family partnership in exchange for an interest in the family partnership.\(^\text{357}\) This transfer triggered a § 708(b)(1)(B) technical termination of Salman Ranch Ltd. due to the sale or exchange in a twelve-month period of at least fifty percent of the total interest in its capital and profits.\(^\text{358}\) With this fictional deemed termination, the resulting "new" partnership is owned by each partner's respective family partnerships. Accordingly, the assets of the former Salman Ranch Ltd. were the assets of the "new" Salman Ranch Ltd. However, the partners were now the family partnerships. On the final return of the "terminated" partnership, an election was made under § 754 for a § 743(b)(1) basis adjustment.\(^\text{359}\) The § 743(b)(1) basis adjustment is the mechanism through which a partner's outside basis, when different from the inside basis of the partnership property's basis, is adjusted to allocate the difference proportionately to the inside basis of the partnership's assets.\(^\text{360}\) In Salman Ranch III, the inflated basis generated from the contribution to Salman Ranch Ltd. of the proceeds from the partner's sale of the treasury note with the related short sale obligation created a high outside partner basis as compared to the inside basis of partnership assets. Accordingly, under the § 754 election for a § 743(b)(1) basis adjustment, the difference in basis was allocated proportionately among the partnership assets, thereby increasing the inside basis of the assets.\(^\text{361}\) The step-up in basis created an additional $6.85 million of basis allocated to all of the partnership property.\(^\text{362}\)

Following the transfer and related step-up in basis of the partnership's underlying property, only one month later, at the end of the tax year 1999, the partnership sold part of the ranch for $7.088 million with an option to sell the remaining portion for $100,000 and

358. Salman Ranch Ltd v. United States (Salman III), 573 F.3d 1362, 1364 (Fed. Cir. 2009). The family partnerships were newly created to provide an entity through which there could be a transfer of the "inflated basis" partnership interests. Id. at 1378. Such a transfer was needed to trigger the technical termination. See discussion supra note 170 (reviewing the technical termination). Remember this is not a legal termination, but a termination solely for tax purposes under the fiction created in Subchapter K.
361. Salman Ranch III, 573 F.3d at 1364.
362. Id.
$656.12 per acre. The 1999 family partnership tax return reported the sale of the ranch for $7.188 million reduced by the alleged "inflated" basis of $6.85 million. The resulting gain of approximately $338,000 was proportionately allocated to each of the WJS, DMS and FSK family partnerships. Although the partners reported their proportionate share of the gain from the ranch sale via flow-through from the appropriate Schedule K-1 reporting, their individual returns reported a small capital loss from the short sale as dated in October 1999 when the partners sold the borrowed treasury notes with the basis determined from the partnership's acquisition of replacement notes. There was no disclosure that Salman Ranch Ltd. had assumed the short sale position, nor that it was the entity that closed the position. Further, there was no indication that the loss was a partnership transaction that would be passed through on the Schedule K-1 to the individual partners.

The IRS did not issue the final partnerships administrative adjustment ("FPAA"), adjusting the capital gain on the 1999 partnership tax return until 2006, well after the expiration of the three-year statute of limitations. It was their position on the FPAA that the "alleged" inflated basis allocated to the sold assets was $4.6 million, thereby increasing the capital gain by $4.6 million from the amount of gain reported on the return. The IRS characterized the transaction as a variant of the Son-of-BOSS tax shelter under I.R. Notice 2000-44, and the rationale for its assessment centered on the following as stated in the FPAA:

Salman Ranch Ltd. was availed of for improper tax avoidance purposes by artificially overstating basis in the partnership interests of its partners. The transactions involving short sales of Treasury Notes,

363. Id. at 1364–65.
364. Id. at 1365.
365. Id.
367. Id.
368. Salman Ranch III, 573 F.3d at 1365.
369. Id.
370. IR Notice 2000-44, 2000-2 C.B. 255. Son-of-BOSS transactions have been described by the Tax Court as a variety of the older Bond and Options Sales Strategy ("BOSS") tax shelter. As described, the common feature involves assets transferred to a partnership which are "encumbered by significant liabilities." As the liabilities are not fixed at transfer and might be deemed uncertain, they may in some circumstances be ignored in calculating basis at the time of the transfer. The result is an increase to basis for the high-value assets, without a corresponding reduction of basis for the uncertain liability. See Kligfield Holdings v. Comm'r, 128 T.C. 192, 194 (2007).
including the formation of Salman Ranch Ltd., the acquisition of short positions in said Treasury Notes, the contribution of said Treasury Note positions to Salman Ranch Ltd. and the assignment of partnership interests to [the family limited partnerships] had no business purpose, lacked economic substance, and, in fact and substance, constitutes an economic sham for federal income tax purposes.\(^\text{371}\)

In response to the FPAA, the taxpayers filed a motion for summary judgment, arguing that the assessment be held invalid since an extended six-year statute of limitations under § 6501(e)(1)(A) was not applicable to a basis overstatement.\(^\text{372}\) The Federal Court of Claims decision in *Salmon Ranch I*\(^\text{373}\) held in favor of the IRS that the six-year statute of limitations would be applicable in these facts.\(^\text{374}\) The taxpayer then petitioned for and was granted certification for an interlocutory appeal to the United States Court of Appeals for the Federal Circuit.\(^\text{375}\) The appeal was based solely on the issue of whether the extended six-year statute of limitations was properly applied by the Federal Court of Claims, and the request to review such an interlocutory order was granted by the Federal Circuit.\(^\text{376}\) These facts set the stage for the Federal Circuit to decide the same interpretative issue regarding the application of the extended statute under § 6501(e)(1)(A), which had been previously addressed in conflicting rulings in the Tax Court and federal district court.\(^\text{377}\)

*Salman Ranch I* did not follow the broader interpretations of Colony that require a specific omission of gross receipts for there to be deemed an "omission" of 25% of gross income. Specifically, the Federal Court of Claims appeared most swayed by the IRS's arguments that Colony was to be construed to define omissions of gross income as an omission of gross income.

