No. 09-3741

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant
v.

KENNETH H. BEARD and SUSAN W. BEARD,
Petitioners-Appellees

ON APPEAL FROM THE ORDER AND DECISION OF
THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT

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REPLY BRIEF FOR THE APPELLANT

As demonstrated in our opening brief, the language of the relevant statutes and the decision in *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968), establish that a misstatement of basis can trigger the longer assessment period of § 6501(e)(1)(A). This interpretation is further confirmed by recently issued temporary regulations, which contain a reasonable interpretation of the statutory language and which are entitled to *Chevron* deference.

Taxpayers' arguments to the contrary are not convincing. Attempting to distinguish *Phinney*, they emphasize the mislabeling of income in that case, but ignore the centrality of basis overstatement to the Fifth Circuit's holding that the six-year assessment period applied. In an effort to invalidate the temporary regulations, taxpayers rely on the Supreme Court's discussion, in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), of the legislative history of the ambiguous statutory language at issue. This focus on legislative history is misconceived in light of *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005), which held that, if the statutory language is ambiguous, deference is given to a reasonable agency interpretation of that language. Taxpayers' arguments should be rejected.

A. The statutory language establishes that misstatement of basis can trigger the longer assessment period

As discussed in our opening brief (pp. 13-14), the Code's general definition of "gross income" establishes that an overstated basis can result in an omission of gross income for purposes of the six-year assessment period (I.R.C. § 6501(e)(1)(A)), and even cases predating the recently issued regulations have so held (though not uniformly). *See, e.g., Phinney, supra*; *Brandon Ridge Partners v. United States*, 100

A.F.T.R.2d (RIA) 5347 (M.D. Fla. 2007); *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678 (E.D.N.C. 2008), *appeal docketed*, No. 09-2353 (4th Cir. Dec. 9, 2009), *Burks v. United States*, 2009 WL 2600358 (N.D. Tex. 2008), *appeal docketed*, No. 09-11061 (5th Cir. Oct. 26, 2009).

In *Phinney*, the Fifth Circuit could not have applied the six-year assessment period without concluding that a basis overstatement could give rise to that extended limitations period. Section 6501(e)(1)(A) conditions the applicability of the extended assessment period on the taxpayer's omission from gross income of an amount exceeding 25% of the amount of gross income stated in the return. Since the executor's return correctly reported the amount of taxpayer's gross receipts from the installment note, the 25% threshold would not have been satisfied unless the basis overstatement was taken into account.

Indeed, the Fifth Circuit identified the failure to disclose the basis step-up as the critical error justifying application of the six-year assessment period:

> It simply defies belief that the Internal Revenue Service, while contesting the right of Bath to claim a stepped-up basis in connection with a community property interest of less than $50,000 would have complacently permitted the

> similar claim for stepped-up basis in the Chambers estate to go unchallenged had the return filed on behalf of Mrs. Chambers disclosed what was really at issue, that is, as claimed by taxpayer, the amount received was in payment of an installment note, which, by virtue of the provisions of Section 1014(b)(6) of the Internal Revenue Code acquired a stepped-up basis upon the death of her husband.

392 F.2d at 685. Thus, *Phinney* holds that when a taxpayer has understated his gross income by overstating his basis in property, and the nature of the basis step-up is inadequately disclosed on his return, the extended assessment period applies.

Taxpayers attempt to distinguish *Phinney* on the ground that the tax reporting in that case was deliberately misleading.[1] (Br. 18-20.) But that is also true here. As in *Phinney*, the taxpayers here did not disclose on their tax returns "what was really at issue" (*see* 392 F.2d at 685), *i.e.*, that they had increased the bases in Kenneth's MMCD stock and MMSD stock by millions of dollars due to his asymmetrical treatment of the short-sale transactions. Kenneth had increased his

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[1] Taxpayers make no attempt to distinguish *Brandon Ridge* and *Home Concrete*; they simply contend that those decisions are wrong. (Br. 15-17.) And they do not even cite *Burks*, which is another pre-regulation district court decision upholding the Government's statutory interpretation.

basis in the MMCD stock and MMSD stock by the amount of the short-sale proceeds contributed to each S corporation – $5,700,000 and $6,460,000, respectively – but had not reduced these bases by the amount of his corresponding obligations to close the short sales, which MMCD and MMSD had assumed.

