No. 09-3741

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant
v.

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

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

BRIEF FOR THE APPELLANT

JOHN A. DiCICCO
Acting Assistant Attorney General

GILBERT S. ROTHENBERG
Acting Deputy Assistant Attorney General

MICHAEL J. HAUNGS (202) 514-4343
JOAN I. OPPENHEIMER (202) 514-2954
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

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STATEMENT REGARDING ORAL ARGUMENT

The Commissioner of Internal Revenue, appellant herein, hereby informs the Court that he 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. § 6501(e)(1)(A), and the effect of the temporary regulations on that question, are questions of first impression in this Court.

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BRIEF FOR THE APPELLANT

JURISDICTIONAL STATEMENT

On April 13, 2006, the Commissioner sent Kenneth and Susan Beard ("taxpayers") a notice of income tax deficiency for 1999. (Doc. 1, Ex. A.)[1] On July 11, 2006, taxpayers commenced a timely action for redetermination of the deficiency. (Doc. 1.) The Tax Court had jurisdiction pursuant to Sections 6213, 6214, and 7442 of the Internal Revenue Code ("I.R.C.") of 1986 (26 U.S.C.).

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[1] "Doc." records are to the documents in the original record on appeal. "A" references are to the documents in the appendix attached to this brief.

On August 12, 2009, the Tax Court entered a final order and decision granting taxpayers' motion for summary judgment and determining that the deficiency notice was untimely. (A1.) On November 4, 2009, the Commissioner filed a timely notice of appeal. (Doc. 34.) *See* I.R.C. § 7483. This Court has jurisdiction pursuant to I.R.C. § 7482(a).

STATEMENT OF THE ISSUE

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).

STATEMENT OF THE CASE

In this action, taxpayers challenge the timeliness of a notice of deficiency. The case was decided on their motion for summary judgment. The Tax Court (Judge Haines), in an opinion reported unofficially at 98 T.C.M. (CCH) 95, determined that the deficiency notice was untimely.

STATEMENT OF THE FACTS

Taxpayers' challenge to the timeliness of the notice of deficiency arises in the context of "the now infamous Son of BOSS tax shelter."[2] *American Boat Co., LLC. v. United States*, 583 F.3d 471, 473 (7th Cir. 2009). A typical Son-of-BOSS 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. That omission results in a vastly overstated basis, which either generates a large artificial tax loss or reduces the

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

gain that would otherwise result from the sale of an asset (as was the case here).

In this case, Kenneth Beard, in a manner "reminiscent of an alchemist's attempt to transmute lead into gold" (*Kornman*, 527 F.3d at 456), attempted to use short-sale transactions to increase his purported bases in his stock in two S corporations, MMCD, Inc. ("MMCD") and MMSD, Inc. ("MMSD") (Doc. 22, Ex. A, Sch. D) in order to reduce his taxable gain from the sale of this stock.[3] On August 24, 1999, he executed a short sale of United States Treasury Notes ("T-Notes"), which generated cash proceeds of $12,160,000. On August 25, 1999, he used the sale proceeds to buy more T-Notes in two transactions of $5,700,000 and $6,460,000. (Doc. 22, Ex. A, Sch. D & Ex. D.) On the same day (August 25), he transferred the purchased T-Notes of $5,700,000 and $6,460,000 to MMCD and MMSD, respectively, along with the obligation to close the short sales. (Doc. 22, Ex. D.) On

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[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).

August 26, MMCD and MMSD sold their T-Notes and closed the short positions on the T-Notes for $7,500,000 and $8,500,000, respectively. (Doc. 22, Exs. E-F.) On August 29, 1999, Kenneth sold his interests in MMCD and MMSD to Unicom Enterprises, Inc., for $6,574,939 and $7,638,211, respectively. (Doc. 22, Ex. A, Sch. D and Form 8023.)

