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; SUZANNE D. PIERCE,
Plaintiffs-Appellants

v.

UNITED STATES OF AMERICA,
Defendant-Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF NORTH CAROLINA

BRIEF FOR THE APPELLEE

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JURISDICTIONAL STATEMENT

Appellants' jurisdictional statement is complete and correct.

STATEMENT OF THE ISSUES

1. Whether an understatement of income resulting from an overstatement of the tax basis of sold property can qualify as an omission from gross income for purposes of the extended, six-year assessment period of I.R.C. § 6501(e)(1)(A).

2. Whether the nature and amount of the income understatement were adequately disclosed on the tax returns in this case, such that the safe harbor for adequate disclosure applies.

STATEMENT OF THE CASE

This TEFRA partnership proceeding[1] involves a challenge to the timeliness of a notice of final partnership administrative adjustment ("FPAA"), in which the Commissioner adjusted items reported on the 1999 partnership return of Home Concrete & Supply, LLC ("Home Concrete"). (JA26.) The case was decided on cross-motions for summary judgment. (JA324.) The District Court (Judge Flanagan), in an opinion reported at 599 F. Supp. 2d 678, determined that the FPAA was timely. Accordingly, it denied the plaintiffs' motion for summary judgment and granted the Government's motion. (JA353.)

STATEMENT OF THE FACTS

This challenge to the timeliness of an FPAA arises in the context of a Son-of-BOSS tax shelter transaction.[2] A typical Son-of-BOSS

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[1] "TEFRA" is an acronym for the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

[2] BOSS is an acronym for Bond and Options Sales Strategy and refers to an abusive tax shelter with no economic outlay that purports

(continued...)

shelter "uses a series of contrived steps in a partnership interest to generate artificial tax losses designed to offset income from other transactions." *Kornman & Associates, Inc. v. United States*, 527 F.3d 443, 446 n.2 (5th Cir. 2008) (internal quotation marks omitted). In such a shelter, a partner contributes encumbered property to the partnership, which expressly assumes the associated obligation. The partner increases his basis in his partnership ("outside basis") by the value of the asset contributed to the partnership. *See* I.R.C. § 722. The partner, however, does not reduce his outside basis under I.R.C. § 752(a) and (b) to reflect the partnership's assumption of the associated obligation, and that omission results in a vastly overstated basis, which, in turn, generates a large, artificial tax loss on the sale of a partnership asset or the disposition of a partnership interest. In Notice 2000-44, 2000-2 C.B. 255, the IRS informed taxpayers that the purported losses arising from these transactions are not allowable for

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[2](...continued)
to generate extraordinary tax savings. Christopher Pietruszkiewicz, *Of Summonses, Required Records and Artificial Entities: Liberating the IRS from Itself*, 73 Miss. L.J. 921 & n.2 (2004). For a description of a BOSS transaction, *see id.* at n.2.

federal income tax purposes and that penalties may be imposed on the participants.

The Son-of-BOSS transaction utilized here involved short-sale transactions, which are economically a wash, to increase basis.[3] The courts have uniformly struck down this type of tax shelter, holding that an obligation to close a short sale is a "liability" under I.R.C. § 752 and that a partner's outside basis must be reduced to account for the partnership's assumption of the obligation to close short sales. *See Kornman*, 527 F.3d at 460-461; *Marriott Internat'l Resorts v. United States*, 586 F.3d 962 (Fed. Cir. 2009). *See also Salina Partnership, L.P. v. Commissioner*, 80 T.C.M. (CCH) 686 (2000).

[3] A short sale is a sale of a security that the investor does not own. Typically this is done by borrowing shares from a broker. The short seller is obligated, however, to buy an equivalent number of shares in order to return the borrowed shares, and he generally makes this covering purchase using the funds he received from selling the borrowed stock. *Zlotnick v. TIE Communications*, 836 F.2d 818, 820 (3d Cir. 1988).

The transactions

In 1999, Robert Pierce, his grantor trusts,[4] and Stephen Chandler (collectively referred to as "taxpayers") owned Home Oil & Coal Co. ("Home Oil"), an S corporation, which they planned to sell. (JA20, JA199, JA205-219.) In a manner "reminiscent of an alchemist's attempt to transmute lead into gold" (*Kornman*, 527 F.3d at 456), taxpayers attempted to use short sale transactions that were economically a wash to increase their bases in Home Oil and thereby reduce their taxable gain when they sold it.

To carry out this plan, on April 15, 1999, they formed Home Concrete, a limited liability company, whose members were taxpayers and Home Oil. On the same day, both Pierce and Chandler formed single-member limited liability companies.[5] (JA21.)

On May 13, 1999, taxpayers executed short sales of U.S. Treasury Notes and received sale proceeds totaling over $7,471,000. Four days

[4] These trusts are the 1999 Robert L. Pierce Grantor Trust A FBO Julie M. Pierce ("Trust A") and the 1999 Robert L. Pierce Grantor Trust B FBO Robert C. Pierce ("Trust B"). (JA213-217.)

[5] A limited liability company with two or more members is generally taxed as a partnership. A single-member limited liability company is generally disregarded as an entity separate from its owner for tax purposes. Treas. Reg. § 301.7701-3(b).

later, they transferred these proceeds, together with the offsetting obligations to close the short sales and some margin cash, to Home Concrete as capital contributions. The following day (May 18, 1999), Home Concrete closed the short sales by purchasing Treasury Notes for $7,359,043 and returning these Notes to the broker. (JA21-23.)

On June 11, 1999, Home Oil transferred substantially all of its business assets to Home Concrete. On June 14, 1999, taxpayers transferred part of their interests in Home Concrete to Home Oil. (JA23.) As a result of these transfers, Home Oil held a substantial partnership interest in Home Concrete, which owned substantially all of its assets and some cash. (JA23-24.) On August 31, 1999, Home Concrete sold substantially all its assets to a third-party purchaser for $10,623,348. (JA24.)

Since Home Concrete had a carryover basis of $4,347,421 in Home Oil's assets (JA197), this sale should have resulted in a capital gain of $6,275,927. Instead, Home Concrete claimed a capital gain of only $69,125. (JA24.) It accomplished this gain reduction through its election under I.R.C. § 754, filed with its 1999 tax return, to adjust its

basis in its assets ("inside basis") under § 743(b) to equal the partners' outside bases. (JA196-197.)

The partners claimed that their outside bases totaled $11,819,826 because they had increased these bases by the amount of the short sale proceeds contributed to Home Concrete (about $7,471,000), but had not reduced them by the offsetting obligation to close the short sales, which Home Concrete had assumed. (*See* JA87-88, 197.) By virtue of its § 754 election, Home Concrete increased the purported basis of its assets from $4,347,421, to $10,527,351.[5] (JA197.) Home Concrete reported the sale of its assets on Form 4797 (Sale of Business Property) and Schedule D, Part II, of its partnership return, which the IRS received on April 11, 2000. (JA170, 174, 185.)

Taxpayers' income tax returns were filed by April 17, 2000. (JA127, 141, 236-238, 295-296.) Because Home Concrete is a pass-through entity, its partners were required to report on their tax returns their respective distributive shares of its gain from its asset sale (*see*

[5] Home Concrete could not use the entire basis step-up resulting from the § 754 election ($7,472,401) because the Internal Revenue Code prohibited increasing basis above the estimated fair market value of the assets ($10,527,351). (JA197.) *See* Treas. Reg. § 1.743-1.

I.R.C. §§ 701-704), which gains were dramatically reduced due to the claimed basis step-up.

Administrative and judicial proceedings

On September 7, 2006, the IRS issued an FPAA to Home Concrete for 1999 in which it, *inter alia*, reduced to zero the outside partnership basis and the short-term capital gain attributable to the Treasury note transactions. (JA154, 161.) It reasoned that Home Concrete was a sham and lacked economic substance, and was formed and used solely for tax avoidance purposes by artificially overstating the partners' outside bases. The IRS added that the obligations to close the short sales were liabilities for purposes of Treas. Reg. § 1.752-6, Home Concrete's assumption of which required the partners to reduce their outside bases, and that Home Concrete had improperly adjusted the bases of its assets pursuant to its § 754 election. (JA163-165.)

Plaintiffs commenced this action and alleged, *inter alia*, that the adjustments in the FPAA were barred by the three-year assessment period of I.R.C. §§ 6229 and 6501. (JA26.) The IRS generally must assess income taxes within three years after the return is filed. I.R.C. § 6501(a). When, however, a taxpayer has omitted from gross income

"an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return," the assessment period is six years. I.R.C. § 6501(e)(1)(A). Section 6229 has similar time periods.

In its amended answer, the Government alleged that the assessment period was tolled for a period under I.R.C. § 7609(e) due to a third-party recordkeeper's tardy compliance with IRS summonses.[6] (JA71, 326.) The Government further alleged that the six-year assessment period applied because the amounts omitted from plaintiffs' tax returns exceeded the 25% threshold. (JA71.)

For purposes of the summary judgment motions, plaintiffs stipulated that the income omitted due to the basis overstatement exceeded this threshold. (JA345.) They urged, however, that a basis overstatement is not an omission of gross income within the meaning of § 6501(e)(1)(A), and they relied on *Colony, Inc. v. Commissioner*, 357

[6] Under I.R.C. § 7609(e)(2), the assessment period is tolled for the period beginning six months after the service of the summons and ending with the recordkeeper's response to the summons. Here, it is undisputed that a third-party recordkeeper did not comply with IRS summonses pertaining to plaintiffs' 1999 tax liabilities until after May 16, 2004, and that consequently, the FPAA was issued within the six-year assessment period. (JA71, 326.)

U.S. 28 (1958), which so held in the context of § 275(c) of the 1939 Code. (JA329-330.) Plaintiffs also contended that they qualified for the safe harbor for adequate disclosure (I.R.C. § 6501(e)(1)(A)(ii)). (JA337.)

The district court rejected plaintiffs' arguments. It held that amendments to the Code in 1954 rendered *Colony* inapplicable and that "Congress intended for it to be possible to 'omit' an item from gross income under § 6501(e)(1)(A) without leaving it completely off the face of a return." (JA332-334.) The court added that "the relevant statutory definitions provided by the IRC . . . further undermine the overly broad reading of *Colony* urged by plaintiffs." (JA335.) It explained:

> "Gross income" is, broadly construed, "all income from whatever source derived, including . . . (3) gains derived from dealings in property." 26 U.S.C. § 61(a). Section 1001(a) fleshes out the meaning of "gains derived from dealings in property," defining gains from dealings in property as "the excess of the amount realized therefrom over the adjusted basis." 26 U.S.C. § 1001(a). Thus, "gross income" as related to dealings in property is defined with reference to the property's adjusted basis. Any overstatement in basis will necessarily decrease the amount of gross income that a taxpayer states on his return. In other words, by overstating basis in the gross income calculation, the taxpayer "leave[s] out" or fails to "include" "an amount properly includible therein." Therefore, where a taxpayer incorrectly states an overestimated basis in property, the taxpayer "omits" gross

> income by leaving the amount out of gross income stated on the taxpayer's return.

Id. (footnote omitted).

The court further held that the safe harbor for adequate disclosure, I.R.C. § 6501(e)(1)(A)(ii), did not protect plaintiffs from the extended assessment period (JA338, JA353.) It held that to disclose the nature and amount of an income omission caused by a basis overstatement, the taxpayer had to disclose the substance of the transaction creating the overstatement. (JA353.) Thus, the returns here needed to contain information "that reasonably apprised the IRS of the disputed election regarding treatment of the obligation to close the short sale." (JA349.) The returns did not do so. To the contrary, they "contain[ed] misleading statements and information that obscured the substance of the disputed underlying transactions." (JA350.)