\(^{371}\) *Salman Ranch III*, 573 F.3d at 1365.

\(^{372}\) Id. at 1367.


\(^{374}\) Id.

\(^{375}\) Id.


receipts that were “left out” solely in inventory transactions involving a trade or business selling goods or services.\textsuperscript{378} \textit{Salman Ranch I} referred several times to the \textit{Colony} facts, which specifically involved the sale of inventory lots as a trade or business.\textsuperscript{379} Nonetheless, the court did consider a review of the conflicting decisions for this interpretation,\textsuperscript{380} after which the court appeared aligned with the Florida federal district court opinion in \textit{Brandon Ridge Partners v. United States},\textsuperscript{381} in which this same definition of an omission of gross income was applied to extend the limitations period in facts presenting a similar basis overstatement in a Son-of-BOSS transaction.\textsuperscript{382} \textit{Salman Ranch I} rejected the findings of \textit{Grapevine Imports, Ltd}, which interpreted \textsection\textsuperscript{6501(e)(1)(A)(i)} to require an omission of gross receipts from the sale of products and services in a trade or business from both inventory sales, as well as other sales involving basis adjustments for reporting gains, such as capital gains.\textsuperscript{383} \textit{Salman Ranch I's} rejection seemed grounded in judicial precedent requiring the statute to be read in its entirety, to avoid any of its language to be considered superfluous. Accordingly, \textit{Salman Ranch I} stated:

\begin{quote}
[S]ection 6501(e)(1)(A)(i) provides an exception to the customary definition of gross income in the event of sales of goods or services by a trade or business, allowing that “gross income,” as used in section 6501(e)(1)(A), will be defined as the ‘gross receipts’ alone of those sales. Under I.R.C. \textsection\textsuperscript{6501(e)(1)(A)}, in order for an omission from gross income to arise in the context of sales of goods or services by a trade or business (which under the I.R.C. \textsection\textsuperscript{6501(e)(1)(A)(i)} gross receipts provision actually should read “omits from gross ‘receipts’”), an omission of a receipt must occur. The \textit{Colony} Court's declaration that section 275(c) is “limited to situations in which specific receipts or accruals of income items are left out of the computation of gross income” makes eminent sense because The Colony, Inc. was a trade or business selling goods or services. The Court’s conclusion that The Colony, Inc. had not omitted any gross income and thus was not liable under section 275(c)
\end{quote}

\textsuperscript{378} \textit{Salman Ranch I}, 79 Fed. Cl. at 201.
\textsuperscript{379} \textit{Id}.
\textsuperscript{380} \textit{Bakersfield I}, 128 T.C. at 215; \textit{Grapevine Imports, Ltd v. United States}, 77 Fed. Cl. 505, 511 (2007) (holding, under its interpretation of \textit{Colony}, that the six-year limitation period under I.R.C. \textsection\textsuperscript{6501(e)(1)(A)} does not apply to an overstatement of basis which creates an understatement of a net gain from the sale of property).
\textsuperscript{383} \textit{Grapevine Imports}, 77 Fed. Cl. at 509–10.
is "in harmony with the unambiguous language of § 6501(e)(1)(A)," in that the resolution would be the same under either provision.

[Salman Ranch Ltd.'s] contention that a taxpayer never may be liable for an omission from gross income due to an overstatement of basis is an impermissibly broad rendering of the Colony holding. It is more accurate to say that Colony held that section 275(c) - in harmony with the unambiguous language of I.R.C. § 6501(e)(1)(A) - only imposes liability on a taxpayer engaged in a trade or business selling goods or services where the taxpayer "omitted some income receipt or accrual in his computation of gross income." Thus, Colony does not speak generally, as [Salman Ranch Ltd.] urge[s], to the meaning of the word "omit," and the Supreme Court did not set forth a general prescription for every instance in which an omission of income may be contested. 384

Of course, Salman Ranch I was appealed to the United States Court of Appeals Federal Circuit, which disagreed with the Court of Federal Claims' limitation of the scope of Colony. The appellate court supported the taxpayer's assertion that Colony did not emphasize the type of sale of property that included a basis overstatement, but rather emphasized the definition of the term "omits." 385 Accordingly, the court interpreted Colony to stand for the premise that an omission of gross income requires an omission of gross receipts, thus limiting the applicability of the six-year extended statute. This interpretation by the Federal Circuit was premised on two familiar interpretations. First, the court emphasized that the language interpreted in Colony ("omits from gross income an amount properly includible therein") is identical to the successor § 6501(e)(1)(A) language discussed in Colony. 386 Second, the Supreme Court decision references that the Colony application was "in harmony with the unambiguous language of § 6501(e)(1)(A) of the Internal Revenue Code of 1954." 387 In combination, it appears that the Federal Circuit considered these two interpretations to indicate that the Supreme Court considered the revised statute as codified in 1954 and considered its decision to be in harmony with the unambiguous language of the "trade or business of selling goods and service" exception of § 6501(e)(1)(A)(i) of the Internal Revenue Code of 1954. 388

Therefore, the Federal Circuit was not prepared to limit the statutory

386. Id. at 1370.
387. Id. at 1369.
388. Id. at 1373.
interpretation of "omissions of gross income" in Colony only to businesses selling goods or service in a trade or business as inventory.

