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

BRIEF FOR THE APPELLEE

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CIRCUIT RULE 26.1 DISCLOSURE STATEMENT

Appellate Court No.: 09-3741
Short Caption: Commissioner of Internal Revenue v. Kenneth H. Beard and Susan W. Beard

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(2) The names of all law firms whose partners or associates have appeared for the party in the case (including proceedings in the district court or before an administrative agency) or are expected to appear for the party in this court: Arnstein & Lehr LLP (Robert E. McKenzie, Adam S. Fayne)

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(i) Identify all its parent corporations, if any; and N/A

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Attorney's Signature: /s/ Adam S. Fayne Date: 07/16/10
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Please indicate if you are *Counsel of Record* for above listed parties pursuant to Circuit Rule 3(d). Yes X

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TABLE OF CONTENTS

CIRCUIT RULE 26.1 DISCLOSURE STATEMENT i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iv

JURISDICTIONAL STATEMENT 1

STATEMENT OF THE ISSUE FOR REVIEW 1

STATEMENT OF THE FACTS 1

SUMMARY OF THE ARGUMENT 3

ARGUMENT 5

I. The Statute At Issue 5

A. The History Of The Statute At Issue 5

B. The Case Law Under Section 275(c) Before *Colony* 6

C. The Supreme Court Resolves The Circuit Split In *Colony* And Concludes That The IRS May Assert The Six-Year Statute Of Limitations Only Where There Has Been An "Omission" Of Income 9

D. Section 6501(e)(1)(A) Of The 1954 Code 11

E. Recent Case Law Supports Colony And Holds That An Overstatement Of Basis Does Not Constitute An Omission Of Income 12

F. Cases Relied Upon By Respondent 15

(i) *Brandon Ridge Partners* and *Home Concrete & Supply* 15

(ii) *Phinney* Case 17

II. The IRS's Recently Issued Regulations Do Not Open Up The Statute Of Limitations In This Case, And Have No Other Application In This Case 22

A. The May 6, 2010 Intermountain Case Supports The Taxpayer's Position That The Regulations Have No Effect On The Instant Case 23

B. The Regulations Do Not Apply Because The 1999 Tax Year Was Closed When The Regulations Took Effect. 25

(i) Applying The Effective Date Provision Before Taking Into Account Other Provisions Of The Regulations Comports With Judicial Precedent And Gives Meaning To The Concept Of An Effective Date. 25

(ii) Applying The Effective Date First Also Avoids Reopening a Previously Closed Tax Year, Which Would Be Legally Prohibited. 26

C. The Regulations Embody An Unreasonable Interpretation Of A Statute And Are Therefore Invalid.... 30

(i) The Regulations Are Invalid Because They Are Directly Contrary To Congressional Intent, As Determined By The Supreme Court In *Colony*. 30

(ii) The Manner In Which The Regulations Evolved Indicates That The Regulations Are Not Impartial Or Deliberative And Are Therefore Entitled To No Deference. 36

D. The Regulations Are Invalid Under The Administrative Procedures Act (“APA”).... 39

CONCLUSION.... 42

CERTIFICATE OF COMPLIANCE.... 44

CERTIFICATE OF SERVICE 45

TABLE OF AUTHORITIES

Cases

Albert J. Petrulis, D.D.S., S.C. v. Commissioner, 938 F.2d 78 (7th Cir. 1991) 25

American Liberty Oil Co. v. Commissioner, 1 T.C. 386 (1942) 6

AT&T Corp. v. *Portland,* 216 F.3d 871 (9th Cir. 2000) 31

Auer v. *Robbins,* 519 U.S. 452 (1997) 41

Bakersfield Energy Partners v. Commissioner, 568 F.3d 767 (9th Cir. 2009) .... passim

Bankers Life and Casualty Company v. United States, 142 F.3d 973 (7th Cir. 1998) 32, 38, 39

Bath v. *United States,* 211 F. Supp. 368 (S.D. Tex. 1963) 20

Beard v. Commissioner, T.C. Memo. 2009-184 (Aug. 11, 2009) 4, 12, 15

Bell Federal Savings & Loan Ass'n v. Commissioner, 40 F.3d 224 (7th Cir. 1994) 32

Boeing Co. v. United States, 537 U.S. 437 (2003) 33

Brandon Ridge Partners v. United States, 2007 WL 2209129 (M.D. Fla. 2007) 16, 17

Chenault v. *US. Postal Service,* 37 F.3d 535 (9th Cir. 1994) 27

Colony, Inc. v. *Commissioner,* 357 U.S. 28 (1958) .... passim

Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991) 33

D. Hoctor v. United States Department of Agriculture; 82 F.3d 165 (7th Cir. 1996) 40

Davis v. Hightower, 230 F.2d 549 (5th Cir. 1956) 7, 8

Deakman-Wells Co. v. Commissioner, 213 F.2d 894 (3d Cir. 1954) 7

Diller v. Commissioner, 133 F.3d 909, 80 A.F.T.R.2d 97 (3d Cir. 1997) 29

Estate of Gibbs v. Commissioner, 21 T.C. 443 (1954) 7

Gold Blossom Explorations, LLC v. Commissioner, No. 13120-07 (Tax Ct. Sept. *3, 2009)* 4, 12, 15

Goodenow v. Commissioner, 238 F.2d 20 (8th Cir. 1956) 8

Grapevine Imports, Ltd v. United States, 77 Fed. Cl. 505 (2007) 3, 12

Home Concrete & Supply, UC v. United States, 599 F. Supp. 2d 678 (E.D. N.C. 2008).. 16, 17

Hughes Aircraft Co. v. *United States,* 520 U.S. 939 (1997)... 26, 29

Intermountain Insurance Service of Vail, LLC v. Commissioner, T.C. Memo 2009-195 (Sept. 1, 2009), opinion supplemented on denial of reconsideration, 134 T.C. No. 11 (Tax Ct., May 6, 2010)........................... 4, 12, 15, 23

Kikalos v. Commisioner, 190 F.3d 791 (7th Cir. 1999).. 38, 39

Landgraf v. USI Film Prods., 511 U.S. 244 (1994).. 27, 28

Lazarus v. United States, 136 Ct. Cl. 283 (1956) 8

Lieberman v. *Cambridge Partners, LLC,* 432 F.3d 482 (3d Cir. 2006) 27

M.I.T.A. Partners v. Commissioner, No. 17832-07 (Tax Ct. Aug. 6, 2009) 4, 12, 15, 21

Margolies v. *Deason,* 464 F. 3d 547 (5th Cir. 2006)... 27, 29

Metropolitan School District of Wayne Township, Marion County, Indiana v. Davila, 969 F.2d 485 (7th Cir. 1992)... 40

Nalle v. Comm'r, 997 F.2d 1134 (5th Cir. 1993)... 33

National Cable & Telecommunications Assoc. v. *Brand X Internet Services,* 545 U.S. 967 (2005) 30

National Muffler Dealers Association, Inc. v. *United States,* 440 U.S. 472 (1979).. 32, 33, 34, 37

Pennington v. Didrickson, 22 F.3d 1376 (7th Cir. 1994) 32

Phinney v. Chambers, 392 F.2d 680 (5th Cir. 1968) 17, 18, 20, 21

R & J Partners v. Commissioner, No. 7166-06 (Tax Ct. Oct. 23, 2009).............................. passim

Reis v. Commissioner, 142 F.2d 900 (6th Cir. 1944)... 6

Rowan Cos. V. United States, 452 U.S. 247 (1981) 33

Salman Ranch Ltd v. United States, 573 F.3d 1362 (Fed. Cir. 2009).................................. passim

Slaff v, Commissioner, 220 F.2d 65 (9th Cir. 1955) 7

Smiley v. Citibank (South Dakota), NA., 517 U.S. 735 (1996).. 40

SN LaGuardia Partners v. Commissioner, No. 4906 (Tax. Ct. Sept. 4, 2009) 3, 12, 15

Snap-Drape v. *Inc.* v. *Commissioner,* 98 F.3d 194 (5th Cir. 1984).. 29

United States v. Cleveland Indians Baseball Co., 532 U.S. 200 (2001) 33

United States v. *Mead,* 533 U.S. 220 (2001) 37, 38

United States v. *Morton,* 467 U.S. 822 (1984) 41, 42

United States v. *Vogel Fertilizer Co.,* 455 U.S. 16 (1982) 30

United Transportation Union-Illinois Legislative Bd. v. Surface Transportation Bd., 169 F.3d 474, 480 (7th Cir. 1999) 39

Uptegrove Lumber Co. v. Commissioner, 204 F.2d 570 (3d Cir. 1953) 7, 8

UTAM Ltd v. Commissioner, T.C. Memo. 2009-253 (Nov. 9, 2009) 3, 12, 15, 21

Warrick v. U.S., 177 F.Supp. 481 (E.D. Mich, 1959) 40

Wilmington Partners, L.P. v. Commissioner, No. 15098-06 (Apr. 30, 2008) 4, 12, 15

Statutes

§ 6501(e)(1) 9

26 U.S.C. Section 22(a) of the 1939 Code 7

26 U.S.C. Section 275(c) of the 1939 Code 6, 7, 8, 13

26 U.S.C. Section 6501 11

26 U.S.C. Section 6501(a) 1, 5, 42

26 U.S.C. Section 6501(e) 1, 42

26 U.S.C. Section 6501(e)(1)(A) 5

26 U.S.C. Section 6501(e)(1)(A)(i) 5, 11, 13

26 U.S.C. Section 6501(e)(1)(A)(ii) 12, 13, 35

26 U.S.C. Section 6501(e)(2) 13, 16

26 U.S.C. Section 6662(h) 2

26 U.S.C. Section 708(b)(1)(B) 12, 14

26 U.S.C. Section 743(b)(1) 12, 14

26 U.S.C. Section 754 14

26 U.S.C. Section 7805(a) 30, 42

5 U.S.C. Section 553 40

Revenue Act of 1934 (Ch. 277, 48 Stat. 680, 745, Section 275(c)) 5, 6

Sarbanes-Oxley Act of 2002 .... 27, 28

Rules

APA Section 553 .... 39, 41

APA Section 553(b) 40

Regulations

Treas. Reg. Section 301.6229(c)(2)-1T (Sept. 24, 2009) 23, 24

Treasury Determinations

T.D. 9466, 74 Fed. Reg. 49321- (Sept. 28, 2009) 4, 22, 30

Miscellaneous

H.R. No. 83-1337 (1954) 11

S. Rep. No. 73-558, at 43-44 5

S. Rep. No. 83-1622 (1954) 11

JURISDICTIONAL STATEMENT

The Appellees believe that the Jurisdictional Statement in the Appellant's Brief is complete and correct.