SUMMARY OF ARGUMENT

1. The Code's general definition of "gross income" establishes that an overstated basis can result in an omission of gross income for purposes of the six-year assessment period (I.R.C. § 6501(e)(1)(A)). The term "gross income," used in § 6501(e)(1)(A), is defined in § 61 as "all income from whatever source derived." The definition of "gross income"

expressly includes "[g]ains derived from dealings in property." I.R.C. § 61(a)(3). Under the Code, gains derived from dealings in property are determined by subtracting the adjusted basis of property from the amount realized on its sale. Because gain is determined by mathematical calculation, an omission from "gross income" under § 6501(e)(1)(A) can occur from an overstatement of basis, as well as from an understatement of gross receipts.

Although the Ninth and Federal Circuits (with one judge dissenting) recently rejected the government's position, the Fifth Circuit long ago ruled in the Government's favor in *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), where the omission of gross income resulted from an overstated basis. *Phinney*, like the district court here, interpreted *Colony* in light of statutory changes made in 1954. It held that the extended assessment period was no longer limited to the specific situation where a taxpayer completely omitted some income receipt from his return, as was the case in *Colony*, but also encompassed the misstating of the nature of an item of income, which included misstating a basis step-up. Under *Phinney*, when, as here, a taxpayer has understated his income by overstating his basis, and the nature of the basis step-up is inadequately disclosed on his

return, the extended assessment period applies. *Phinney* is persuasive authority that should be followed here.

The correctness of the Fifth Circuit's and the district court's statutory interpretation is confirmed by recent temporary regulations. These regulations provide that, in the case of a disposition of property, the term "gross income" generally means the excess of the amount realized over the property's adjusted basis and that, consequently, an understated amount of gross income resulting from an overstated basis constitutes an omission of gross income for purposes of I.R.C. § 6501(e)(1)(A). *See* Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii). These regulations, which are consistent with the general definition of "gross income" in the Code, are reasonable and are entitled to *Chevron* deference.

Neither the Supreme Court's interpretation of "gross income" in *Colony* nor the issuance of the regulations in response to litigation affects the deference to which these regulations are entitled. The Supreme Court has held that a prior judicial interpretation of an ambiguous statute is no impediment to an agency's issuing a regulation containing a different interpretation. It has also held that the issuance

of regulations during litigation does not affect the deference to which they are entitled.

The temporary regulations apply to this case even though they were issued after the district court's determination. The version of I.R.C. § 7805(b) applicable here establishes a presumption that regulations apply retroactively unless otherwise specified. The temporary regulations do not specify otherwise, but provide that they "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b).

2. Section 6501(e)(1)(A)(ii) provides a safe harbor from the six-year assessment period if the taxpayer has adequately disclosed the nature and amount of the omitted item. Since the omitted gross income here resulted from an overstated basis, and the overstated basis resulted from taxpayers' asymmetric treatment of the short sale transactions, the returns, to provide adequate disclosure, had to contain information reasonably apprising the IRS of this tax treatment. They did not do so. Thus, the safe harbor is inapplicable.

ARGUMENT

I

The underreporting of capital gain is an omission of gross income within the meaning of the extended assessment period regardless of whether the gross sales price is underreported or the basis of the property is overstated

A. An overview of TEFRA partnership proceedings and the statutory limitations on tax assessment

When the IRS disagrees with a partnership's reporting of any partnership item, it must issue an FPAA before making any assessments against the partners attributable to this item.[7] I.R.C. §§ 6223(a)(2), (d)(2), 6225(a). The mailing of the FPAA suspends the running of the limitations period for assessing any income taxes that are attributable to any partnership item or affected item. I.R.C. § 6229(d).

[7] Although partnerships do not pay federal income tax, they are nevertheless required to file annual information returns reporting the partners' distributive shares of income, gain, deductions or credits. I.R.C. §§ 701, 6031; *Randell v. United States*, 64 F.3d 101, 103 (2d Cir. 1995). The individual partners report their respective distributive shares on their federal income tax returns. I.R.C. §§ 701-704. Unpaid taxes are assessed against the individual partners.

The standard limitations period for assessing tax, both generally and in the specific context of a taxpayer who has an interest in a partnership, is three years. The Commissioner thus generally has three years after the later of the due date for filing a tax return or the date on which the taxpayer actually files its return to assess any additional tax due. I.R.C. § 6501(a). Additionally, § 6229 provides special rules that extend the period of limitations prescribed by § 6501 in the case of partnership items. The period of limitations for assessing income tax (against the partners) attributable to partnership items "shall not expire before" three years after the date on which the partnership return was filed, or the last day for filing such return (determined without regard to extensions), whichever is later.[8] I.R.C. § 6229(a).

The Code doubles both the general limitations period and the special minimum period for assessing partnership items in cases

[8] The period specified in § 6229 is not a separate and independent limitations period; rather, it operates as a minimum period of limitations that may, if necessary, extend the period of assessment as to partnership items so that it will never expire before three years from the filing of the partnership return. *AD Global Fund, LLC v. United States*, 481 F.3d 1351, 1354 (Fed. Cir. 2007); *Andantech L.L.C. v. Commissioner*, 331 F.3d 972, 976-77 (D.C. Cir. 2003).

involving substantial omission of income from the return. In cases of substantial omissions from individual returns, § 6501(e)(1) provides a six-year assessment period:

> (e) Substantial Omission of Items—Except as otherwise provided in subsection (c)—
>
> (1) Income Taxes.—In the case of any tax imposed by subtitle A—
>
> (A) General Rule.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph–
>
> (i) 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; and
>
> (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.

Similarly, the special minimum limitations period for assessing partnership items is extended from three to six years if a partnership's omission from gross income exceeds the 25% threshold. *See* I.R.C. § 6229(c)(2).[9] Limitations statutes barring the assessment and collection of tax are strictly construed in favor of the Government. *Bufferd v. Commissioner*, 506 U.S. 523, 527 n.6 (1993); *Badaracco v. Commissioner*, 464 U.S. 386, 391-392 (1984).

A taxpayer raising the affirmative defense of the expiration of the three-year assessment period has the initial burden of showing its expiration. *Hoffman v. Commissioner*, 119 T.C. 140, 146 (2002); *Mecom v. Commissioner*, 101 T.C. 374, 382-83 (1993). The burden then shifts to the Commissioner to show that the return omitted gross income in excess of 25% of the amount of gross income stated in the return. *Hoffman*, 119 T.C. at 146; *Mecom v. Commissioner*, 101 T.C. 374, 382-83 (1993); *see Azevedo v. Commissioner*, 246 F.2d 196, 200 (9th Cir. 1957). If the Commissioner makes this showing, the burden shifts back to the taxpayer to show that its return adequately disclosed the nature and amount of the omitted gross income. *Hoffman*, 119 T.C. at 146.

[9] Section 6229(c)(2), enacted in 1982 by TEFRA § 402(a), does not contain subsections analogous to §§ 6501(e)(1)(A)(i) & (ii).

"Notwithstanding the shifting of the burden of going forward, the burden of ultimate persuasion never shifts from the party who pleads the bar of the period of limitations." *Id.* at 146-47.

In these cases, as we shall demonstrate, the six-year assessment period applies for several reasons. First, because the term "gross income," contained in § 6501(e)(1)(A), includes "[g]ains derived from dealings in property" (I.R.C. § 61(a)(3)), and these gains are determined by subtracting the adjusted basis of property from the amount realized on its sale, an omission from "gross income" can occur from a basis overstatement, as well as from an understatement of gross receipts. Second, under *Phinney*, the six-year period applies when, as here, the taxpayers have substantially understated their income by virtue of an overstated basis and have not adequately disclosed the nature of the basis step-up on their return. Third, the Government's statutory interpretation is confirmed by recent temporary regulations, which "clarify that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)." T.D. 9466, 74 Fed. Reg. 49321, 49321 (2009).

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

1. The definition of "gross income" in I.R.C. § 61 establishes that an omission of gross income for purposes of the extended assessment period can occur from an overstatement of the basis of sold property

The general definition of "gross income" in the Internal Revenue Code establishes that an omission of gross income can result from an overstated basis. The critical statutory phrase in I.R.C. § 6501(e)(1)(A) and § 6229(c)(2) is "omits from gross income." The term "omit" cannot be defined and understood without reference to the qualifying term "gross income." Both terms deserve equal weight, and § 6501(e)(1)(A) and § 6229(c)(2) must be interpreted in a way that gives both terms meaning. *See Regions Hosp. v. Shalala*, 522 U.S. 448, 467 (1998) ("It is a cardinal rule of statutory construction that significance and effect shall, if possible, be accorded to every word") (internal quotation marks omitted); *Washington Market Co. v. Hoffman*, 101 U.S. 112, 115 (1879) (same); *Hawkins v. United States*, 469 F.3d 993, 1000 (Fed. Cir. 2006) (court "must try to read the statute as a whole, to give effect to all of its

parts, and to avoid, if possible, rendering language superfluous") (internal quotation marks omitted).

Since "gross income" is not defined in § 6501, the general definition of "gross income" in I.R.C. § 61 applies. *See Hoffman v. Commissioner*, 119 T.C. 140, 148 (2002). Section 61 defines "gross income" as "all income from whatever source derived" and explicitly includes "[g]ains derived from dealings in property" in "gross income." I.R.C. § 61(a) & 61(a)(3). *See also* Treas. Reg. § 1.61-6(a).

Gains from the sale of property are defined as "the excess of the amount realized therefrom over the adjusted basis. . . ." I.R.C. § 1001(a). *See also* Treas. Reg. § 1.61-6(a). Because gain is determined mathematically, by subtracting basis from the amount realized, an "omi[ssion] from gross income" within the meaning of § 6501(e)(1)(A) can occur either from an understatement of the amount realized (the minuend) or from an overstatement of basis (the subtrahend). Indeed, two other recent district court decisions, which are on all fours with this case, have so held. *See Brandon Ridge Partners v. United States*, 100 A.F.T.R.2d (RIA) 5347 (M.D. Fla. 2007); *Burks v. United States*,

2009 WL 2600358 (N.D. Tex. 2008), *appeal docketed*, No. 09-11061 (5th Cir. Oct. 26, 2009).

Section 6501(e)(1)(A)(i) also supports the Commissioner' position that gross income can be omitted under § 6501(e)(1)(A) by overstating the basis of sold property. Added to the Code in 1954, § 6501(e)(1)(A)(i) provides a special definition of the "gross income" of trades or businesses, for purposes of the extended assessment period, as follows:

> 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 . . . prior to diminution by the cost of such sales or services. . . .

Thus, under § 6501(e)(1)(A)(i), "gross income" essentially means gross receipts in the case of income from "the sale of goods or services" by "a trade or business."

Section 6501(e)(1)(A)(i) supplies a definition of "gross income" applicable only in limited circumstances. It "provides an exception – in the case of a trade or business – to the general meaning of 'gross income' as stated in section 6501(e)." *Insulglass Corp. v. Commissioner*, 84 T.C. 203, 210 (1985). Under this exception, "'gross income' is

equated with gross receipts.[10] Otherwise, 'gross income' means those items listed in section 61(a), which includes . . . gains derived from dealings in property." *Id*. (footnote omitted).