The court did, however, recognize that the Supreme Court did not appear to interpret § 6501(e)(1)(A) in the Colony decision. However, the Federal Circuit did extend the Colony interpretation to § 6501(e)(1)(A). Its decision considered that the absence of congressional action to overrule the judicial interpretation of the limiting interpretations of Colony may be construed as an expression of intent to accept the judicial interpretations. In light of this, one should suggest that in this era of inflated basis transactions, which seem far beyond the intent of Subchapter K, we should begin a mass letter campaign to our local senators and congressmen to reconsider acceptance of this interpretation by default. The result of all this precedential authority in the Federal Court of Claims, as well as in the Tax Court, and now the Ninth Circuit, can lead to an inability to quickly prosecute enough to re-claim tax dollars contributing to the growing tax gap. The question remaining, as we consider this for the North Carolina practitioner, is whether the Fourth Circuit will follow the precedential considerations of the Federal Circuit, the Tax Court, or the Ninth Circuit. The following cases offer some guidance, although limited.

D. Interpretation of I.R.C. § 6501(e)(1)(A)'s Extension of the Three-Year Statute of Limitations to Six Years with Tax Basis Understatement in Cases Appealable to the Fourth Circuit

As we look to the United States Court of Appeals for the Fourth Circuit for the Carolinas, Virginia, and Maryland, we will see that it has not had an opportunity to interpret what qualifies as an omission of gross income under I.R.C. § 6501(e)(1)(A), despite the litigation of two such cases in district courts within its geographic region. The first case, from the Eastern District of North Carolina, Home Concrete & Supply, LLC v. United States, rejected the Tax Court position asserted by the taxpayer in interpreting § 6501(e)(1)(A) and upheld the IRS's assertion of an extended six-year statute. Unfortunately, there will not be an opportunity to determine whether the United States Court of Appeals for the Fourth Circuit would take a different position from the Tax Court, the Ninth Circuit and the Federal Circuit, since the parties settled after

389. Id.
390. Id.
391. Id. (citing Bob Jones Univ. v. United States, 461 U.S. 574, 600-02 (1983)).
the IRS won the first scrimmage. The second case, *Highwood Partners v. Commissioner*, originates with a Virginia partnership in Tax Court with yet a different type of an "inflated basis" transaction challenged by the IRS as a sham transaction.393 *Highwood Partners* presents a shift in the Tax Court's positions due to the nature of the underlying transaction. In this decision, the Tax Court departs from its prior restrictive interpretation of § 6501(e)(1)(A)'s six-year extended limitations period through rejecting the applicability of the *Colony* rationale in these unique facts.394 This case is discussed for the practitioner's awareness that regulatory compliance reporting requirements can be quite important in determining whether a transaction might be classified as an "omission" of gross income. It is important to note in the Virginia case that the foreign currency transaction had unique disclosure requirements regulated under § 988, which led to a different interpretation of what constitutes an "omission" of gross income under § 6501.395

1. **Success for the IRS in the Eastern District of North Carolina in Extending the Three-Year Statute of Limitations to Six Years... Too Bad the Taxpayer Settled after this Decision, Leaving Us Without a Clear Picture of How the Fourth Circuit Might Rule**

In *HCS I*, taxpayers Robert and Susanne D. Pierce and Stephen R. and Rebecca R. Chandler on April 15, 1999 formed three Limited Liability Companies (Home Concrete & Supply, LLC ("Home Concrete"), Salisbury Investments LLC396 ("Salisbury"), and Goodnight Investments, LLC. ("Goodnight")).397 Home Concrete was entitled to partnership treatment as a pass-through entity with its owners deemed partners for purposes of federal tax reporting.398 The other crucial related entity in this case is Home Oil & Coal Company, Inc. ("Home

394. *Id.* at *12.
395. *Id.* at *12–13.
396. *HCS I*, 599 F. Supp. 2d at 682 n.7 (noting that Pierce & Goodnight Investments, LLC (owned by Chandler) owned Salisbury Investments, LLC).
397. *HCS I*, 599 F. Supp. 2d at 678; Home Concrete & Supply, LLC v. Comm'r (*HCS II*), No. 7:06-CV-181-FL, 2009 U.S. Dist. LEXIS 127250, at *14 (Mar. 9, 2009) (addressing the standard to qualify for adequate disclosure, which exempts an omission from gross income from triggering the six year extended limitations period under I.R.C. § 6501(e)(1)(A)).
Oil") owned by Mr. Pierce and Mr. Chandler. In review of HCS I, the focus of this case, as with the others discussed in Section III, begins with a plan involving the use of a short sale of United States treasury notes in combination with a transfer of the sales proceeds of the short sale with the obligation to close the short sale to a related entity. Approximately twenty-eight days later, the taxpayers, through their respective investment LLCs and several other family trusts, implemented a transaction in which they sold borrowed United States treasury notes in the open market subject to an obligation to replace the borrowed securities with the lending brokerage house. The short sale transaction is a common investment tool strategy used to sell borrowed securities at a high fair market value to be followed by a repurchase of identical securities hopefully at a lower fair market value for replacing the borrowed securities. Obviously, the obligation in a speculative investment market with certain securities can make this a risky venture. However, the risk associated with the United States treasury notes is nominal. No one can know the exact liability for the replacement securities; thus, the argument that the liability to replace the borrowed notes is a "contingent" liability. As discussed in the earlier cases in Section III, this is a crucial aspect to the transaction since it impacts the basis calculation when the liability to replace the treasury notes is assumed by the partnership. In HCS I, four days later on May 17, 1999, the taxpayers transferred the proceeds from the short sale, with the obligation to close the short sale by repurchase, to the newly formed

