RECORD NO. 09-2353

In The

United States Court of Appeals

For The Fourth Circuit

HOME CONCRETE & SUPPLY, LLC; ROBERT L. PIERCE; STEPHEN R. CHANDLER; REBECCA R. CHANDLER; HOME OIL AND COAL COMPANY, INCORPORATED; SUSANNE D. PIERCE,

Plaintiffs – Appellants,

v.

UNITED STATES OF AMERICA,

Defendant – Appellee,

BAUSCH & LOMB, INC.,

Amicus in Support of Appellants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF NORTH CAROLINA AT NEW BERN

REPLY BRIEF OF APPELLANTS

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ARGUMENT

I. AN OVERSTATEMENT OF BASIS CANNOT CONSTITUTE AN OMISSION FROM GROSS INCOME

A. "OMITS" MEANS OMITS, REGARDLESS OF WHAT "GROSS INCOME" MEANS

The only matter properly before this Court is whether the normal three-year statute of limitations should be extended to six years by the application of 26 U.S.C. § 6501(e).[1] The IRS argues that the longer statute applies by focusing on the definition of "gross income" and ignoring the words "omits from," much as it did in *Colony, Inc. v. United States*, 357 U.S. 28 (1958). This argument was rejected in *Colony* and more recently by two courts of appeal,[2] and the Court of Federal Claims.[3] The IRS also ignores the fact that the Tax Court has consistently followed the Supreme Court's holding in *Colony*, holding that an overstatement of

[1] As it did in the trial court, the IRS attempts to paint the taxpayers as subversive individuals involved in an abusive tax shelter. There is no support in the record for such accusations, and in fact the converse is true. The taxpayers owned and ran a small family business and, otherwise, had no significant financial or tax backgrounds. They relied entirely on advice from their tax and financial advisors. At the time the taxpayers filed the relevant returns, the phrase "Son-of-Boss" had not yet been coined by the IRS, Notice 2000-44 had not been issued, and the transactions engaged in by the taxpayers were not known as "listed transactions" or "tax shelter" transactions.

[2] *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009), *rev'g* 79 Fed. Cl. 189 (2007); *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767 (9th Cir. 2009), *aff'g* 128 T.C. 207 (2007).

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

basis cannot constitute an omission from gross income for purposes of extending the statute of limitations in 26 U.S.C. § 6501(e).[4] The jurisprudence is clear, "omits" means omits, regardless of the definition of "gross income," and thus an overstatement of basis cannot be an omission.

B. <u>26 U.S.C. § 6501(e)(1)(A)(i) IS NOT RENDERED SUPERFLUOUS BY APPLYING COLONY'S HOLDING TO THIS CASE</u>

The IRS argues that *Colony*'s holding is limited only to sales of goods[5] or services in a trade or business, and that applying its holding to all cases would render 26 U.S.C. § 6501(e)(1)(A)(i) superfluous. The Federal Circuit in *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362, 1376 (Fed. Cir. 2009), *rev'g*, 79 Fed. Cl. 189 (2007), may have reconciled this misconception best when it stated "we believe that Congress enacted subparagraph (i), not to define 'omits from gross income an amount properly includible therein,' but to assist the IRS in its calculation of whether any omitted gross income exceeded 25% of the gross income stated in the return." *See also Bakersfield*, 568 F.3d at 776-777 (explaining

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[4] *See*, *e.g.*, *Bakersfield Energy Partners, LP v. Comm'r*, 128 T.C. 207 (2007), *aff'd* 568 F.3d 767 (9th Cir. 2009); *UTAM, Ltd., v. Comm'r*, T.C. Memo. 2009-253; *Intermountain Ins. Serv. Of Vail, LLC v. Comm'r*, T.C. Memo. 2009-195; *Beard v. Comm'r*, T.C. Memo. 2009-184.

[5] *Colony* involved the sale of real property. While there is no definition of "goods" in the Internal Revenue Code, it is doubtful that real property would be included. "Goods" in other parts of the law have traditionally only included personal property. *See*, *e.g.*, U.C.C., Art. 9, § 9-102(a)(44) ("'Goods' means all things that are moveable when a security interest attaches.").

specific instances, and citing specific cases, in which subparagraph (i) of 26 U.S.C. § 6501(e)(1)(A) may be dispositive, regardless of whether the IRS's argument regarding *Colony* is accepted); *Hoffman*, *supra* at 148; *Insulglass*, *supra* at 209-210. Nothing in the Supreme Court's opinion indicates that its holding should be limited to cases involving sales of goods or services in a trade or business. The IRS is simply reading into the opinion something that is not there. *See Salman Ranch*, *supra* at 1373. Accordingly, *Colony's* holding is not limited to cases involving sales of goods or services and controls here.

II. *PHINNEY* IS AN ADEQUATE DISCLOSURE CASE, NOT AN OMISSION CASE, AND DOES NOT CONTROL HERE

As a result of mounting losses on the statute of limitations issue, the IRS has been forced to focus its reliance on *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), which is plainly distinguishable from this case. *Phinney* involved a husband and wife who owned capital stock as community property. *Id.* at 681. They sold the stock in an installment sale to a third party and, before all of the payments were completed, the husband passed away. *Id.* A fiduciary income tax return was filed by the executor for the decedent's estate reporting the decedent's half of the long-term capital gains from the installment sale of the stock on Schedule D. *Id.* at 682. However, on a separate return prepared by the same tax preparer on behalf of the wife, long-term capital gains from the installment sale of the stock were omitted. *Id.* at 682. Instead, the wife reported the income from the

sale "under a different heading and under an incorrect designation as of the sale of stock acquired on 10-27-56 and sold in '1958.'" *Id.* at 684. The wife made no report or reference to the receipt of her share of the installment payment on her personal income tax return. *Id.* at 683.