That Congress defined "gross income" under § 6501(e)(1)(A)(i) as gross receipts irrespective of basis in the case of trades and businesses supports the conclusion that "gross income" in § 6501(e)(1)(A) is not that special definition, but rather is the definition contained in § 61(a). *See* David A. Brooks, *How the IRS Time Limits on Assessing a Deficiency Can Be Used in Planning*, 14 Tax'n for Law. 296, 299 (1986) ("Under Section 6501(e)(1)(A)(i), gross income is the total of the amounts received or accrued from the sale of goods or services without reduction for the cost of such sales or services. Where the taxpayer is not engaged in a trade or business, gross income means the statutory gross income as defined in Section 61") (footnote omitted).

If Congress had intended the definition of § 6501(e)(1)(A)(i) to apply to all circumstances, the qualifying language "[i]n the case of a trade or business" and "amounts received or accrued from the sale of

---

[10] Customarily, gross income from the sale of goods or services in a trade or business is computed by subtracting the cost of goods sold from the sales receipts. Treas. Reg. § 1.61-3(a); *In re Lilly*, 76 F.3d 568, 572 (4th Cir. 1996).

goods or services" would be superfluous. *Brandon Ridge*, 100 A.F.T.R.2d at 5352 (ruling that "gross receipts test only applies to situations described in § 6501(e)(1)(A)(i)," because "[t]o conclude otherwise would render § 6501(e)(1)(A)(i) superfluous"); *Grapevine Imports, Ltd. v. United States*, 77 Fed. Cl. 505, 511 n.7 (2007), *notice of appeal filed* (Fed. Cir. June 23, 2008) (recognizing that to apply "the . . . gross receipts test . . . to every sort of sale is to render surplusage Congress' reference to that same test as applying '[i]n the case of a trade or business'").[11] To hold § 6501(e)(1)(A)(i) superfluous would violate the canon of statutory construction that "a legislature is presumed to have used no superfluous words." *Bailey v. United States*, 516 U.S. 137, 145 (1995); *Platt v. Union Pac. R.R. Co.*, 99 U.S. 48, 58 (1878).

Section 6501(e)(2) of the Code provides additional support for the conclusion that an omission from "gross income" under § 6501(e)(1)(A) can occur from a basis overstatement. Section 6501(e)(2) provides that

[11] Notwithstanding this recognition, the Court of Federal Claims in *Grapevine* held that the addition of the gross receipts provision to § 6501(e)(1)(A) did not modify § 6501(e)(1)(A), and that an omission of "gross income" under § 6501(e)(1)(A) did not encompass an overstated basis. *Grapevine*, 77 Fed. Cl. at 510 n.7 & 511. As explained in this brief, the court erred in so holding.

the IRS has six years to assess estate and gift taxes "if the taxpayer omits . . . *items* includible in such gross estate or such total gifts" in an amount exceeding "25 percent of the gross estate stated in the return or the total amount of gifts stated in the return." I.R.C. § 6501(e)(2) (emphasis added.) Congress used the word "items" to "make[ ] it clear that the 6-year period is not to apply merely because of differences between the taxpayer and the Government as to the valuation of property." Staff of the Joint Committee on Taxation, 83rd Cong., *Summary of the New Provisions of the Internal Revenue Code of 1954 (H.R. 8300)* at 130 (1955).

But Congress used the word "amount" in § 6501(e)(1)(A), instead of "item." As one district court explained (*Brandon Ridge*, 100 A.F.T.R.2d at 5353):

> This suggests that the extended limitations period in § 6501(e)(2) regarding estate and gift taxes only applies when an item is completely left out, while the extended limitations period in § 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 reported is understated due to an error in the calculation.

Thus, there is ample textual authority for the conclusion that a basis overstatement can result in an omission of gross income for purposes of the extended assessment period, as the district court correctly concluded.

2. Although the Circuits are divided on this issue, this Court should follow the rationale of the Fifth Circuit in *Phinney*

Notwithstanding the wording of the current statutes, appellants rely (Br. 13-26) on *Colony*, a Supreme Court decision interpreting pre-1954 law, to support their argument that a basis overstatement cannot give rise to the extended assessment period. In *Colony*, the Supreme Court construed the statutory language "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," then contained in § 275(c) of the Internal Revenue Code of 1939 and now contained in I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A).[12]

[12] The extended assessment period in cases of substantial omissions of income originated in the Revenue Act of 1934, ch. 277, 48 Stat. 680, 745, § 275(c), and was incorporated in § 275(c) of the 1939 Internal Revenue Code (26 U.S.C. 1952 ed.).

The Court found this statutory language to be ambiguous. *See* 357 U.S. at 33 ("it cannot be said that the [statutory] language is unambiguous"). After examining the legislative history, the Court concluded that "in enacting § 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." *Id.* at 36. The Court then held that the ambiguous statutory language referred 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. Under this interpretation, the real estate company that had understated its business income from selling residential lots by overstating the cost bases of these lots had not omitted gross income within the meaning of § 275(c), and the extended assessment period was inapplicable.

The tax years at issue in *Colony* – 1946 and 1947 – predated the adoption of the 1954 Code, in which Congress enacted a "comprehensive revision" of the internal revenue laws. H.R. Rep. No. 83-1337 at 1

(1954) *reprinted in* 1954 U.S.C.C.A.N. 4017, 4025. Congress noted that, in enacting § 6501(e), it "changed the existing law in several respects." *Id*. at A414, 1954 U.S.C.C.A.N. at 4561. As discussed *supra*, p. 22, in § 6501(e)(1)(A)(i) it "redefined" the term "gross income" in the context of the sale of goods or services by a trade or business, so that in that situation, "gross income" means gross receipts, undiminished by basis. *Id*. The definition of "gross income" is not so limited in any other circumstances. In addition, in § 6501(e)(1)(A)(ii), Congress created a "safe harbor" for adequate disclosure by excluding from the 25% omission computation any amount that is adequately disclosed on the return.

In light of these amendments, the Fifth Circuit in *Phinney* concluded that the extended assessment period was no longer limited to the situation where a taxpayer actually omitted an income receipt or accrual from his return. *Phinney* involved the taxation of proceeds of an installment note that taxpayer and her husband had received from their 1954 sale of stock held as community property. Taxpayer's husband had died in 1956, and his executor took possession of the entire note. In 1958, the principal balance of the note ($751,472.13)

was paid. The executor prepared a fiduciary return for taxpayer's half-interest in the community property, in which it correctly reported her share of the note proceeds ($375,736.06), but mislabeled this income as payment for stock sold in 1958. It then claimed a basis in the stock of $375,736.06 and reported a gain or loss of zero. Although not apparent from the face of the return, the claimed basis of $375,736.06 was a basis step-up claimed in taxpayer's share of the community property upon her husband's death.

The IRS denied the basis step-up after the three-year assessment period had expired and relied on the extended assessment period of § 6501(e). The executor, relying on *Colony*, insisted that since the entire proceeds that taxpayer had received were reported on the return, no "omission" of income occurred. 392 F.2d at 683.

The district court agreed with the executor, but the Fifth Circuit reversed. It interpreted *Colony* in light of the adequate disclosure provision, I.R.C. § 6501(e)(1)(A)(ii), enacted in 1954:

> We conclude that the enactment of subsection (ii) as a part of section 6501(e)(1)(A) makes it apparent that the six 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.

392 F.2d at 685 (internal quotation marks omitted; emphasis in original).

In other words, the Fifth Circuit held that, after the 1954 amendments, the extended assessment period was no longer limited to "the specific situation where a taxpayer actually omitted some income receipt or accrual in his computation of gross income" (*Colony*, 357 U.S. at 33), but also encompassed the "misstating of the nature of an item of income which places the commissioner . . . at a special disadvantage in detecting errors" (*Phinney*, 392 F.2d at 685) (internal quotation marks omitted).

Although the district court in *Phinney* had not considered whether disclosure was adequate, the Fifth Circuit considered that issue in the first instance, noting several reporting errors on the return. *See* 392 F.2d at 684-685. It identified the failure to disclose the basis step-up as the critical error justifying application of the six-year assessment period:

> It simply defies belief that the Internal Revenue Service, while contesting the right of Bath to claim a stepped-up basis in connection

> with a community property interest of less than $50,000 would have complacently permitted the similar claim for stepped-up basis in the Chambers estate to go unchallenged had the return filed on behalf of Mrs. Chambers disclosed what was really at issue, that is, as claimed by taxpayer, the amount received was in payment of an installment note, which, by virtue of the provisions of Section 1014(b)(6) of the Internal Revenue Code acquired a stepped-up basis upon the death of her husband.

392 F.2d at 685.

Indeed, the Fifth Circuit could not have applied the six-year assessment period without concluding that a basis overstatement could give rise to this extended period. A prerequisite for the applicability of this period is the omission from gross income of "an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return"; a mere misdescription of an income item is insufficient. I.R.C. § 6501(e)(1)(A). Since the executor correctly reported the amount of taxpayer's gross receipts, the 25% threshold would not have been satisfied unless the basis overstatement was taken into account. Thus, under *Phinney*, when a taxpayer has understated his income by overstating his basis in property, and the

nature of the basis step-up is inadequately disclosed on his return, the extended assessment period applies.[13]

Phinney has been followed not only by the district court in this case (*see* JA334), but also by the Northern District of Texas, which concluded that an overstatement of basis could result in an omission of gross income:

> Despite the taxpayer's invocation of *Colony*, the *Phinney* Court held that the taxpayer's overstatement of basis resulted in an omission of gross income under section 6501(e)(1)(A). . . . . According to the *Phinney* Court, an omission of gross income could arise from either an overstatement of basis and/or a pure omission of gross proceeds as long as the "item of income . . . is not shown in a manner sufficient to enable the secretary by reasonable inspection of the return to detect the errors."

Burks v. United States, 2009 WL 2600358 at *3 (N.D. Tex. 2008), *appeal docketed*, No. 09-11061 (5th Cir. Oct 26, 2009).

Despite the logic of *Phinney*, the Ninth Circuit in *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767, 768 (9th Cir. 2009), and the Federal Circuit (over a vigorous dissent) in *Salman*

[13] In this case, as discussed *infra*, pp.72-81, the district court correctly held that the tax returns did not adequately disclose the basis step-up. (JA346-353.)

Ranch Ltd v. United States, 573 F.3d 1362, 1372-1377 (Fed. Cir. 2009), *rev'g* 79 Fed. Cl. 189 (2007), recently reached a different conclusion. We respectfully submit that these decisions are wrong as a matter of statutory interpretation, as well as inconsistent with a sister circuit's earlier decision on the same issue. The Ninth Circuit did not even cite *Phinney*. The Federal Circuit acknowledged *Phinney* in a footnote, but did not distinguish it or otherwise explain its failure to follow it.[14] *See Salman Ranch*, 573 F.3d at 1373 n.9.

Moreover, to the extent that these decisions turn on Congress's failure to overrule *Colony* legislatively by further amending § 6501 (Br. 19-20),[15] they are inconsistent with the Supreme Court's repeated pronouncements that Congressional silence lacks persuasive significance. For example, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the Court rejected

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[14] In *Utam, Ltd. v. Commissioner*, 98 T.C.M. (CCH) 422 (2009), on which appellants rely (Br. 30-31), the Tax Court incorrectly concluded that "*Phinney* is not directly on point. . . ." *Id.* at 423. The *Utam* court failed to understand that in *Phinney*, the Fifth Circuit could not have applied the six-year assessment period unless it concluded that an overstated basis could render this extended period applicable. Thus, *Phinney* is directly on point.