STATEMENT OF THE ISSUE FOR REVIEW

Whether the Appellees' alleged overstatement of basis on the sale of their ownership interests constitutes an omission of gross income under Internal Revenue Code Section 6501(e), such that the statute of limitations on assessment was six (6) years, not three (3) years under Internal Revenue Code Section 6501(a)?

STATEMENT OF THE FACTS

The Appellees (hereafter "Taxpayers") founded the company, known as KHB, Inc. ("KHB"), during 1974. (Doc 13, Page 4-5, Statement of Facts.) KHB was in the business of servicing and constructing HVAC systems. Id. In 1989, the Taxpayers formed a new corporation, MMSC, Inc. ("MMSC"). Id. The Taxpayers transferred all the assets concerning the HVAC service business from KHB to MMSC. Id. This transfer was motivated by the Taxpayers desire to reduce the risk and exposure of KHB. Id. Similarly, in 1989, the Taxpayers formed MMCD, Inc. ("MMCD") and transferred all the assets related to the HVAC construction business from KHB to this new corporation, MMCD. Id. This transfer was also motivated by the Taxpayers desire to reduce the risk and exposure of KHB. Id. After the transfer of these assets, KHB remained as the management, payroll, and leasing company providing services to MMSC and MMCD. Id.

During the 1999 tax year, the Taxpayers entered into a tax advantaged transaction whereby they are alleged by the Appellant (hereafter "IRS" or "Service") to have inflated the

basis in their stock of MMSC and MMCD, through the use of Treasury Note short sale agreements. *Id.* This increased basis was reported on the face of the Taxpayers' 1999 income tax return. *Id.* Specifically, on August 29, 1999, the Taxpayers sold their stock in KHB to Unicom for $1,740,518.00. *Id.* Unicom was a third-party unrelated purchaser. *Id.* On August 29, 1999, the Taxpayers sold their stock in MMCD to Unicom for $6,574,939.00. *Id.* On August 29, 1999, the Taxpayers sold their stock in MMSC to Unicom for $7,638,211.00. *Id.*

On or about April 11, 2000, the Taxpayers timely filed their 1999 personal income tax return. *Id.* The Taxpayers' 1999 income tax return reflected the following long-term capital gains:

1. 760 shares of KHB stock sold for $1,740,518.00, with a basis of $890,392.00, and a capital gain of $850,126.00.
2. 760 shares of MMCD stock sold for $6,574,949.00 with a basis of $6,161,351.00, and a capital gain of $413,588.00.
3. 760 shares of MMSD stock sold for $7,638,211.00 with a basis of $6,645,463.00, and a capital gain of $992,748.00.

(Doc. 22.)

These capital gains were listed on the Taxpayers' Schedule D attached to their 1999 income tax return. *Id.*

In a Notice of Deficiency issued by the IRS on or about April 13, 2006, the IRS alleged that the Taxpayers' basis in the sale of the MMCD and MMSC stock was overstated. (Doc. 1, Ex. A.) Based on this allegation, the IRS alleged that the Taxpayers had an additional $12,160,000.00 in capital gains, and, as a result, owe an additional $2,493,724.00 in taxes, and are also liable for an Internal Revenue Code Section 6662(h) penalty in the amount of $997,489.00. *Id.* (hereafter all references to Internal Revenue Code will be referenced as the "Code" and all section within the Internal Revenue Code will be referenced as "Section").

In response to the Notice of Deficiency, on or around July 11, 2006, the Taxpayers timely filed a petition with the United States Tax Court (hereafter "Tax Court") contesting the timeliness of the IRS's Notice of Deficiency. (Doc. 1.) On or around, September 11, 2007, the Taxpayers filed their Motion for Summary Judgment. (Doc. 13.) On or around August 11, 2009, the Tax Court entered an Order and Decision granting the Taxpayers' Summary Judgment Motion and holding that the Notice of Deficiency was barred by the statute of limitations. (Doc. 33.)

SUMMARY OF THE ARGUMENT

The issue in this case was decided long ago by the U.S. Supreme Court in *Colony, Inc.* v. *Commissioner,* 357 U.S. 28 (1958). In *Colony,* the Supreme Court held that an overstatement of basis does not constitute an omission of income that can trigger an extended limitations period. Although the *Colony* case dealt with the predecessor statute to Section 6501 *(i.e.,* before the Code was amended in 1954), the relevant language in Section 6501(e) remains essentially the same as the language in the predecessor statute. *Colony* has been the law for over 50 years and controls the outcome of this case.

Subsequent to *Colony* the Tax Court and many other courts, including the Tax Court in the instant case, have held that an overstatement of basis does not constitute an omission of gross income to extend the statute of limitations under Section 6501. *See Salman Ranch Ltd v. United States,* 573 F.3d 1362 (Fed. Cir. 2009); *Bakersfield Energy Partners v. Commissioner,* 568 F.3d 767 (9th Cir. 2009); *Grapevine Imports, Ltd v. United States,* 77 Fed. Cl. 505 (2007); *UTAM Ltd v. Commissioner,* T.C. Memo. 2009-253 (Nov. 9, 2009); *R & J Partners v. Commissioner,* No. 7166-06 (Tax Ct. Oct. 23, 2009); *SN LaGuardia Partners v. Commissioner,* No. 4906-07 (Tax. Ct. Sept. 4, 2009); *Gold Blossom Explorations, LLC v. Commissioner,* No. 13120-07 (Tax Ct.

Sept. *3, 2009); Intermountain Insurance Service of Vail, LLC v. Commissioner,* T.C. Memo. 2009-195 (Sept. 1, *2009); Beard v. Commissioner,* T.C. Memo. 2009-184 (Aug. 11, 2009); *M.I.T.A. Partners v. Commissioner,* No. 17832-07 (Tax Ct. Aug. 6, 2009); *Wilmington Partners, L.P. v. Commissioner,* No. 15098-06 (Apr. 30, 2008).

Faced with mounting court losses on this issue, the IRS issued self-serving Regulations on September 24, 2009, that purport to "resolve a continuing issue as to whether an overstatement of basis in a sold asset results in an omission of income" for purposes of the extended six (6) year statute of limitations. T.D. 9466, 74 Fed. Reg. 49321-01 (Sept. 28, 2009) (hereinafter “Regulations”). The Regulations, however, are either inapplicable or invalid for the following reasons:

(i) The Regulations are effective September 24, 2009 and apply only to tax years open on that date. The statute of limitations with respect to the Taxpayer’s 1999 tax year expired well before that date.

(ii) The Regulations cannot be used to reopen a year previously barred by the statute of limitations.

(iii) The Regulations are invalid because they represent an unreasonable interpretation of an unambiguous statute. The Regulations fail because they reflect nothing more than a marginally dressed up litigating position that the U.S. Supreme Court has already rejected as contrary to Congressional intent.

(iv) The Regulations are invalid because the IRS failed to adhere to the notice-and-comment requirements of the Administrative Procedure Act (“APA”).

Supporting this conclusion is *Intermountain Insurance Service of Vail, LLC v. Commissioner*, in which the United States Tax Court very recently found these Regulations to be invalid. 134 T.C. No. 11 (May 6, 2010). Thirteen (13) United States Tax Court Judges participated in the *Intermountain* decision. Nine (9) judges held that the Regulations were invalid for all or some of the reasons stated above in (i) through (iv). The other four (4) judges did not participate in the decision. There was no descent.

ARGUMENT

I. The Statute At Issue

An assessment of income tax for a tax year generally must be made within three years after the date on which the taxpayer files an income tax return for the tax year. 26 U.S.C. Section 6501(a). Section 6501(e)(1)(A) of the Code provides that, if the taxpayer "omits from gross income an amount properly includible therein which is in excess of twenty-five (25) percent of the amount of gross income stated in the return," the IRS may assess the resulting income tax within six (6) years of the date the tax return was filed. Section 6501(e)(1)(A) includes two additional provisions, both of which were added as part of the 1954 Code. First, Section 6501(e)(1)(A)(i) provides:

> In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.

The second additional provision is set forth in Section 6501(e)(l)(A)(ii):

> In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

A. The History Of The Statute At Issue

The first provision for an extended statute of limitations for substantial omissions was set forth in the Revenue Act of 1934 (Ch. 277, 48 Stat. 680, 745, Section 275(c)), which was later incorporated in the Internal Revenue Code of 1939. While the statutory language as originally proposed by the House Ways and Means Committee provided for no limitations period, the Senate Finance Committee approved the language of the House bill, but, instead of an unlimited extension, provided for a five (5) year period. S. Rep. No. 73-558, at 43-44. The Senate Finance

Committee recognized that it would be unfair to leave the limitations period for assessments open indefinitely in the case of "an honest but negligent taxpayer," and provided the following example:

> A case might arise where a taxpayer failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital or he might report as income for one year an item of income which properly belonged in another year.

Id.

As ultimately enacted by Congress, Section 275(c) provided in relevant part:

> (c) Omission from gross income. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

26 U.S.C. Section 275(c) of the (1939) Code (repealed 1954).

B. The Case Law Under Section 275(c) Before *Colony*

Uncertainty as to the application of the extended limitations period for substantial omissions in Section 275(c) of the 1939 Code led to litigation, ultimately resulting in a split among the Circuit Courts of Appeal.

A minority of courts had found that the extended period was triggered any time there was an understatement of twenty-five (25) percent of gross income. In *Reis v. Commissioner*, 142 F.2d 900, 903 (6th Cir. 1944), the Sixth Circuit held that the extended limitations period applied in a situation in which the taxpayer "adopted an incorrect basis." The Tax Court had also found that an extended limitations period applied when there was a twenty-five (25) percent omission of income caused by an overstatement of basis or cost of goods sold. *American Liberty Oil Co. v. Commissioner*, 1 T.C. 386 (1942) (holding that the extended limitations period applies when the deficiency was caused by overstatement of basis as a result of an "honest mistake" of law and

noting that the definition of "gross income" under Section 22(a) of the 1939 Code includes gains from dealing in property); *Estate of Gibbs v. Commissioner*, 21 T.C. 443 (1954) (holding that an improper inclusion of an item in the cost of goods sold that resulted in an understatement of income in excess of twenty-five (25) percent of the gross income stated on the return was sufficient to extend the statute of limitations because gross income is defined as gross sales less cost of goods sold).

The majority of courts had ruled that the extended period was not implicated when: (1) items were disclosed but not included in income; or (2) items were included but incorrectly offset by basis or cost of goods sold. In *Slaff v, Commissioner*, 220 F.2d 65 (9th Cir. 1955), the Ninth Circuit held that the general three-year limitations period was not extended when a taxpayer disclosed foreign-source income on his tax forms but erroneously claimed it was excluded from gross income.

