professor who has spearheaded support for a successful similar ReadyReturn program in California, and even former President Ronald Reagan, who together with the U.S. Treasury Department, endorsed a simple-return approach in a 1984 study.

The "simple return" system should achieve the paramount goal of getting crucial tax refund dollars into military households as quickly as possible with little or no out-of-pocket taxpayer costs, time or aggravation. While this tax return preparation and filing system should provide a meaningful benefit for military families, it should also benefit the federal government with more accurate, comprehensive and less expensive federal tax compliance. Enlisted members of the armed services and their families are well suited for this type of government tax assistance because of their tax profiles as well as their confidence in and reliance upon the government for many goods and services. If successful, the "simple return" system could be used to streamline and meaningfully lower the high cost of tax return preparation and filing for the federal government and more than 100 million taxpayers. As thousands of delighted ReadyReturn filers in California (99% want to receive the free service again) exclaimed, "Finally, the government is doing something to make my life easier." Private Ryan and his family deserve no less.

Old James Ryan: Tell me I have had a good life.
Ryan's Wife: What?
Old James Ryan: Tell me I'm a good man.
Ryan's Wife: You **are**. ■

What's Next in the Section 6501(e) Overstated Basis Controversy?

By Steve R. Johnson*

Section 6501(e) is among the exceptions to the normal three-year statute of limitations on assessment. Under section 6501(e)(1), a six-year limitations period applies "[i]f 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 six-year period clearly applies when the taxpayer fails to report taxable receipts surpassing the 25% threshold. Does it also apply when overstatement of basis sufficiently reduces reported gain on the sale of assets, particularly when the sale is not incident to conduct of a trade or business?

The courts have been divided on the issue. The taxpayers have had the upper hand recently, prevailing in three 2009 cases. This article describes case law on the issue and considers possible future moves in the controversy.

Judicial Division

In light of earlier judicial division, the Supreme Court heard and decided *Colony Inc. v. Commissioner*, 357 U.S. 28 (1958). The Court held for the taxpayer under section 6501(e)'s predecessor in the 1939 Code. The Government accepts that *Colony* controls when, as in that case, the sales in question are incident to the taxpayer's trade or business. In non-trade or business cases, however, the Service has continued to assert the six-year limitations period as to basis overstatements of sufficient magnitude. The Government has sought to distinguish *Colony* based on textual differences between the current section and its predecessor and to limit *Colony* to sales incident to a trade or business.

In the ensuing years, courts split again. Cases holding for the Government include *Taylor v. United States*, 417 F.2d 991, 993 (5th Cir. 1969), *Brandon Ridge Partners v. United States*, 100 A.F.T.R.2d 5347, 5351-53 (M.D. Fla. 2007), and *Insulglass Corp. v. Commissioner*, 84 T.C. 203, 210 (1985).

Cases holding for taxpayers include *Grapevine Imports, Ltd. v. United States*, 77 Fed. Cl. 505 (2007), and the three 2009 cases. In *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. June 17, 2009), a unanimous panel upheld a decision for the taxpayer, 128 T.C. 207 (2007). In *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. July 30, 2009), a divided panel reversed a decision for the Government, 79 Fed. Cl. 189 (2007). Most recently, in a case appealable to the Seventh Circuit, the Tax Court, relying on *Colony* and *Bakersfield*, held for the taxpayer. *Beard v. Commissioner*, T.C. Memo. 2009-184 (Aug. 11, 2009).

Salman Ranch is analytically the richest of the three 2009 cases. The taxpayer was a family partnership which participated in what the Service saw as a variant of the Son-of-BOSS tax shelter. *See* Notice 2000-44, 2000-2 C.B. 255. The partnership allegedly overstated its basis in certain assets as a result of adjustments under sections 754 and

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743(b)(1). It later sold those assets, reporting the sale on its partnership return and listing it on K-1 schedules issued to the partners.

More than three years but less than six years after the relevant returns were filed, the Service issued a Final Partnership Administrative Adjustment to the partnership, reducing the claimed basis and so increasing gain on sale enough to exceed the 25% threshold. The partnership brought suit in the Court of Federal Claims, and the parties filed cross motions for summary judgment on the statute of limitations issue. The trial court held for the Government. By a vote of two-to-one, the Federal Circuit reversed, relying primarily on *Colony*.

The *Salman Ranch* opinions are a treat for statutory interpretation mavens. They touch on "plain meaning" of the text, use of legislative history, and such constructional canons as legislative ratification by inaction and avoiding rendering any statutory language superfluous. But the fact that I and others enjoy reading such opinions is insufficient "redeeming social value" for the unsettled state of the section 6501(e) basis issue. The pre-*Salman Ranch* courts were split, and so was *Salman Ranch* itself. Two of the judges who heard the case agreed with the taxpayer, and two (the trial judge and the appellate panel dissenter) agreed with the Government.

Possible Next Steps

In light of the three recent losses, the ball clearly is in the Government's court. I have no special insight on what the Government will do, but it is interesting to review the possibilities. First, it might give up, *i.e.*, concede the issue in current cases and not set it up in future audits. I hope that is the choice the Service makes. The Government has plausible statutory interpretation arguments, but there is little in the way of policy to support its position. The Government has offered no compelling reason why the Service needs more than normal time to audit returns in which large deficiencies result from overstated basis in sales that are reported on the return.