[15] *See Bakersfield*, 568 F.3d at 775; *Salman Ranch*, 573 F.3d 1373-1374.

the argument that Congress, by its silence, had acquiesced in the judicial interpretation of § 10(b) of the Securities Exchange Act of 1934, reasoning that "[i]t is impossible to assert with any degree of assurance that congressional failure to act represents affirmative congressional approval of the [courts'] statutory interpretation." *Id.* at 186 (internal quotation marks omitted). *Accord Helvering v. Hallock*, 309 U.S. 106, 119-120 (1940) (" To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities. Congress may not have had its attention directed to an undesirable decision. . .") (footnote omitted).

As concurring Justice Scalia stated in *United States v. Estate of Romani*, 523 U.S. 517, 535-536 (1998):

> . . . Congress cannot express its will by a failure to legislate. The act of refusing to enact a law (if that can be called an act) has utterly no legal effect, and thus has utterly no place in a serious discussion of the law. The Constitution sets forth the only manner in which the Members of Congress have the power to impose their will upon the country: by a bill that passes both Houses and is either signed by the President or repassed by a supermajority after his veto. Art. I, § 7. . . . .
>
> Second, even if Congress could express its will by not legislating, the will of a later Congress

> that a law enacted by an earlier Congress should bear a particular meaning is of no effect whatever. The Constitution puts Congress in the business of writing new laws, not interpreting old ones.

We respectfully submit that *Phinney* is more persuasively reasoned than *Bakersfield* and *Salman Ranch*. Further, the fact that the latter were decided without the benefit of the new regulations, discussed below, is an additional reason why they should not be followed.

C. Recently issued temporary regulations confirm the Commissioner's interpretation of the statutory language

As we have explained, the Ninth Circuit and the Federal Circuit recently departed from the forty-year-old precedent of *Phinney* to hold that an omission from gross income under § 6501(e)(1)(A) does not occur by reason of the overstatement of the basis of sold property. *Bakersfield Energy*, 568 F.3d at 768; *Salman Ranch*, 573 F.3d at 1372-1377. Because "[t]he Treasury Department and the Internal Revenue Service disagree[d] with these courts that the Supreme Court's reading of the predecessor to section 6501(e) in *Colony* applies to sections 6501(e)(1)(A) and 6229(c)(2)," temporary regulations were issued on September 24, 2009, clarifying that a basis overstatement can cause an

omission from gross income for purposes of the six-year assessment period.[16] T.D. 9466, 74 Fed. Reg. at 49321; Temp. Treas. Reg. §§ 301.6501(e)-1T(a)(1)(iii), 301.6229(c)(2)-1T(a)(1)(iii). As the Ninth Circuit itself recognized in *Bakersfield*, "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, quoting *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-983 (2005).

The temporary regulations interpret the phrase "omission from gross income" contained in I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2). These regulations "clarify that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)." T.D. 9466, 74 Fed. Reg. at 49321. Since, in the case of the sale of property, "gross income" under § 61 means the excess of the amount realized over the

[16] The amicus thus incorrectly asserts (Am. Br. 7) that the justification for the temporary regulations was the affected taxpayers' participation in tax shelters and listed transactions. There is not a single reference to "listed transactions" or "tax shelters" in the Treasury Decision promulgating the regulations.

adjusted basis of the property, under the temporary regulations, "any basis overstatement that leads to an understatement of gross income under section 61(a) constitutes an omission from gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2)." *Id.*

Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) (26 C.F.R.) provides (74 Fed. Reg. at 49323 (emphasis in original)):

> For purposes of paragraph (a)(1)(i) of this section, the term *gross income*, as it relates to any income other than from the sale of goods or services in a trade or business, has the same meaning as provided under section 61(a), and includes the total of the amounts received or accrued, to the extent required to be shown on the return. In the case of amounts received or accrued that relate to the disposition of property, and except as provided in paragraph (a)(1)(ii) of this section, *gross income* means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property. Consequently, except as provided in paragraph (a)(1)(ii) of this section, 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 6501(e)(1)(A).

Accord Temp. Treas. Reg. § 301.6229(c)(2)-1T(a)(1)(iii). The temporary regulations "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b).

As we shall demonstrate, the new regulations are entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), and provide an additional reason for affirming the district court's determination.[17]

1. Since the regulations are properly classified for purposes of the Administrative Procedure Act ("APA") as "interpretive," they are exempt from the APA's notice-and-comment requirements

In an attempt to demonstrate that the regulations are invalid, the amicus argues (Am. Br. 11-15) that they were not issued in compliance with the APA's notice-and-comment requirements. This argument lacks merit. To begin with, Congress authorized Treasury to issue temporary regulations without notice and comment by requiring any temporary regulation to be issued also as a proposed regulation. *See* I.R.C. § 7805(e)(1). In accordance with § 7805(e), the temporary regulations were issued simultaneously as proposed regulations – Prop.

[17] The district court's opinions in this case predated the promulgation of the regulations. However, an appellate court can affirm on any ground, whether it was considered by the lower court or not. *United States v. Arthur Young & Co.*, 465 U.S. 805, 814 n.12 (1984); *Dandridge v. Williams*, 397 U.S. 471, 475 n.6 (1970). Thus, this Court may rely on the regulations as an additional reason for affirmance.

Treas. Reg. §§ 301.6229(c)(2)-1, 301.6501(e)-1. This notice of proposed rulemaking provides for comments from the public and for requests for a public hearing. 74 Fed. Reg. at 49354.[18] Further, the APA's notice-and-comment requirements apply to legislative regulations, but not to interpretive regulations, as the amicus concedes (Am. Br. 12). *See* 5 U.S.C. § 553(b)(3)(A). As we shall demonstrate, the regulations at issue were interpretive.

In determining whether an agency's action is legislative or interpretive, "the proper focus . . . is the source of the agency's action, not the implications of that action." *Fertilizer Institute v. U.S. E.P.A.*, 935 F.2d 1303, 1308 (D.C. Cir. 1991). The District of Columbia Circuit has explained:

> If the rule is based on specific statutory provisions, . . . it is an interpretative rule. If, however, the rule is based on an agency's power to exercise its judgment as to how best to implement a general statutory mandate, the rule is likely a legislative one.

[18] Although the IRS believes that regulations issued under I.R.C. § 7805(a) do not require notice and comment, it nevertheless usually follows notice and comment procedures. *Bankers Life and Cas. Co. v. United States*, 142 F.3d 973, 978 (7th Cir. 1998).

Id. (internal quotation marks omitted.) *See also Syncor Intern. Corp. v. Shalala*, 127 F.3d 90, 94 (D.C. Cir. 1997) ("An interpretative rule . . . typically reflects an agency's construction of a statute that has been entrusted to the agency to administer. The legal norm is one that Congress has devised. . ."). That a rule "may affect how parties act does not make the rule legislative – regardless of the consequences of a rulemaking, a rule will be considered interpretive if it represents an agency's explanation of a statutory provision." *Fertilizer Institute*, 935 F.2d at 1308. *Accord Sentara-Hampton Gen'l Hosp. v. Sullivan*, 980 F.2d 749, 759 (D.C. Cir. 1992).

Thus, an agency's construction of a statutory provision is an interpretive rule under the APA. *Paralyzed Veternas of America v. West*, 138 F.3d 1434, 1436 (Fed. Cir. 1998) (interpretive rules "clarify or explain existing law or regulations"); *United States v. Yuzary*, 55 F.3d 47, 51 (2d Cir. 1995) (same); *Sentara-Hampton*, 980 F.2d at 759 ("When an agency issues an interpretive rule, it is only intending to explain ambiguous language. . ."); *York v. Secretary of Treasury*, 774 F.2d 417, 420 (10th Cir. 1985) (a ruling "that further defines the language of 26 U.S.C. § 5846(b) was merely an interpretive rule not subject to . . . notice and comment procedure under 5 U.S.C. § 553. . .").

The temporary regulations here merely interpreted the ambiguous statutory language "omits from gross income," contained in I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A). They were therefore interpretive regulations under the APA, not legislative regulations, as the amicus erroneously contends. That the regulations conflict with some judicial interpretations of the pre-regulation law does not mean that the regulations are a substantive change, rather than a clarification, of existing law. *See Levy v. Sterling Holding Co., LLC*, 544 F.3d 493, 507 (3d Cir. 2008), *cert. denied*, 129 S. Ct. 2827 (2009). Indeed, "one could posit that quite the opposite was the case – that the new language was fashioned to clarify the ambiguity made apparent by the caselaw." *Id.* (internal quotation marks omitted).

The Treasury Department's promulgation of the regulations pursuant to the general rule-making authority contained in I.R.C. § 7805(a) (*see* T.D. 9466, 74 Fed. Reg. at 49322) provides additional support for the conclusion that the regulations are interpretive.[19] *See Boeing Co. v. United States*, 537 U.S. 437, 448 (2003) (characterizing

[19] Section 7805(a) provides that "the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title. . . ."

"regulations promulgated under § 7805(a)'s general rulemaking grant rather than pursuant to a specific grant of authority" as "interpretive"); *Pickus v. U.S. Bd. of Parole*, 507 F.2d 1107, 1113 (D.C. Cir. 1974) ("Treasury Regulations interpreting the Internal Revenue Code are a prime example" of interpretive rules); *Wing v. Commissioner*, 81 T.C. 17, 28 (1983) ("'interpretive' treasury regulations, though usually deemed to have the force of law, still qualify as 'interpretive' rules of the Secretary of the Treasury, and therefore are exempt from the requirements of 5 U.S.C. sec. 553(c)").

2. *Chevron* governs review of the temporary regulations

Perhaps realizing that its argument that the regulation is legislative is unlikely to prevail, the amicus argues in the alternative (Am. Br. 17) that, if the regulations are "interpretive," they are not entitled to *Chevron* deference, but are evaluated under the lesser power-to-persuade standard of *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).[20] Under *Skidmore,* the weight given to any agency

[20] The amicus also incorrectly argues (Am. Br. 16 n.35) that, if the regulations are "interpretive," they violate the Regulatory Flexibility Act ("RFA"), 5 U.S.C. §§ 601-612. The RFA is inapplicable because it only applies to interpretive regulations involving the internal revenue

(continued...)

determination "depend[s] 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." *Id.* at 140. The amicus also advocates (Am. Br. 18) the multi-factor approach employed in *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979), in evaluating the regulations' reasonableness.[21]

But regardless of whether the regulations are "legislative" or "interpretive," we submit that the standards established in *Chevron*, not *Skidmore* and *National Muffler Dealer*, govern in determining their

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[20](...continued)
laws to the extent that these regulations impose a collection of information requirement on small entities. 5 U.S.C. § 603(a). As stated in the Preamble, these regulations do not impose such a requirement. 74 Fed. Reg. at 49354. *See* 5 U.S.C. § 605(b). Treas. Reg. § 301.6501(e)-1T(a)(1)(iv), on which the amicus relies for its assertion that there is an RFA violation (Am. Br. 16 n.35), does not require a collection of information for purposes of the RFA, but merely acknowledges the adequate disclosure safe harbor in I.R.C. § 6501(e)(1)(A)(ii). Accordingly, any reporting requirement flows from the statute, not the regulations.