In *Uptegrove Lumber Co. v. Commissioner*, 204 F.2d 570,573 (3d Cir. 1953) the Third Circuit held that a manufacturing corporation's tax return did not make an omission from gross income when it erroneously inflated cost of goods sold. Similarly, in *Deakman-Wells Co. v. Commissioner*, 213 F.2d 894 (3d Cir. 1954), the Third Circuit held that the extended limitations period applies only when the taxpayer altogether *omits an item* from the reported income, rather than simply when the final gross income amount is understated.

In *Davis v. Hightower*, 230 F.2d 549 (5th Cir. 1956), the Fifth Circuit held that when a taxpayer reports all the items of income on its returns, but incorrectly treats an item as a result of a disagreement with the IRS as to the legal characterization of a transaction, the general three-year limitations period applies rather than the extended period. Following the Third Circuit's construction of Section 275(c) and the section's legislative history, *Davis* held that for purposes

of determining whether the extended statute of limitations should apply, the focus of judicial inquiry is on "whether a specific item of income has been completely omitted from the return." 230 F.2d at 553. In rejecting the IRS's argument that an amount of "gross income" was understated as a result of a disagreement regarding a transaction disclosed on the return, the Fifth Circuit reasoned:

> It cannot be thought that if a taxpayer accurately fills in every blank space provided for his use in the income tax return, giving every "gross" or maximum figure called for, and arrives at an incorrect computation of the tax only by reason of a difference between him and the Commissioner as to the legal construction to be applied to the disclosed transaction, the use of a smaller figure than that ultimately found to be correct in one stage of the computation amounts to an omission from "gross income" of the difference between the correct and incorrect item.

Id.

In *Goodenow v. Commissioner*, 238 F.2d 20 (8th Cir. 1956), the Eighth Circuit held that an understatement of the taxpayer's gross profits from the taxpayer's farm business resulting from the overstatement of opening inventory did not constitute an omission of income for the purposes of Section 275(c) of the 1939 Code. Following the Third Circuit's decision in *Uptegrove Lumber*, the Eighth Circuit held that "the five-year statute was applicable only to an understatement which resulted from a taxpayer's completely leaving out of his computations some specific item of gain." *Goodenow*, 238 F.2d at 22, citing *Uptegrove Lumber*, 204 F.2d at 571-72.

In *Lazarus v. United States*, 136 Ct. Cl. 283, 285 (1956), the Court of Claims held that the government should not be given the benefit of the extended limitations period "if in fact the income in question is shown on the return, though it is omitted in arriving at the amount shown on the return as gross income."

C. The Supreme Court Resolves The Circuit Split In *Colony* And Concludes That The IRS May Assert The Six-Year Statute Of Limitations Only Where There Has Been An "Omission" Of Income

To settle the split among the Circuits, the Supreme Court considered the effect of an overstatement of tax basis on the statute of limitations period in *Colony.* 375 U.S. 28 (1958). Although the decision was issued after the enactment of the 1954 Code, the Court considered Section 275(c) (which had been replaced by § 6501(e)(1) in the 1954 Code), because the case involved tax years prior 1954.

In *Colony*, a real estate development corporation had overstated its basis in certain residential lots sold during the year by erroneously including some unallowable items of development expense. 357 U.S. at 30. The IRS argued that the taxpayer had "omitted" income on its return because it had understated the gain on the sale of the lots as a result of overstated basis. *Id*.

The IRS argued that the statutory reference to "amount" suggests "a concentration on the quantitative aspect of the error, that is, whether or not gross income was understated by as much as twenty-five (25) percent." *Id.* at 32. The Supreme Court remarked that "[t]his view is somewhat reinforced if, in reading the [statutory language], one touches slightly on the word 'omits' and bears down hard on the words 'gross income,' for where a cost item is overstated, as in the case before us, gross income is affected to the same degree as when a gross-receipt item of the same amount is completely omitted from a tax return. " *Id*

In contrast, the taxpayer argued that the IRS's reading failed to take full account of the word "omits," when Congress could have chosen other words such as "reduces" or "understates." *Id.* Under the word's ordinary meaning, "omits" means "to leave out or unmentioned; not to insert, include, or name[.]" *Id.* (internal citation omitted). Thus, the taxpayer contended that

Section 275(c) applied only in "situations in which specific receipts or accruals of income items are left out of the computation of gross income." *Id.* at 33

As an initial matter, the Supreme Court noted that, on its face, the language in Section 275(c) appeared to support the taxpayer's position. *Id.* at 33. When the Supreme Court consulted the legislative history, the Supreme Court found "persuasive evidence that Congress was addressing itself to the specific situation where a taxpayer actually omitted some income receipt or accrual in his computation of gross income and not more generally to errors in that computation arising from other causes." *Id.*

The Supreme Court held that Congress did not intend for the extended limitations period to apply in all instances when gross income was understated:

> In enacting Section 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting "gross income" or one, such as overstated deductions, affecting other parts of the return. To accept the Commissioner's interpretation and to impose a five-year limitation when such errors affect "gross income," but a three-year limitation when they do not, not only would be to read Section 275(c) more broadly than is justified by the evident reason for its enactment, but also to create a patent incongruity in the tax law.

Id. at 36-37. The Supreme Court specifically compared overstated basis with erroneous deductions as items which appear on the return (and are not "omitted"), and with respect to which the IRS is at no special disadvantage in the audit process.

The Supreme Court's holding makes clear that where a taxpayer reports the gross proceeds of a disclosed transaction, but calculates his tax liability incorrectly because the

taxpayer and the IRS disagree about how basis should be computed, there has been no omission of income.

Finally, with respect to the then newly-enacted Section 6501(e)(l)(A), which added a special rule for determining gross income in the trade or business setting, the Supreme Court observed in dicta that "without doing more than noting the speculative debate between the parties as to whether Congress manifested an intention to clarify or to change the 1939 Code, we observe that the conclusion we reach is in harmony with the unambiguous language of Section 6501(e)(l)(A) of the Internal Revenue Code of 1954." *Id*. at 37.

D. Section 6501(e)(1)(A) Of The 1954 Code

The Code was recodified in its entirety in 1954. When the Code was reenacted, the statute of limitations provision was renumbered from Section 275 to Section 6501. Report of the Committee on Ways and Means, H.R. No. 83-1337 at 414 (1954); see also S. Rep. No. 83-1622 at 583-644 (1954). The operative provisions of new Section 6501(e)(1) remained identical to former Section 275(c) (other than the change of "per centum" to "percent"), but exceptions were added in new subsections 6501(e)(1)(A)(i) and (ii). The revised Section 6501(e)(1)(A) also extended the five (5) year statute of limitations to six (6) years.

The critical operative language of former Section 275(c) at issue in *Colony* was identical to Section 6501(e)(1)(A). The legislative history of Section 275(c) of the 1939 Code and its references to omissions of specific items of gross income, which served as the underpinning of the Supreme Court's holding in *Colony*, was equally relevant to the 1954 and 1986 Codes.

Accordingly, the legislative history of both former Section 275(c) of the 1939 Code and Section 6501(e)(1)(A) of the 1954 and 1986 Code, the majority of the cases decided under former Section 275(c), as well as the Supreme Court's decision in *Colony* that "omit" means "leave out," all support the conclusion that the absence of an item of income from tax returns is

the sole circumstance under which an amount is considered an "omission." Moreover, even if such item is omitted from the return, if there is adequate disclosure under 6501(e)(1)(A)(ii) to apprise the IRS of the nature and amount of such item, the amount of such item is not included in the "omission."

E. Recent Case Law Supports *Colony* And Holds That An Overstatement Of Basis Does Not Constitute An Omission Of Income

Several federal courts have recently considered the same issue presented in this case and have held that an overstatement of basis does not constitute the omission of income. The decisions are by the Court of Appeals for the Ninth Circuit, the Court of Appeals for the Federal Circuit, and the U.S. Tax Court.[1] All of these cases involve facts similar to those at issue in the instant case and were correctly decided.

In the Federal Circuit's decision in *Salman Ranch Ltd. v. United States, 573* F.3d 1362 (Fed. Cir. 2009), the partners of a partnership contributed a portion of their partnership interests to three new partnerships, causing a termination of the partnership for tax purposes because of the transfer of more than fifty (50) percent of the partnership interests. *See Salman Ranch,* 573 F.3d at 1364; I.R.C. Section 708(b)(1)(B). This in turn allowed the partnership to make an election under Section 754 to increase its basis in partnership assets (a ranch). *See Salman Ranch,* 573 F.3d at 1364; I.R.C. Sections 743(b)(1), 754. The partnership sold certain interests in the ranch and reported the gross proceeds from the sale of the ranch interests on its 1999 partnership tax return. *See Salman Ranch,* 573 F.3d at 1364-65. The IRS, however, disallowed

[1] *See Salman Ranch Ltd v. United States,* 573 F.3d 1362 (Fed. Cir. 2009); *Bakersfield Energy Partners v. Commissioner,* 568 F.3d 767 (9th Cir. 2009); *Grapevine Imports, Ltd v. United States,* 77 Fed. Cl. 505 (2007); *UTAM Ltd v. Commissioner,* T.C. Memo. 2009-253 (Nov. 9, 2009); *R & J Partners v. Commissioner,* No. 7166-06 (Tax Ct. Oct. 23, 2009); *SN LaGuardia Partners v. Commissioner,* No. 4906-07 (Tax. Ct. Sept. 4, 2009); *Gold Blossom Explorations, LLC v. Commissioner,* No. 13120-07 (Tax Ct. Sept. *3, 2009); Intermountain Insurance Service of Vail LLC v. Commissioner,* T.C. Memo. 2009-195 (Sept. 1, *2009); Beard v. Commissioner,* T.C. Memo. 2009-184 (Aug. 11, 2009); *M.I.T.A. Partners v. Commissioner,* No. 17832-07 (Tax Ct. Aug. 6, 2009); *Wilmington Partners, L.P. v. Commissioner,* No. 15098-06 (Apr. 30, 2008).

the partnership's increased basis for purposes of computing gain on the sale of the ranch interests. *Id.* at 1365.