The Fifth Circuit compared the proper reporting on the husband's return of income, and the absence, or *omission*, of a similar reported amount of income on the wife's return, noting that the wife "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 filed." *Id.* at 684.

Phinney does not discuss, nor does it hold, that an overstatement of basis equates to an omission of income. Nor does *Phinney* indicate that the enactment of 26 U.S.C. § 6501 somehow superceded *Colony*. To the contrary, it cites *Colony* as controlling precedent. *See id.* at 685 ("we think the following language of the court's opinion in *Colony* should control here…"). The omission in *Phinney* resulted from the failure to report an amount income comprising proceeds from an installment sale, not an overstatement of basis. The Fifth Circuit then found that the incorrect designation of the payment as a sale of stock in 1958 failed to constitute adequate disclosure under the "new" 26 U.S.C. § 6501(e)(1)(A)(ii).

In a similarly situated case, the Tax Court found that *Phinney* was a case where "the Commissioner was at a disadvantage identifying the error" and "not

directly on point". *See Utam v. Commissioner*, T.C. Memo 2009-253.[6] Here, the IRS was at no such disadvantage. The taxpayers have adequately disclosed the transaction, including gross receipts, the tax bases of the assets being sold before and after the short sale of Treasury notes, and the net gain. The partnership included a 26 U.S.C. § 754 election in its return, and both Mr. Pierce and Mr. Chandler included a statement providing that "[d]uring the year the proceeds of a short sale not closed by the taxpayer in this tax year were received." Accordingly, even if an omission is found to have occurred, the taxpayers adequately disclosed on their returns "a clue to the existence of the omitted item." *Colony*, *supra* at 36; *see also White v. Comm'r*, 991 F.2d 657, 661 (10th Cir. 1993); *Benderoff v. United States*, 398 F.2d 132, 136 (8th Cir. 1968).

III. <u>THE NEW REGULATIONS DO NOT APPLY</u>

The IRS has attempted to reverse its losses on the issue in this case by issuing temporary regulations (the "regulations"), under 26 U.S.C. §§ 6229(c)(2) and 6501(e)(1)(A) on September 24, 2009. *See* §§ 301.6229(c)(2)-1T and

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[6] In contrast to *Utam*, the Northern District of Texas issued a cursory unpublished opinion in a case similarly situated to this case, and relied upon by the IRS in their brief, in which the court found *Phinney* to be controlling on the issue of whether an overstatement of basis constitutes an omission. *Burks v. United States*, 2009 WL 2600358 (N.D. Tex. 2008), appeal docketed, No. 09-11061 (5th Cir. Oct. 26, 2009). The taxpayers argue that *Burks* misinterpreted the holding in *Phinney*, and was decided incorrectly. Nevertheless, this court is not bound by *Phinney*, as was the case in *Burks*, and should follow the Supreme Court's holding in *Colony* like the Ninth Circuit, the Federal Circuit, the Tax Court and the Court of Federal Claims have done.

301.6501(e)-1T, Temp. Proced. & Admin. Regs., 74 Fed. Reg. 49322-49323 (Sept. 28, 2009). These regulations were simultaneously issued as proposed regulations. The temporary regulations attempt to define "gross income," as that term is used in 26 U.S.C. §§ 6229(c)(2) and 6501(e)(1)(A), in such a manner that an overstatement of basis "constitutes an omission from gross income."[7] The regulations "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." In this case, the IRS has taken the aggressive position that these regulations now bind this Court to rule against the taxpayers. Put quite simply, the IRS's attempt to dictate the outcome in this case, and many others, is untenable.

A. THE REGULATIONS DO NOT APPLY TO THIS CASE BECAUSE THE PERIOD FOR ASSESSING TAX EXPIRED LONG BEFORE THE REGULATIONS WERE ISSUED.

The applicability date provision in the regulations precludes their application here. The regulations provide that they are effective for "taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Reg. §§ 301.6229(c)(2)-1T(b) and 301.6501(e)-1T(b). This begs the question: did the applicable period for assessing tax expire before September 24, 2009?

[7] Interestingly, the IRS makes no attempt to define "omits," perhaps because any such definition would contradict the Supreme Court's holding in *Colony*.

From the very beginning of this controversy, the taxpayers have maintained that the three-year period for assessing their federal income taxes expired long before the FPAA was issued. This would mean that the applicable period for assessing tax also expired before September 24, 2009. If so, the regulations have no application to this case according to their plain meaning. *Intermountain Ins. Serv. Of Vail, LLC v. Comm'r*, 134 T.C. No. 11 (May 6, 2010).

Only if this Court finds that the six-year statute of limitations applies do the regulations even become relevant according to the applicability language. If the statute is six years, however, there is no need to apply the regulations because the Court will have determined the issue without them. In either case, the Court should decide which limitations period applies in order to determine whether it needs to investigate the validity of the regulations.

The IRS attempted to avoid this common sense approach when it issued IRS Chief Counsel Notice CC-2010-001 on November 23, 2009 in which it stated:

> [T]he temporary regulations apply to any docketed Tax Court[[8]] case in which the period of limitations under sections 6229(c)(2) and 6501(e)(1)(A), *as interpreted in the temporary regulations*, did not expire with respect to the tax year at issue, before September 24, 2009, and in which no final decision has been entered.

[8] This case was filed in the United States District Court for the Eastern District of North Carolina, not the Tax Court.

(emphasis added). What the IRS meant by "as interpreted in the temporary regulations" is not explained. However, it is clear that the IRS wants the regulations to determine the outcome here.