None of this was reported on their income tax return for 1999. Instead, taxpayers merely reported bases in the MMCD stock and MMSD stock of $6,161,351 and $6,645,463, respectively (Doc. 22, Ex. A., Sch. D), and did not disclose the connection between those bases and the short-sale transactions (*see* Doc. 22, Ex. A). Nor did they disclose Kenneth's transfer of the short-sale proceeds and the obligation to close the short sales to MMCD and MMSD. Thus, disclosure was inadequate. *See Phinney, supra*; *Brandon Ridge*, 100 A.F.T.R.2d at 5355 ("In order to adequately disclose the gain on the sale of the FES stock, information regarding the contribution of the obligation to cover the short-sale and its effect on the basis of the Jeffersons' interest in the Partnership . . . was necessary. . . .").

The Fifth Circuit's observation that "we do not have a novice individual taxpayer who had attempted to state an item of income, but has chosen a technically incorrect handle to attach to it and is thus

penalized for his lack of technical skill" (392 F.2d at 685), applies equally here. As in *Phinney*, an accounting firm – Arthur Anderson LLP – prepared taxpayers' tax return. (Doc. 22, Ex. A at 2.) Moreover, taxpayers, who entered into complex Son-of-BOSS transactions, were sophisticated. Kenneth was an executive, his wife was a consultant, and they reported adjusted gross income of $4,945,173 on their 1999 income tax return. (*Id.* at 1-2.) *Phinney* is thus virtually on all fours with this case.

Taxpayers' reliance (Br. 21) on unreported Tax Court opinions, such as *R & J Partners v. Commissioner*, T.C. No. 7166-06, purporting to distinguish *Phinney*, is misplaced. Unreported Tax Court decisions lack precedential value. *See Lebron v. United States*, 279 F.3d 321, 326 (5th Cir. 2002). Further, in *R & J*, the Tax Court erred in failing to recognize that the Fifth Circuit could not have applied the six-year assessment period unless it concluded that an overstatement of basis could give rise to the applicability of that extended period. Improper labeling of an item of gross income does not satisfy the substantial omission requirement of § 6501(e)(1)(A).

B. The temporary regulations support application of the six-year assessment period

1. The regulations are valid under the APA and are entitled to *Chevron* deference

In our opening brief, we provided extensive support for our argument (pp. 32-38) that the temporary regulations are "interpretive" regulations and are thus exempt from the APA's notice-and-comment requirements. We relied, *inter alia*, on *Metropolitan Sch. Dist. of Wayne Tp. v. Davila*, 969 F.2d 485, 489 (7th Cir. 1992), where this Court upheld the validity of an interpretive rule issued without notice and comment.

Taxpayers do not respond that the regulations are substantive regulations, but merely suggest that "[t]he characterization of the temporary regulations as interpretive regulations is far from clear, however, where the 'interpretation' is contrary to the language of the statute and fifty (50) years of judicial precedent." (Br. 40.) This suggestion, however, is meritless, as the regulations are consistent with, and supported by, the statutory language.

The regulations provide that the term "gross income," used in §§ 6229(c)(2) and 6501(e)(1)(A), "has the same meaning as provided in

section 61(a)" of the Code and that, in the case of the disposition of property, the term "means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property." Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii). *Accord* Temp. Treas. Reg. § 301.6229(c)(2)-1T(a)(1)(iii). As discussed in our opening brief (pp. 46-47), the definition of "gross income" in the case of the disposition of real property is supported by I.R.C. § 61(a)(3), which includes "[g]ains derived from dealings in property" as "gross income." The regulatory definition is also supported by I.R.C. § 1001(a), which defines gains from the sale of property as "the excess of the amount realized therefrom over the adjusted basis. . . ."