In reaching its decision under Section 6501, the court in *Salman Ranch* rejected the lower court's conclusion that *Colony's* interpretation of "omits from gross income" in Section 275(c) should be limited to the sale of goods or services by a trade or business. *Id.* at 1372-73. The *Salman Ranch* court concluded that:

> In our view, ... the court's approach incorrectly reads into *Colony* what is not stated. After analyzing the language of Section 275(c) and the pertinent legislative history, the Court in *Colony* held that "omits from gross income an amount properly includible therein" does not include an overstatement of basis, as was alleged in the case of the taxpayer before it, and the Court did not say that its holding was limited to sales of goods or services by a trade or business. We are not prepared to conclude - based simply upon the Court's reference to ambiguity in Section 275(c) and the lack thereof in Section 6501(e)(1)(A) - that the Court's facially unqualified holding nevertheless carries with it a qualification.

Id. at 1373.

In addition, the court found that *Colony's* holding applies to the 1954 Code. The court determined that the definition of "omits" did not change with the enactment of the 1954 Code and furthermore the addition of Section 6501(e)(1)(A)(i)-(ii) did not change the fact that an overstatement of basis is not an omission from income. *Id.* at 1374-76. The court rejected the IRS's argument that use of the word "item" in Section 6501(e)(2), as opposed to "amount," required the court to alter its conclusion that an overstatement of basis is not an omission from gross income. *Id.* at 1376.

In the Ninth Circuit's decision in *Bakersfield Energy Partners* v. *Commissioner,* 568 F.3d 767 (9th Cir. 2009), the partners of a partnership sold their partnership interests to a limited liability company. *See Bakersfield,* 568 F.3d at 769. The sale of the partnership interests caused a termination of the partnership for tax purposes; and the partnership made an election under

Section 754 to increase its basis in partnership assets. *Id.* at 769-70; I.R.C. Sections 708(b)(1)(B), 743(b)(1), 754. The partnership then sold certain assets to a third party. *See Bakersfield,* 568 F.3d at 769. The sale of the assets and the basis adjustments were reported on the relevant returns. *Id.* at 769-70.

The IRS disallowed the partnership's basis adjustment for purposes of computing a gain on the sale of those assets. *Id.* at 770. The IRS argued that (i) *Colony's* holding is not binding with regards to Section 6501(e)(1)(A) because the language in it is materially different from Section 275(c), and (ii) alternatively, *Colony's* interpretation of Section 275(c) applies only in the case of a trade or business. *Id.* at 775, 777-78.

In rejecting the Government's first argument, the Ninth Circuit stated:

> Congress did not change the language in the body of Section 6501(e)(1)(A), which is identical to the language in Section 275(c) that the Supreme Court construed in *Colony.* As a general rule, we construe words in a new statute that are identical to words in a prior statute as having the same meaning. We therefore interpret Section 6501(e)(1)(A) in light of *Colony.*

Id. at 775-76 (internal citations omitted).

In rejecting the Government's second argument, the Ninth Circuit stated:

> There is no ground for suggesting that the *[Colony]* Court intended the same language in Section 275(c) to apply differently to taxpayers in a trade or business than to other taxpayers. The only mention of the phrase "trade or business" in *Colony* is in a quotation from Section 6501(e)(1)(A)(i). *See* 357 U.S. at 37 n.3. Under a fair reading of *Colony,* the Court provides a general construction of Section 275(c) that is not limited to any particular type of taxpayer.

Id. at 778. As a result, the court affirmed the Tax Court's holding on the grounds that an overstatement of basis cannot constitute an omission of gross income for the purposes of Section 6501(e)(1)(A). *Id.*

Following the Ninth Circuit's affirmation of the Tax Court's decision in *Bakersfield,* the Tax Court has decided several other cases involving the same issue in favor of taxpayers. *See UTAM Ltd.* v. *Commissioner,* T.C. Memo. 2009-253 (Nov. 9, 2009); *R & J Partners* v. *Commissioner,* No. 7166-06 (Tax Ct. Oct. 23, 2009); *SN LaGuardia Partners* v. *Commissioner,* No. 4906-07 (Tax. Ct. Sept. 4, 2009); *Gold Blossom Explorations, LLC* v. *Commissioner,* No. 13120-07 (Tax Ct. Sept. 3, 2009); *Intermountain Insurance Service of Vail LLC* v. *Commissioner,* T.C. Memo. 2009-195 (Sept. 1, 2009); *Beard* v. *Commissioner,* T.C. Memo. 2009-184 (Aug. 11, 2009; *M.I.T.A. Partners* v. *Commissioner,* No. 17832-07 (Tax Ct. Aug. 6, 2009); *Wilmington Partners, L.P.* v. *Commissioner,* No. 15098-06 (Apr. 30, 2008). In each of these cases, citing to *Bakersfield* and/or *Colony,* the Tax Court has held that the alleged overstatement of basis does not constitute an "omission" of income for purposes of Section 6501(e)(1)(A).

Thus, the Ninth Circuit, the Federal Circuit and the United States Tax Court all agree that, under the Supreme Court's holding in *Colony,* the overstatement of basis on the sale of an asset does not constitute an omission of gross income for purposes of the six (6) year statute of limitations under Section 6501. These courts properly recognize that the relevant language considered by the Supreme Court in *Colony* remains unchanged and that *Colony* therefore remains the law. There must still be an *omission* of income before the six (6) year statute of limitations can apply. If the overstatement of basis did not constitute an omission of income in *Colony,* it does not constitute an omission of income today.

F. Cases Relied Upon By Respondent

(i) *Brandon Ridge Partners* and *Home Concrete & Supply*

Prior to the issuance of the Court of Appeals and Federal Circuit opinions in *Bakersfield Energy* and *Salman Ranch*, there were two district court cases which concluded that an

overstatement of basis constituted an omission of gross income. *Brandon Ridge Partners v. United States*, 2007 WL 2209129 (M.D. Fla. 2007) and *Home Concrete & Supply, UC v. United States*, 599 F. Supp. 2d 678 (E.D. N.C. 2008).

The *Home Concrete* court concluded that by overstating basis, a taxpayer "leaves out" or "fails to include" an amount properly includable in gross income. *Home Concrete,* 599 F. Supp. 2d at 687. This conclusion is wrong because it fails to acknowledge that there must be an *omission* of gross income for the extended limitations period to apply. The district court's approach, like the IRS's argument in *Colony*, "touches lightly on the word 'omits' and bears down hard on the words 'gross income'", the approach the Supreme Court rejected in *Colony* as contrary to Congressional intent. *Colony,* 357 U.S. at 32.

The *Brandon Ridge* opinion made two errors. First, it held that the *Colony* test should be limited to situations described in Section 6501(e)(1)(A)(i), which applies a special definition of gross income in the case of the sale of goods or services in a trade or business. This provision merely provides a special definition of the term 'gross income' in the trade or business setting; it does not alter the fact that there must first be an omission of gross income before the six (6) year statute is implicated. Contrary to the *Brandon Ridge* court's suggestion, Section 6501(e)(1)(A)(i) does not overrule or limit the holding of *Colony*. The Ninth, Federal Circuits, and U.S. Tax Court have rejected this argument. Second, the *Brandon Ridge* court based its conclusion in part on the fact that the Congress used the term 'item' in Section 6501(e)(2), which provides a six year statute where a "taxpayer omits ... items includable in the gross estate or [the] total gifts," as opposed to the use of the term 'amount' in Section 6501(e)(1). 2007 WL 2209129 at 7. The *Brandon Ridge* court reasoned that this difference in terminology suggested that "the extended limitations period in Section 6501(e)(2) regarding estate and gift taxes only applies when an item

is completely left out, while the extended limitations period in Section 6501(e)(1) regarding income taxes applies both in cases where an item of income is completely left out and in situations where the amount of gross income is understated due to an error in calculation." *Id.*

The court in *Salman Ranch* considered and rejected this argument and held that, in its analysis of the statute, the Supreme Court in *Colony* did not attribute controlling significance to the use of the word "amount." *Salman Ranch*, 573 F.3d at 1376. The court noted that the legislative history examined in *Colony* included several references to instances where taxpayers left out 'items' from their tax returns. *Id*. Moreover, the court noted that *Colony*, in summarizing the Congressional purpose underlying the statute, stated: "[c]ongress manifested no broader purpose than to give the Commissioner an additional two years [now three years] to investigate tax returns where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors." *Salman Ranch*, 573 F.3d at 1376 (quoting *Colony*, 357 U.S. at 36).

Accordingly, the holdings of the district courts in *Home Concrete* and *Brandon Ridge* are incorrect and contrary the Supreme Court's decision in *Colony*, the Ninth Circuit, the Federal Circuit and the United States Tax Court. The core language of former Section 275(c) construed by *Colony* in 1958 is virtually identical to the language in current Section 6501(e)(1)(A). An overstatement of basis did not constitute an omission of income in *Colony* or the other cases cited herein, and it should not constitute an omission of gross income in the instant case.

(ii) *Phinney* Case

The IRS allocates a large portion of its brief to *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968). One reason for the great amount of attention to this case is that almost all other cases decided on this issue have ruled against the IRS. Nevertheless, *Phinney* should be addressed.

The *Phinney* Court did not hold that the overstatement of basis would trigger the six (6) year statute of limitations. Rather, the Fifth Circuit held that the extended six (6) year limitations period applied to a transaction where the taxpayer grossly misreported the very nature of the income item at issue.

At issue in *Phinney* was whether the six (6) year statute of limitations applied to an assessment where the taxpayer misrepresented in several respects the nature of the payments at issue on her return. *See Phinney,* 392 F.2d at 681-84. Prior to the death of the taxpayer's husband (Mr. Dunbar Chambers), taxpayer and her husband sold stock in property they held as community property. *Id.* at 681. The stock was sold in 1954 with part of the consideration evidenced by a promissory note. *Id.* Mr. Chambers died in 1956. *Id.* The balance of the note was paid in full in 1958. *Id.* at 681-82.

For the 1958 tax year, Mr. Chambers' executor filed a U.S. fiduciary income tax return as executor of Mr. Chambers' estate in which it properly reported Mr. Chambers' one-half community property interest in the payments received on the promissory note using the installment sales method. *Id.* at 682. Gain from the sale was reported on Mr. Chambers' return under the designation of an "installment sale" as follows:

Sale of High Point Realty Stock	
Amount collected -fiscal year ended 9-30-58	$378,736.07
Times Percent of gross profit	84.07468%
Gain to be reported:	$318,904.79

Id.

The executor also prepared Mrs. Chambers' federal income tax return on the same day. *Id.* The return preparer believed Mrs. Chambers was entitled to a "step up" in basis on the note. *Id.* In claiming the increase in basis, the return preparer significantly misreported the note payments in the following manner:

Descr.	Acquired	Sold	Price	Basis	GAIN OR LOSS
High Point Realty Stock	10-27-56	1958	$375,736.06	$375,736.06	-0-

Id.