In its brief, the IRS cites to 26 U.S.C. § 7805(b) (1994 ed.), which "establishes a presumption that regulations will apply retroactively unless otherwise specified." Br. at 64. The IRS subsequently, and inexplicably, concludes that "[s]ince the regulations do not specify that they apply prospectively only, their application encompasses the 1999 tax year, at issue here." *Id.* at 65. While it is true that the IRS did not specify that the regulations apply prospectively only, it did specify precisely the taxpayers to which the regulations would apply—those taxpayers for which the applicable period for assessing tax did not expire as of September 24, 2009. It is indisputable that the applicable period for assessing tax has not yet been determined with finality in this case. To the contrary, the applicable statutory period is precisely what is in dispute.

The United States Tax Court recently considered the issue of whether the regulations applied to a case involving the same statute of limitations issue for a taxpayer's 1999 tax year where the FPAA was issued more than three years after the applicable returns were filed. *See Intermountain*, s*upra*. The Tax Court considered and rejected the IRS' attempt to avoid its own applicability date provision by saying: "we find the interpretation to be 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 [the IRS] believes was an abusive tax transaction." *Id.* (slip op. at 15). The same logic applies to this case. The period for assessing tax has not yet been determined. Such a determination, one way or the other, will render application of the regulations to this case moot.

B. THE REGULATIONS ARE PROCEDURALLY INVALID UNDER THE ADMINISTRATIVE PROCEDURE ACT

The regulations violate the "notice and comment" rulemaking requirements set forth in the Administrative Procedure Act (the "APA"). The APA requires agencies, including the IRS, to publish contemplated rules, including regulations, to allow the public to make comments on their content and effect. 5 U.S.C. § 553(b) and (c). The rule must generally be published "not less than 30 days before its effective date". *Id.* § 553(d). The notice and comment requirements do not apply to interpretive rules, general statements of policy, rules of agency organization, procedure, or practice or where the agency finds for good cause that such notice is impractical, unnecessary or contrary to the public interest. *Id.* § 553(b). For purposes of this case, in order for the regulations to be valid, they must either be "interpretive" or for "good cause".

When regulation drafters find good cause to forego the notice and comment requirement, Internal Revenue Manual pt. 32.1.5.4.7.5.1(4) (Aug. 11, 2004),

directs them to include the following text in the regulations: "'These regulations are necessary to provide taxpayers with immediate guidance. Accordingly, good cause is found for dispensing with notice and public comment pursuant to 5 U.S.C. 553(b) and (c)'". *See Intermountain*, *supra* at __, n. 7 (slip. op. at 49, n. 7) (Halpern and Holmes, JJ., concurring). While this text may be determined by a court to satisfy the good cause exemption, it was neither in the regulations nor the related Treasury Decision. *See* T.D. 9466, 74 Fed. Reg. 49321-49323 (Sept. 28, 2009). Accordingly, the good cause exception does not apply to the regulations.

The Treasury Decision does include a statement that "[i]t also has been determined that section 553(b) of the …[APA] does not apply to these regulations." *Id.* at 49322. The IRS argues that the regulations are interpretive rules (as opposed to "legislative" rules) that clarify the phrase "omitted from gross income" without changing existing law. Br. at 39. The IRS also argues that the regulations can be filed without notice and comment if issued as proposed regulations as well—citing 26 U.S.C. § 7805(e)(1) as authority. Br. at 38-39. Both arguments lack merit.

In a concurring opinion in *Intermountain*,[9] judges Halpern and Holmes (the "concurring judges") suggested that they would have invalidated the regulations as failing to meet the APA notice and comment requirements because the regulations were legislative, not interpretive, and they were issued with the intent to have the force of law binding on the public. *Intermountain*, *supra* (Halpern and Holmes, JJ., concurring). The concurring judges describe the difference between the meaning of "interpretive" in tax law with its meaning in administrative law as follows:

> In administrative law, 'interpretive' is a label reserved for regulations that 'advise the public of the agency's construction of the statutes and rules which it administers.'…. Substantive or legislative rules, on the other hand, are 'rules, other than organizational or procedural * * * issued by an agency pursuant to statutory authority and which implement the statute * * *. Such rules have the force and effect of law.'…. In other words, legislative rules are those that are binding.

Id. at __ (slip. op. at 51, 52) (citations omitted). The concurring judges then applied the test they labeled as the "dominant standard" for distinguishing between legislative and interpretive rules, found in *American Mining Congress v. Mine*

[9] As mentioned above, the majority in *Intermountain* cited the "circular-result driven logic and wishful notion that the temporary regulations should apply" as a plausible reason for holding that the temporary regulations could not apply to a case involving an FPAA issued long after the three year period for assessing tax under 26 U.S.C. § 6501(a) had passed. (slip. op. at 15-16). However, the primary reason for holding the regulations invalid was a finding by the majority that *Colony* "'unambiguously forecloses the agency's interpretation' of sections 6229(c)(2) and 6501(e)(1)(A) and displaces [the IRS's] temporary regulations." *Id.* at __ (slip. op. at 24-25) (citing *Natl. Cable & Telecomms. Assoc. v. Brand X Internet Servs.*, 545 U.S. 967, 983 (2005) (footnotes omitted).

Safety & Health Administration, 995 F.2d 1106 (D.C. Cir. 1993), which has been cited with approval in this Circuit. *Id.* at 52; *see Chen Zhou Chai v. Carroll*, 48 F.3d 1331 (4th Cir. 1995).

The D.C. Circuit listed four ways an agency could show it intended to issue legislative rules:

> (1) whether in the absence of the rule there would not be an adequate legislative basis for enforcement action or other agency action to confer benefits or ensure the performance of duties, (2) whether the agency has published the rule in the Code of Federal Regulations, (3) whether the agency has explicitly invoked its general legislative authority, or (4) whether the rule effectively amends a prior legislative rule. If the answer to any of these questions is affirmative, we have a legislative, not an interpretive rule.