The evident reason for section 6501(e) is to give the Service extra time to ferret out non-fraudulent return errors that are unusually hard to identify, investigate, and adjust within three years. *See Colony, supra*, 357 U.S. at 36. Why would basis overstatements in reported transactions fit within that purpose? When a sale or exchange is reported, the revenue agent knows from the start of the examination that basis is material. The agent will ask the taxpayer to substantiate the claimed basis. If the taxpayer cannot provide substantiation within the normal audit time frame, the agent can ask the taxpayer to consent to extend the limitations period or the Service can issue a notice of deficiency disallowing any unsubstantiated basis. Because it is not clear why the Service needs more than the usual three years in order to audit overstated basis issues, good tax policy would not be offended by the Government conceding the issue.

But that outcome is unlikely. Either because some exigency appears more forceful to the Service than it does to me or simply for revenue reasons, the Government may choose to continue pressing its current position. There are three possible routes to that end: continued litigation, amendment of the section 6501(e) regulations, or amendment of section 6501(e) itself.

Continued litigation is the path of least resistance. Revenue agents can continue to set up adjustments after expiration of the normal three-year period; Chief Counsel attorneys can continue to approve deficiency notices containing those adjustments, relying on the Government's interpretation of section 6501(e); parties can continue to litigate the issue in tax trial tribunals; and the parties losing at trial can continue to appeal. However, it may well be that continued litigation will result in more inconsistent decisions.

To get tax administration off this treadmill, the Government might consider asking the Supreme Court to hear *Salman Ranch* or *Bakersfield*. However, the Court could easily deny a certiorari petition, perhaps because it may perceive that the issue is already moving towards resolution, obviating the need for Supreme Court intervention. Even if the Court does hear the case, we still would have two years of uncertainty until it handed down its opinion, and the possibility exists that the Court would find some very narrow basis of decision that would allow uncertainty to persist.

Resolution by amended regulations would be interesting. In *Brand X*, the Supreme Court held that a subsequent regulation can trump a case as long as the regulation qualifies for deference under *Chevron* and the case does not state that it reached its result based on an unambiguous statute. *National Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005); *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). These conditions probably would be fulfilled here, which would allow Treasury to amend the section 6501(e) regulations to prevent the *Salman Ranch* outcome in future cases.

First, the amended regulation should be *Chevron* qualified. The section 6501(e) regulations are general authority regulations promulgated under section 7805(a) rather than specific authority regulations arising from language within section 6501 itself. However, the trend of the cases is to recognize that general authority tax regulations can qualify for deference under *Chevron*. *E.g., United States v. Memorial Sloan-Kettering Cancer Center*, 563 F.3d 19, 36 & n.4 (2d Cir. 2009); *Mayo Foundation for Med. Educ. & Res. v. United States*, 568 F.3d 675, 679 (8th Cir. 2009); *Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162, 167-68 (3d Cir. 2008). *Chevron*'s two steps should be satisfied. The split in the courts suggests both that section 6501(e) is ambiguous and that a regulation saying that basis overstatements are within section 6501(e) is at least reasonable.

Second, the recent pro-taxpayer decisions did not assert that their holdings were compelled by an unambiguous statute. Nor could they easily have done so. *Colony* stated that the predecessor of current section 6501(e) was ambiguous, *see* 357 U.S. at 33; plausible arguments can be made about the meaning of the current statute; and the judicial division in *Salman Ranch* and among prior decisions underlines the ambiguity.

The amendment of the regulation during ongoing controversy should not matter. Some cases have expressed concern about "bootstrapping," *i.e.*, an agency issuing pronouncements to influence in its favor resolution of pending cases. *E.g., Caterpillar Tractor Co. v. United States*, 589 F.2d 1040, 1043 (Ct. Cl. 1978). However, this concern applies principally to "agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988). In contrast, "[r]egulations issued in response to pending litigation should be entitled to *Chevron* deference." ABA Section of Taxation, *Report of the Task Force on Judicial Deference*, 57 TAX LAW. 717, 742 (2004); *see, e.g., Smiley v. Citibank*, 517 U.S. 735, 742-43 (1996); *Texaco, Inc. v. United States*, 528 F.3d 703, 710-11 (9th Cir. 2008).

Finally, the controversy could end by Congress amending section 6501(e). In theory, this route is equally available to the private sector and to the Treasury. In the current environment, however, the Treasury would be the party more likely to achieve its desired outcome through legislation. As described above, I do not see a good tax policy reason why the Service should have an extended limitations period in basis overstatement cases. However, revenue often trumps tax policy. The Administration and Congress are now searching for revenue wherever it can be found in order to fund ambitious spending proposals. A proposal to confirm that the six-year limitations period covers basis overstatements would be scored a revenue raiser. It wouldn't raise a lot, but Congress might feel "every little bit helps." *See* Martin A. Sullivan, *So 1980s: The Return of Nickel-and-Dime Tax Policy*, TAX NOTES, Aug. 10, 2009, at 507.

[As this article was going to press, the Treasury issued temporary and proposed regulations under sections 6229 and 6501 embodying its litigating position. T.D. 9466. The temporary regulations apply to tax years as to which the assessment period had not expired before September 24, 2009. Based on the above analysis, the author believes that substantive challenge to the new regulations probably would fail. However, procedural challenges might succeed. T.D. 9466 stated, without explanation, that section 553 of the Administrative Procedure Act did not require promulgation of the new regulations through notice-and-comment procedures. This conclusion might be successfully challenged, in the author's opinion.] ■