And, as discussed in our opening brief (pp. 36-37), the Federal Circuit has held an amended regulation to be interpretive, and thus exempt from the notice-and-comment requirements, even though the regulation stated that prior "judicial decisions did not accurately reflect the requirements of the statute. . . ." *National Organization of Veterans' Advocates, Inc. v. Secretary of Veterans Affairs*, 260 F.3d 1365, 1375-1377 (Fed. Cir. 2001) (internal quotation marks omitted). Taxpayers do not attempt to distinguish this case. Nor do they address our argument (Op. Br. 38-40) that, by virtue of I.R.C. § 7805(e), temporary Treasury

regulations are exempted from the APA's requirements. Thus, taxpayers have failed to support their allegation (Br. 39) that the regulations are invalid under the APA.

Nevertheless, they rely on the absence of notice-and-comment rulemaking to support their contention that (Br. 36-39) that the regulations are entitled to no deference. But this argument ignores the Supreme Court's observation in *United States v. Mead Corp.*, 533 U.S. 218 (2001), that the lack of notice-and-comment rulemaking "does not decide the case, for we have sometimes found reasons for *Chevron* deference even when no such administrative formality was required and none was afforded. . . ."[2] *Id.* at 231.

Taxpayers' argument also ignores *Barnhart v. Walton*, 535 U.S. 212 (2002), where the Supreme Court gave *Chevron* deference to an agency's regulatory interpretation that was "reached . . . through

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[2] Although the *Mead* Court ultimately declined to give *Chevron* deference to the tariff classification rulings at issue there, the lack of notice-and-comment rulemaking was only one reason for this conclusion. The Court also reasoned that "Customs had regarded a classification as conclusive only as between itself and the importer to whom it was issued" and that "to claim that classifications have legal force is to ignore the reality that 46 different Customs offices issue 10,000 to 15,000 of them each year. . . ." 533 U.S. at 233.

means less formal than 'notice and comment' rulemaking. . . ." *Id.* at 221. The Court reasoned (*id.* at 222):

> [T]he interstitial nature of the legal question, the related expertise of the Agency, the importance of the question to administration of the statute, the complexity of that administration, and the careful consideration the Agency has given the question over a long period of time all indicate that *Chevron* provides the appropriate legal lens through which to view the legality of the Agency interpretation here at issue.

As in *Walton*, *Chevron* also "provides the appropriate legal lens" through which to view the validity of the temporary regulations at issue in the case at bar. Taxpayers provide no principled reason for this Court to rule otherwise.

Finally, taxpayers' argument ignores *Long Island Care at Home, Ltd v. Coke*, 551 U.S. 158 (2007), where the Supreme Court deferred to the Department of Labor's interpretation of an existing regulation that was made in an "Advisory Memorandum" issued only to internal Department personnel and drafted in response to the pending litigation. Noting that the Department may have interpreted its regulations differently at different times (551 U.S. at 171), the Court, nevertheless, upheld the agency's most recent interpretation because the Court had no reason to suspect that this interpretation was "merely

a *post hoc* rationalizatio[n] of past agency action or that it does not reflect the agency's fair and considered judgment on the matter in question." *Id.* (internal quotation marks omitted).

As explained in our opening brief (pp. 58-59), there is even more reason to defer to the temporary Treasury regulations here than there was to defer to the agency interpretation in *Long Island Care*. Unlike the interpretation at issue there, which was set forth in an internal agency document, the temporary regulations challenged here were published in the Federal Register. And unlike the interpretation at issue in *Long Island Care*, the temporary regulations do not follow a history of fluctuating agency interpretations, but are "consistent with the Secretary's application of those provisions both with respect to a trade or business . . . , as well as outside of the trade or business context . . ." T.D. 9466, 74 Fed. Reg. 49321, 49322 (2009). Since the regulations reflect Treasury's "fair and considered judgment on the matter in question" (*Long Island Care*, 551 U.S. at 171), they are entitled to *Chevron* deference.