American Mining, *supra* at 1112; *see also Intermountain*, *supra* at __, (slip. op. at 53) (Halpern and Holmes, JJ., concurring).

With respect to the threshold question of whether the IRS has the authority to issues rules having the force of law, the concurring judges found that (1) Congress delegated such authority to the Secretary of the Treasury in various code sections, including the broadest delegation under 26 U.S.C. § 7805(a), (2) such regulations carry the force of law because the Internal Revenue Code imposes penalties for failing to follow them,[10] and (3) the regulations, if valid, would bind

[10] Citing 26 U.S.C. § 6662(b).

both the government and the taxpayer.[11] *Intermountain*, *supra* at __ (slip. op. at 55).

While only one indicator of intent to issue legislative rules need be found, the concurring judges found that two of the four ways an agency can show it intends a rule to have the force of law were present with respect to the regulations. First, the Secretary of the Treasury invoked his general authority to issue regulations in the Treasury Decision containing the regulations—"he promulgated one of these regulations explicitly under section 7805 alone and the other under both section 7805 and section 6230(k), knowing that regulations issued under these sections carry the force of law." *Id.* at __ (slip. op. at 56). Second, and more persuasive, is that the regulations "effectively changed (or at least tried to change) existing law…. Certainly, as the Ninth Circuit recognized in *Bakersfield*, 568 F.3d at 768, 778, a Supreme Court decision such as *Colony* binds lower courts at least until something changes." *Id.* at 57. The IRS has demonstrated its hope that these regulations, if effective, would overturn 50 years of Supreme Court precedent, not

[11] Citing *Shaefer v. Commissioner*, 105 T.C. 227, 229 (1995).

to mention two recent appellate decisions, *Bakersfield* and *Salman Ranch*[12] (both of which were specifically referenced in the Treasury Decision)[13] and numerous Tax Court cases (some of which, like *Intermountain*, have outstanding motions to vacate filed by the IRS pending in the Tax Court).[14] Filing motions to rehear or to vacate court decisions based solely on hastily issued regulations firmly establishes intent to carry the force of law.

With respect to the IRS's argument that 26 U.S.C. § 7805(e)[15] somehow allows the IRS to bypass the notice and comment requirements by issuing proposed regulations simultaneously with the issuance of temporary regulations, there is simply no indication that compliance with that provision somehow waives the notice and comment requirements for the IRS. The IRS fails to provide any substantive explanation for its position that such a waiver might exist; however, it appears to imply that allowing post-promulgation comment, as opposed to pre-promulgation notice and comment, satisfies the APA.

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[12] The IRS filed a Petition for Panel Rehearing in *Salman Ranch* on October 14, 2009 with the Court of Appeals for the Federal Circuit (Docket. No. 2008-5053).

[13] *See* T.D. 9466, 74 Fed. Reg. 49321, 49322 (Sept. 28, 2009).

[14] *See*, *e.g., Utam, Ltd. v. Comm'r* (Docket No. 24762-06).

[15] 26 U.S.C. § 7805(e) directs the Treasury to issue a simultaneous notice of proposed rulemaking when it issues temporary regulations, and sets a 3-year expiration date for all temporary regulations.

Congress specified in the APA that "'no subsequent legislation shall be held to supercede or modify the provisions of this Act except to the extent that such legislation shall do so expressly.'" *See Intermountain*, *supra* at __ (slip. op. at 60) (Halpern and Holmes, JJ., concurring) (quoting *Dickinson v. Zurko*, 527 U.S. 150, 154-155 (1999)); 5 U.S.C. § 559; *see also Robinette v. Commissioner*, 439 F.3d 455, 460 (8th Cir. 2006). Neither 26 U.S.C. § 7805(e) nor its legislative history mentions the APA. *See* H.R. Rep. No. 100-1104, 100th Cong., 2d Sess., Conference Report to Accompany H.R. 4333, at 217-218; *see also* Explanation of Finance Committee Amendment to S. 2238, Joint Committee on Taxation, JCX-28-88. While the legislative history notes that temporary regulations are often effective immediately upon issuance, Congress may have been referring only to temporary regulations that already fit within an exception to the APA, considering that a need for temporary regulations would normally only be expected in emergency or "good-cause" situations. *Intermountain*, *supra* at __, n. 17 (slip. op. at 60, n. 17) (Halpern and Holmes, JJ., concurring).

"Giving the public a chance to comment only after making the regulations effective does not comply with the APA." *Id.* at __ (slip. op. at 61) (citing *Chrysler Corp. v. Brown*, 441 U.S. 281, 315 (1979); *Paulsen v. Daniels*, 413 F.3d 999, 1005 (9th Cir. 2005) ("It is antithetical to the structure and purpose of the APA for an agency to implement a rule first, and then seek comment later."). "[5

U.S.C.] [s]ection 553 is designed so that affected parties have an opportunity to participate in and influence agency decision making at an early stage, when the agency is more likely to give real consideration to alternative ideas." *U.S. Steel Corp. v. U.S. E.P.A*, 595 F.2d 207, 214 (5th Cir. 1979) (holding that allowing post-promulgation comments to resolve any harm caused by a lack of notice and comment would render the notice and comment procedures toothless); *see also United States v. Dean*, ___ F.3d. ___, 2010 WL 1687618 (11th Cir. 2010) (slip. op. at 12-13). Accordingly, the regulations should be invalidated on procedural grounds for failure to comply with the notice and comment requirements of the APA.

C. <u>THE REGULATIONS MAY NOT BE APPLIED RETROACTIVELY</u>

If the applicability date provision in the regulations is not found to be an obstacle to their use in this case, and the regulations are found not to be procedurally invalid under the APA, the regulations should be rendered invalid based on the hardship and prejudice their retroactive application would cause to the taxpayers.