399. Id. at 680.
400. Id. at 681, 682 n.7. The Treasury note short sales were initiated by Salisbury Investments, LLC, Goodnight Investments, LLC, and trusts owned by the Pierces and Chandler. Id. at 682 n.7. The tax planning in HCS I was devised by Arthur Andersen LLP, in conjunction with the law firm of Jenkins & Gilchrist. Id. at 681. Arthur Andersen, LLP is no longer a viable firm despite the unanimous Supreme Court verdict overturning a 2002 conviction for obstruction of justice. See Arthur Andersen LLP v. United States, 544 U.S. 696 (2005). Similarly, Jenkins & Gilchrist is now dissolved due to class settlements, penalties and overall bad publicity driving partners and clients away in droves from tax strategies found lacking in economic substance. Katie Fairbank & Terry Maxon, How Jenkens & Gilchrist Lost Its Way, THE DALLAS MORNING NEWS, Apr. 1, 2007, http://www.dallasnews.com/sharedcontent/dws/bus/stories/040107dnentjenkens.3e099d1.html.
401. Id. at 682 n.7.
403. See Salman Ranch Ltd. v. United States (Salman Ranch III), 573 F.3d 1362, 1365 (Fed. Cir. 2009) (discussing the impact of contingent liabilities contributed to partnership on a partner's outside basis).
At this point, the cash contribution increased the contributing partner's basis in Home Concrete, yet with the obligation to close the short sale position asserted as an indeterminable contingent liability, their outside basis in the partnership was not reduced by its assumption of this liability to replace the borrowed treasury notes. On the very next day, the Home Concrete partners, using the contributed proceeds, acquired the replacement securities and closed the short sale obligation. The end result: the Home Concrete partners' outside basis is greatly increased due to the contribution of the cash proceeds from the initial short sale on May 17, 1999, without any reduction for the short sale obligation satisfied by the partnership.

This "strategy" to "inflate" the basis of the partners' interests in Home Concrete, LLC was designed in anticipation of the sale of Home Oil, Inc. After increasing the partners' outside basis in Home Concrete, LLC, within the next thirty days, substantially all of the business assets of Home Oil, Inc. were transferred to Home Concrete as a capital contribution. Twenty-four days later, Pierce and Chandler transferred their member/partnership interests in Home Concrete, LLC (with the related "inflated" outside basis) to Home Oil, Inc. as capital contributions. At this point, Home Oil, Inc. became a holding company controlling Home Concrete, LLC, which now held the low-basis business assets formerly owned by Home Oil, Inc. This set the stage for the partner, Home Oil Inc., with a high outside basis in its partnership interests in Home Concrete, LLC to operate under an I.R.C. § 754 election to equalize its outside basis in partnership interests in Home Concrete, LLC proportionately to increase the lower inside basis of Home Concrete, LLC's business assets. The result was to increase

404. HCS I, 599 F. Supp. 2d at 682 n.7.
405. I.R.C. § 752 (2000). Under I.R.C. § 752, a known liability assumed by the partnership would be deemed a cash distribution to a transferor/partner, thereby reducing the partner's outside basis in the partnership. See id.
406. HCS I, 599 F. Supp. 2d at 682 n.7.
407. Id.
408. See supra note 196. Home Oil, Inc. was controlled by Pierce and Chandler. HCS I, 599 F. Supp. 2d at 680.
409. HCS I, 599 F. Supp. 2d at 682 n.7. Remember, Home Concrete is deemed a partnership for federal income tax purposes, so Home Oil, Inc. obtains a partnership interest in exchange for the transfer of assets.
410. Id. I.R.C. § 362(a)(2) assigns a carryover basis to property that a corporation receives as a capital contribution, with increases for any gain recognized on the transfer by the transferor. See I.R.C. § 362(a)(2).
411. HCS I, 599 F. Supp. 2d at 682 n.7.
412. Id. at 682.
basis of the business assets of Home Concrete, LLC from $4.5 million to $10.5 million. 413 With the subsequent sale of substantially all of Home Concrete, LLC’s assets for $10.6 million a couple of months thereafter, obviously the strategy, gone unchallenged, would have significantly reduced the taxpayer’s gain on the sale of its business. 414

Foiling this capital gain reduction strategy, the IRS challenged the increased basis under prior arguments, alleging it was a “sham” transaction through an FPAA assessment in September 2006. 415 The taxpayer paid the deficiency and sued under a claim for refund of approximately $1.4 million in the Eastern District Court of North Carolina. 416 The taxpayer immediately requested a summary judgment, asserting that the IRS assessment was barred by the expiration of the three-year statute of limitations. 417 Consistent with its previous arguments, the IRS argued that I.R.C. § 6501(e)(1)(A) provided an extended six-year limitation period due to a significant omission of gross income exceeding the required twenty-five percent omission threshold. 418 Again, the IRS contended that the omission of gross income occurred through an overstatement of Home Oil, Inc.’s basis in Home Concrete, LLC, originating in the manipulation of the basis calculation and the assumed “contingent” liability to replace the sold treasury notes. 419 Allegedly, this basis overstatement ultimately led to an overstatement in the basis used to calculate gain on the 1999 sale of Home Concrete, LLC’s business assets, hence, the statute should be extended. 420

The district court reviewed all of the existing arguments regarding the applicability of the Supreme Court’s decision in Colony as reviewed in the previous cases discussed herein. Yet, it appeared to emphasize the rationale of Salman Ranch I 421 (prior to its reversal by the Ninth Circuit in Salman Ranch II). 422 It also appeared to give significant weight to the statutory definitions of “gross income” asserted by the IRS. Specifically that gross income is broadly construed as “all income from whatever

413. Id.
414. Id.
415. Id.
416. Id. at 680.
417. Id.
418. Id.
419. Id. at 682.
420. Id. at 683.
422. Salman Ranch Ltd v. United States (Salman Ranch III), 573 F.3d 1362, 1364 (Fed. Cir. 2009).
source derived, including . . . (3) gains derived from dealings in property,\(^\text{423}\) with gains derived from dealings in property defined in § 1001(a) as "the excess of the amount realized therefrom over the adjusted basis."\(^\text{424}\)