2. The issuance of the regulations during the pendency of this litigation does not affect the deference to which they are entitled

There is no merit to taxpayers' contention (Br. 4, 23, 41-43) that regulations issued in response to litigation are not entitled to deference. While the courts "deny deference to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice," *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 740-741 (1996) (internal quotation marks omitted), the rule (as discussed in our opening brief (pp. 55-59)) is to the contrary for litigating positions that are later incorporated into regulations. *See, e.g., id.* at 740-741; *United States v. Morton*, 467 U.S. 822 (1984). *See also Mayo Foundation for Medical Educ. and Research v. United States*, 568 F.3d 675, 683 (8th Cir. 2009), *cert. granted*, 130 S. Ct. 3353 (2010) (*Chevron* deference accorded to Treasury regulations promulgated under I.R.C. § 3121(b)(1) after Government lost excise tax cases under prior regulation); *Estate of Gerson v. Commissioner*, 507 F.3d 435 (6th Cir. 2007), *cert. denied sub nom. Kleinman v. Commissioner*, 128 S. Ct. 2502 (2008) (*Chevron* deference accorded to Treasury regulations issued

under § 2601 after Government lost Eighth Circuit case under prior regulations).

Also lacking merit is taxpayers' contention (Br. 36-37) that the promulgation of the temporary regulations over 50 years after the enactment of § 6501(e)(1)(A) counsels against their validity. In *Smiley*, the Supreme Court gave *Chevron* deference to a regulation promulgated over 100 years after the enactment of the relevant statute, stating that "[t]he 100-year delay makes no difference." 517 U.S. at 740. Similarly, in other cases *Chevron* deference was given to regulations that were not contemporaneous with the statute but were issued in response to litigation. *See, e.g., Morton*, *supra*; *Friends of Everglades v. South Florida Water Mgmt. Dist.*, 570 F.3d 1210, 1219 (11th. Cir. 2009); *Motorola, Inc. v. United States*, 436 F.3d 1357, 1366 (Fed. Cir. 2006). *See also Barnhart*, 535 U.S. at 221 (declining to disregard agency's interpretation of its formal regulations enacted only recently, perhaps in response to that litigation).

3. *Colony*'s contrary interpretation of the statutory phrase "omits from gross income" does not diminish the deference due the regulations

Taxpayers argue (Br. 34) that the Supreme Court's analyses in *Chevron USA, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), and *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979), "make clear that legislative history takes precedent [*sic*] over any contrary agency interpretation." They then rely on the Supreme Court's analysis of legislative history in *Colony* to challenge the validity of the temporary regulations. (Br. 34-35.) Their arguments lack merit for several reasons.

First, taxpayers' argument makes an end run around the settled principle that "[o]nly a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction." *Brand X*, 545 U.S. at 982-983. To allow the legislative history analyzed in *Colony* to preclude Treasury from disagreeing with the Supreme Court's interpretation of what it held to be ambiguous

statutory language (*see* 357 U.S. at 33)[3] would be to do indirectly what cannot be done directly, *i.e,* to "allow[ ] a judicial precedent to foreclose an agency from interpreting an ambiguous statute." *Brand X*, 545 U.S. at 982.