As mentioned above with respect to legislation passed before July 30, 1996 (i.e., the effective date of the amended 26 U.S.C. § 7805(b)), the Treasury and the IRS had explicit statutory authority to "prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without

retroactive effect." 26 U.S.C. § 7805(b) (1994 ed.). In its prior form, 26 U.S.C. § 7805(b) reflected Congress's recognition that when the Treasury applied a regulation retroactively, the retroactive application could result in hardship and inequity. H.R. Rep. No. 704, 73d Cong., 2d Sess. 48 (1934).

The IRS's authority to issue retroactive regulations is subject to review for abuse of discretion. *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 302 (2d Cir. 1971). "'The Internal Revenue Service does not have *carte blanche*. Its choice must be a rational one, supported by relevant considerations.'" *Id.* (citing *Int'l Bus. Machs. Corp. v. United States*, 343 F.2d 914, 920 (Ct. Cl. 1965)).

> [C]ourts have declined to give retroactive effect to regulations or rulings of the Commissioner when retroactivity would work a change in settled law relied on by the taxpayer and implicitly approved by Congress, *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110…(1939), when it would lead to inequality of treatment between taxpayers, [*Int'l Bus. Machs. Corp.*, *supra*], when litigation involving the area clarified by the regulation had already begun, *Commissioner of Internal Revenue v. Goodwyn Crockery Co.*, 315 F.2d 110, 113 (6th Cir. 1963), or when, in general, the result of retroactivity in a particular case would be unduly harsh, *Lesavoy Foundation v. Commissioner*, 238 F.2d 589, 594 (3d Cir. 1956); cf. *Woodward v. United States*, 322 F.Supp. 332, 335 (W.D.Va. 1971).

Id. at 302, n. 6; *see also Snap-Drape Inc., v. Comm'r*, 98 F.3d 194, 202 (5th Cir. 1996); *Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 981 (5th Cir. 1977).

The taxpayers in this case filed suit in December 2006, more than six years after the relevant returns were filed with the IRS and nearly three years before the

regulations were promulgated. The regulations were issued in an attempt to guarantee a win for the IRS in this case, and to revive and overturn various losses suffered in similarly situated cases in other jurisdictions. The Taxpayers clearly relied on *Colony* and its progeny when they filed this case.

"Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change." *Lorillard v. Pons*, 434 U.S. 575, 580 (1978). In *Colony*, the Supreme Court held that an overstatement of basis is not an omission of income for purposes of 26 U.S.C. § 6501(e)(1)(A). Since that ruling, 26 U.S.C. § 6501(e) has been amended at least 8 different times.[16] Not once has Congress expressed disagreement with the holding in *Colony*, nor has it attempted to redefine the term "omits from gross income" to include an overstatement of tax basis. Congressional inaction is construed as acquiescence where the interpretation of statutory language generates controversy and Congress does not amend the statute. *Bob Jones Univ. v. United States*, 461 U.S. 574, 600-02 (1983); *see also Salman Ranch*, *supra* at

[16] *See* American Jobs Creation Act of 2004, P.L. 108-357, § 413(c)(28); Revenue Act of 1978, P.L. 95-600, § 701(t)(3)(A); Black Lung Benefits Revenue Act of 1977, P.L. 95-227, § 4(d)(4); Tax Reform Act of 1976, P.L. 94-455, §§ 1307(d)(2)(F)(vi) and 1906(b)(13)(A); Employee Retirement Income Security Act of 1974, P.L. 93-406, § 1016(a)(14); Excise, Estate, and Gift Tax Adjustment Act of 1970, P.L. 91-614, § 102(d)(8); Tax Reform Act of 1969, P.L. 91-172, §101(g)(3); Excise Tax Reduction Act of 1965, P.L. 89-44, § 810(b).

1374-75 ("if Congress had so desired, it would have expressed its intention to change the meaning of the relevant language.").

The IRS argues that it is not changing the law retroactively. Rather, it maintains it is merely "clarifying" the law with its new regulations. However, the preamble to the regulations specifically asserts that the regulations were issued for the very purpose of changing the result in *Bakersfield* and *Salman Ranch*. *See* T.D. 9466, 74 Fed. Reg. 49321, 49322 (Sept. 28, 2009). There is no doubt that the regulations would change the law settled by the Supreme Court 50 years ago, confirmed time and again in recent years by lower courts, and implicitly approved of by Congress.

The taxpayers have expended substantial time, energy, and financial resources (in litigation costs, including legal fees and, potentially, in continuously accruing interest) with the expectation that they were fighting on a level playing field, and would ultimately prevail on the statute of limitations issue based on longstanding Supreme Court precedent. Now the IRS has declared victory by enacting regulations that purport to dictate the outcome without any regard for due

process[17] or fair treatment of the taxpayers. "Unduly harsh" would be an understated description of this result if the regulations are upheld.

The IRS abused its discretion when it issued the regulations. Accordingly, the regulations should be invalidated.

D. THE REGULATIONS ARE NOT ENTITLED TO ANY DEFERENCE

1. *Chevron* does not apply

The IRS posits that the regulations are both interpretive (and thus exempt from the APA notice and comment requirements)[18] and entitled to deference in accord with the standard set forth in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-843 (1984). The Supreme Court has clarified that interpretive regulations do not merit *Chevron* deference. *United States v. Mead Corp.*, 533 U.S. 218, 234-35 (2001); *see also Christensen v. Harris County*, 529 U.S. 576, 587 (2000). Rather, the proper test for determining the validity of interpretive regulations is set forth in *Skidmore v. Swift & Co.*, 323 U.S.

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[17] In *United States v. Carlton*, 512 U.S. 26, 32-33 (1994), the Supreme Court held that, under the Due Process Clause of the Constitution, Congress may adopt retroactive tax rules only when they are rationally related to a valid government purpose and only when the period of retroactivity is "modest." The regulations were filed more than 9 years after the returns were filed here and, therefore, violate due process.