After the three (3) year statute of limitations had expired, the IRS made an assessment of tax against Mrs. Chambers disallowing her basis increase. *Id.* at 683. The taxpayer argued that the IRS adjustment was barred by the statute of limitations. *Id.* Citing *Colony,* she argued further that, because the full amount of payments were reported on her return, the six (6) year statute of limitations did not apply. *Id.* at 683-84.

Clearly troubled by the misreporting of the note payments on Mrs. Chambers' return, the court said the following:

> The basic difficulty with the taxpayer's position here is that taxpayer simply didn't give the government a chance to make a 'challenge' to the taxpayer's contention, because the taxpayer made no such contention on the return it filed. Although it fairly and simply reported on Mr. Dunbar Chambers' return that he had received a final payment on the installment note of which some 84% represented gain when his return was filed on March 13, 1959, it, for some reason that is not apparent, reported the income received as 'trustee' for Mrs. Chambers in precisely the same amount under a *different* heading and under an *incorrect designation as of the sale of stock* acquired on 10-27-56 and sold in '1958.' In point of fact, neither the trustee for Mrs. Chambers or Mrs. Chambers personally owned any High Point Realty Stock at the time after the sale to Mr. Sharpe in 1954. There was no sale of stock by the trustee either acting for Mrs. Chambers or as executor of the estate of her husband.

Id. at 684 (emphasis added). Thus, the court was clearly offended by the factual misrepresentations made by the taxpayer on her return. The court suggested that if the note payments had been properly identified, the IRS would have timely made its adjustments. *Id.* at 685. The court noted that, at the time the returns were filed, the IRS was challenging a similar claim involving a step up in basis in another case. *Id.* at 684-85 (citing *Bath* v. *United States,*

211 F. Supp. 368 (S.D. Tex. 1963)). The court found it hard to believe that the IRS would have ignored the transaction on this return if it had been properly reported when it was litigating the same issue in another case. *Id.* at 685.

The court also elaborated on the knowledge and sophistication of the return preparer, suggesting that the court may have viewed the misreporting as a deliberate attempt to avoid IRS detection. Said the court:

> It seems worth commenting on that here 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. We have, instead, a return filed for the taxpayer by the same accounting firm that had handled the taxpayer's return before Mr. Chambers' death and whose client has now alleged in its brief before us in this case that taxpayer was fully aware of the tax effects of the death of one of a community on the remaining member's ownership of a community interest in an installment note.

Id. at 685-86.

Faced with the significant factual misrepresentations of the transaction at issue, and the apparent deliberateness of the misreporting, the *Phinney* Court concluded that an omission existed for purposes of the six (6) year statute of limitations. The court held that the enactment of subsection (ii) of Section 6501(e)(l)(A) makes it apparent that the six (6) year statute is "intended to apply where there is either a complete omission of an item of income of the requisite amount or *misstating of the nature of an item of income* which places the 'commissioner ... at a special disadvantage in detecting errors.'" *Id.* at 685 (emphasis added).

Notably, *Phinney* did not involve a situation where the only reason for the IRS adjustment is due to a disagreement as to how basis should be computed or determined. The taxpayer in *Phinney* misrepresented the entire nature of the item of income at issue *(i.e.,* the promissory note payments). Mrs. Chambers identified the note payments as payments from the

sale of stock in the current year rather than as payments received under an installment note. She also reported the stock that triggered the installment note payments as having been acquired on October 27, 1956, the date of Mr. Chambers' death, when in fact neither she nor Mr. Chambers owned the stock on that date. Her return identified the sales price of the stock at $375,736.06 when in fact the stock was sold several years earlier at an entirely different price. Her return stated that the stock was sold in 1958, when in fact the stock was sold four years earlier in 1954. Her return also stated that the stock was acquired as "trustee" for Mrs. Chambers when in fact that was simply not true. Thus the entire nature of the promissory note payments received in 1958 was grossly misreported, mislabeled, and mischaracterized.

In three recent decisions, the Tax Court has rejected the IRS's argument that *Phinney* stands for the proposition that the overstatement of basis constitutes the omission of income. *See UTAM, Ltd.* v. *Commissioner,* T.C.Memo. 2009-253 *(2009); R & J Partners* v. *Commissioner,* Order & Decision, No. 7166-06 (Tax Ct. Oct. 23, *2009); M.I.T.A. Partners* v. *Commissioner,* Order & Decision, No. 17832-07 (Aug. 6, 2009).

In one of these cases, the Tax Court held that "nothing in *Phinney* indicates that the Supreme Court's opinion in *Colony, Inc.* was limited to sales of goods or services or was rendered obsolete in its reasoning by the language of Section 6501 that was not in effect for the year before the Supreme Court." *See M.I.T.A. Partners,* Order & Decision, No. 17832-07. In the two other cases, the Tax Court determined that *Phinney's* holding was not controlling because *Phinney* involved a situation where the taxpayer misstated the nature of the income at issue. In *R & J Partners,* for example, the court held:

> We conclude that *Phinney v. Chambers* is not controlling. The *Phinney* court found that the 6-year statute of limitations applied to the taxpayer because she misstated the nature of that item of income. Unlike *Phinney,* petitioner's disclosure contains no misstatement of the nature of items of

> income that would place respondent "at a special disadvantage in detecting errors." The Commissioner could not identify the transaction in issue in *Phinney* because the taxpayer completely omitted the installment sale income from the return. Here, there is no improper labeling or misidentification. The partnership completely reported the transaction including the gross receipts, the cost or basis, and the net gain. The partnership also notified respondent that a section 754 election had been made. These disclosures did not mislead respondent or place him at a special disadvantage in detecting the error he alleges occurred. As a result, *Phinney* does not persuade this Court to overrule *Bakersfield* or to read any other limitations into *Colony.*

R & J Partners, Order & Decision, No. 7166-06.

Any reliance on *Phinney* in this case is likewise misplaced. The IRS's argument that, under *Phinney,* the overstatement of basis may result in the omission of income misreads the court's holding. In *Phinney,* it was the taxpayer's gross misreporting of the income at issue that resulted in an omission of that income. The overstatement of basis did not factor into the court's conclusion. In the instant case, the Taxpayers properly reported the sale of their stock. (Doc. 22). It was reported on the correct return as a stock sale, with the correct sales date, by the correct parties, and with the correct sales amount. *See Id.* Moreover, the gross receipts from the sales were fully disclosed. *See Id.* Thus, *Colony* and not *Phinney* controls the outcome of this case.

II. The IRS's Recently Issued Regulations Do Not Open Up The Statute Of Limitations In This Case, And Have No Other Application In This Case

Following a significant number of losses in other cases, on September 24, 2009, the IRS issued self-serving Regulations that purport to "resolve a continuing issue as to whether an overstatement of basis in a sold asset results in an omission from gross income." T.D. 9466, 74 Fed. Reg. 49321-01 (Sept. 28, 2009). The Regulations state that "except as provided in paragraph (a)(1)(ii) [dealing with gross income from a trade or business] . . . , an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis

constitutes an omission from gross income for purposes of Section 650l(e)(1)(A). "A similar change is made under Section 6229, which provides a limitations period for partnerships. *See Treas. Reg.* Section 301.6229(c)(2)-1T (Sept. 24, 2009).

The IRS is attempting to bootstrap their litigating position after consistently losing these cases across the country and across the courts. Aside from the inherent unfairness of a system that would permit this, the Regulations very clearly do not compel a decision in favor of the IRS for a number of reasons. Thus, under no circumstances do the Regulations compel a decision in favor of the IRS. First, the United States Tax Court, on May 6, 2010 (decided approximately two (2) months before the filing of this brief) held the Regulations invalid. Second, the Regulations do not apply because the effective date language in the Regulations makes clear that they do not apply in this case. Third, the Regulations cannot be applied retroactively in a manner that would open a statute of limitations period that has already closed. Fourth, the Regulations are invalid because they adopt a statutory interpretation that directly undermines Congressional intent. Fifth, the Regulations are invalid because they fail to adhere to the notice-and-comments requirement of the Administration Procedure Act.

A. The May 6, 2010 *Intermountain* Case Supports The Taxpayer's Position That The Regulations Have No Effect On The Instant Case

On May 6, 2010, the Tax Court, in a unanimous opinion[2], with divided rationales, denied motions to reconsider and vacate its prior decision that held that a final partnership administrative adjustment was untimely because a basis overstatement didn't trigger the six (6) year statute of limitations and rejected the retroactive application of the Regulations. *Intermountain Insurance Service of Vail, LLC v. Commissioner*, 134 T.C. No. 11 (May 6, 2010). The IRS, in its Brief For The Appellant in the instant case, argues that the nine (9) Tax Court

[2] Thirteen (13) Tax Court Judges participated in the decision. Nine (9) judges held that the Regulations were invalid. The other four (4) judges did not participate in the decision. There was no descent.

Judges that contributed to the opinion, who all held for the taxpayer and against the IRS's use of the retroactive Regulations, were all wrong.

In *Intermountain*, the IRS made an untimely motion to vacate and reconsider the case in light of the Regulations. The IRS argued that the Regulations were made effective to any tax year that was open as of its effective date of September 24, 2009. Because the Regulations provide that an overstatement of basis constitutes an omission from gross income, the IRS argued that it should apply in *Intermountain* to extend the statute of limitations for assessment. The majority rejected this argument, finding it "irreparably marred by circular, result-driven logic and the wishful notion that the temporary regulations should apply to this case because Intermountain was involved in what he believes was an abusive tax transaction."

The majority then rejected the IRS's claim that the regulations were entitled to deference as an agency interpretation of an ambiguous statute because, "They face a formidable obstacle to deference-- *The Colony v. Commissioner*, 257 U.S. 28 (1958)." The Tax Court held that even if *Chevron* applied to the temporary regulations, the majority of circuits have applied traditional rules of statutory construction to determine whether a statute is unambiguous, including a review of legislative history. The majority determined that the Supreme Court found that the legislative history added clarity to the ambiguous text of the statute. Therefore, the Tax Court held that, "…[t]he Supreme Court's opinion in *Colony Inc. v. Commissioner*…unambiguously forecloses the agency's interpretation of Sections 6229(c)(2) and 6501(e)(1)(A) and displaces respondent's temporary regulations." Therefore, the majority held the Regulations to be invalid and not entitled to judicial deference.

In a concurring opinion, Judge Cohen stated that the court should have denied the IRS's motions on the ground that they were untimely. In a second concurring opinion, Judge Halpern

and Judge Holmes held that the Regulations were invalid because they were issued in violation of the Administrative Procedures Act.