Second, taxpayers' reliance on *National Muffler* to support their focus on legislative history is misplaced. Under recent Supreme Court jurisprudence, the validity of regulations is tested under *Chevron*, not *National Muffler*. In *Mead*, the Court "h[e]ld that administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the

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[3] To be sure, the Supreme Court, while characterizing the language "omits from gross income" in the 1939 Code as ambiguous, in dicta described § 6501(e)(1)(A) of the Internal Revenue Code of 1954 as "unambiguous." *Colony*, 357 U.S. at 37. The Ninth Circuit refused to rely on this characterization because "[t]he Court expressly avoided construing the 1954 Code. . . ." *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767, 778 (9th Cir. 2009). Moreover, since the language "omits from gross income," described by the Supreme Court as ambiguous, carried over into § 6501(e)(1)(A) of the 1954 Code, the Supreme Court's observation in *Colony* as to the "unambiguous language of § 6501(e)(1)(A)" must have referred to the addition, in the 1954 Code, of a gross receipts provision and an adequate-disclosure provision not present in the 1939 Code.

exercise of that authority." 533 U.S. at 226-227. *Accord Brand X*, 545 U.S. at 980 ("apply[ing] *Chevron*'s framework to the Commission's interpretation of the term 'telecommunications service'").[4] Even before *Mead* and *Brand X*, this Court analyzed the validity of Treasury regulations under *Chevron*, rather than *National Muffler*. *See Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 978-983 (7th Cir. 1998). This Court "favor[ed] *Chevron* because many courts contend that the traditional rule [*National Muffler*] accords less than *Chevron* deference to tax regulations." *Id.* at 983.

Third, as discussed in our opening brief (pp. 53-54), according to *Brand X* the *Chevron* step-one analysis focuses on the statute's text, not its legislative history:

> At the first step, we ask whether the *statute's plain terms* directly addres[s] the precise question at issue. *If the statute is ambiguous* on

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[4] Taxpayers cite (Br. 33 n.4) the following cases in support of the Supreme Court's continued reliance after *Chevron* on *National Muffler*'s multi-factor analysis: *Boeing Co. v. United States*, 537 U.S. 437 (2003); *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001); *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991); *Rowan Cos. v. United States*, 452 U.S. 247 (1981). These cases all predate *Brand X*, however, and all except *Boeing*, which does not even cite *National Muffler*, predate *Mead*. *Rowan Cos.* even predates *Chevron*.

> this point, we defer at step two to the agency's interpretation. . . .

Brand X, 545 U.S. at 986 (internal quotation marks omitted; emphasis added). Both before and after *Brand X*, this Court for the most part considered only the statutory language in the *Chevron* step-one analysis. *See Square D Co. and Subs. v. Commissioner*, 438 F.3d 739, 744 (7th Cir. 2006); *Bankers Life*, 142 F.3d at 983.

Fourth, *Brand X* establishes that where a court's holding states merely the "best," rather than the "only permissible," interpretation of a statute, such a decision does not foreclose a later, differing agency interpretation. *Brand X*, 545 U.S. at 985; *see AARP v. E.E.O.C.*, 390 F. Supp. 2d 437, 442, 448 (E.D. Pa. 2005), *aff'd on other grounds*, 489 F.3d 558 (3d Cir. 2007). In *Colony*, the Court did not state that its interpretation of "omits from gross income" was the only possible interpretation. Instead, it recognized that the language was susceptible of differing interpretations and therefore resorted to legislative history to determine its meaning. *See* 357 U.S. at 33-36.

Further, the Supreme Court did not characterize the legislative history of § 275(c) as "conclusive," but merely as "persuasive."[5] 357 U.S. at 33.

In light of *Brand X*, the legislative history analyzed in *Colony* cannot preclude the Treasury Department from construing the statutory language differently. *See Intermountain Ins. Serv. of Vail, LLC v. Commissioner*, No. 25868-06, 2010 WL 1838297 at *15 (Tax Ct. May 6, 2010) (". . . *Colony*'s resort to legislative history in the first place shows a gap that the Secretary is ipso facto allowed to fill") (Halpern, J., concurring); *AARP*, 390 F. Supp. 2d at 448-450 (Third Circuit's interpretation of Age Discrimination in Employment Act, which interpretation was partially based on legislative history, did not foreclose contrary agency interpretation).