[18] We reiterate our assertion that the regulations are legislative, not interpretive, and fail to satisfy the notice and comment requirements set forth in the APA. However, in the event the Court finds the regulations to be interpretive, they should nonetheless be invalidated.

134, 140 (1944). Compliance with the notice and comment requirements in the APA is "significant…in pointing to *Chevron* authority." *Mead*, 533 U.S. at 230; *see also De La Mota v. Dep't of Educ*, 412 F.3d 71, 79 (2d Cir. 2005) (stating that informal rulemaking is not entitled to *Chevron* deference without a notice and comment period).

Skidmore provides that an administrative regulation's validity "will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control." *Skidmore*, *supra* at 140. The regulations in this case are merely a published version of the IRS's litigating position in this and other matters; thus, they are not entitled to deference. "Deference to what appears to be nothing more than an agency's convenient litigating position" is "entirely inappropriate." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988). "[T]he Commissioner [of Internal Revenue] may not take advantage of his power to promulgate retroactive regulations during the course of litigation for the purposes of providing himself with a defense based on the presumption of validity accorded to such regulations." *Chock Full O' Nuts*, *supra* at 303.

Issuing regulations in an attempt to reverse the outcome in litigation to which an agency is a party is an "abuse of the interaction between administrative

agencies and the courts" and an "abuse [of] the litigation process." *Tallahassee Mem'l Reg'l Med. Ctr. v. Bowen*, 815 F.2d 1435, 1452, 1456 (11th Cir. 1987), *cert. denied*, 485 U.S. 1020 (1988). This is not the first time that the IRS has tried, and ultimately failed, to utilize regulations with retroactive effect in the context of existing litigation.[19]

Arguing that the regulations are entitled to deference, the IRS relies heavily on two cases: *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996) and *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158 (2007). Both are distinguishable from this case. *Smiley* involved a class action case between private parties, during which the Comptroller of Currency promulgated a regulation during litigation after full notice and comment proceedings. 517 U.S. at 739-40. The Supreme Court rejected the plaintiffs' contention that the regulation should not

[19] *See*, *e.g.*, Treasury Regulation § 1.752-6, which the IRS initially promulgated as a temporary regulation in clear anticipation of tax shelter litigation to expand the meaning of the term "liability" for purposes of 26 U.S.C. § 752. The purpose of that regulation was to affirmatively change the law retroactively to cover prior transactions in those cases. The courts almost universally held the regulation to be invalid. *See* Mark Allison, *The New Battle in an Old War: Omissions From Gross Income*, Special Report Tax Notes, 1227, 1240 (Mar. 8, 2010) (citing *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516 (2009); *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636, 671 (2008); *Sala v. United States*, 552 F. Supp. 2d 1167, 1197 (D. Colo. 2008); *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608, 625 (E.D. Tex. 2006) (noting that the "narrow time frame [of retroactivity], coupled with conduct the Service specifically called out in the preamble of the Regulation, is a strong indication that the promulgation of the Regulation was to buttress the government litigation position in this and similar cases").

receive deference because it was "prompted by litigation," and noted that the regulation did not merely represent the litigating position of the Comptroller, but rather it was a "full-dress" regulation issued after deliberation and full notice and comment procedures. *Id.* at 741.

In *Coke*, the controversy also involved private parties and the proper interpretation of a regulation issued by the Department of Labor. 551 U.S. at 164. During litigation, the Department of Labor issued an internal advisory memorandum explaining and defending the regulation in question. *Id.* at 171. In accepting the explanation set forth in the memorandum, the Court emphasized that the Department had carefully deliberated over the interpretation and subjected its views to notice and comment. *Id.* at 171, 173. We have already established that the regulations were issued before the public had an opportunity to comment, and that they were issued to support the IRS's own litigating position in a multitude of pending cases throughout the country through an abuse of its regulatory power. The holdings in *Smiley* and *Coke*, therefore, have no application to this matter. The Supreme Court's finding that litigation sometimes spurs a need for regulation does not equate to a requirement that federal courts must defer to a regulation with retroactive application issued by a party litigant without deliberation of any sort due to a lack of success in other cases concerning the issue it is trying to resolve in its own favor.

Justice Scalia, who wrote for the Court in *Smiley*, commented that the Court would refuse deference to agency litigating positions that lacked the careful consideration that notice and comment rulemaking ensures. 517 U.S. at 741. In a dissent in *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967, 1017 (2005), discussed *infra*, Justice Scalia commented on the fundamental Constitutional dangers of permitting an administrative agency to regulate its way out of adverse judicial decisions. Accepting the IRS's interpretation of *Smiley* would require this Court to believe that Justice Scalia changed his mind completely between the issuance of *Smiley* in 1996 and *Brand X* in 2005. Considering the lack of deliberation by the IRS, the abuse of its regulatory power, and the due process concerns that come with allowing one party in a controversy to change the law to its own advantage in the middle of litigation, the regulations deserve no deference in this matter.

2. The Regulations Fail Under *Chevron* If Applied

Even if the regulations are analyzed under *Chevron*, they are not entitled to deference. Chevron provides a two-step analytical framework. "First, always, is the question whether Congress had directly spoken to the precise question at issue. If 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*, *supra* at 842-43. The Court clarified step one in the analysis in a footnote:

> The judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent…. If a court, employing *traditional tools of statutory construction*, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect.

Id. at 843, n.9 (emphasis added). If the Court cannot determine that "Congress had an intention on the precise question at issue," the second step in the analysis requires the Court to answer whether the agency's interpretation is permissible or reasonable. *Id.* at 843-844.