Taxpayers' 1999 tax return was timely filed (*see* Doc. 13, Decl. at 1) and was thus deemed to have been filed on April 15, 2000. *See* I.R.C. § 6513(a). On it, taxpayers reported long-term capital gains of $413,588 and $992,748 from the sale of Kenneth's stock in MMCD and MMSD, respectively, which were computed by subtracting the purported bases of $6,161,351 and $6,645,463 from the sale prices of $6,574,949 and $7,638,211. (Doc. 13, Decl. at 1.)

The high bases resulted from Kenneth's asymmetric treatment of the short-sale transactions. He had increased his bases in the stock by the amount of the short-sale proceeds contributed to each corporation, without reduction for the offsetting obligation to close the short sales, which each corporation had assumed and fulfilled. The courts have uniformly struck down identical tax shelters, 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). *Cf. Cemco Investors, LLC v. United States*, 515 F.3d 749, 751 (7th Cir.), *cert. denied*, 129 S. Ct. 131 (2008) (rejecting offsetting-options version of Son-of-BOSS shelter and stating that "[a] transaction with an out-of-pocket cost of $6,000 . . . . while generating a tax loss of $3.6 million . . . seems to lack economic substance. . . .").

The Commissioner mailed taxpayers a notice of deficiency on April 13, 2006 (Doc. 1, Ex. A), just under six years from the filing of their 1999 tax return. In it, the IRS decreased Kenneth's adjusted bases in the MMCD and MMSD stock to $874,939 and $1,178,211, respectively, and increased his capital gains by $5,700,000 and $6,460,000, respectively. (Doc. 1, Ex. A, Explanation of Adjustments.)

Taxpayers commenced this action and alleged, *inter alia*, that the adjustments are barred by the general three-year assessment period of I.R.C. § 6501. When, however, "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 assessment period is six years. I.R.C. § 6501(e)(1)(A).

In their summary judgment motion, taxpayers urged that the six-year assessment period was inapplicable because a basis overstatement is not an omission of gross income within the meaning of the six-year assessment period. They relied on *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which interpreted § 275(c) of the Internal Revenue Code of 1939. (Doc. 13, Memo. at 3-6.) The Commissioner opposed summary judgment. (Docs. 20-22, 31.)

The Tax Court upheld the applicability of the three-year assessment period and granted taxpayers' motion. It relied on *Colony*, as well as *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009), a recent appellate decision holding that, under the Internal Revenue Code of 1986, an understatement of income resulting from an overstatement of the tax basis of sold property does not qualify as an omission from gross income for purposes of the six-year assessment period. (A8-12.)

SUMMARY OF ARGUMENT

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." This 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 Commissioner's position, the Fifth Circuit long ago ruled in his favor in *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), where the omission of gross income resulted from an overstated basis. *Phinney* interpreted *Colony* in light of the 1954 statutory changes. 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 in *Colony*, but also encompassed the misstating of the nature of an item of gross 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 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 Tax Court's decision. 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 rather confirm 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. § 301.6501(e)-1T(b).

ARGUMENT

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 understated or the basis of the property is overstated

Standard of review

Construction of the Internal Revenue Code and the propriety of summary judgment are questions of law, reviewed *de novo.*

A. Introduction

The Commissioner 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 his return to assess any additional tax due. I.R.C. § 6501(a). The Code doubles this general limitations period in cases involving substantial omission of income from the return, as follows:

> **(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.

I.R.C. § 6501(e)(1)(A).

In this case, 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 because 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) . . . 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) 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) must be interpreted to give 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, in turn, 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, three 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); *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678 (E.D.N.C. 2008), *appeal docketed*, No. 09-2353 (4th Cir. Dec. 9, 2009).[4]

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" 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

[4] We discuss some appellate decisions to the contrary at pp. 25-29, *infra*.

in section 6501(e)." *Insulglass Corp. v. Commissioner*, 84 T.C. 203, 210 (1985). Under this exception, "'gross income' is equated with gross receipts. (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 sales receipts. Treas. Reg. § 1.61-3(a).) 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 the different context of § 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 special 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 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'").[5] 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 further supports the conclusion that an omission from "gross income" under § 6501(e)(1)(A) can occur

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

from basis overstatement. Section 6501(e)(2) gives the IRS 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 under I.R.C. § 6501(e)(1)(A).