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[5] Moreover, as discussed in our opening brief (pp. 54-55), the statutory changes in 1954, *i.e.*, the addition of the gross-receipts provision, I.R.C. § 6501(e)(1)(A)(i), and the adequate-disclosure provision, I.R.C. § 6501(e)(1)(A)(ii), limit the significance of the legislative history discussed in *Colony*. *See* T.D. 9466, 74 Fed. Reg. at 49321 ("by amending the Internal Revenue Code, including the addition of a special definition of 'gross income' with respect to a trade or business, Congress effectively limited what ultimately became the holding in *Colon*y, to cases subject to section 275(c) of the 1939 Internal Revenue Code").

4. The regulations apply to the tax assessment at issue

The temporary regulations "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b). As discussed in our opening brief (pp. 59-60), the IRS has interpreted the temporary regulations as applying to cases "in which the period of limitations under sections 6229(c)(2) and 6501(e)(1)(A), as interpreted in the temporary regulations, did not expire with respect to the tax year at issue, before September 24, 2009. . . ." *See* CC-2010-001, 2009 WL 4753220. Taxpayers do not deny that an agency's interpretation of its regulations is entitled to deference. *See, e.g.*, *Long Island Care*, 551 U.S. at 171; *Auer v. Robbins*, 519 U.S. 452, 461 (1997).

Taxpayers' argument (Br. 26) that the temporary regulations cannot apply because the assessment period expired before the regulations were issued assumes the premises to be proved – that the assessment period is three years and that the temporary regulations changed that period. These premises are false. The applicability of the three-year assessment period is the very thing at issue in this case, and

no final determination has yet been made on that score. In the Internal Revenue Code, Congress has provided a number of limitations periods, any one of which may be applicable in a given situation. To apply the effective-date provisions of the temporary regulations, one must start with the premise that a six-year limitations period may apply, rather than automatically foreclosing that possibility by assuming, as taxpayers do, that the three-year limitations period applies.

Before the temporary regulations were issued, the applicable assessment period was uncertain where the underreported gross income had resulted from vastly inflated bases of property the taxpayer sold. Although several courts held that the three-year period applied, other courts held that the six-year assessment period applied. *See Phinney, supra*; *Brandon Ridge, supra*; *Home Concrete, supra*; *Burks, supra*. Thus, it was, at the very least, unclear which assessment period applied before promulgation of the temporary regulations. While the Tax Court here ruled that the three-year assessment period applied, its determination was not a "final decision" for assessment purposes. When an appeal is taken from a Tax Court decision, that decision is not final until the appeal has been determined and the time for seeking Supreme Court review has expired, or, if Supreme Court review is

granted, until the Supreme Court has decided the case. I.R.C. § 7481. Since the Tax Court decision in this case has not become final, the tax year in issue remains open, and the temporary regulations are not retroactive as applied to this case.

But even if they were retroactive, the regulations would still be valid. The version of I.R.C. § 7805(b) applicable here – I.R.C. § 7805(b) (1994 ed.) – establishes a presumption that regulations apply retroactively unless otherwise specified. *See, e.g.*, *Gehl Co. v. Commissioner*, 795 F.2d 1324, 1331 (7th Cir. 1986). Since the regulations do not specify that they apply prospectively only, their application encompasses the 1999 tax year at issue here. *See Intermountain*, 2010 WL 1838297 at *10-*11. Taxpayers have made no response to this argument, which was contained in our opening brief (pp. 62-68).