The Court in *Chevron* utilized legislative history as part of its step one analysis, and has continued to do so in more recent opinions. *Id.* at 862; *see also Zuni Pub. Sch. Dist. No. 89 v. Dept. of Educ.*, 550 U.S. 81, 90-91 (2007); *Gen. Dynamics Land Sys., Inc. v. Cline*, 540 U.S. 581, 587-590, 600 (2004). This Court has also recognized that a "statute's legislative history is the first tool of statutory construction a court utilizes to determine congressional intent when statutory language is unclear." *Dominion Resources, Inc. v. United States*, 219 F.3d 359, 365 (4th Cir. 2000) (*citing Toibb v. Radloff*, 501 U.S. 157, 162 (1991); *see also Elm Grove Coal Co. v. Director, O.W.C.P.*, 480 F.3d 278, 293-294 (4th Cir. 2007) ("As we have heretofore concluded, 'the traditional rules of statutory construction to be used in ascertaining congressional intent include: the overall statutory scheme,

legislative history, the history of evolving congressional regulation in the area, and a consideration of other relevant statutes.'" (citing *Brown & Williamson Tobacco Corp. v. FDA*, 153 F.3d 155, 162 (4th Cir. 1998)).[20] In essence, this means that if a court, employing traditional tools of statutory construction, ascertains that Congress intended to address a precise question at issue in a specific way, the statutory provision is considered unambiguous, and the meaning of the statutory provision is determined under step one of the *Chevron* framework.

The IRS has persistently cited the Supreme Court's statement that "it cannot be said that the language is unambiguous" when referring to the term "omits from gross income" in arguing that such language remains ambiguous. However, as the Tax Court in *Intermountain* correctly points out, reliance on this statement "ignores the Supreme Court's subsequent review of, and reliance on, the statute's legislative history." 134 T.C. at __ (slip. op. at 23). In *Colony*, the Supreme Court confirmed the plain meaning of the statutory language "omits from gross income"

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[20] Many courts of appeals have recognized legislative history as a "traditional tool of statutory construction" that is an important element in a *Chevron* step one analysis. *See Intermountain, supra* at __, n. 18 (slip. op. at 21-22, n. 18) (citing *Catawba County v. EPA*, 571 F.3d 20, 35 (D.C. Cir. 2009); *Miccosukee Tribe of Indians v. United States*, 566 F.3d 1257, 1273 (11th Cir. 2009); *New York v. U.S. Dept. of Health & Human Servs. Admin. For Children & Families*, 556 F.3d 90, 97 (2d Cir. 2009); *Natural Res. Def. Council v. U.S. EPA*, 526 F.3d 591, 603 (9th Cir. 2008); *Wheatland Tube Co. v. United States*, 495 F.3d 1355, 1359-1360 (Fed. Cir. 2007); *Succar v. Ashcroft*, 394 F.3d 8, 22-23 (1st Cir. 2005); *Anderson v. U.S. Dept. of Labor*, 422 F.3d 1155, 1180 (10th Cir. 2005); *North Dakota ex rel. Olson v. Ctrs. For Medicare & Medicaid Servs.*, 403 F.3d 537, 539-540 (8th Cir. 2005).

by referring to legislative history and repeatedly emphasized Congress' intent that the statute should be extended only in specific situations when taxpayers "leave out items" or a taxpayer "overlooks an item," "failed to report a dividend," or "might report as income for one year an item of income which properly belonged in another year." 357 U.S. at 33-35. The Court cited these instances as "persuasive indications that Congress merely had in mind *failures to report particular income receipts and accruals*, and did not intend the five-year [now six year] limitation to apply whenever gross income was overstated." *Id.* at 35 (emphasis added).

After reviewing the legislative history, the Supreme Court, therefore, clarified that the only reasonable interpretation of the term "omits from gross income" involves leaving out an actual item of income, and not an overstatement of tax basis. The ambiguity was resolved by the Court 50 years ago, and has been confirmed by two courts of appeals, multiple Tax Court judges and the Court of Federal Claims. The regulations fly directly in the face of the Supreme Court's construction of the statutory language and the unambiguous intent of Congress. Accordingly, this Court must give effect to Congress's clear intent, as construed by the Supreme Court, and strike down the regulations under *Chevron* step one.[21]

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[21] If it is determined that the regulations pass muster under *Chevron* step one, for the reasons explained in section III. D. 1., *supra*, the regulations would nonetheless fail *Chevron* step two because they are unreasonable.

3. *Brand X* does not control

a. *Brand X* does not give the IRS authority to overrule Supreme Court precedent and the unambiguous intent of Congress.

The preamble to the regulations cites *Brand X* as authority for its argument that the regulations are entitled to deference, despite being contrary to the opinions of *Bakersfield* and *Salman Ranch* (not to mention *Colony*).[22] *Brand X* involved a situation in which an agency regulation interpreting a statute followed an opinion by the Ninth Circuit interpreting the same statute differently. Considering the issue again after the agency (the FCC) had issued the regulation, the Ninth Circuit concluded it was bound by its own prior interpretation of the statute without regard to the fact that its interpretation conflicted with that of the FCC. 545 U.S. at 982.

Upon review, Justice Thomas, writing for the majority, concluded that the Ninth Circuit should have applied the *Chevron* framework to the agency interpretation rather than follow the prior Ninth Circuit opinion. *Id.* at 980. The

[22] The IRS suggests that the Ninth Circuit, in *Bakersfield*, invited it to issue the regulations when it stated "The IRS *may have* the authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code, even if its interpretation runs contrary to the Supreme Court's 'opinion as to the best reading' of the provision." 568 F.3d at 778 (emphasis added) (quoting *Brand X*, 545 U.S. at 982-983). The Ninth Circuit's statement is far from definitive about its opinion as to whether regulations could trump Supreme Court precedent with respect to this and similar cases. The taxpayers seriously doubt the Ninth Circuit was contemplating regulations issued with no deliberation and without following the notice and comment procedures in an attempt to create wins in cases that have been in litigation for years.