B. The Regulations Do Not Apply Because The 1999 Tax Year Was Closed When The Regulations Took Effect.

The Regulations state that they only apply to "taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." The Regulations also include no statement saying that they apply retroactively. This should end the Court's inquiry. Under *Colony,* the statute of limitations was closed at the time the Regulations were issued. Thus, the Regulations have no application to the facts of this case.

The IRS argues that the Regulations have the effect of making the proposed assessment timely even if under prior law they were barred by the statute of limitations. The only way the Regulations could apply in this manner is if the effective date provision is applied by first taking into account other provisions of the Regulations. This extreme interpretation of the Regulations' effective date language, if upheld, would undermine judicial precedent, fly in the face of the whole concept of having an "effective date" provision, and have the extraordinary effect of reopening a year previously barred by the statute of limitations, which is legally prohibited.

(i) Applying The Effective Date Provision Before Taking Into Account Other Provisions Of The Regulations Comports With Judicial Precedent And Gives Meaning To The Concept Of An Effective Date.

The law makes clear that the timeliness of a Notice of Deficiency is determined *on the date the IRS mails it. Albert J. Petrulis, D.D.S., S.C. v. Commissioner,* 938 F.2d 78, 90 (7th Cir. 1991). If the effective date provision in the Regulations is applied by first taking into account other provisions in the Regulations, the timeliness of the Notice of Deficiency would be determined on the date the Regulations were issued, rather than on the date the Notice of Deficiency was mailed. This would mean that for over three years, the timeliness of the Notice

of Deficiency would remain uncertain.[3] This is clearly contrary to the notion that the timeliness of a Notice of Deficiency is determined on the date it is mailed. On the other hand, by applying the effective date language without first incorporating other portions of the Regulations, the Court will avoid this absurd result and preserve the longstanding rule that the timeliness of a Notice of Deficiency is determined when it is mailed.

This approach also gives meaning to the generally accepted definition of the term "effective date." Black's Law Dictionary (9th ed.) defines *effective date* as "[t]he date on which a statute, contract, insurance policy, or other such instrument becomes BLACK'S LAW DICTIONARY 592 (9th ed. 2009) (emphasis added). Applying this definition, the new Regulations became enforceable on September 24, 2009. If this Court initially applies the other provisions of the regulations before applying the effective-date provision, it would be applying *unenforceable* regulations so as to make them *enforceable.* This circular method of construing an effective date provision nullifies the whole point of having an effective date.

(ii) Applying The Effective Date First Also Avoids Reopening a Previously Closed Tax Year, Which Would Be Legally Prohibited.

The Taxpayer's interpretation avoids the extraordinary effect of reopening a tax year previously barred by the statute of limitations, which is legally prohibited. Federal Courts have demonstrated a strong reluctance to applying a statute or regulation in a manner that would open a previously closed year or revive a previously barred claim. This is particularly the case where, as here, the statute or regulation at issue does not specifically require retroactive application.

The Supreme Court in *Hughes Aircraft Co.* v. *United States,* 520 U.S. 939 (1997), held that an amendment to the jurisdictional provisions of the False Claims Act could not be applied

[3] The IRS mailed the Notice of Deficiency on April, 13, 2006. (Doc. 1, Ex. A). The Regulations were not issued until September 24, 2009, more than three (3) years after the Notice of Deficiency was issued.

retroactively to conduct occurring before its effective date. In so holding, the Supreme Court stated:

> We have frequently noted, and just recently reaffirmed, that there is a "presumption against retroactive legislation [that] is deeply rooted in our jurisprudence." ... "The 'principle that the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal appeal.'" ... Accordingly, we apply this time-honored presumption unless Congress has clearly manifested its intent to the contrary.

Hughes Aircraft, 520 U.S. at 946 (internal citations omitted).

In its holding, the Supreme Court in *Hughes Aircraft* made an analogy to reviving a closed statute of limitations, citing with approval a Ninth Circuit case which relied on another Supreme Court case, *Landgraf v. USI Film Prods.,* 511 U.S. 244 (1994), for this point:

> The 1986 amendment would revive that action, subjecting Hughes to previously foreclosed *qui tam* litigation, much like extending a statute of limitations after the pre-existing period of limitations has expired impermissibly revives a moribund cause of action, *see, e.g., Chenault* v. *US. Postal Service,* 37 F.3d 535, 537, 539 (9th Cir. 1994) (relying on *Landgrafin* concluding that newly enacted statute that lengthens the applicable statute of limitations may not be applied retroactively to revive a plaintiffs claim that was otherwise barred under the old statutory scheme because to do so would alter the substantive rights of a party and increase a party's liability" (internal quotation marks omitted)).

Id. at 950; *see also Lieberman* v. *Cambridge Partners, LLC,* 432 F.3d 482 (3d Cir. 2006) (applying *Hughes* to hold that securities claim that expired prior to Sarbanes-Oxley was not revived by such legislation).

In *Margolies* v. *Deason,* 464 F. 3d 547 (5th Cir. 2006), the Fifth Circuit relied on *Hughes Aircraft* and *Landgraf* to hold that a statute of limitations could not be applied retroactively to revive an expired claim. In *Margolies,* the plaintiffs alleged federal securities law violations on the part of persons who acquired stock from the plaintiffs on March 19, 1998. *See Id.* at 549. According to the law existing at the time of the stock sale, the plaintiffs were required to bring

their securities actions within three years following such sale. *See Id.* at 550. Congress, however, passed the Sarbanes-Oxley Act of 2002 (the "SOA") on July 30, 2002, which provided that certain securities claims could be brought no later than the earlier of: (i) two years after the discovery of the facts constituting the violation; or (ii) five years after the violation. *See Id.*

The plaintiffs filed their complaint on March 17, 2003, after their claims had expired under the pre-SOA limitations period, but before their claims would have expired under the new SOA limitations period. *See Id.* at 549-550. Plaintiffs argued that the extended period for bringing securities claims under the SOA made their claims timely. *See Id.* at 550. The district court dismissed the claim as time-barred and the Fifth Circuit affirmed on appeal. *See Id.* at 549.

Citing to Supreme Court precedent, the Fifth Circuit applied a two part test in determining if SOA would render the plaintiffs claim timely. The first part of the test asked "whether Congress has expressly prescribed the statute's proper reach." *Id.* at 552 (quoting *Landgraf,* 511U.S.at 280). If Congress had not expressly prescribed the statute's proper reach, the second question the court should ask is whether the statute would have a "retroactive effect." *See Id.* at 552. If the statute would have retroactive effect, the presumption was that it cannot be applied retroactively absent clear congressional intent. *See Id.* at 552 (quoting *Landgraf,* 511 U.S. at 280). After concluding that neither the language of the statute nor its legislative history indicated a clear intent to apply the statute retroactively, the Fifth Circuit Court held that a statute of limitations could not be applied retroactively to revive an expired claim:

> It is clear that [the SOA's] effect would be retroactive. The fact that the [SOA] would permit a cause of action on July 31, 2002 [post-SOA], that was definitively time-barred on July 29, 2002 [pre-SOA], indicates a retroactive effect if applied as such. The presumption against retroactive legislation therefore indicates that the previous three-year period applies. Accordingly, the district court properly dismissed the first and second causes of action as time-barred.

Id. at 553 (citing *Hughes Aircraft,* 520 U.S. at 950) (internal citations omitted).

In addition to statutes, courts have held that regulations cannot be applied retroactively unless the regulations themselves specifically provide for such application. *In Diller v. Commissioner,* 133 F.3d 909 (Table), 80 A.F.T.R.2d 97-8284 (3d Cir. 1997), the Third Circuit affirmed the Tax Court's dismissal of a taxpayer's petition challenging IRS proposed adjustments because the Tax Court received the petition after the ninety (90) day period for filing a petition. The Tax Court dismissed the petition as untimely, because the taxpayer mailed the petition with a courier that, at that time, was not a "designated delivery service" for purposes of the timely-mailed, timely-filed. *See Id.* at 97-8285. While the taxpayer was appealing the Tax Court's decision, the IRS issued a notice identifying the courier as a "designated delivery service." *See Id.* Although the IRS notice was issued after the taxpayer filed his petition, the taxpayer argued that the Third Circuit should apply the notice to his case. *See Id.* The Third Circuit refused, finding "no legal basis for applying the Secretary's nonretroactive rule to [the taxpayer's] case." *See id.* at 97-8286.

In the present case, this Court faces an issue very similar to the issue faced in both *Diller* and *Margolies.* The IRS is asking the Court to apply the Regulations in a manner that would make the 1999 Notice of Deficiency timely even though at the time the Regulations were issued the Notice of Deficiency was barred by the statute of limitations. The Court should reject this approach because the Regulations on their face make no mention of retroactive application and doing so would have the extraordinary effect of opening a previously closed year.

If the Regulations did provide for retroactive application, they would fail as an abuse of discretion. *See Snap-Drape* v. *Inc.* v. *Commissioner,* 98 F.3d 194, 197 (5th Cir. 1984). The Regulations seek to reopen a tax year that has been closed for several years by overruling a

Supreme Court decision that has remained untouched for over fifty (50) years. There should be no doubt that this is an abuse of discretion.

C. The Regulations Embody An Unreasonable Interpretation Of A Statute And Are Therefore Invalid.

The Regulations are also invalid. The IRS has limited authority in some instances to issue regulations construing a federal statute that does not conform to case law. That authority does not, however, extend to the Regulations in this case because: (i) the Supreme Court in *Colony* concluded that Congress did not intend for the overstatement of basis to constitute an omission of gross income; (ii) the Regulations are directly contrary to that Congressional intent; and (iii) the Regulations reflect nothing more than the IRS's litigating position, which is not entitled to any deference.

(i) The Regulations Are Invalid Because They Are Directly Contrary To Congressional Intent, As Determined By The Supreme Court In *Colony.*

Treasury regulations promulgated pursuant to the general delegation under Section 7805(a) are considered interpretive regulations entitled to the lesser reasonableness standard of judicial deference. *See United States* v. *Vogel Fertilizer Co.,* 455 U.S. 16, 24 (1982). The Regulations issued under Section 6501 were promulgated pursuant to the Treasury's authority under Section 7805(a) since there is no specific Congressional direction for issuing regulations under Section 6501(e)(1)(A).

The preamble to the Regulations cites to the Supreme Court's holding in *National Cable & Telecommunications Assoc.* v. *Brand X Internet Services,* 545 U.S. 967, 982 (2005) as providing judicial authority for the Regulations. *See* T.D.9466, 74 Fed. Reg. 49321-01 (Sept. 28, 2009). The preamble states that the Regulations are entitled to deference even though they may

run contrary to the Ninth Circuit's decision in *Bakersfield* and the Federal Circuit's decision in *Salman Ranch. See id.* However, neither *Brand X* nor any of the cases cited therein give the IRS authority to issue regulations that directly contradict Congressional intent.