[21] These factors include whether the regulation harmonizes with the statutory language and its purpose; whether the regulation is a contemporaneous construction of the statute by those presumed to have been aware of congressional intent; the manner in which a regulation from a later period evolved; the length of time the regulation has been in effect; and the consistency of the Commissioner's interpretation. *National Muffler*, 440 U.S. at 477.

validity. *Chevron* provides a two-step process for determining the validity of a regulation:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has 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. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if 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.

Chevron, 467 U.S. at 842-843 (footnotes omitted.) *Accord Barnhart v. Thomas*, 540 U.S. 20, 26 (2003); *Martinez v. Flowers*, 164 F.3d 1257, 1259 (10th Cir. 1998). Thus, if the statutory language is ambiguous or silent on the issue, the agency's regulation receives controlling weight unless it is arbitrary, capricious, or manifestly contrary to the statute. *Chevron*, 467 U.S. at 843-844; *Wottlin v. Fleming*, 136 F.3d 1032, 1035 (5th Cir. 1998); *Martinez*, 164 F.3d at 1259.

In *United States v. Mead Corp.*, 533 U.S. 218 (2001), the Court, refining its *Chevron* analysis, determined that *Chevron* deference was available to *any* administrative implementation of a statutory provision "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law," and "the agency interpretation claiming deference was promulgated in the exercise of that authority." *Id.* at 226-227. *See A.T. Massey Coal Co. v. Holland*, 472 F.3d 148, 166 (4th Cir. 2006). This reference to regulations having the "force of law" is not confined to legislative regulations, but applies equally to regulations issued pursuant to an agency's "generally conferred authority" to interpret and enforce the law. *Mead*, 533 U.S. at 229. *See also* Kristin Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 Minn. L. Rev. 1537, 1548 (2006) ("The more revolutionary but less often recognized aspect of *Chevron* is its call for strong, mandatory deference not only where Congress specifically mandates regulations, but also where Congress implicitly delegates rulemaking authority through the combination of statutory ambiguity and administrative responsibility. . . .").

It is readily apparent that Congress intended that rules and regulations issued under the authority granted by I.R.C. § 7805(a) to

enforce the Internal Revenue Code would bind all persons who are subject to the federal tax laws. *E.g.*, *United States v. Correll*, 389 U.S. 299, 307 (1967) (describing I.R.C. § 7805(a) as imposing a "congressional mandate" to prescribe rules and regulations).

The language of I.R.C. § 7805(a) is also similar to the language of other statutes authorizing the issuance of regulations that have been held to warrant *Chevron* deference. *E.g.*, *Brand X*, 545 U.S. at 980-981 (regulations issued pursuant to statute granting FCC authority to "execute and enforce" the Communications Act, and to "prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions" of the Act, evaluated under *Chevron* framework).

Accordingly, the validity of the temporary regulations should be evaluated under *Chevron*, rather than under the differing standards of pre-*Chevron* jurisprudence. There is thus no basis for according less deference to regulations issued by the Treasury Department pursuant to I.R.C. § 7805(a) than is accorded to regulations issued under similar statutes, using similar procedures, by other agencies.

Indeed, several appellate courts have recently held that all Treasury regulations are entitled to *Chevron* deference, regardless of

whether they are described as "interpretive" or "legislative." *See Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162, 169 (3d Cir. 2008) (adopting *Chevron*, and not *National Muffler*, as the proper standard for evaluating Treasury Regulations); *Hosp. Corp. of Am. & Subs. v. Commissioner*, 348 F.3d 136, 140-141 (6th Cir. 2003). *See also Bankers Life and Cas. Co. v. United States*, 142 F.3d 973, 979-984 (7th Cir. 1998) (giving *Chevron* deference to an interpretive regulation issued with notice and comment procedures). And temporary regulations are entitled to the same weight as final regulations. *E. Norman Peterson Marital Trust v. Commissioner*, 78 F.3d 795, 798 (2d Cir. 1996). *See also Allen v. United States*, 173 F.3d 533, 537-38 (4th Cir. 1999) (upholding temporary Treasury regulation under *Chevron*); *McDonnell v. United States*, 180 F.3d 721, 722-23 (6th Cir. 1999) (same); *Miller v. United States*, 65 F.3d 687, 689-90 (8th Cir. 1995) (same).

The amicus cites cases applying *National Muffler*, not *Chevron*, in evaluating the deference due regulations issued under I.R.C. § 7805(a), but each such case predated *Mead*. (Am. Br. 18 n.45.) *See, e.g., Snowa v. Commissioner*, 123 F.3d 190 (4th Cir. 1997); *Nalle v. Commissioner*, 997 F.2d 1134 (5th Cir. 1993). This Court appears not to have

explicitly considered the level of deference applicable to so-called "interpretive" regulations post-*Mead*. However, in a post-*Mead* case, this Court recognized that *Chevron* deference is not limited to "legislative" regulations and that there were many "possible forms that a congressional grant of interpretive authority might take." *Massey Coal*, 472 F.3d at 166. It did "not undertake to describe all of the[se] possible forms" and recognized that when there was "an explicit or implicit grant of interpretive power from Congress to the agency," *Chevron* deference applied to the agency's implementation of that grant. *Id.*

That principle applies here. Congress granted interpretive power to the Treasury Department when it required it to "prescribe all needful rules and regulations for the enforcement of this title." I.R.C. § 7805(a). *Chevron* deference, therefore, applies to regulations issued pursuant thereto. *See Massey Coal*, 472 F.3d at 166.

3. The new regulations are entitled to *Chevron* deference

As discussed above, the current statutes (I.R.C. §§ 6229(c)(2), 6501(e)(1)(A)) resolve what the Supreme Court in *Colony* held to be ambiguous in the predecessor statute. The Court's characterization of

§ 6501(e)(1)(A) of the 1954 Code as "unambiguous" (357 U.S. at 37) supports this conclusion, as does *Phinney*. *See* 392 F.2d at 685. Under the first step of the *Chevron* analysis, this is the end of the inquiry.

But even if this Court were to agree with the Ninth and Federal Circuits that the statutory language in these Code sections remains ambiguous (*see Bakersfield*, 568 F.3d at 778; *Salman Ranch*, 573 F.3d at 1367),[22] the new regulations resolve this ambiguity and pass muster under *Chevron*. The regulations provide that, in general, the term "gross income" "has the same meaning as provided in section 61(a)" of the Internal Revenue Code, and that, in the case of the disposition of property, "*gross income* means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property." Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) (emphasis in original). *Accord* Temp. Treas. Reg. § 301.6229(c)(2)-1T(a)(1)(iii).

Far from being arbitrary or capricious, these regulations are reasonable because they are consistent with, and supported by, the

[22] The Ninth Circuit refused to rely on *Colony*'s characterization of § 6501(e)(1)(A) as unambiguous because "[t]he Court expressly avoided construing the 1954 Code. . . ." *Bakersfield*, 568 F.3d at 778.

general definition of "gross income" in I.R.C. § 61. As discussed *supra*, p. 21, § 61 broadly defines "gross income" as "all income from whatever source derived," and it explicitly includes within the meaning of that term "[g]ains derived from dealings in property." I.R.C. § 61(a) & 61(a)(3). *See also* Treas. Reg. § 1.61-6(a). Because gain is determined mathematically, by subtracting basis from the amount realized (*see* I.R.C. § 1001(a)), the Treasury Department reasonably concluded that "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 6501(e)(1)(A)." Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii). Indeed, the Ninth Circuit has characterized the Commissioner's interpretation of the statutory language, now incorporated in the temporary regulations, as both "reasonable" and "sensible." *Bakersfield*, 568 F.3d at 775, 778.

Further, before the present controversy arose, the Tax Court had held that the general definition of "gross income," contained in § 61, applies to § 6501(e)(1)(A). *See, e.g.*, *Hoffman v. Commissioner*, 119 T.C. 140, 148 (2002) ("Gross income is not defined in section 6501. We have held, however, that the general definition of gross income found in the Code applies to section 6501(e), except for the modification provided in

section 6501(e)(1)(A)(i)"); *Northern Ind. Pub. Serv. Co. & Subs. v. Commissioner*, 101 T.C. 294, 299 n.7 (1993) ("For nonbusiness items and those not covered under sec. 6501(e)(1)(A)(i), the general definition of gross income found in the Code applies"); *Schneider v. Commissioner*, 49 T.C.M. (CCH) 1032, 1034 (1985) (Tax Court "look[ed] to the general definition of gross income to determine the proper treatment of non-business gross income under section 6501"). Thus, there can be no doubt that the regulations are reasonable and are entitled to *Chevron* deference.[23]

That the temporary regulations were promulgated before notice-and-comment does not preclude giving them *Chevron* deference. *See Mead Corp.*, 533 U.S. at 226-227, 230-231 (while notice-and-comment rulemaking almost always assures *Chevron* deference, the absence of such formalities does not preclude such deference, so long as it appears that Congress intended to grant the agency the power to make rules with the "force of law" and "the agency interpretation claiming deference was promulgated in the exercise of that authority"); *Barnhart*

[23] The regulations would still be valid even if reviewed under cases such as *National Muffler*. The "permissible" or "reasonable" standard applies, regardless of what factors are considered. As we have just discussed, the regulations satisfy this standard.

v. Walton, 535 U.S. 212, 221-222 (2002) (according *Chevron* deference to agency interpretation reached through "means less formal than 'notice and comment' rulemaking"); *Massey Coal*, 472 F.3d at 166 (observing that the absence of notice-and-comment rulemaking is "not conclusive" as to whether the agency action deserves *Chevron* deference); *Hosp. Corp.*, 348 F.3d at 140-141, 144 (according *Chevron* deference to temporary Treasury Regulations adopted without notice and comment).[24]

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

A prior judicial interpretation of an ambiguous statute, such as that contained in *Colony*, is no impediment to the Treasury Department's subsequent issuance of a regulation containing a different interpretation. As the Supreme Court stated in *Brand X*, 545 U.S. at 982-983:

[24] *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979), and *Jerri's Ceramic Arts, Inc. v. Consumer Prod. Safety Com'n*, 874 F.2d 205 (4th Cir. 1989), on which the amicus relies (Am. Br. 11 n.20), are not to the contrary, as neither involves a temporary regulation.

> [A]llowing a judicial precedent to foreclose an agency from interpreting an ambiguous statute . . . would allow a court's interpretation to override an agency's. *Chevron*'s premise is that it is for agencies, not courts, to fill statutory gaps. . . . . Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.

Accord Bakersfield, 568 F.3d at 778. *See also Mayo Foundation for Medical Educ. and Research v. United States*, 568 F.3d 675, 683 (8th Cir. 2009), *petition for cert. filed*, 78 U.S.L.W. 3439 (Sup. Ct. Jan. 14, 2010) (No. 09-837) ("The Supreme Court has repeatedly held that agencies may validly amend regulations to respond to adverse judicial decisions, or for other reasons, so long as the amended regulation is a permissible interpretation of the statute"); *Fernandez v. Keisler*, 502 F.3d 337, 347-347 (4th Cir. 2007), *cert. denied*, 129 S. Ct. 65 (2008) (upholding, under *Brand X*, regulatory interpretation of ambiguous statute that conflicted with prior Fourth Circuit decision); *Elm Grove Coal Co. v. Director, O.W.C.P.*, 480 F.3d 278, 291-292 (4th Cir. 2007) (same).