Court found that the Ninth Circuit's prior decision held only that the *best reading* of the statute in question was that a cable modem service was a "telecommunications service," not that it was the *only permissible reading* of the statute. *Id.* at 982, 984. The Court added that "[a] court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." *Id.* at 982.

In a concurring opinion, Justice Stevens suggested that the majority's explanation of "why a court of appeals' interpretation of an ambiguous provision in a regulatory statute does not foreclose a contrary reading by the agency…would not necessarily be applicable to a decision by [the Supreme] Court that would presumably remove any pre-existing ambiguity." *Id.* at 1003 (J. Stevens, concurring). This premise is supported by a variety of earlier cases decided by the

Court, each of which was cited with approval by the majority in *Brand X*, *supra* at 984.[23]

In *Colony*, the Supreme Court stated:

> "[w]e find in that [legislative] history 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…
>
> *We have been unable to find any solid support of the Government's theory in the legislative history.* Instead…, this 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.

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[23] *Neal v. United States*, 516 U.S. 284, 296 (1996) ("Were we to alter our statutory interpretations from case to case, Congress would have less reason to exercise its responsibility to correct statutes that are thought to be unwise or unfair."); *Lechmere, Inc. v. NLRB*, 502 U.S. 527, 536-539 (1992) (rejecting an agency's interpretation of a statute because it conflicted with the Supreme Court's prior interpretation of the statute); *Maislin Indus. U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990) ("Once we have determined a statute's clear meaning, we adhere to that determination under the doctrine of *stare decisis*, and we judge an agency's later interpretation of the statute against our prior determination of the statute's meaning."); *see also Tran v. Mukasey*, 515 F.3d 478, 484 (5th Cir. 2008).

357 U.S. at 33, 36 (emphasis added). Thus, the Supreme Court believed that the interpretation it adopted was the *only permissible reading* and not only the *best* reading.[24]

The IRS's reliance on *Hernandez-Carrera v. Carlson*, 547 F.3d 1237 (10th Cir. 2008), to support its argument that this Court should defer to the regulations instead of *Colony* is similarly misguided. *See also Marquez-Coromina v. Hollingsworth*, __ F.Supp. 2d __, 2010 WL 610745 (D. Md. Feb. 18 2010) (following the reasoning of *Hernandez*). In the relevant Supreme Court case that was construed by the Tenth Circuit, the Supreme Court "could not find 'any *clear* indication of congressional intent….'" *Id.* at 1245 (quoting *Zadvydas v. Davis*, 533 U.S. 678, 697 (2001)). The Supreme Court was unable to resolve the ambiguity through principles of statutory construction, and instead resolved the issue by invoking the canon of constitutional avoidance. While we disagree with the premise that a regulation can trump Supreme Court precedence, *Hernandez* and *Marquez* are nonetheless distinguishable from this case in that the Supreme Court case being construed was not a *Chevron* step one holding, but rather only provided

[24] *See* Patrick J. Smith, *Brand X and Omissions from Gross Income*, Tax Analysts, 665, 670 (Feb. 1 2010) ("Thus, that the *Colony* opinion used language suggesting that the statutory provision was ambiguous should not be taken as meaning that the *Colony* holding was subject to being overruled by a contrary agency interpretation under *Brand X*, because it is unreasonable to expect that the *Colony* decision would give the terms 'ambiguous' and 'unambiguous' the special meaning assigned to them by the *Chevron* decision 26 years later.")

what the Court found to be the "best reading" of the statute at that time. *Colony*, on the other hand, provides the *only permissible reading* of the pertinent statutory language in this case and cannot be overruled by the regulations.

That the Supreme Court did not explicitly say that its interpretation was the only permissible reading is irrelevant. *Colony* was decided 26 years before *Chevron*, and 47 years before *Brand X*. The Supreme Court in 1958 was unaware of the standards against which its opinion would be tested. In a post-*Brand X* opinion, this Court has described precisely how to evaluate such a situation when it stated "[w]e…do not hold that a court must say in so many magic words that its holding is the only permissible interpretation of the statute in order for that holding to be binding on an agency." *Fernandez v. Keisler*, 502 F.3d 337, 347 (4th Cir. 2007). Accordingly, the holding in *Colony* was a *Chevron* step one holding and cannot, under *Brand X*, be overruled by the regulations.

b. *Colony* cannot be overruled by regulations that fail to follow the notice and comment requirements

The Ninth Circuit opinion in *Brand X* clarifies that the FCC followed the notice and comment procedures in arriving at the position that was being challenged, and had received 250 comment letters as part of this process. 345 F.3d 1120, 1126. There is nothing in either the Ninth Circuit opinion or in the Supreme Court opinion that suggests that any of the parties were arguing that the FCC position was defective for failure to satisfy notice and comment requirements. It is

doubtful that the Supreme Court would give equal weight and deference to regulations issued without such deliberation, and failing to follow the notice and comment requirements. Given that the regulations were issued without deliberation, and are otherwise unreasonable, deference under *Chevron* and *Brand X* is inappropriate.

CONCLUSION

For the foregoing reasons, the taxpayers respectfully request that this Court reverse the trial court's final judgment in favor of the IRS and enter judgment in favor of the taxpayers.

Respectfully Submitted,

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Dated: June 1, 2010

/s/ Robert T. Numbers, II
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I hereby certify that on this 1st day of June, 2010, I caused this Reply Brief of Appellants to be filed electronically with the Clerk of the Court using the CM/ECF System, which will send notice of such filing to the following registered CM/ECF users:

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