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Bakersfield: Overstatement of Basis is not "Omission of Gross Income" that Triggers Extended Six-Year Limitations Period for Assessing Tax

The IRS normally has three years to assess tax. However, a six-year limitations period will apply if a 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 special six-year limitations period of IRC Section 6501(e)(1)(A) has been at issue recently in a number of cases in which the basis of assets has been increased by application of the partnership tax rules shortly before the sale of those assets.1

Almost 50 years ago, the US Supreme Court in Colony2 rejected the IRS' position that an overstatement of basis can trigger the extended limitations period. Interpreting Section 275(c) of the 1939 Internal Revenue Code, the Supreme Court held that the extended period applied only to situations where a taxpayer actually left some income receipt or accrual out of his or her computation of gross income, and not more generally to errors in the computation arising from other causes.3

The Tax Court, Court of Federal Claims and several District Courts have recently confronted the issue of whether Colony is applicable to Section 6501(e)(1)(A), the reenactment of former Section 275(c).4 The US Court of Appeals for the Ninth Circuit in Bakersfield5 is the first appeals court to address this widely contested issue.

On June 17, 2009, the Ninth Circuit held that Colony was binding and, therefore, a taxpayer's purported overstatement of basis is not an "omission of gross income" for purposes of applying the extended six-year limitations period of Section 6501(e)(1)(A). The Ninth Circuit's holding is a significant taxpayer victory—the expiration of the limitations period bars completely the assessment of tax and penalties, regardless of the substantive merits of the underlying transaction.

The Tax Court and Ninth Circuit Opinions

In Bakersfield, Bakersfield Energy Partners, LP (Bakersfield) had a zero basis in its interest in certain oil and gas property. After a proposed sale of the property to an unrelated party fell through, a majority of Bakersfield's partners restructured the partnership by selling their partnership interests to a newly formed LLC for approximately $20 million. This sale terminated...
Bakersfield's tax year under Section 708. Bakersfield then elected, under Section 754, to step up its basis in its assets by the $20 million sales price. Bakersfield allocated approximately $16.5 million of the new $20 million basis to its oil and gas property. It then sold that property to the same unrelated party for approximately $23.9 million, and reported a gain of approximately $7.4 million ($23.9 million sales price less new adjusted basis of approximately $16.5 million).

More than three but less than six years after the tax returns of Bakersfield and its partners were filed, the IRS issued a notice of final partnership administrative adjustment (FPAA) to Bakersfield determining that the partnership's adjusted basis in the oil and gas property was zero, not $16.5 million. The IRS asserted the claimed $16.5 million basis “was the result of a sham transaction, a transaction lacking economic substance that had no business purpose and no economic effect and/or was availed for tax avoidance purpose and should not be respected for tax purposes.” The IRS also asserted a 40 percent penalty. After petitioning the Tax Court, Bakersfield moved for summary judgment on the ground that the FPAA was untimely under Section 6501(a). The IRS countered that the FPAA was timely under the extended six-year limitations period of Sections 6501(e)(1)(A) and 6229(c)(2) because Bakersfield had omitted from gross income an amount properly includible therein which exceeded 25 percent of the amount of gross income stated in the return.

The Tax Court granted Bakersfield's motion, holding that the Supreme Court's decision in Colony—that an overstatement of basis is not an omission within the meaning of the extended six-year limitations period—controlled. The Tax Court reasoned that, under Colony, a taxpayer “omits” income only if it something is “left out,” not if something is overstated. The Tax Court subsequently reaffirmed its position in an unpublished Order following Bakersfield.

The IRS raised two arguments in its Ninth Circuit appeal. Its primary argument was that Colony was not binding in interpreting Section 6501(e)(1)(A) because the provision interpreted in Colony had been materially altered by Congress's addition of a new subparagraph specifically providing that an overstatement of basis cannot constitute an omission from gross income in the case of a trade or business. Continued application of Colony, the IRS argued, would render this new subparagraph superfluous. The IRS also argued that if Colony had any continued viability in the context of Section 6501(e)(1)(A), it was limited to the case of a sale by a trade or business.