The court concluded that this basis overstatement did produce an omission of the gain derived from dealings in property that constituted an omission from gross income of an amount properly included therein under § 6501(e)(1)(A).\(^\text{425}\) Accordingly, the court denied the taxpayer's motion for summary judgment, in part applying the six-year statute of limitation asserted by the IRS.\(^\text{426}\) The court held the final decision in abeyance pending additional review of the substantive question of whether the omission which exceeds 25% percent of the gross income originally reported was adequately disclosed such that the IRS would have been apprised of the "nature and amount" of the omission as required under the safe harbor exception of § 6501(e)(1)(A)(ii).\(^\text{427}\) If such disclosure was found to have been made, the six-year extended limitations period would not apply, despite the sufficiency of the omission of gross income.\(^\text{428}\)

The issues held in abeyance were resolved in HCS II, when a final decision was rendered in March 2009.\(^\text{429}\) In this decision, the court addressed whether the taxpayer could assert the safe harbor exception under § 6501(e)(1)(A)(ii) due to adequate disclosure of the nature and amount of the item leading to the understatement of gross income. The court scrutinizes the sufficiency of the taxpayer's disclosures of the transactions leading to the basis increase as follows:

(1) First, the taxpayers assert that Pierce and Chandler's individual tax returns disclosed the short sale and referred to the fact that the obligation to close it was outstanding. The district court found nothing in this disclosure to "reasonably indicate[] that the opening of the short sales was related to the basis step-up of Home Concrete."\(^\text{430}\) Instead, the court felt that this disclosure "mask[ed] the ultimate purpose of those short sales."\(^\text{431}\)

\(^{423}\) HCS I, 599 F. Supp. 2d at 686 (quoting 26 U.S.C. § 61(a) (1999)).

\(^{424}\) Id. at 687.

\(^{425}\) Id.

\(^{426}\) Id.

\(^{427}\) Id.

\(^{428}\) Id.


\(^{430}\) Id. at *14.

\(^{431}\) Id.
Implicit in the court's analysis of the return disclosures was the determination that these two items do not provide an indication of the essence of the transaction in question— that is, that they are connected as an opening of a short sale on the individual tax returns ultimately closed and reported on the Home Concrete return.\textsuperscript{433} Interesting dicta from the court indicates some link of the two transactions; even the words on the Home Concrete, LLC return indicating that the gain was derived from the closing of a short sale, may have been sufficient.\textsuperscript{434} Finding no adequate disclosure, the court ruled that the adequate disclosure exception was not applied and the extension of the six-year statute was sustained.\textsuperscript{435} Had the parties not settled the substantive issues after this decision by joint stipulation entered on June 1, 2009, followed by a joint motion for judgment on October 2, 2009, a subsequent appeal may have offered practitioners the opportunity to assess the Fourth Circuit's likelihood of following the Tax Court, the Ninth Circuit, and the Federal Circuit's consensus as to the precedential value of the Supreme Court's decision in Colony.\textsuperscript{436}

2. **Successful IRS Challenge to Extend Limitations Period in a Unique Inflated Tax Basis Shelter Transaction with Incorrect Compliance Disclosures Due to Netting of a Foreign Currency Gain and Loss Transaction for Offsetting Long and Short Options**

*Highwood Partners* involves foreign currency transactions as the basis for an IRS assertion that Highwood Partners was a sham designed solely in 1999 to artificially inflate the bases of stock contributed to the

\textsuperscript{432} Id. at *15–16.

\textsuperscript{433} Id. at *14–16.

\textsuperscript{434} Id. at *16 n.7 ("[H]ad plaintiffs correctly identified the short sale of Treasury Bonds on Home Concrete's Schedule D, they may have had a strong claim to adequate disclosure.").

\textsuperscript{435} Id. at *21.

This case originated as part of an IRS "John Doe" summons on Jenkens & Gilchrist in 2003, by which the law firm was forced to identify their clients who participated in "listed transactions." The taxpayers were identified as a result of this summons in May 2004. Approximately two years later, in August 2006, the IRS issued a Final Partnership Administrative Adjustment ("FPAA") assessment to Highwood Partners. This Tax Court decision focuses primarily on the IRS's ability to assert the extended six-year extension of the statute of limitations under I.R.C. § 6501(e)(1) to this particular transaction and does not delve into the merits of the taxpayer's tax treatment of these transactions.

Without analyzing the technical issues involved in the alleged sham "artificial inflated bases" aspects of the foreign currency transactions at issue in this case, some introduction of the transaction is warranted to identify the income omission by Highwood Partners. The partners who are the taxpayers/petitioners in this case, entered into foreign exchange digital option transactions ("FXDOTs") through their disregarded LLC entities. The FXDOTs involved an option spread on the United States dollar/Japanese yen exchange rate. Considering the long leg of the FXDOT premium ($8.4 million), as offset by the short leg of the FXDOT premium ($8.316 million), the partners through their LLCs were only financially responsible to finance the net of the long and the short premiums or $84,000.

Around this transaction, the partners contributed the FXDOT options, cash, and their shares in Heilig-Meyers Co. ("HM Co.") and

---


438. IRS.gov, EP Abusive Tax Transactions - Listed Transactions, http://www.irs.gov/retirement/article/0,,id=119551,00.html (last visited June 30, 2010) (defining a "listed transaction" as a "transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance").

439. Highwood, 2009 U.S. Tax Ct. LEXIS 19, at *4. The relevant taxpayers are Michael and Karen Booth Adams, Richard and Mary Fowlkes, and the Booth and Adams Irrevocable Family Trust. Id. The transaction included the use of single-member disregarded LLCs to form Highwood Partners, with respected ownership by Mrs. Adams' LLC of 47.62%, Mrs. Fowlkes' LLC of 29.76%, and the Trust's LLC of 22.62%. Id.

