

## TAX LETTER

### 2 CASES, 2 DIFFERENT “STATUTE OF LIMITATION”

Dear Clients and friends

WISH EVERYONE HAS A HAPPY AND RECOVERING 2010

The following cases were selected as the first in 2010 for reasons that they may help us to remind our readers to think twice before “paying” or “depositing” taxes, and understating income in the coming “tax season”.

#### I ) TAX DEPOSIT V. ESTIMATE PAYMENT AND/OR ANY PAYMENT OF TAXES

In a Federal District Court case, **Ciccotelli** (April 2, 2009), if it is a “**payment**”, it will be **forfeited** when the Statute of Limitation expired. If it is a “**deposit**”, there will be no time limit to request for a refund. According to the District Court : “a deposit of tax is a remittance made “when no assessment if then outstanding against the taxpayer. Therefore, the fund deposited is a remittance in the nature of a cash bond for the payment of taxes **thereafter** found to be due and payable.”

In order to determine whether it is a “**payment**” or a “**deposit**”. The Third Circuit Court of Appeals decided that Courts should apply a “facts and circumstances” analysis of the following factors before making any judgment. These factors are:

- (1) the intent of the taxpayer when the remittance was made,
- (2) the timing of the remittance, and
- (3) the treatment by the IRS upon receipt of the remittance.

At the time of this writing, there are no indication that the IRS is going to appeal the Ciccotelli ruling.

#### II ) THREE (3) YEARS OR SIX (6) YEARS STATUTE OF LIMITATION

Internal Revenue Code Section 6501(e) extends the statute of limitation from 3 years to 6 years for the IRS to assess and collect taxes on a tax return if the taxpayer understate gross income by 25% or more. This is known as “substantial understatement of gross income subject to tax”.

However, in *Bakersfield Energy Partners, LP* (June 17, 2009), the Ninth Circuit court of Appeals agreed with the Tax Court that according to IRC Section 6501, the term “gross

income” was defined as total amount received or accrued from sales of goods and/or services prior to diminution by the cost of such sales and/or services. Given the fact that Bakersfield Energy Partners, LP understated their “gross income” as the result of overstating their cost basis of the related inventories which were part of “cost of good sold”. Therefore, the Court of Appeals upheld the decision of the Tax Court that such an understatement should not be treated, for IRC Sec. 6501 purposes, as an understatement of “gross income” subject to a 6-year Statute of Limitation. Since the IRS made their tax assessment against Bakersfield Energy Partners after the standard 3-year Statute of Limitation, the tax assessment was time-barred. Thus, no tax was due and payable.

Roughly one month after the 9<sup>th</sup> Circuit ruling, the Federal Circuit Court of Appeals made the same decision against the IRS. As a result, two Circuit Courts of Appeals have ruled that overstatement of cost/basis will not be treated as understatement of “gross income” for IRC Section 6501 Statute of Limitation purposes.

However, the IRS refused to give up on this 6-year Statute of Limitation, therefore, a proposed and temporary regulation was prepared to further address and regulate this issue. A new Treasury Regulation (temporary) Section 301.6229(c)(2)-1T was issued to clarify that, outside the Trade and Business context, an overstatement of cost/basis can create a substantial understatement of “gross income” under IRC Sections 6299(c) and 6501(e) for purposes of the 6-year Statute Limitation to assess and collect taxes. Definitely, the “full and proper” disclosure exception provided under IRC Section 6501(e) continue to be valid.

In conclusion if the taxpayer wish to protect against the possible 6-year Statute of Limitation, the taxpayer may rely on the Circuit Courts’ rulings regarding “cost of good sold” in a Trade or Business context, or attach a full disclosure about the calculation and other information pertaining to the cost/basis claimed on the tax return for any taxable sales or exchange of assets.

Any questions and discussions, please contact us at 415-381-0681. For other information, please visit our website at [chochan.com](http://chochan.com).

Sincerely

CHO F CHAN CPA INC.