In *Brand X,* the Supreme Court reviewed a declaratory ruling of the Federal Communications Commission ("FCC") that classified broad band Internet service provided by cable companies as an "information service" and not a "telecommunications service" and thereby made them exempt from mandatory common carrier regulations. *See Id.* at 977-78. The Ninth Circuit Court of Appeals had overruled the FCC's ruling on the basis of its prior holding in *AT&T Corp.* v. *Portland,* 216 F.3d 871 (9th Cir. 2000) wherein the Ninth Circuit concluded that cable modem service was a “telecommunication service." *See Id.* at 979-80.

The Supreme Court in *Brand X* cited extensively to its prior holding in *Chevron* as providing the applicable standard for reviewing an agency's statutory interpretation. At issue in *Chevron* was whether a regulation issued by the Environmental Protection Agency was based on a reasonable construction of the statute. *See Chevron,* 467 U.S. at 840. The regulation permitted states to treat all pollution-emitting devices within the same industrial grouping as though they were encased within a single "bubble" for purposes of issuing permits under the Clear Air Act Amendments of 1977. *See Id.*

The *Chevron* Court stated that when a court reviews an agency's construction of a statute which it administers, it is confronted with two questions. *See Id.* at 842-43. The first is whether Congress has directly spoken to the precise question at issue. According to the Supreme Court, "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *See Id.* The Supreme Court also noted that "[t]he judiciary is the final authority on issues of statutory

construction and must reject administrative constructions that are contrary to clear congressional intent." *Id.* at 843 n.9. *See also Bankers Life and Casualty Company v. United States*, 142 F.3d 973, 980 (7th Cir. 1998) *citing to Pennington v. Didrickson*, 22 F.3d 1376 (7th Cir. 1994) and *Bell Federal Savings & Loan Ass'n v. Commissioner*, 40 F.3d 224, 226 (7th Cir. 1994) (This Court stated that a Regulation must be consistent with legislative intent). Second, if the court determines that the statute is silent or ambiguous with respect to the specific issue, "the question for the court is whether the agency's answer is based on a permissible construction of the statute." *See Chevron*, 467 U.S. at 840-843.

In applying this two part test, the *Chevron* Court first examined the language of the statute and determined that its language was not dispositive. *See Id.* at 859-62. The statutory terms were overlapping and the language was not precisely directed to the question of the applicability of given term in the context of a larger operation. *See Id.* at 862. The Supreme Court also looked closely at the legislative history of the statutory provision at issue and concluded that the legislative history was silent on the precise issue before the Supreme Court. *See Id.* at 851-53. The Supreme Court noted, however, that the regulation was consistent with one of the policy concerns identified in the legislative history -the allowance of reasonable economic growth. *See Id.* at 862-63. Ultimately, the Supreme Court determined that the EPA regulations at issue reflected a reasonable interpretation of the statute. *See Id.* at 865.

In the context of evaluating the reasonableness of IRS regulations, the Supreme Court's prior holding in *National Muffler Dealers Association, Inc.* v. *United States,* 440 U.S. 472 (1979), is also instructive. The Supreme Court has repeatedly and consistently held in the federal income tax law realm that the reasonableness of an agency interpretation of the Code is

determined using the multi-factor analysis espoused by *National Muffler.*[4] *National Muffler* involved the issue of whether a trade organization consisting of muffler dealers qualified as a "business league" entitled to exempt status for federal income tax purposes under Section 501(c)(6) of the Code. *See Id.* at 473. Citing to its regulations, the IRS concluded that the organization did not for exempt status because it was not an "industry wide" organization. *See id* at 474.

The Supreme Court stated that it would customarily defer to a regulation if it implements "congressional mandate in some reasonable manner." *Id.* at 476. The Supreme Court also stated that in determining whether a particular regulation carries out the Congressional mandate in some reasonable manner it would "look to see whether the regulation harmonizes with the plain language of the statute, its origin and its purpose." *Id* at 477. The Supreme Court further noted that a regulation may have particular force if it reflects a "substantially contemporaneous construction of the statue by those presumed to have been aware of congressional intent." *Id.* "If a regulation dates from a later period, the manner in which it evolved merits inquiry." *Id.* The Supreme Court also held that other considerations relevant to its analysis of an agency's interpretation are "the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute." *Id.*

Much like the Supreme Court did later in *Chevron,* the *National Muffler* Supreme Court carefully considered the applicable legislative history, including testimony presented to the

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[4] *See Boeing Co. v. United States,* 537 U.S. 437, 448 (2003 (citing to *Cottage Savings,* which applied *National Muffler*); *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001); *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991); *Rowan Cos. V. United States*, 452 U.S. 247 (1981). The Supreme Court has continued to consider the *National Muffler* factors following the Court's decisions in *Chevron. See Cottage Savings*, 449 U.S. at 560; *Cleveland Indians Baseball*, 532 U.S. at 219; *Boeing*, 537 U.S. at 448; *see also Nalle v. Comm'r*, 997 F.2d 1134, 1136 (5th Cir. 1993).

Senate Finance Committee. *See Id.* at 478-79. Ultimately, the Supreme Court upheld the IRS's reading of the statute because, although it was not the only possible interpretation, it bore a fair relationship to the language of the statute, it reflected the views of those who sought its enactment, and it matched the purpose they articulated. *See Id.* at 484.

The Supreme Court's analyses in *Chevron* and *National Muffler* make clear that Congressional intent takes precedent over any contrary agency interpretation. *Chevron* specifically holds that "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron,* 467 U.S. at 842-43. In determining the reasonableness of an IRS Regulation, *National Muffler* makes this point clear also by focusing its inquiry on whether the agency construction implements the *"congressional mandate* in some reasonable manner" and "whether the regulation harmonizes with the plain language of the statute, its *origin and its purpose."* *National Muffler,* 440 U.S. at 477 (emphasis added). Both cases examined the legislative history in determining if Congressional intent was clear and whether the agency rule at issue was consistent with the Congressional intent and purpose.

In this case, the Regulations fail. In addition to failing to implement Congressional intent as identified by the Supreme Court in *Colony,* they directly contradict it.

The Supreme Court in *Colony* held that the overstatement of basis does not constitute an omission of income under Section 275(c). Much like the Supreme Court did in *Chevron* and *National Muffler,* the *Colony* Court looked closely at the legislative history to determine Congressional intent. On the basis of committee reports and committee testimony, the Supreme Court concluded that the legislative history provides "persuasive evidence that Congress was addressing itself to the specific situation where a taxpayer actually *omitted some income receipt*

or accrual in his computation of gross income, and not more generally to errors in that computation arising from other causes." *Id.* at 33 (emphasis added). The Supreme Court therefore concluded that the taxpayer's overstated basis did not constitute an omission of income. *See Id.* at 38.

Notably, the Supreme Court in *Colony* did not base its decision on the "best reading" of the statute as did the lower court in *Brand X.* Nor did it conclude that, in light of Congressional intent, the statute could be read in more than one manner. Rather, the Supreme Court determined that its conclusion reflected the intent of Congress. Moreover, the Supreme Court did not express any uncertainty or ambiguity in the Congressional intent following its consideration of the legislative history. Instead, the Supreme Court unequivocally concluded, "this [legislative] history shows to our satisfaction that the Congress intended an exception to the usual three-year statute of limitations only in the restricted type of situation already described." *Id.* at 36. The Supreme Court's confidence is further manifested in its observation that its conclusion was "in harmony" with the *unambiguous* statutory language of Section 6501(e)(1)(A). *See Id.* (emphasis added).

The relevant language in the current version of Section 6501 is virtually identical to the language considered by the Supreme Court in *Colony.* The Ninth Circuit in *Bakersfield* observed, "[o]ther than replacing the five (5) year period with a six (6) year period, and 'per centum' with 'percent,' [the] language in the 1939 Code is identical to the language in the body of the current provision, 26 U.S.C. Section 6501(e)(1)(A)." *Bakersfield,* 568 F.3d 767,771. In addition, Congress has amended Section 6501(e)(1)(A) twice since *Colony* was decided,[5] and has

[5] The current language of Section 6501(e)(I)(A) is the same as it existed when *Colony* was decided, except: (ii) the heading of the current version refers to a "Substantial omission of items," as opposed to an "Omission from gross income," *see* P.L. 89-44, Section 810(b)(2) (1965); and (ii) the term "Secretary or his delegate" was replaced with "Secretary" in Section 6501(e)(1)(A)(ii), *see* P.L. 94-455, Section 1906(b)(13)(A) (1976).

also enacted 41 Public Laws amending Section 6501 since then. *See* 26 U.S.C.A. Section 6501 (historical notes). Congress has never changed the language that served as the basis for the Supreme Court's holding in *Colony* regarding Congressional intent. Thus, *Colony's* conclusions regarding Congressional intent still apply today. *See Bakersfield,* 568 F.3d 776 (noting that Congress "could have expressly added a definition of 'omits' if it wanted to overrule the cases that concluded, as the Supreme Court later did in *Colony,* that 'omits' did not include an overstatement of basis.")

In short, rather than supporting the Regulations, *Brand X* and the case it relies on, *Chevron,* make clear that the Regulations are invalid. First, the Supreme Court in *Colony* specifically and unequivocally determined what the Congressional intent was in enacting Section 275(c) (now Section 6501(e)(1)(A)) with respect to the issue addressed in the Regulations *(i.e.,* whether the overstatement of basis constitutes an omission of gross income). With Congressional intent firmly established on this issue, there is no room for agency interpretation.

In addition, the Regulations are directly contrary to that Congressional intent. Rather than giving effect to Congressional intent, the Regulations directly contradict it. The Taxpayer is not aware of any Supreme Court case that would permit an agency charged with administering a statute to deliberately and blatantly contradict clear Congressional intent. That is precisely what the Regulations do in this case. That makes them invalid. No matter how much deference to which the IRS believes it may be entitled, federal law does not permit the IRS to use the regulatory process to blatantly undermine Congressional intent as it has done in this case.

(ii) The Manner In Which The Regulations Evolved Indicates That The Regulations Are Not Impartial Or Deliberative And Are Therefore Entitled To No Deference.