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

Notwithstanding the wording of the current statutes, the Tax Court relied on *Colony*, a Supreme Court decision interpreting pre-1954 law, to support its holding 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 (26 U.S.C. 1952 ed.) and now contained in I.R.C. § 6501(e)(1)(A).[6]

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

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[6] 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).

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 completely 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, *reprinted in* 1954 U.S.C.C.A.N. at 4561. 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 only, "gross income" means gross receipts, undiminished by basis. *Id.* 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 completely 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 gross income by overstating his basis in property, and the nature of the basis step-up is inadequately disclosed on his return, the extended assessment period applies.

Phinney has recently been followed 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, 2009 WL 2600358 at *3.

Despite the logic of *Phinney*, the Ninth Circuit in *Bakersfield Energy, supra,* and the Federal Circuit (over a vigorous dissent) in *Salman 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. *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 (*see Bakersfield*, 568 F.3d at 775; *Salman Ranch*, 573 F.3d 1373-1374), they are inconsistent with the Supreme Court's repeated pronouncements that Congressional silence lacks persuasive significance. 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. . . . .
>
> 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.

Accord Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 186 (1994) ("It is impossible to assert with any degree of assurance that congressional failure to act represents affirmative congressional approval of the [courts'] statutory interpretation") (internal quotation marks omitted); *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") (footnote omitted); *Lantz v. Commissioner*, No. 09-3345, 2010 WL 2267046 at *2 (7th Cir. June 8, 2010) ("[W]e would not accept 'audible silence' as a reliable guide to congressional meaning"). *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.

In this case, if, as the Commissioner alleges (Doc. 3 at 2), taxpayers did not adequately disclose the basis step-up, they have made a substantial omission of gross income within the meaning of § 6501(e)(1)(A) because they reported adjusted gross income of $4,945,173 when they should have reported $17,105,173. (*See* Doc. 1, Ex. A at 4; Doc. 22, Ex. A at 1.) Accordingly, this Court should reverse and remand this case to the Tax Court with directions to apply the six-year assessment period if it determines that the basis step-up was not adequately disclosed.

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

As explained above, 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*, 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),"[7] 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. 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

[7] Section 6229, applicable to income taxes attributable to partnership items, provides time periods similar to those of § 6501. The period for assessing income taxes attributable to partnership items "shall not expire before" three years from the filing of the partnership return. I.R.C. § 6229(a). This period is extended to six years in the case of a substantial omission of income. I.R.C. § 6229(c)(2).

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). The 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 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).

The Tax Court recently considered the validity and applicability of these regulations in *Intermountain Ins. Serv. of Vail, LLC v. Commissioner*, 98 T.C.M. (CCH) 144 (2009), *opinion supplemented on denial of reconsideration*, No. 25868-06, 2010 WL 1838297 (Tax Ct., May 6, 2010). In a reviewed (*i.e.*, *en banc*) opinion, the Tax Court denied the Commissioner's motions to reconsider and vacate the court's decision based on the new temporary regulations.

Seven of the thirteen participating judges held that "[t]he plain meaning of the temporary regulations' effective/applicability date provisions indicates that the temporary regulations do not apply to this case" and that this holding provided "a plausible ground" on which to deny the motions. 2010 WL 1838297 at *6. That ground became "compelling" (*id.*) when combined with the additional holding that "the Supreme Court's opinion in *Colony* . . . unambiguously forecloses the agency's interpretation of sections 6229(c)(2) and 6501(e)(1)(A) and displaces respondent's temporary regulations." *Id.* at *8 (internal quotation marks and footnote omitted).