Taxpayers argue (Br. 26) that federal courts have demonstrated a strong reluctance to apply a statute or regulation in a manner that would open a previously closed year. But, as discussed above, this case does *not* involve a previously closed year. Moreover, the cases on which taxpayers rely deal with statutes, not regulations. *See, e.g.*, *Hughes Aircraft Co. v. United States ex rel. Schumer*, 520 U.S. 939 (1997)

(involving retroactivity of amendment to False Claims Act); *Landgraf v. USI Film Prods.*, 511 U.S. 244 (1994) (involving retroactivity of § 102 of Civil Rights Act of 1991); *Margolies v. Deason*, 464 F.3d 547 (5th Cir. 2006) (involving retroactivity of Sarbanes-Oxley Act). These cases do not purport to invalidate a regulation that applies to years preceding its issuance.[6]

The Supreme Court has authorized retroactive rulemaking when there is an "express statutory grant." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 209 (1988). As discussed above, I.R.C. § 7805(b) (26 U.S.C. 1994 ed.) contains such an express grant. The courts have repeatedly upheld the validity of retroactive regulations when the Treasury Department did not abuse its discretion in issuing them. *See,*

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[6] Taxpayers' reliance (Br. 29) on *Diller v. Commissioner*, 133 F.3d 909 (Table), 80 A.F.T.R.2d 8284 (3d Cir. 1997), is also misplaced. *Diller*, which is not reported officially, concerned the applicability of IRS Notice 97-26, in which the IRS selected "designated delivery services" under I.R.C. § 7502(f). Since this Notice explicitly provided that it only applied to documents taxpayers gave to a designated delivery service on or after April 11, 1997, the Third Circuit held that the Notice did not apply to documents served before that date. Here, on the other hand, the temporary regulations "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b). They, therefore, apply to this case.

e.g., *Caterpillar Tractor Co. v. United States*, 589 F.2d 1040, 1043 (Ct. Cl. 1978) (no abuse of discretion in making regulation promulgated in 1977 retroactive to 1972 when Treasury's interpretation of statute was evident as early as 1972); *Spang Industries, Inc. v. United States*, 791 F.2d 906, 909 (Fed. Cir. 1986) (amended regulation "applies retroactively to this case under section 7805(b) of the Code"); *Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 985 (5th Cir. 1977) (no abuse of discretion in applying Treas. Reg. § 1.902-3(d)(1) retroactively).

Furthermore, even when there is no express statutory authority for retroactive rulemaking, the courts have held that the general prohibition on retroactive agency rulemaking does not apply to rules that merely clarify existing law. *See, e.g.*, *First Nat'l Bank of Chicago v. Standard Bank & Trust*, 172 F.3d 472, 478 (7th Cir. 1999); *Levy v. Sterling Holding Co.*, 544 F.3d 493, 506 (3d Cir. 2008), *cert. denied*, 129 S. Ct. 2827 (2009); *Orr v. Hawk*, 156 F.3d 651, 654 (6th Cir. 1998). As this Court has stated, "[A] clarification of an unsettled or confusing area of law does not change the law, but restates what the law according to the agency is and has always been; it is no more retroactive in its operation than is a judicial determination construing

and applying a statute to a case in hand." *First Nat'l Bank*, 172 F.3d at 478 (internal quotation marks omitted). Thus, a regulation that merely clarifies existing law can constitutionally be applied to pre-promulgation conduct. *Levy*, 544 F.3d at 506; *Orr*, 156 F.3d at 654. As discussed in our opening brief (pp. 37-38), the temporary regulations here are clarifications of existing law. Thus, there is abundant authority for applying the temporary regulations to taxpayers' 1999 tax year.

CONCLUSION

The order and decision is incorrect and should be reversed. The case should be remanded to the Tax Court for consideration of the applicability of the safe harbor for adequate disclosure, I.R.C. § 6501(e)(1)(A)(ii).

Respectfully submitted,

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August 9, 2010

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The undersigned hereby certifies that she has filed electronically, pursuant to Circuit Rule 31(e), versions of the brief and all of the appendix items that are available in non-scanned PDF format.

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CERTIFICATE OF SERVICE

It is hereby certified that fifteen copies of this reply brief in paper form were sent to the Clerk via FedEx on August 9, 2010, and that service of this reply brief has been made on counsel for the appellees by sending two paper copies thereof and one copy in diskette form by FedEx, on August 9, 2010, in an envelope, properly addressed to him as follows:

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