The amicus misconstrues *Brand X* as holding that "an agency cannot reverse a prior court ruling applying a different interpretation

or say that the ruling was wrong – the prior ruling 'remains binding law.'" (Am. Br. 23-24.) To the contrary, the *Brand X* Court stated (545 U.S. at 983) that an agency's differing construction is not an attempt to "reverse" the court ruling:

> [T]he agency's decision to construe that statute differently from a court does not say that the court's holding was legally wrong. Instead, the agency may, consistent with the court's holding, choose a different construction. . . . In all other respects, the court's prior ruling remains binding law (for example, as to agency interpretations to which *Chevron* is inapplicable).

The amicus also incorrectly argues that an agency cannot adopt a different construction of an ambiguous statute from the construction adopted by the Supreme Court. (Am. Br. 22-24.) The cases on which it relies – *Neal v. United States*, 516 U.S. 284 (1996); *Maislin Industries, U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116 (1990), and *Lechmere, Inc. v. NLRB*, 502 U.S. 527 (1992) (Am. Br. 23 n.65) – were distinguished by the Supreme Court in *Brand X* on the ground that they precluded a regulation from trumping a court's determination *only* when the statute was unambiguous. *See, e.g.*, 545 U.S. at 984 ("*Neal* established only that a precedent holding a statute to be unambiguous forecloses a contrary agency construction"). *See also id.* at 982.

In *Hernandez-Carrera v. Carlson*, 547 F.3d 1237, 1242 (10th Cir. 2008), *cert. denied*, 78 U.S.L.W. 3360 (Dec. 14, 2009), the Tenth Circuit found "unpersuasive the argument that *Brand X* applies to lower courts, but not to the Supreme Court" because "*Chevron* deference is not a policy choice subject to balancing against other policy considerations; it is a means of giving effect to congressional intent." 547 F.3d at 1247. That Congressional "intent [is] to vest an agency with the power to fill in the gaps within its own statute." *Id.* Moreover, the proposed rule "would disregard the central premise of both *Chevron* and *Brand X* . . . [that] it is for agencies, not courts, to fill statutory gaps." *Id.* (internal quotation marks omitted).

Thus, the Tenth Circuit held that, under *Brand X*, "a subsequent, reasonable agency interpretation of an ambiguous statute . . . is due deference notwithstanding the Supreme Court's earlier contrary interpretation of the statute." *Accord Marquez-Coromina v. Hollingsworth*, 2010 WL 610745 at *7 (D. Md. Feb. 18, 2010) (stating that "[t]he persuasive reasoning of *Hernandez-Carrera* is consistent with Fourth Circuit precedent addressing similar issues").[25]

[25] Although *Tran v. Mukasey*, 515 F.3d 478 (5th Cir. 2008), held (continued...)

The amicus misinterprets *Cuomo v. Clearing House Ass'n, L.L.C.*, 129 S. Ct. 2710 (2009), as limiting the reach of *Brand X*. (Am. Br. 23 & n.64.) It did not do so. In *Cuomo*, the Court merely observed that the statutory term "visitorial powers" contained "some ambiguity," that "[t]he Comptroller [of the Currency] can give authoritative meaning to the statute within the bounds of that uncertainty," but that "the presence of some uncertainty does not expand *Chevron* deference to cover virtually any interpretation of the National Bank Act." *Id.* at 2715.

Thus, the Supreme Court's interpretation in *Colony* of ambiguous statutory language does not affect the deference to which the Treasury Department's recent interpretation of this phrase, contained in the temporary regulations, is entitled. Furthermore, nothing in the *Colony*

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[25](...continued)
that an agency interpretation cannot overrule a Supreme Court decision, *Tran*, as the Tenth Circuit observed, was decided without considering *Brand X*. *Hernandez-Carrera*, 547 F.3d at 1248. *Tran* is, therefore, of doubtful authority. It is unlikely that a current Fifth Circuit panel, to whom *Brand X* is cited, will follow *Tran* because under Fifth Circuit law, a panel is "without power to disregard the Supreme Court's precedent. . . ." *See Wilson v. Taylor*, 658 F.2d 1021, 1035 (5th Cir. 1981). When a Fifth Circuit panel is confronted with a prior panel decision and an applicable Supreme Court decision that the prior panel did not interpret or even mention, the second panel must follow the Supreme Court decision. *Id.*

Court's analysis of the legislative history of § 275(c) of the 1939 Code prevented the Treasury Department from interpreting "omits from gross income," now contained in §§ 6501(e)(1)(A) and 6229(c) of the 1986 Code, differently from the Supreme Court's interpretation of that phrase in the 1939 Code. The Supreme Court did not characterize the legislative history of § 275(c) as "conclusive," but as merely "persuasive." 357 U.S. at 33.

Moreover, statutory changes limit the significance of the legislative history discussed in *Colony*. As discussed *supra*, p. 22, § 6501(e)(1)(A)(i), enacted in 1954, "redefined" the term "gross income" in the context of the sale of goods or services by a trade or business, so that in that situation, "gross income" means gross receipts, undiminished by basis. H.R. Rep. No. 83-1337 at A414 *reprinted in* 1954 U.S.C.C.A.N. at 4561. The definition of "gross income" is not so limited in any other circumstances. Further, in § 6501(e)(1)(A)(ii), Congress created a "safe harbor" for adequate disclosure by excluding from the 25% omission computation any amount that is adequately disclosed on the return. Thus, the legislative history of § 275(c) has little relevance to the interpretation of § 6501(e) in subsequent Codes. *See* T.D. 9466, 74 Fed. Reg. at 49321 ("by amending the Internal

Revenue Code, including the addition of a special definition of 'gross income' with respect to a trade or business, Congress effectively limited what ultimately became the holding in *Colony*, to cases subject to section 275(c) of the 1939 Internal Revenue Code"). *See also Phinney*, 392 F.2d at 685 (construing *Colony* "[i]n light of the subsequent enactment of the 1954 Internal Revenue Code . . ."). Thus, the legislative history on which the amicus relies does not support the conclusion that the temporary regulations are unreasonable.

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

That the regulations were issued in response to litigation is no impediment to giving them *Chevron* deference. *See, e.g., Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996); *United States v. Morton*, 467 U.S. 822 (1984); *Motorola, Inc. v. United States*, 436 F.3d 1357, 1366 (Fed. Cir. 2006). For example, in *Smiley*, the regulation in issue was allegedly prompted by that very case and similar cases in which the Comptroller of the Currency had participated as *amicus curiae*. The challenged regulation was proposed after the California Superior Court's dismissal of the complaint and was adopted after the

California Supreme Court's affirmance of that dismissal. *Id.* at 739-740.

Notwithstanding these undisputed facts, and the promulgation of the regulation over 100 years after the enactment of the relevant statute, the Supreme Court gave *Chevron* deference to the regulation. 517 U.S. at 744-745. The Court reasoned (*id.* at 740-741):

> The 100-year delay makes no difference. . . . We accord deference to agencies under *Chevron*, . . . because of a presumption that Congress, when it left ambiguity in a statute meant for implementation by an agency, understood that the ambiguity would be resolved, first and foremost, by the agency, and desired the agency (rather than the courts) to possess whatever degree of discretion the ambiguity allows. *See Chevron*, *supra*, at 843-844. . . . Nor does it matter that the regulation was prompted by litigation, including this very suit. . . . That it was litigation which disclosed the need for the regulation is irrelevant.

Accord United States v. Deaton, 332 F.3d 698, 711 (4th Cir. 2003).

Likewise, in *Morton*, the Court ruled that OPM's promulgation of 5 C.F.R. § 581.305(f) after commencement of the action was "of no consequence" to the question whether the Court should defer to the regulation. 467 U.S. at 836 n.21. The Court explained (*id.*):

> Congress authorized the issuance of regulations so that problems arising in the administration of

> the statute could be addressed. Litigation often brings to light latent ambiguities or unanswered questions that might not otherwise be apparent. Thus, assuming the promulgation of § 581.305(f) was a response to this suit, that demonstrates only that the suit brought to light an additional administrative problem of the type that Congress thought should be addressed by regulation. When OPM responded to this problem by issuing regulations it was doing no more than the task which Congress had assigned it.

Accord Barnhart, 535 U.S. at 221 (declining to disregard regulations that were recently enacted, perhaps in response to that very litigation); *Friends of Everglades v. South Florida Water Mgmt. Dist.*, 570 F.3d 1210, 1219 (11th Cir. 2009) ("Under *Smiley* . . . and *Morton* . . . , it does not matter that the regulation was proposed and issued well after the beginning of this lawsuit. Neither does it matter that it was done in response to this and similar lawsuits"); *Motorola* 436 F.3d at 1366 (giving *Chevron* deference to regulatory interpretation of the word "treatment" and stating that "[i]t makes no difference to our analysis that the regulation was promulgated in 2002, after the controversy arose and after this litigation began").

In *Long Island Care at Home, Ltd v. Coke*, 551 U.S. 158 (2007), the Supreme Court even deferred to an agency's interpretation of an existing regulation that was made in an internal agency document

drafted in response to the pending litigation. Noting that the Department of Labor may have interpreted its regulations differently at different times (551 U.S. at 171), the Court, nevertheless, upheld the Department's most recent interpretation because it had no reason to suspect that this interpretation was "merely a ' "*post hoc* rationalizatio[n]"' of past agency action or that it 'does not reflect the agency's fair and considered judgment on the matter in question'" *Id.*, quoting *Auer v. Robbins*, 519 U.S. 452, 462 (1997).

There is even more reason to defer to the temporary Treasury regulations at issue here than there was to defer to the agency interpretation in *Long Island Care.* Unlike the interpretation at issue there, which was set forth in an internal agency document, the temporary regulations at issue here were published in the Federal Register. Unlike the interpretation at issue in *Long Island Care*, the temporary regulations do not follow a history of fluctuating agency interpretations. To the contrary, the regulations are "consistent with the Secretary's application of those provisions both with respect to a trade or business (that is, gross income means gross receipts), as well as outside of the trade or business context (that is, section 61 definition of gross income applies). . . ." T.D. 9466, 74 Fed. Reg. at 49322. Since

the regulations reflect Treasury's "fair and considered judgment on the matter in question" (*Long Island Care*, 551 U.S. at 171), they are entitled to *Chevron* deference.

Moreover, the Court's observation (*Morton*, 467 U.S. at 836 n.21) that litigation often discloses the necessity for a regulation applies with particular force here. For almost 50 years, no significant problems regarding *Colony*'s application of § 6501(e)(1)(A) outside of the trade-or-business context occurred until 2007, when the Tax Court in *Bakersfield* and the Court of Federal Claims in *Grapevine* applied *Colony* to block the application of the six-year assessment period to understated capital gain resulting from basis overstatements. It was therefore hardly surprising that the Treasury Department saw fit to issue regulations clarifying the meaning of the ambiguous statute that gave rise to the controversy.

Amicus seems to contend that when, as here, an agency issues regulations partly in response to litigation, these regulations are not entitled to deference. (Am. Br. 23.) Nothing in *Brand X* supports this contention, and the cases are to the contrary. The Eighth Circuit gave *Chevron* deference to Treasury regulations promulgated under I.R.C. § 3121(b)(1) after the Government lost excise tax cases promulgated

under a prior regulation. *Mayo*, 568 F.3d at 683. And the Sixth Circuit gave *Chevron* deference to Treasury regulations issued under § 2601 in response to the Government's loss of an Eighth Circuit case involving the generation-skipping transfer tax. *Estate of Gerson v. Commissioner*, 507 F.3d 435 (6th Cir. 2007), *cert. denied sub nom. Kleinman v. Commissioner*, 128 S. Ct. 2502 (2008); Generation-Skipping Transfer Issues, 64 Fed. Reg. 62997, 62999 (proposed Nov. 18, 1999). And in *Morton*, in which the Government was a party, the Supreme Court gave *Chevron* deference to regulations issued during the pendency of the suit. The regulations here are also entitled to *Chevron* deference.