Two judges, who joined in a separate concurring opinion, were "persuaded by neither of the majority's analyses. . . ." 2010 WL 1838297 at *9. They concluded that the regulations were procedurally invalid under the Administrative Procedure Act. (*Id.* at *17.) The remaining four judges preferred to "defer discussion of the difficult and divisive issues" regarding the validity and applicability of the new regulations. (*Id.* at *9.) They concurred in the denial of the Commissioner's motions "on narrower grounds relating to motions to vacate and reconsider or untimely motions to amend pleadings." (*Id.*)

As discussed below, we disagree with the nine Tax Court judges who held the regulations invalid and/or inapplicable. In our view, the regulations are valid, are entitled to *Chevron* deference, and apply to the tax years predating their issuance. They therefore warrant reversal of the Tax Court's determination.

1. The temporary regulations are exempt from the notice-and-comment requirements of the Administrative Procedure Act ("APA")

Appellees can be expected to argue that the regulations are procedurally invalid for failure to satisfy the APA's notice-and-comment requirements. *See Intermountain*, 2010 WL 1838297 at *17-*22 (Halpern J., concurring). As we shall show, the regulations are exempt from these requirements on two alternate grounds. First, the regulations are properly classified as "interpretive," not "legislative," and "interpretive" regulations are exempt from these requirements. Second, Congress exempted temporary Treasury regulations from the APA's requirements. Thus, in our view, two concurring judges in *Intermountain* erred in concluding that the Secretary was required to follow notice-and-comment procedures.

The Treasury Department promulgated the regulations pursuant to its general rule-making authority contained in I.R.C. § 7805(a)[8] (*see* T.D. 9466, 74 Fed. Reg. 49321, 49322 (2009)), rather than pursuant to a specific grant of rule-making authority. Thus, the regulations are "interpretive" regulations for APA purposes. *See Boeing Co. v. United States*, 537 U.S. 437, 448 (2003) (characterizing "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). Treasury's interpretive regulations are exempt from the APA's notice-and-comment requirements. *See* 5 U.S.C. § 553(b)(3)(A). As a commentator explained:

> Congress is sending a message when it places a specific delegation into a statute. The message is that the statute is incomplete. It needs to be completed through the adoption of a regulation. That regulation is intended to be tax law. The Treasury acts legislatively when it adopts the regulation, perhaps creating distinctions, refinements, formulas, or safe harbors not to be

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[8] Section 7805(a) provides that "the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title," *i.e.*, Title 26 of the United States Code.

> found in the statute itself. . . . . When Congress fails to make a specific delegation, its message is that the statute is complete (even though it may need regulatory interpretation). This distinction seems worth preserving. It is preserved by treating regulations adopted under section 7805(a) of the Code as interpretive, but regulations adopted under specific delegations as legislative.

Michael Asimow, *Public Participation in the Adoption of Temporary Tax Regulations*, 44 Tax Law. 343, 360 (1990) (footnotes omitted).

Application of this Court's tests for determining whether a regulation is "legislative" or "interpretive" also shows that the temporary regulations at issue here are "interpretive" for APA purposes. A legislative regulation "create[s] law, usually implementary to an existing law." *Board of Trustees of Knox County Hosp. v. Shalala*, 135 F.3d 493, 500 (7th Cir. 1998) (internal quotation marks omitted). "An interpretive rule is a statement as to what the administrative officer thinks the statute or regulation means." *Id.* at 501 (internal quotation marks omitted). *Accord Alabama Tissue Center of University of Alabama Health Service Foundation, P.C. v. Sullivan*, 975 F.2d 373, 377 (7th Cir. 1992). *See also Hoctor v. U.S. Dept. of Agriculture*, 82 F.3d 165, 170 (7th Cir. 1996) ("'Interpretation' in the narrow sense is the ascertainment of meaning") (Posner, J.).