440. Id. at *7.

441. Id. at *2–3.

442. Id. at *3.

443. Id.

444. Id. at *6.
Modis Professional Services, Inc. ("Modis") to Highwood Partners.445
Upon this contribution of the FXDOT options, the partners' outside bases in Highwood Partners were calculated considering only the premiums paid by the taxpayers for the long leg of the options ($8.4 million) as an increase to their outside basis in Highwood Partners.446 Yet, these partners' outside bases were not reduced by the premiums received by the taxpayers on the short leg of the option ($8.316 million), which effectively reduced their combined net premium to $84,000.447 The FXDOTs were not exercised and expired while held by the partnership.448 Subsequently, the individual partners transferred their partnership interests in Highwood Partners (as alleged to be inflated) to a newly formed S Corporation, Highwood Investors, Inc, and their basis in Highwood Partners carried over the outside basis in the partnership interests to the S Corporation under the authority of I.R.C. § 362(a).449 Of course, as argued by the IRS, this carryover basis in Highwood Partners, now owned by Highwood Investors, Inc., was overstated due to a failure to consider the receipt of the premiums in the short leg of the option as a reduction to the premiums paid for the options originally contributed to Highwood Partners.450

Subsequently, at the end of 1999, the partners distributed the cash and the Heilig-Meyers and Modis stock to Highwood Investors, Inc. (and a related family trust also involved in the transactions).451 Therefore, Highwood Investors, Inc.'s outside basis in the partnership interests of Highwood Partners under the authority of § 732(b) was allocable to the distributed property.452 The assets distributed from Highwood Partners were proportionately allocated the partner's (Highwood Investors, Inc.) outside basis in the partnership.453 It is again, important to remember that the basis of the Highwood Partners interest (now allocated to distributed assets) in the hands of Highwood Investors, Inc. had been determined in a manner that inflated the outside basis, which now was

445. Id. at *4.
446. I.R.C. § 723 (2000) ("The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.").
448. Id. at *4.
449. Id.
450. Id. at *7.
451. Id. at *4.
452. Id. at *4–5.
453. Id. at *5.
being allocated to assets distributed. This established the precedent facts for an alleged understatement of the gain generated on December 30, 1999, when Highwood Investors, Inc. sold the Heilig-Meyers and Modis stock to an unrelated party. These overstated losses were ultimately applied as flow-through items to the Pierces and Chandler from Highwood Investors, Inc. as a S Corporation.\footnote{454} Alleging that Highwood Partners was a sham transaction, lacking economic substance, through which the related basis calculations were overstated, was the underlying premise on which the IRS ultimately issued the 2006 FPAA assessment.\footnote{455}

Crucial to the IRS's continuation of this litigation was its success in arguing that under I.R.C. § 6501, the failure to report the FXDOT long and short options transactions separately was an omission of gross income sufficient to extend the limitations period to six years.\footnote{456} Since the long and short option legs were netted and not reported separately, the IRS argued that Treas. Reg. § 1.988-1(e) specifically requires a separate reporting of each I.R.C. § 988 transaction, even if they are economically related.\footnote{457} The Tax Court agreed that each short option was required to be separately stated from the long option.\footnote{458} Since Highwood Partners reported a netting of the gain and loss from each, they considered there to be an omission of $8.316 million in gross income as reported.\footnote{459} Considering all the prior arguments interpreting Colony, as discussed herein, the IRS was successful in extending the three-year limitations period to six years.\footnote{460} The result was finally a win for the IRS in Tax Court, in a long skirmish to simply get around the three-year statute in an inflated basis case, opening a door of opportunity to have the technical issues decided. The moral of the story for practitioners relates to the clear understanding of the compliance reporting requirements to assure an omission of gross income does not occur in the tax compliance reporting process. Here, if the netting of the transactions had been adequately disclosed in the return, attempts to attack the transaction may have been moot under a three-year statute. Alas, if the goal was to avoid detection of a questionable basis strategy, adequate disclosure of omitted income obviously would thwart all plans.

\footnote{454}{Id. at *10.}
\footnote{455}{Id. at *14–15.}
\footnote{456}{Id. at *20–21.}
\footnote{457}{Id. at *28–29.}
\footnote{458}{Id. at *35–36.}
\footnote{459}{Id.}
\footnote{460}{Id. at *31–33.}
E. The Battle Moves to Interpretation of Temporary Regulations § 301.6501(e)-1T and § 301.6229(c)(2)-1T (Omission from Return)

Following many disappointments in its efforts to assert extensions of the statute of limitations in the inflated basis litigation, the IRS proceeded with a bold move when proposed and temporary regulations were issued September 24, 2009, under I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2). Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) offered a surprise for tax practitioners throughout all jurisdictions, as it attempted to circumvent the judicial reasoning through which the IRS lost the extended limitations cases. This regulation clearly defines “gross income,” for purposes of an omission of gross income under I.R.C. § 6501(e)(1)(A), exactly the same as the definition under § 61(a). Specifically it states, “Gross income,’ with respect to disposals of property other than goods or services sold in a trade or business, shall be defined to include the gain from the amount realized as reduced by the ‘unrecovered cost or other basis of the property.’” Furthermore, the regulation specifically provides that “except for disposals of property other than goods or services sold in a trade or business, any basis overstatement which creates an understated amount of gross income will be deemed an ‘omission of gross income’ for purposes of . . . § 6501(e)(1)(A).”