6. The regulations apply to this case

The temporary regulations "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b). In other words, they apply to taxable years for which the period of limitations under §§ 6229(c)(2) and § 6501(e)(1)(A), as interpreted in the temporary regulations, did not expire with respect to the tax year at issue before September 24, 2009. *See* CC-2010-001, 2009 WL 4753220 (interpreting the temporary regulations as applying

to cases "in which the period of limitations under sections 6229(c)(2) and 6501(e)(1)(A), as interpreted in the temporary regulations, did not expire with respect to the tax year at issue, before September 24, 2009. . ."). [26] They, therefore, apply to this case.

Any doubt as the applicability of the regulations is resolved by I.R.C. § 7805(b) (26 U.S.C. 1994 ed.), which allows Treasury to "prescribe the extent, if any, to which any . . . regulation, relating to internal revenue laws, shall be applied without retroactive effect." Section 7805(b) thus establishes a presumption that regulations will apply retroactively unless otherwise specified. [27] *Snap-Drape, Inc. v.*

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[26] The interpretation of the applicability date of the temporary regulations contained in CC-2010-001, issued to coordinate the IRS's treatment of docketed Tax Court cases involving the six-year assessment period, is entitled to deference. *See Long Island Home Care*, 551 U.S. at 171 (deferring to agency interpretation of a regulation, even though interpretation was set forth in an internal agency document); *Auer v. Robbins*, 519 U.S. 452, 461(1997) (agency's interpretation of its own regulations is "controlling unless plainly erroneous or inconsistent with the regulation") (internal quotation marks omitted).

[27] In 1996, Congress amended § 7805(b) to preclude retroactive regulations, except in certain circumstances, such as the prevention of abuse, the correction of procedural defects, etc. *See* Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452, § 1101(a). The amended § 7805(b) applies "with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment of this Act," *i.e.*, July 30, 1996. *Id*. § 1101(b). Since §§ 6229(c)(2) and 6501(e)(1)(A)

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Commissioner, 98 F.3d 194, 202 (5th Cir. 1996); *Likins-Foster Honolulu Corp. v. Commissioner*, 840 F.2d 642, 647 (9th Cir. 1988). Since the regulations do not specify that they apply prospectively only, their application encompasses the 1999 tax year, at issue here.

To be sure, Treasury's failure to limit regulations to prospective application is judicially reviewable, but only for abuse of discretion. *Likins-Foster*, 840 F.2d at 647; *Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 980-981 (5th Cir. 1977). Abuse may be found where retroactive application of a regulation produces an unduly harsh result. *Snap-Drape*, 98 F.3d at 202; *Likins-Foster*, 840 F.2d at 647. Other relevant factors include: (1) the extent to which a taxpayer justifiably relied on "settled prior law or policy," (2) the extent to which that law or policy has received implicit Congressional approval, and (3) whether retroactivity would advance or frustrate equal treatment of similarly situated taxpayers. *Snap-Drape*, 98 F.3d at 202.

According retroactive effect to the regulations in this case would not produce an unduly harsh result or frustrate the policy of treating

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[27](...continued)
were enacted before July 30, 1996, the amended version of § 7805(b) is inapplicable.

similarly situated taxpayers similarly. To the contrary, it would treat appellants' tax liabilities the same as those of the taxpayers in *Phinney*, *Brandon Ridge,* and *Burks*, whose liabilities were held subject to the six-year assessment period in cases predating the regulations. Nor can appellants establish reliance; they had no justifiable expectation that the three-year assessment period would be applied to them in light of the uncertain state of the law and the Commissioner's consistent position that an overstated basis must be taken into account in determining the applicability of the six-year assessment period. And, as discussed *supra*, pp. 33-35, it cannot be said that *Colony* has received Congressional approval; the Supreme Court has repeatedly stated that Congressional silence lacks persuasive significance. Furthermore, "[n]o case has held that the Secretary abused his discretion to promulgate retroactive regulations merely because the regulation at issue affected a legal matter pending before a court at the time the regulation was adopted." *Anderson*, 562 F.2d at 980. Accordingly, the Secretary did not abuse his discretion in failing to limit the regulations to prospective application. Thus, the temporary regulations apply to this case.

The amicus's argument (Am. Br. 26) that "the Temporary Regulations cannot be applied retroactively to revive a closed

limitations period" is fundamentally misconceived. Amicus's argument rests on the premise that the three-year assessment period clearly applied and that the temporary regulations changed settled law in a belated attempt to "revive" closed tax years. This premise is false. Which assessment period applies is the very thing at issue here, and no determination has ever been made that that period closed. Indeed, the district court judgment under review, in a decision predating the temporary regulation, held that the six-year assessment period applied. Other courts also reached similar conclusions in decisions predating the regulation. *See Phinney, supra; Burks, supra; Brandon Ridge, supra.* Although some courts have disagreed (*see, e.g., Bakersfield Energy, supra; Salman Ranch supra*), it was, at the very least, unclear which assessment period applied before promulgation of the temporary regulations.

Moreover, when, as here, a regulation merely clarifies existing law, that regulation can constitutionally be applied to pre-promulgation conduct. *Levy*, 544 F.3d at 506; *Orr v. Hawk*, 156 F.3d 651, 654 (6th Cir. 1998). *See also Austin v. United States*, 611 F.2d 117, 119 (5th Cir. 1980) ("Because we hold that the 1971 [statutory] amendment constituted a clarification, we need not discuss taxpayer's argument

that there was a retroactive application violative of due process"); *Handley v. Chapman*, 587 F.3d 273, 283 (5th Cir. 2009) ("The new rule merely clarifies the BOP's position; its application to Handley does not create an impermissible retroactive effect"). Indeed, "[c]larification, effective *ab initio*, is a well recognized principle." *Liquilux Gas Corp. v. Martin Gas Sales*, 979 F.2d 887, 890 (1st Cir. 1992), citing *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367 (1969).

As the Third Circuit explained (*Levy*, 544 F.3d at 506):

> [W]e have held that a new rule should not be deemed to be 'retroactive' in its operation – and thus does not implicate the Supreme Court's concerns in *Bowen* – if it "d[oes] not alter existing rights or obligations [but] merely clarifie[s] what those rights and obligations ha[ve] always been." [Citation omitted.] Thus, where a new rule constitutes a clarification – rather than a substantive change – of the law as it existed beforehand, the application of that new rule to pre-promulgation conduct necessarily does *not* have an impermissible retroactive effect, regardless of whether Congress has delegated retroactive rulemaking power to the agency. [Emphasis in original.]

First Nat'l Bank of Chicago v. Standard Bank & Trust, 172 F.3d 472, 478 (7th Cir. 1999) ("a clarification of an unsettled or confusing area of law does not change the law, but restates what the law according to the agency is and has always been; it is no more retroactive in its operation

than is a judicial determination construing and applying a statute to a case in hand") (internal quotation marks omitted).

There is no bright-line test for determining whether a new regulation merely clarifies existing law. *Levy*, 544 F.3d at 506. In making this determination, the courts have considered, *inter alia*, whether the new regulation resolved or attempted to resolve an ambiguity and whether the new regulation's resolution of the ambiguity is consistent with the agency's prior treatment of the issue. *Id.* at 507; *First Nat'l Bank*, 172 F.3d at 479. *See also Piamba Cortes v. American Airlines, Inc.*, 177 F.3d 1272, 1283-1284 (11th Cir. 1999). Some courts have also relied on the declaration of the adopting body that the regulation (or statute) is intended to be a clarification of existing laws. *See First Nat'l Bank*, 172 F.3d at 478; *Piamba Cortes*, 177 F.3d at 1284. Indeed, the Seventh Circuit is of the view that "[i]f the agency expressly communicates that its intention in issuing the regulation was to clarify rather than change existing law, courts should defer to such announcements unless the revisions are in plain conflict with earlier interpretations." 172 F.3d at 478.

When these factors are applied to this case, it is apparent that the new regulations are clarifications, rather than changes, of existing law.

The temporary regulations resolve what courts have held to be a statutory ambiguity. The Supreme Court and other courts have stated that the language "omission from gross income," now contained in §§ 6229(c)(2) and 6501(e)(1)(A), is ambiguous. *See* discussion *supra,* p. 27. In promulgating the regulations, the Treasury Department expressly referred to the acknowledgement of this ambiguity by the Ninth and Federal Circuits. T.D. 9466, 74 Fed. Reg. at 49322. Further, the temporary regulations are consistent with Treasury's prior application of the statutory provisions.[28] *Id.* (regulations "are consistent with the secretary's application of those provisions both with respect to a trade or business . . . , as well as outside of the trade or business context. . .").

Moreover, in at least three places Treasury described these regulations as clarifications of existing law. Treasury stated that the "temporary regulations are a clarification of the period of limitations provided in sections 6501(e)(1)A) and 6229(c)(2)" (T.D. 9466, 74 Fed. Reg. at 49322) and that they "clarify that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A)

[28] The wording of §§ 6501(e)(1)(A) and 6229(c)(2) has remained unchanged since their enactment in 1954 and 1982, respectively.

and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)" (*id.* at 49321). *See also id.* at 49322 ("regulations clarify what constitutes an 'omission from gross income' under sections 6501(e)(1)(A) and 6229(c)(2)"). That the regulations conflict with some judicial interpretations of pre-regulation law does not mean that the regulations are a substantive change, rather than a clarification. *Levy*, 544 F.3d at 507. Since the regulations attempt to resolve statutory ambiguity, are consistent with Treasury's prior application of the statutory provisions, and are intended to be a clarification of existing law, application of them to 1999 does not have an impermissible retroactive effect. *See Levy*, 544 F.3d at 506.

Amicus errs in relying on *Hughes Aircraft Co. v. United States ex rel. Schumer*, 520 U.S. 939 (1997), *Landgraf v. USI Film Prods.*, 511 U.S. 244 (1994), and *Margolies v. Deason*, 464 F.3d 547 (5th Cir. 2006). (Am. Br. 26 nn.74-75.) These cases involve statutes significantly changing the law. *See Hughes Aircraft*, 520 U.S. at 949 ("The extension of an FCA cause of action to private parties in circumstances where the action was previously foreclosed is not insignificant"); *Landgraf*, 511 U.S. at 283 ("The new damages remedy in § 102 . . . is the kind of provision that does not apply to events

antedating its enactment in the absence of clear congressional intent"); *Margolies*, 464 F.3d at 553 ("The fact that the statute would permit a cause of action on July 31, 2002, that was definitively time-barred on July 29, 2002, indicates a retroactive effect if applied as such"). Here, on the other hand, the regulations do not authorize a tax assessment that "was definitively time-barred" when it was adopted.[29] Moreover, § 7805(b) specifically authorized the application of regulations to conduct predating them.

II

Appellants do not qualify for the safe harbor for adequate disclosure

A. Introduction

Section 6501(e)(1)(A)(ii) provides an exemption from the extended assessment period for a taxpayer who has adequately disclosed the nature and amount of the omitted sum:

> 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

[29] The temporary regulations do not apply in a manner that would have the effect of reopening any tax year that was otherwise closed as of September 24, 2009.