In determining whether a rule is "interpretive" or "legislative," "[t]he 'starting point' of the analysis is the agency's characterization of the rule." *Metropolitan Sch. Dist. of Wayne Tp. v. Davila*, 969 F.2d 485, 489 (7th Cir. 1992). When a rule "is based on specific statutory provisions . . . and its validity stands or falls on the correctness of the agency's interpretation of the statute . . . it is clear that the rule is an interpretive one." *Id.* at 492. A rule can be interpretive even though it affects the parties' rights and obligations. *Id.* at 493; *Production Tool Corp. v. Employment and Training Administration*, 688 F.2d 1161, 1166 (7th Cir. 1982); *Rodriguez v. Peake*, 511 F.3d 1147, 1154 (Fed. Cir. 2008).

Metropolitan School District illustrates these principles. There, a rule issued without notice and comment interpreted the Individuals with Disabilities Education Act to require school districts to provide educational service to disabled children who are expelled or suspended for an extended period for reasons unrelated to their disability. The school district asserted, and the district court agreed, that the rule was "legislative" because it imposed a substantial financial burden on school districts.

This Court disagreed. It held that the rule, which was based on the language of the statute and its legislative history, "satisfies the general test of an interpretive rule." 969 F.2d at 492. In upholding the validity of the rule, issued without notice and comment, this Court observed that "[p]revailing authority rejects the proposition that a rule that has substantial impact is necessarily legislative." *Metropolitan*, 969 F.2d at 493.

Similarly, in *National Organization of Veterans' Advocates, Inc. v. Secretary of Veterans Affairs*, 260 F.3d 1365, 1375-1377 (Fed. Cir. 2001) ("*NOVA*"), the Federal Circuit held that an amended regulation clarifying an agency's interpretation of a statute was "interpretive" under the APA even though the interpretation altered the parties' rights by precluding benefits that were available under judicial decisions. The court explained (260 F.3d at 1375-1376):

> The agency . . . promulgated the revisions to § 3.22 to make clear that those judicial decisions did "not accurately reflect the requirements of the statute [38 U.S.C. § 1318] and the [Department of Veterans Affairs'] intention in issuing that regulation [38 C.F.R. § 3.22]." Final Rule, 65 Fed. Reg. at 3,390. In short, the . . . revisions merely clarified the Department of Veterans Affairs' interpretation (in 38 C.F.R. § 3.22) of 38 U.S.C. § 1318. And a rule that does no more than clarify the interpretation of a

> statute is necessarily interpretive in character, even if that interpretation has consequences for the rights of the parties.

See also 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. . . .").

Under these decisions, the temporary regulations at issue are interpretive. Like the rule in *Metropolitan*, the temporary regulations "purport[ ] to be an interpretation" of statutes (969 F.2d at 489) – I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A) – because they define the term "gross income," contained therein. *See* Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(a)(1)(ii) & (iii); 301.6501(e)-1T(a)(1)(ii) & (iii). Further, 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)" (*id.*) and that they "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)" (*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)"). Treasury also relied on the statutory history, concluding that "by amending the Internal Revenue Code [in 1954] . . . Congress effectively limited what ultimately became the holding in *Colony*, to cases subject to section 275(c) of the 1939 Internal Revenue Code." *Id.* at 49321.

That the regulations conflict with some judicial interpretations of pre-regulation law does not make them a substantive change in, rather than a clarification of, existing law. *NOVA*, 260 F.3d at 1375-1376; *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). Since the regulations are a clarification of existing law, they are "interpretive" under the APA, and notice and comment is not required.

In addition, the provisions of § 7805(e), added to the Code in 1988,[9] establish that the APA's notice-and-comment requirements do not apply to temporary Treasury regulations. I.R.C. § 7805(e)(1)

[9] *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, § 6232(a).

requires any temporary regulation to be issued also as a proposed regulation. Temporary regulations cannot remain in effect for longer than three years; they expire three years from the date of issuance. I.R.C. § 7805(e)(2). If the absence of notice and comment could deprive temporary regulations of validity, then § 7805(e) is meaningless. Such a conclusion violates the canon of construction that "a legislature is presumed to have used no superfluous words." *Bailey*, 516 U.S. at 145; *Platt*, 99 U.S. at 58. Such a conclusion is also at odds with the legislative history, which provides that the expiration of the temporary regulations at the end of the three-year period "is not to affect the validity of those regulations" during this period. H.R. Conf. Rep. No. 100-1104 at 218 (1988), *reprinted in* 1988-3 C.B. 473, 708. Congress did not authorize temporary regulations only to have them declared invalid for violation of the APA.