The Supreme Court has made clear that if a regulation is not contemporaneous with the related statute, the manner in which the regulation evolved is a factor properly considered by the

court in determining reasonableness. *See National Muffler,* 440 U.S. at 477. This Court also made it clear in *Bankers Life and Casualty Company* that "[t]he weight given to an agency interpretation depends on many factors, including the validity of its reasoning, its consistency with earlier and later agency pronouncements and *whether the administrative documents was issued contemporaneously with the passage of the statute."* 142 F.3d 973 at 979-980 *citing Doe v. Reivitz*, 830 F.2d 1441, 1447 (7th Cir. 1987), amended, 842 F.2d 194 (7th Cir. 1988). The Regulations were promulgated more than fifty years after Congress enacted Section 6501(e)(1)(A) as part of the 1954 Code and therefore are obviously not contemporaneous. As a result, examination of the manner in which the Regulations evolved is appropriate in determining their reasonableness.

The Supreme Court's judicial deference decisions have emphasized multiple times the importance of the deliberativeness and impartiality exercised by government agencies in promulgating regulations. For example, in *Chevron,* the Supreme Court noted there that the agency interpretation represented a reasonable accommodation of manifestly competing interests, the agency considered the matter in a detailed and reasoned fashion, and the agency's decision involved reconciling conflicting policies. *See Chevron,* 467 U.S. at 865.

The Supreme Court's more recent holding in *United States* v. *Mead* likewise emphasized the significance of impartiality and deliberateness of agency rulemaking. 533 U.S. 220 (2001). The issue in *Mead* was whether certain tariff classification rulings issued by the U.S. Customs Services were entitled to judicial deference. *See Id.* at 221. The Supreme Court observed that when Congress has left a gap for an agency to fill, there is an express delegation of authority for the agency to issue interpretive regulations. *See Id.* at 227. Regulations issued under such delegation of authority, according to the Supreme Court, are generally binding on the courts

unless procedurally defective, arbitrary or capricious in substance or manifestly contrary to the statute. *See Id.*

In considering the existence of Congressional delegation, the *Mead* Court stated, "It is fair to assume generally that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force." *See Id.* at 230. The Supreme Court stated that the overwhelming number of cases applying *Chevron* deference have dealt with agency interpretations that were the product of notice-and-comment rulemaking or formal adjudication. *See Id.* The Supreme Court in *Mead* described the use of notice-and comment procedure as "significant ... in pointing to *Chevron* authority," although the court noted that the lack of notice-and-comment procedure does not necessarily, by itself, resolve the issue of whether regulations are entitled to *Chevron* deference. *See Id.* at 230-31.

Ultimately, *Mead* held that the tariff classification rulings were not entitled to *Chevron* deference because they were not issued pursuant to a Congressional delegation of authority. In support of its holding, the Supreme Court also noted that the ruling was not issued pursuant to notice-and-comment procedures and were binding only with respect to the importer to whom it was issued. *See Id.* at 232.

This Court recognized the weight an administrative regulation should be given without a notice-and-comment procedure in its decision in *Bankers Life*. 142 F.3d 973). This Court also addressed the same issue in *Kikalos v. Commisioner*, 190 F.3d 791 (7th Cir. 1999). The IRS would like the Court to believe that this Court held that great deference should be given to all agency regulations. However, the IRS is mistaken. This Court, in *Bankers Life*, determined that the agency regulation in that case was entitled to a certain level of deference because it went

through the formal notice-and-comment procedures. *Id.* at 983 (…we owe full *Chevron* deference to a regulation issued with the full *deliberative process* [referring to the notice-and-comment procedures].” (emphasis added). The Regulations in the instant case are temporary regulations and went through no such notice-and-comment procedure. This Court, in *Kikalos*, stated that a temporary regulation may be entitled to no more deference than a proposed regulation. 190 F.3d at 796, *citing United Transportation Union-Illinois Legislative Bd. v. Surface Transportation Bd.*, 169 F.3d 474, 480 (7th Cir. 1999) (“Lesser deference may be in order depending on the ‘circumstances surrounding the agency's adoption of its statutory interpretation.’ ”), quoting *Bankers Life*, 142 F.3d at 979) . In fact, this Court stated in *Kikalos*)that, “we [this Court]… reserve for another day what degree of deference, if any, temporary regulations issued without prior notice and comment command [are entitled].” *Id.* We put forth to this Court that based on the discussion herein, these Regulations are entitled to no deference.

D. The Regulations Are Invalid Under The Administrative Procedures Act (“APA”)

Thus, while not dispositive, the existence of notice-and-comment procedures are clearly relevant in analyzing the reasonableness of an agency's regulation. The significance of traditional notice-and-comment procedures is greater in a case such as this because it is the only aspect of the Regulations that would keep it from being nothing more than a reflection of the IRS's litigating position, which is not entitled to any judicial deference.

The IRS issued the Temporary Regulations without putting them through the formal notice and comment process. Pursuant to APA Section 553, when an agency issues a substantive rule, it must: (i) publish a notice of in the Federal Register regarding the proposed rulemaking; (ii) give persons who may be affected by the proposed rulemaking an opportunity to comment; and (iii) provide an effective date that is at least thirty (30) days after the publication in the

Federal Register. 5 U.S.C. Section 553; *D. Hoctor v. United States Department of Agriculture*; 82 F.3d 165 (7th Cir. 1996); *Metropolitan School District of Wayne Township, Marion County, Indiana v. Davila*, 969 F.2d 485 (7th Cir. 1992). The notice and comment procedures do not apply where: (i) the regulations are interpretive, provide general statements of policy or rules of agency organization, procedure or practice; or (ii) the agency, upon the finding of good cause, which is clearly stated in the rules, determines that the notice and comment procedure is "impracticable, unnecessary, or contrary to the public interest." *Id.*

Generally, temporary regulations are subject to the same notice and comment procedures as final regulations. There are some circumstances where the notice and comment procedure is not required for a temporary regulation, but the IRS must determine that an exemption under APA Section 553(b) applies. *Id.; and See Warrick v. U.S.*, 177 F.Supp. 481 (E.D. Mich, 1959).

In the present case, the IRS is operating under the exception for interpretive regulations in APA Section 553(b). The 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.

In *Smiley v. Citibank (South Dakota), NA.,* 517 U.S. 735, 737-38 (1996), the Comptroller of the Currency promulgated regulations in response to litigation between a bank and its cardholder regarding whether certain late charges imposed by the bank were excessive. The Government was not a party to the lawsuit and had no stake in the outcome of the dispute. The regulations were promulgated pursuant to the proper notice-and-comment procedures of the Administrative Procedure Act (the "APA"). *See Id.* at 740-41.

The Supreme Court in *Smiley* noted that it would deny deference to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice because

the deliberativeness, if not their authoritativeness, is suspect. *See Id.* at 741. The Supreme Court held the mere fact that litigation disclosed the need for the regulations was irrelevant when the agency interpretation at issue was a full-dress regulation adopted pursuant to the notice-and-comment procedures of the APA designed to assure due deliberation. *See Id.* Thus, the Supreme Court found the notice-and-comment procedures to be a significant element that prevented the regulations at issue from reflecting nothing more than the Government's litigating position.

The present situation is markedly different than the facts of *Smiley.* Here, the IRS is a litigating party with an economic stake in the outcome of this case. The new Regulations were not merely prompted by litigation. They reflect the IRS's adversarial position in the litigation. In addition, there can be no added comfort regarding the due deliberativeness of the Regulations because they were not issued with prior notice-and-comment pursuant to the procedures of APA Section 553(b). Accordingly, there are ample reasons to conclude that the Regulations are not entitled to deference and merely represent a "post hoc rationalization" of the IRS's prior unsuccessful litigation efforts and that the regulations do "not reflect the agency's fair and considered judgment on the matter in question." *See Auer* v. *Robbins,* 519 U.S. 452,462 (1997).

In *United States* v. *Morton,* 467 U.S. 822 (1984), the Supreme Court upheld regulations issued by the federal government addressing an issue that was the subject of litigation. *Morton* dealt with a military officer who sued the federal government for withholding from his pay pursuant to a writ of garnishment issued by a state court. *See Id.* at 824. Thus, the government was a party to, and had an economic interest in the outcome of, the litigation. *See Id.* at 826. *Morton,* however, is distinguishable because the regulations at issue in that case were promulgated pursuant to an explicit delegation from Congress to promulgate regulations on the very point that was at issue in the litigation-the procedures through which payment could be

made in connection with honoring a writ of garnishment in order for the federal government to avoid liability. *See Id.* at 834. The Court concluded that the regulations fulfilled the precise objective for which the authority was delegated. *See Id.*

In contrast to *Morton,* in this case the Regulations were not issued pursuant to an express delegation by Congress to promulgate regulations addressing the specific question at issue in this litigation. The Regulations were merely promulgated pursuant to the general delegation of rulemaking authority in Section 7805(a). Furthermore, the Regulations directly contradict the Congressional intent underlying the unambiguous terms of Section 6501(e)(l)(A), as determined by the Supreme Court in *Colony.* As a result, the Regulations reflect an attempt by the IRS to issue regulations outside the scope of its congressionally delegated rulemaking authority.

In short, the manner in which the Regulations evolved clearly establishes that the Regulations are nothing more than a reflection of the IRS's litigating position. The Regulations were issued more than fifty (50) years after *Colony* was decided and only after a significant number of losses in federal courts. Moreover, they were issued without the benefit of the notice-and-comment procedures, which calls into question their deliberativeness and authoritativeness. The Court should therefore reject the Regulations for what they are: a mere reflection of the IRS's litigating position which is not entitled to any deference.

CONCLUSION

The Appellant’s Brief fails to support its claim that the six (6) year statute of limitations under Internal Revenue Code Section 6501(e) is applicable to the Taxpayers’ 1999 tax year. The Taxpayers’ 1999 tax year is barred by the statute of limitations under Internal Revenue Code Section 6501(a). The Supreme Court in *Colony* made it clear that an overstatement of basis does not constitute the omission of gross income. The Appellant’s attempt to bootstrap their litigating

position by the issuance of retroactive Regulations fail because the Regulations are invalid and have no impact on the Taxpayers' 1999 tax year.

Respectfully Submitted

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CERTIFICATE OF COMPLIANCE

This reply brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this reply brief contains 13,257 words, excluding the parts of the reply brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). This reply brief further complies with the typeface requirements of Fed R. App. P. 32(a)(5), and Circuit Rule 32, and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word Times New Roman, 12-point.

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CERTIFICATE OF SERVICE

I, Adam S. Fayne, an attorney, do hereby certify that fifteen copies of this brief in paper form and one CD-ROM containing a non-scanned digital version of the brief were sent to the Clerk via messenger on July 16, 2010, and that service of this brief has been made on counsel for the appellant by sending two paper copies of the Appellee's Brief, and one CD-ROM containing a non-scanned digital version of the brief by UPS delivery on July 16, 2010 to:

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