# New law clarifies when IRS gets more time to audit

**Bruce Givner** *is a partner at Givner & Kaye in Los Angeles. He can be reached at bruce@givnerkaye.com.*

**Owen Kaye** *is a partner at Givner & Kaye in Los Angeles. He can be reached at owen@givnerkaye.com.*

Normally the Internal Revenue Service has three years to audit tax returns. So if you filed your personal income tax return - IRS Form 1040 - this year on April 15, the IRS must start and complete its audit of the return by April 15, 2018. Of course, if you are waiting until the extended due date, Oct. 15, to file your return, the IRS must complete its audit by Oct. 15, 2018. California's Franchise Tax Board has an extra year to begin an audit of your personal income tax return, FTB Form 540. So if you filed April 15, the FTB has until April 15, 2019, and it has until Oct. 15, 2019, if you wait until the extended due date.

There are many rules that extend the statute. For example, if you file a false or fraudulent return with the intent to evade tax, the government can audit your return at any time. The same applies if you do not file a return.

One special rule has received extra attention recently. It provides that "If the taxpayer omits from gross income an amount properly includible ... and ... [the] amount is in excess of 25% of the amount of gross income stated in the return ... the tax may be assessed ... at any time within 6 years after the return was filed." Congress intended "to give the Commissioner an additional [three] years to investigate tax returns in cases where, because of a taxpayer's omission to report some table item, the Commissioner is at a special disadvantage in detecting errors .... [because] the return on its face provides no clue to the existence of the omitted item." *The Colony Inc. v. Commissioner*, 357 U.S. 28, 37 (1958).

A bill signed by President Barack Obama on Friday clarifies what constitutes an "omission" so as to trigger the extended statute. Presumably, the California Legislature will follow suit.

*United States v. Home Concrete & Supply LLC*, 132 S. Ct. 1836 (2012), was one of at least a dozen cases that addressed whether an overstatement of basis could be viewed as an "omission" of gross income. *Home Concrete* involved a tax shelter commonly used in the 1990s which was successfully overturned by the IRS in the 2000s. The owners of Home Oil and Coal Company embarked on a series of "Son of BOSS" transactions (short sales of Treasury Bonds). The intent was to increase their basis in certain assets and, as a result, decrease their tax liability on the sale of the business. When the owners and the tax shelter LLC (Home Concrete & Supply LLC) timely filed their tax returns in April 2000, for the 1999 year, the LLC elected to step up the basis in its assets under the Internal Revenue Code to equal the owners' basis.

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Over three years later, the IRS issued a notice adjusting the taxpayers' basis in the LLC to zero, substantially increasing their taxable income. The taxpayers paid the tax and sued in federal district court for a refund. The court ruled that the IRS's adjustment was timely under the extended statute of limitations as an omission of gross income. By contrast, the 4th U.S. Circuit Court of Appeals agreed with the taxpayers that the three-year statute of limitations applied and that the IRS's adjustment was untimely: An overstated basis in property is not an omission from gross income.

To resolve a circuit split, the U.S. Supreme Court heard the case and in April 2012, affirmed the 4th Circuit's finding that an overstatement of basis is not an "omission" of gross income. It also held that regulations issued by the IRS during the course of the litigation designed to support its position were not entitled to deference. *Chevron, U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1987); *Mayo Foundation v. United States*, 562 U.S. 44 (2011).

The IRS, of course, was unhappy with the result. Although Congress has starved the IRS for funding over the past decade, it has given the IRS a sympathetic ear regarding tax shelters. As a result, Congress changed the law with a bill that easily passed in the House of Representatives and the president promptly signed into law on July 31.

The law amends the Internal Revenue Code to provide that "An understatement of gross income by reason of an overstatement of unrecovered cost or other basis is an omission from gross income." The change applies to returns filed after the date of enactment and to previously filed returns that are still open (determined without regard to this amendment).

The age of classic tax shelters has passed. So how might this new law have an impact? Death is still a capital gain loophole. With a $5.43 million per person (as adjusted by the cost of living) estate and gift tax exclusion, there is an incentive to choose the highest possible value for property at a parent's death. That is reflected both in property directly inherited, and in partnership interests for which an adjustment of basis is permitted under the IRC. Also, a taxpayer has a $250,000 per person exclusion on the sale of a principal residence. In calculating basis for purposes of the sale, many taxpayers have kept inadequate records of improvements and other elements that are part of the basis. That inaccuracy now may lead to a six-year audit exposure. The same applies to anyone selling a business.

There are going to be more situations in the future than there have been in the past where the IRS (and probably the FTB) will have a doubled statute of limitations to audit your return.

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