That Congress chose to exempt temporary Treasury regulations from the notice-and-comment requirement is not surprising. Recognizing that "taxes are the lifeblood of government, and their prompt and certain availability an imperious need," Congress has given Treasury special powers that other agencies do not enjoy. *Bull v. United States*, 295 U.S. 247, 259 (1935). For example, a tax assessment

has the force of a judgment, and administrative officials are authorized to seize a taxpayer's property to satisfy the debt. *Id.*; I.R.C. §§ 6321, 6331. Similarly, in § 7805(e), Congress codified Treasury's policy and practice of issuing temporary regulations as long as they were issued at the same time as identical proposed regulations providing notice and an opportunity for public comment.[10]

2. *Chevron* governs the review of the temporary regulations

Regardless of whether the regulations are "legislative" or "interpretive," the two-step process established in *Chevron v. USA, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), governs in determining their validity:

> 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

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[10] Treasury complied with the requirements of § 7805(e) here, as the temporary regulations were issued simultaneously as a notice of proposed rulemaking – Prop. 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. Although the IRS believes that regulations issued under I.R.C. § 7805(a) do not require notice and comment (*see* discussion *infra*, pp. 32-38), it nevertheless usually follows notice-and-comment procedures. *Bankers Life and Cas. Co. v. United States*, 142 F.3d 973, 978 (7th Cir. 1998).

> 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.

Id. at 842-843 (footnotes omitted). If the agency's construction passes muster under this test, "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency." *Id.* at 844 (footnote omitted). *Accord Arnett v. Commissioner*, 473 F.3d 790, 793 (7th Cir. 2007).

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 Bankers Life and Cas. Co. v. United States*, 142 F.3d 973, 979 (7th Cir. 1998) (noting that "*Chevron* itself dealt with a regulation promulgated under an arguably general grant of authority . . ."); 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 Dealers Ass'n v. United States*, 440 U.S. 472 (1979), as the proper standard for

evaluating Treasury Regulations); *Hosp. Corp. of Am. & Subs. v. Commissioner*, 348 F.3d 136, 140-141 (6th Cir. 2003). 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).

This Court gives *Chevron* deference to interpretive regulations issued with notice-and-comment procedures. *Kikalos v. Commissioner*, 190 F.3d 791, 795 (7th Cir. 1999); *Bankers Life*, 142 F.3d at 979-984 . Although this Court "reserv[ed] for another day what degree of deference, if any, temporary regulations issued without prior notice and comment command," it did give *Chevron* deference to one such regulation when the parties "assumed that full *Chevron* deference is in order. . . . and the Kikalos certainly have waived any contention to the contrary." *Kikalos*, 190 F.3d at 796.

Supreme Court cases decided after *Kikalos* remove any doubt about the applicability of *Chevron* deference to temporary regulations

issued without notice and comment. In *Barnhart v. Walton*, 535 U.S. 212 (2002), the Supreme Court emphasized that the absence of notice-and-comment rulemaking did not preclude giving *Chevron* deference to an agency determination:

> And the fact that the Agency previously reached its interpretation through means less formal than "notice and comment" rulemaking, *see* 5 U.S.C. § 553, does not automatically deprive that interpretation of the judicial deference otherwise its due. *Cf. Chevron*, 467 U.S., at 843. . . . Indeed, *Mead* pointed to instances in which the Court has applied *Chevron* deference to agency interpretations that did not emerge out of notice-and-comment rulemaking. 533 U.S. at 230-231. . . . It indicated that whether a court should give such deference depends in significant part upon the interpretive method used and the nature of the question at issue. . . . . And it discussed at length why *Chevron* did not require deference in the circumstances there present–a discussion that would have been superfluous had the presence or absence of notice-and-comment rulemaking been dispositive.