One cannot fault the IRS for its frustrating attempts to close the “tax gap” by litigating cases clearly appearing to lack any business purpose or economic substance short of eliminating taxes. The substantive arguments against these various forms of Son-of-BOSS cases were silenced with an end-play using the fifty-year-old Supreme Court Colony interpretation based on the legislative intent interpretations of a predecessor statute. One cannot help but consider the pitfalls of interpreting the earlier statute and the real logic to several of the IRS’s asserted arguments. Nonetheless, the “rule of law” guarding constitutional judicial precedent is a strong sword. Given the real differences between the 1958 interpretations when “inflated basis” arose solely from the improper deduction of research and development expenses, in comparison to the Son-of-BOSS transactions lacking in economic substance, one can ponder if a different conclusion would occur if Colony were decided today. Nonetheless, in light of Treas. Reg.

462. Id.
463. Id.
464. Id.
§ 301.6501(e)-1T(a)(i)(iii), it appears that the IRS has promulgated a definition of gross income that comports with its arguments in the cases it lost in front of the Tax Court, the Ninth Circuit and the Federal Circuit. One might have expected the IRS to enlist congressional assistance for statutory modification to override this case law. However, in light of the revenues lost from its defeats, one can only assume that the IRS was likely wary of wasting any further time losing “tax-gap” dollar recovery. Nonetheless, challenges to this regulation have already begun.

The first litigation challenging these newly issued treasury regulations appeared during the editing of this Article with the Tax Court decision issued on May 6, 2010, in a motion to reconsider *Intermountain Insurance Service of Vail, LLC v. Commissioner.* In its original decision in *Intermountain I,* siding with the taxpayer, the Tax Court held that the IRS was barred from asserting the application of the extended six-year statute of limitation under I.R.C. § 6501. The assessment in this case was also due to an allegedly overstated basis by Intermountain Insurance Service. In determining the invalidity of the asserted six-year extended statute, again the Tax Court followed *Bakersfield* as precedent, supported by the rationale of the Supreme Court’s holding in *Colony.* That is, as discussed *infra,* *Colony* interpreted the omission of gross income required under § 6501 to be an omission of “specific income receipts,” not merely an overstatement of basis.

466. *Intermountain Ins. Serv. of Vail, LLC v. Comm’r (Intermountain I),* No. 25868-06, 98 T.C.M. (CCH) 144 (2009).
467. *Id.* at *2–3. In *Intermountain I,* several transactions occurred through which a greater tax basis was asserted for business assets sold in 1999 for $1.9 million. *Id.* at *2. The 1999 partnership income tax return reported the gross sales price, reduced by the stepped up basis of approximately $2 million, after deducting $131,544 of depreciation. *Id.* In 2006, the IRS issued an FPAA asserting that capital contributions to the partnership of $2.197 million were overstated, thereby overstating partnership basis by approximately $2 million. *Id.* at *2–3. Through the transactions, the overstated partnership basis was used to step up the partnership’s business assets, resulting in an alleged $2 million overstatement of the tax basis as reported on form 4797 (sales of business property) in the 1999 partnership tax return. *Id.* at *2.
469. *Colony, Inc. v. Comm’r,* 357 U.S. 28, 33, 36 (1958) (emphasizing the legislative history of section 275(c), the predecessor of I.R.C. § 6501, in deciding that a basis overstatement was not within the classification of an omission of gross income).
Based on the issuance of these temporary regulations in *Intermountain II*, the IRS filed a motion to reconsider and vacate to the Tax Court. Based on *Alioto v. Commissioner*, the IRS argued that the Tax Court had the authority to vacate its decision in *Intermountain I* to consider the application of these regulations. *Alioto* recognized that revisions in the law could be grounds for granting a motion to reconsider and a motion to vacate. However, the Tax Court did not simply deny the motion by distinguishing *Alioto*. Instead, the Tax Court appeared ready to do battle against these temporary regulations as it proceeded to address the viability of these regulations.

The court first addressed the applicability of the temporary regulations based on their effective date. The clear language of these temporary regulations makes them applicable to all tax years for which the statute of limitations for assessing tax has not expired before September 24, 2009. These regulations offer no further guidance or instructive definitions as to how to calculate the "statute of limitations for assessing tax." On November 23, 2009, the IRS chief counsel did indicate, in Notice CC-2010-010, that the temporary regulations applied to "any docketed Tax court case in which the period of limitations... as interpreted in the temporary regulations did not expire with respect to the tax year at issue, before September 24, 2009, and in which no final decision has been entered." The IRS's position in *Intermountain II* was that under § 6501(e)(1)(A), as interpreted in the newly issued regulations, the six-year statute would apply to Intermountain's 1999 tax years.

---

474. Id. As discussed in the concurring opinion, *Alioto* is easily distinguished from the facts of *Intermountain I*, as *Alioto* involved the vacating of a Tax Court decision in which jurisdiction was found not to exist, but the grounds for such jurisdiction was subsequently provided by a statutory expansion in the Tax Relief and Health Care Act of 2006. Id. The Tax Court could easily have substantiated a position that law revisions from statutory revisions by Congress are distinguished as stronger grounds to vacate a prior judgment, when compared to the situation in *Intermountain I* in which the IRS speedily issued regulations thirty days after the *Intermountain I* verdict, particularly in light of arguments as to the legality of the process through which these regulations were issued. *Intermountain II*, 2010 U.S. Tax Ct. LEXIS 14, at *37–39.
476. Id. at *16–17.
477. Id. at *17–18.
478. Id. at *17 n.9.
return for two reasons. First, under the newly issued regulations, the basis overstatement which created an understated amount of gross income in Intermountain II would be deemed an "omission of gross income" for purposes of § 6501(e)(1)(A), since it did not arise from the trade or business of selling goods and services. Second, as the IRS logic follows, the six-year statute would apply in Intermountain II. Since the FPAA assessing the additional tax attributable to the understated gain as derived from the overstated basis had been issued to Intermountain on September 14, 2006, before the expiration of the six-year statute, the statute of limitations for assessing tax had not expired before September 24, 2009.