> return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

In applying this statute, the district court held that "the plain language of § 6501(e)(1)(A)(ii) requires something far more than a mere clue that might intrigue Sherlock Holmes." (JA340; internal quotation marks omitted.) Rather, "the taxpayer must disclose the substance of a transaction. . . ." (JA341.) Since "the nature of the omission here . . . is the manner in which plaintiffs generated the alleged basis which allowed them to step-up that basis," the district court held that, to satisfy § 6501(e)(1)(A)(ii), taxpayers had "to have disclosed something on the face of their returns that reasonably apprised the IRS of the disputed election regarding treatment of the obligation to close the short sale." (*Id.*)

The court held that, far from revealing the substance of the disputed election, "plaintiffs' returns contain misleading statements and information that obscured the substance of the disputed underlying transactions" (JA350) and that "even an IRS examiner trained in the art of divination would have been hard pressed to discern plaintiffs' true actions" (JA352). As we shall demonstrate, the court was correct.

B. The district court properly required taxpayers to disclose the substance of the underlying transactions to qualify for the safe harbor for adequate disclosure

The adequate disclosure requirement "has to be read in light of its purpose, namely to give the taxpayer the shorter limitations period where the taxpayer omitted a particular income item from its calculations but disclosed it in substance." *CC & F Western Operations Ltd. Partnership v. Commissioner*, 273 F.3d 402, 408 (1st Cir. 2001). To disclose the nature and amount of an omitted item, "the tax return [must] reveal more than obscure, disconnected marks on a treasure map which the IRS was expected to decipher at its peril." *In re G-I Holdings Inc.*, 2006 WL 2595264 at *6 (D.N.J. Sept. 8, 2006).

While some courts have used the word "clue" to describe adequate disclosure,[30] "[o]n its face, the 'adequate to apprise the Secretary of the nature and amount' language establishes a much stiffer test than a mere clue, and quite properly the cases tend to interpret it as requiring far more than a mere clue that might intrigue Sherlock Holmes." *CC & F Western Operations*, 273 F.3d at 407. To satisfy the requirements of § 6501(e)(1)(A)(ii), an amount must be shown on the

[30] *See, e.g., White v. Commissioner*, 991 F.2d 657, 661 (10th Cir. 1993).

face of the return or in an attached statement "in a manner sufficient to enable the secretary by reasonable inspection of the return to detect the errors. . . ." *Phinney*, 392 F.2d at 685. *See also Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987) ("The statement must be sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one"). "[T]he adequate disclosure standard is not met by a retrospective demonstration that the transaction was not so well concealed that a competent IRS agent could not have unraveled the scheme given diligent efforts." *In re G-I Holdings Inc.*, 2006 WL 3511150 at *2 (D.N.J. Dec. 5, 2006). Thus, the district court correctly held that the taxpayers had to disclose the substance of the transaction to avail themselves of the protection of § 6501(e)(1)(A)(ii).[31]

Two cases have considered adequate disclosure in the context of the short-sale variant of the Son-of-BOSS tax shelter, *Brandon Ridge*

[31] The amicus urges (Am. Br. 5) that the lower court committed legal error "by ignoring Supreme Court precedent" *i.e.*, *Colony*, on the proper standard in favor of the substance-of-the-transaction test. *Colony*, however, involved § 275(c) of the 1939 Code and did not purport to interpret the current adequate disclosure provision of the 1954 Code.

and *Salman Ranch*.[32] In both cases, the trial courts held that the safe harbor for adequate disclosure was applicable only if the tax returns disclosed information concerning the effect on basis of the partners' contribution of the short sale to the partnership. In *Brandon Ridge*, the district court stated (100 A.F.T.R.2d at 5355):

> In order to adequately disclose the gain on the sale of the FES stock, information regarding the contribution of the obligation to cover the short sale and its effect on the basis of the Jeffersons' interest in the Partnership . . . was necessary so that the IRS could detect the error in the calculation of the net long-term capital gain on the sale of the FES stock.

Likewise, in *Salman Ranch*, the Court of Federal Claims ruled that the safe harbor for adequate disclosure would apply only if the returns disclosed that the partners had transferred to the partnership the short sale proceeds and the accompanying obligation to close the short sale (79 Fed. Cl. at 204):

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[32] Although the Court of Federal Claims' determination in *Salman Ranch* was reversed as to whether a basis overstatement could give rise to the extended assessment period, it was not reversed on the adequate disclosure issue, which the Federal Circuit had no occasion to consider. However, in dissent, Judge Newman agreed with the Court of Federal Claims that the case was a "paradigm" of the category of cases in which "basis errors arose from economically meaningless transactions that were unrelated to the property sold and that were not disclosed on the returns." 573 F.3d at 1382.

> To understand how plaintiffs reached their basis step-up figure, one must have a "clue" that a transfer of the proceeds from the short sale of the Treasury Notes to the partnership took place. . . . Even to recognize that a dispute could arise over this calculation . . . one must also have a "clue" as to the "nature" of the transaction: that the partners transferred an accompanying obligation to close the short position, along with the transfer of proceeds from the short sale of Treasury Notes to the partnership.

Appellants cite no contrary authority.

Thus, the district court correctly determined that, to avail themselves of the protection of § 6501(e)(1)(A)(ii), appellants had to have made disclosures "that reasonably apprised the IRS of the disputed election regarding treatment of the obligations to close the short sale." (JA349.) In other words, the taxpayers/partners had to have made disclosures that reasonably apprised the IRS of their election to treat the short sale transactions asymmetrically by increasing their outside bases by the amount of the short sale proceeds contributed to Home Concrete, without reduction for the offsetting obligation to close the short sale. As the district court correctly observed (*id.*):

> The step-up in basis is part of the error alleged in this case, but only because it is the result of an earlier, allegedly erroneous, election made by

> plaintiffs in their treatment of the transfer of the short sale obligations from Pierce and Chandler to Home Concrete. Disclosure of an election to step-up basis alone is simply insufficient to apprise the IRS of the nature of the omission here. There are any number of legitimate ways in which Home Concrete could have claimed a stepped-up basis on its 1999 tax return. . . . . Merely disclosing such a stepped-up basis simply cannot form sufficient disclosure to trigger the safe harbor provisions of § 6501(e)(1)(A)(ii) in this situation because such disclosure does not in and of itself "apprise the Secretary" of the alleged error – namely the allegedly erroneous treatment of the short sale obligations.

C. The returns did not adequately disclose the nature and amount of the omitted income

The safe harbor has been held inapplicable in other cases where taxpayers failed to disclose the transactions underlying a Son-of-BOSS shelter. In *Brandon Ridge*, the safe harbor for adequate disclosure was inapplicable because the tax returns did not disclose the partners' transfer of the short sale proceeds to the partnership, the partnership's assumption of the obligation to close the short sale, or the partners' failure to reduce their outside basis by the value of the assumed obligation or the stepped-up stock basis resulting from the § 754 election. 100 A.F.T.R.2d at 5355. Similarly, the safe harbor was inapplicable in *Salman Ranch* because "[t]he critical facts that the

Treasury Notes transaction was a short sale and that the accompanying obligation to close the short sale was transferred to the partnership, along with the proceeds, are not disclosed in substance or by implication anywhere in the returns." 79 Fed. Cl. at 204.

The returns in this case are similarly deficient. Neither the partners' income tax returns nor the partnership return disclosed the transfer of the short sale proceeds and the offsetting obligation to Home Concrete. Nor did these returns disclose the fact that the basis step-up resulted from the partners' asymmetric treatment of the short sales and the offsetting obligations to close the short sales. (JA127-153, 170-197, 237-320.) Although the partnership return shows a § 754 election, that election does not even mention the short-sale transactions, let alone the fact that the basis step-up resulted from these transactions. (JA196-197.)

Indeed, the partnership return contains no reference whatsoever to short sales. (JA170-197.) Although Home Concrete closed the short sales of Treasury Notes (JA23), it misleadingly described this transaction on its tax return as the "Sale of US Treasury Bonds" (JA174), instead of as the "closing of a short sale position." Home Concrete's reporting a basis in the "Treasury Bonds" of $7,359,043, a

sales price of $7,472,405, and a gain of $113,362 (*id.*) "reveals nothing of the actual nature of the transaction," as the district court correctly determined. (JA351.) Furthermore, by describing the acquisition date and sale date of the bonds as May 18, 1999, and May 19, 1999, respectively (JA174), plaintiffs "reinforced the notion that they were reporting a straight sale of Treasury bonds instead of the back-end of a short sale transaction" (JA351).

The "footnote[ ]" on each taxpayer's return that "[d]uring the year the proceeds of a short sale not closed by the taxpayer in this tax year were received" (JA139, 152, 278, 310), is also misleading and "actually masks the ultimate purpose of those sales," as the district court correctly determined. (JA350.) As it explained (*id.*):

> The statement on Pierce and Chandler's tax returns indicates that those taxpayers retained the obligation to close the short sales they had opened. There is no hint that either taxpayer had transferred the obligation to close the short sale. The logical inference from this disclosure is exactly the opposite. Such misdirection cannot form the basis of adequate disclosure.

Furthermore, viewing these two disclosures together does not provide adequate disclosure, as "[n]othing on the face of the returns connects these two disclosures together. . . ." (JA3552.) The other

"disclosures" on which appellants rely, *e.g.*, the asset sale for $10,623,348, the distributions of $8,693,414 to partners (Br. 33-34), do not improve appellants' case, as they do not reasonably apprise the IRS of the partners' election to step up their outside basis by their asymmetric treatment of the short-sale transactions. Thus, the district court correctly concluded that the omitted income was not disclosed "in a manner sufficient to enable the secretary by reasonable inspection of the return to detect the errors. . . ." *Phinney*, 392 F.2d at 685.

CONCLUSION

The district court judgment is correct and should be affirmed.

STATEMENT REGARDING ORAL ARGUMENT

The United States of America, appellee herein, hereby informs the Court that it believes that oral argument should be heard in this case, because whether an understatement of income resulting from an overstatement of the tax basis of sold property can qualify as an

omission from gross income under I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A), and the effect of the temporary regulations on that question, are questions of first impression in this Court.

Respectfully submitted,

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ADDENDUM

Internal Revenue Code of 1986 (26 U.S.C.):

Sec. 6229. Period of Limitations for Making Assessments.

(a) General Rule.–Except as otherwise provided in this section, the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is 3 years after the later of–

(1) the date on which the partnership return for such taxable year was filed, or

(2) the last day for filing such return for such year (determined without regard to extensions).

. . . . .

(c) Special Rule in Case of Fraud, Etc.--

(1) False Return.–If any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item—

(A) in the case of partners so signing or participating in the preparation of the turn, any tax imposed by subtitle A which is attributable to any partnership item (or affected item) for the partnership taxable year to which the return relates may be assessed at any time, and

(B) in the case of all other partners, subsection (a) shall be applied with respect to such return by substituting "6 years" for "3 years."

(2) Substantial Omission of Income.–If any partnership omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in its return, subsection (a) shall be applied by substituting "6 years" for "3 years".

. . . . .

Sec. 6501. Limitations on Assessment and Collection.

(a) General Rule.–Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period. For purposes of this chapter, the term "return" means the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit).

. . . . .

(e) Substantial Omission of Items.–Except as otherwise provided in subsection (c)--

(1) Income Taxes.–In the case of any tax imposed by subtitle A–

(A) General Rule.–If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph–

(i) 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; and

(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.

. . . . .

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Dated: April 30, 2010

CERTIFICATE OF SERVICE

I hereby certify that on this 30th day of April, 2010, I electronically filed the foregoing 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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