The Ninth Circuit rejected both arguments. Noting that the language in the body of Section 6501(e)(1)(A) is identical to the language in former Section 275(c), the court wrote that, as a general rule, “we construe words in a new statute that are identical to words in a prior statute as having the same meaning.” The Ninth Circuit further observed that, while the IRS' view of why the new subparagraph was added might be plausible, it was equally plausible that Congress added the new subparagraph to clarify, rather than rewrite, existing law. The new subparagraph does not establish that Congress intended to alter the general judicial construction of "omits" in all other contexts. Finally, the Ninth Circuit found that applying Colony would not render the new subparagraph superfluous. The Ninth Circuit then summarily dismissed the IRS' other argument, finding nothing in the Supreme Court's decision even hinting that its holding was limited to cases in which the taxpayer was engaged in a trade or business.

The Ninth Circuit's decision constitutes a major victory for taxpayers where the IRS has not timely challenged
transactions involving allegedly overstated basis. For taxpayers in the Ninth Circuit where Bakersfield applies, the IRS is now clearly barred in such a case from assessing any additional tax or penalties, regardless of the merits of similar underlying transactions or the amount of money involved. Thus, where the IRS claims that the six-year limitations period under Section 6501(e)(1)(A) applies because a taxpayer has omitted gross income by overstating basis, the taxpayer may be able to avoid the time and expense of litigating the merits of the underlying transaction.

Next Steps

Companies should take a hard look during IRS examinations and in litigation at the applicable statute of limitations to determine whether the IRS is barred from seeking to assess any additional tax. In making this determination, taxpayers must also be aware of contrary decisions in other courts and weigh the impact of those decisions against the favorable position in the Tax Court and the Ninth Circuit.10

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The tax controversy attorneys at Latham & Watkins LLP have extensive experience advising and representing companies in connection with a myriad of federal and state tax issues, including application of the TEFRA procedural rules and statute of limitations issues. We have expertise in IRS audits, administrative appeals, alternative dispute resolution and, where necessary and appropriate, litigation.

Endnotes

1 The Court of Federal Claims has decided the issue twice, once in the taxpayer’s favor (Grapevine Imports, Ltd. v. US, 77 Fed. Cl. 505 (2007)) and once in the IRS’ favor (Salman Ranch Ltd. v. US, 79 Fed. Cl. 189 (2007)). District Courts in North Carolina, Texas and Florida have decided the issue in the IRS’ favor. Home Concrete & Supply, LLC v. US, 103 AFTR 2d 2009-465 (DC NC 2008); Burks v. US, No. 3:06-CV-1747 (N.D. Tex. 2008); Brandon Ridge Partners v. US, 100 AFTR 2d 2007-5347 (M.D. Fla. 2007).
3 Id. at 33.
4 See note 1.
5 Bakersfield Energy Partners, LP v. Commissioner, No. 07-74275 (9th Cir. June 17, 2009). The Tax Court had held that Colony controlled (see 128 T.C. 207 (2007)), and the government appealed that decision to the Ninth Circuit.
6 The dates the partnership’s return and the individual partners’ returns were filed are significant for purposes of determining whether the applicable limitations period has expired in cases involving partnerships. The law in the Tax Court, the Federal Circuit and the D.C. Circuit is that the limitations periods in Sections 6229 and 6501 are alternative periods in which to assess tax and that the IRS therefore has until three years after the later of the filing of the partnership’s return and the filing of the individual partners’ returns to assess tax attributable to partnership items. Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. 544 (2000); AD Global Fund, LLC v. US, 481 F.3d 1351 (Fed. Cir. 2007); Andantech L.L.C. v. Commissioner, 331 F.3d 872 (D.C. Cir. 2003).
8 Bakersfield at 7213.
9 In computing whether there has been a more than 25 percent omission there is a comparison of two numbers: the “gross income” omitted with the “gross income” on the return. If the first number divided by the second number is greater than 25 percent, the six-year limitations period applies. Colony’s holding affects only the numerator. Section 6501(e)(1)(A)(i) redefines “gross income” for both the numerator and denominator for taxpayers engaged in a trade or business. Colony, thus, does not render Section 6501(e)(1)(A)(i) superfluous. Bakersfield at 7215.
10 The opinions of other courts (see note 1) are not binding on the Tax Court, which will continue to follow its decision in Bakersfield regardless of the Circuit to which an appeal would lie, unless and until another Court of Appeals decides the issue in the IRS’ favor. Under Golsen v. Commissioner, 54 T.C. 742 (1970), the Tax Court is bound to follow the a decision of a Court of Appeals in all cases in which an appeal would lie to that circuit.
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