**Tax Controversy Updates:**
IRS issues final regulations including overstatement of basis as omission from income

On December 14, 2010, the IRS published final regulations (T.D. 9511) defining an omission from gross income, including an omission of gross income for partnership items, for purposes of the six-year period of limitations on assessment. IRC § 6501(a) provides that an assessment must be made within three years after the income tax return is filed; however, IRC § 6501(e) extends the statute of limitation on assessment to six years where there is a substantial omission of income. The regulations provide that gross income, includes the excess of the amount realized from the disposition of property over the basis of the property. As a result, an overstatement of the basis of an asset not sold in a trade or business context could result in a substantial omission from gross income; thus extending the statute of limitations on assessment to six years from the date the return is filed. The same rule does not apply to the overstatement of the basis of assets sold in the ordinary course of business.

The definition of “omits from income” outside of the trade or business context has been frequently litigated. Numerous cases in the Ninth Circuit and the Federal Circuit relied upon a Supreme Court case, *Colony v. Commissioner*, 357 U.S. 28 (1958), decided under the predecessor to IRC § 6501(e), to hold that the overstatement of basis does not result in an omission from income. In *Colony*, the Supreme Court explained that the phrase "omits from income" was ambiguous and interpreted it as to exclude the overstatement of basis. The proposed and temporary regulations issued on September 24, 2009 were intended to clarify the meaning of omission of income under IRC § 6501(e). However, in a case before the Tax Court on a motion to vacate its prior opinion and a motion to reconsider its prior opinion, the Tax Court declared that the temporary regulations were invalid because the Supreme Court’s interpretation in *Colony* of this phrase was the only permissible interpretation of the statutory language. *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. No. 11 (May 6, 2010). This same issue is currently pending before several United States Courts of Appeals, and will likely continue to be litigated despite the final regulations’ intent to clarify the issue.

The final regulations also clarify the effective date provisions by providing that the regulations apply to taxable years for which the assessment period was “open on or after September 24, 2009.” The effective date of the temporary regulations was also challenged in *Intermountain* in which the Tax Court interpreted the temporary regulations as not being applicable to the case because the three year general statute of limitations had previously expired. In order to resolve the effective date issue, the preamble to the final regulations expressly states that the expiration of the three year period does not render a tax year closed if a longer period, such as the exception provided in IRC § 6501(e), applies. Furthermore, the preamble to the final regulations states that taxable years for which the assessment period was open on or after September 24, 2009 include all taxable years that are the subject of any case pending before any court, including the Tax Court and Court of Federal Claims, in which a decision had not become final as of September 24, 2009.

In addition to the modifications discussed above, the final regulations adopt the proposed regulations (T.D. 9466) with some updates reflecting changes to IRC §§ 6229(c)(2) and 6501(e) as amended by the Hiring Incentives to Restore Employment Act. The final regulations also reinstate estate, gift, and excise tax provisions which were inadvertently removed from the temporary regulations.