While reading this decision, one can almost imagine mocking laughter from the Tax Court as it concludes that the IRS's interpretation of its own regulation is "erroneous and inconsistent with the regulations" as well as an interpretation that is "irreparably marred by circular, result-driven logic and the wishful notion that the temporary regulations should apply to this case because Intermountain was involved in what... [is believed to be] an abusive... transaction." Judges Halpern and Holmes (who concurred in the result of the majority's decision only) considered the authority of § 7805(b), by which the secretary can determine the extent to which regulations can be applied without retroactive effect. Considering the specific statements in IRS Chief Counsel Notice CC-2010-010, the concurring judges felt that the majority's conclusion was misplaced by solely applying the three-year statute to determine applicability under the "effective date analysis." Instead, the concurring judges sought a more thoroughly reasoned legal analysis by the majority opinion of the secretary's

479. Id. at *16–17.
480. Id. at *17.
482. Id. at *19.

The temporary regulations apply to taxable years with respect to which the applicable period of limitations for assessing tax did not expire before September 24, 2009. Accordingly, the temporary regulations apply to any docketed Tax Court case in which the period of limitations under sections 6229(c)(2) and 6501(e)(1)(A), as interpreted in the temporary regulations, did not expire with respect to the tax year at issue, before September 24, 2009, and in which no final decision has been entered.

Id.
authority to retroactively override the Supreme Court's interpretation of a statute.\(^{485}\) Absent that, these judges preferred an abandonment of the effective date applicability issue in favor of a decision grounded in different issues.\(^{486}\)

The second issue that the majority briefly reviewed was the standard to apply when determining whether judicial deference should be given to the temporary regulations, if applicable.\(^{487}\) Its review does not delve deeply into the judicial debate over how much deference should be afforded an agency's rules for enforcement of the code. Rather, it concluded that the Supreme Court's review of legislative history in Colony had clarified what was first considered ambiguous language, thereby foreclosing the agency's interpretation.\(^{488}\) The concurring judges offer us a preview of the likely issues to be raised as other courts consider this same issue, yet they do not seem as assured of the conclusion and rationale behind the majority decision.\(^{489}\) Nonetheless, where the majority stops with these two issues in its holding to support denying both motions, the concurring judges would reach the same result as the majority, yet they would base their conclusion on what they identify as "firmer ground."\(^{490}\) That is, the regulations are in violation of the rulemaking procedures required by the Administrative Procedure Act.\(^{491}\) The concurring decision offers an excellent review of this argument, which we will likely see repeated as the validity of these regulations continues to be challenged. However, the scope of this discussion is beyond the goals of this Article.

Nonetheless, one thing is clear, the validity of Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) is yet to be determined as Intermountain II was appealed by the IRS, through notice of appeal filed with the United States Court of Appeals for the D.C. Circuit on July 27, 2010. Look for further discussions and developments on these issues in the future because the IRS is not likely to give up easily, given the extent of tax revenues at risk under the interpretations of the applicability of the six-year extended statute.

\(^{485}\) Id. at *44-45.
\(^{486}\) Id. at *45.
\(^{487}\) Id. at *21.
\(^{488}\) Id. at *21-34.
\(^{489}\) Id. at *46-60.
\(^{490}\) Id. at *60.
III. CONCLUSION

This concludes coverage of the income tax developments from 2009 through the spring of 2010 which impacted Subchapter K and Subchapter S taxation of partnerships and corporations, as well as the application of the extended statute of limitations. It is this Author's intent that such primary authority aid practitioners by providing guidance for the avoidance of I.R.C. § 6662 accuracy related penalties, and instructions for navigating the possible traps of § 6694(a) preparer penalties and Circular 230 sanctions. Coverage of statutory tax law enactments as well as Tax Court and Fourth Circuit judicial pronouncements interpreting tax law facilitates this goal. Nonetheless, attention to developments from outside of the Fourth Circuit's geographic jurisdiction, will enhance formulation of tax positions on which the Fourth Circuit has not yet taken a position. This is particularly true where the Tax Court or appropriate district court has not definitively addressed an issue. With this caveat in mind, consider these developments as a valuable "tool in the toolbox" for maneuvering the "land mines" of today's complex tax practice.
APPENDIX A
IMPACT OF 2010 HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT TO MODIFICATION OF IRC § 6501(E)

IRC § 6501(e) (2009)
IRC § 6501(e) Substantial Omission of Items.—Except as otherwise provided in subsection (c)—

6501(e)(1) Income taxes.—In the case of any tax imposed by subtitle A—

6501(e)(1)(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—

6501(e)(1)(A)(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

6501(e)(1)(A)(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.

IRC § 6501(e) (March 18, 2010)
IRC § 6501(e) Substantial Omission Of Items. —Except as otherwise provided in subsection (c)

6501(e)(1) Income taxes.—In the case of any tax imposed by subtitle A—
6501(e)(1)(A) General rule.—If the taxpayer omits from gross income an amount properly includible therein and—

6501(e)(1)(A)(i) such amount is in excess of 25 percent of the amount of gross income stated in the return, or

6501(e)(1)(A)(ii) such amount—

6501(e)(1)(A)(ii)(I) is attributable to one or more assets with respect to which information is required to be reported under section 6038D (or would be so required if such section were applied without regard to the dollar threshold specified in subsection (a) thereof and without regard to any exceptions provided pursuant to subsection (h)(1) thereof), and

6501(e)(1)(A)(ii)(II) is in excess of $5,000,

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

6501(e)(1)(B) Determining gross income. —For purposes of subparagraph (A)—

6501(e)(1)(B)(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

6501(e)(1)(B)(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.