Id. at 222. *See also Coeur Alaska, Inc. v. Southeast Alaska Conservation Council*, 129 S. Ct. 2458, 2479 (2009) (suggesting that Court's deference to agency memorandum not subject to notice and comment was "identical to *Chevron* deference except for the name") (Scalia, J., concurring). Thus, recent Supreme Court decisions support applying *Chevron* deference to regulations issued without notice and

comment. Indeed, even the Tax Court majority that held the regulations invalid in *Intermountain* assumed that *Chevron* deference applied. 2010 WL 1838297 at *6.

3. The regulations are valid

In evaluating the reasonableness of a Treasury regulation under *Chevron*, this Court assesses "whether the regulation harmonizes with the language, origins, and purpose of the statute." *Arnett*, 473 F.3d at 795; *Bankers Life*, 142 F.3d at 983. The temporary regulations harmonize with the statutory language by providing that the term "gross income," used in Sections 6229(c)(2) and 6501(e)(1)(A) "has the same meaning as provided in section 61(a)" of the Code, and that, in the case of the disposition of property, the term "means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property." Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii). *Accord* Temp. Treas. Reg. § 301.6229(c)(2)-1T(a)(1)(iii).

Section 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). 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, 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. And three district courts (*Brandon Ridge, Home Concrete,* and *Burks, supra*) upheld the Commissioner's interpretation of the statutory language in cases predating the regulations, as did the Court of Federal Claims in *Salman Ranch*.

Further, before the present controversy arose, the Tax Court held that the general definition of "gross income," contained in § 61, applied 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"). The temporary regulations are also consistent with the statutory history of the extended assessment period. *See* T.D. 9466, 74 Fed. Reg. at 49321 ("by amending the Internal Revenue Code, including the addition of a special definition of 'gross income' with respect to a trade or business, Congress effectively limited what ultimately became the holding in *Colon*y, to cases subject to section 275(c) of the 1939 Internal Revenue Code").

Thus, the temporary regulations pass muster under *Chevron*. Indeed, they pass muster even under pre-*Chevron* jurisprudence, such as *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944), where the weight given to any agency 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."

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

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

> [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.

See also id. at 983 ("whether Congress has delegated to an agency the authority to interpret a statute does not depend on the order in which the judicial and administrative constructions occur"); *Arnett*, 473 F.3d at 794 n.2; *Bakersfield*, 568 F.3d at 778; *Mayo Foundation for Medical Educ. and Research v. United States*, 568 F.3d 675, 683 (8th Cir. 2009),

cert. granted, 50 U.S.L.W. 3439 (U.S. June 1, 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").

In *Hernandez-Carrera v. Carlson*, 547 F.3d 1237, 1242 (10th Cir. 2008), *cert. denied*, 134 S. Ct. 1011 (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.* To hold otherwise "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, 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." *Id.* at 1242. *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").

The *Intermountain* majority, however, "was hesitant to contradict the Supreme Court's ruling in *Colony*." 2010 WL 1838297 at *6 n.14. It relied (*id.*) on *Rodriguez de Quijas v. Shearson/American Exp., Inc.*, 490 U.S. 477, 484 (1989), which stated, "If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions."

Rodriguez de Quijas predated *Brand X*, where the Court rejected the Ninth Circuit's construction of certain Supreme Court opinions as "establish[ing] that a prior judicial construction of a statute categorically controls an agency's contrary construction." 545 U.S. at 984. The Court ruled that its prior decisions, *e.g., Neal v. United States*, 516 U.S. 284 (1996), "established only that a precedent holding a statute to be *unambiguous* forecloses a contrary agency construction." *Id.* (emphasis added). Thus, as concurring Judge Halpern recognized in *Intermountain*, "The validity of the regulation after *Brand X* cannot depend entirely on whether prior caselaw conflicts with a later

regulation." 2010 WL 1838297 at *12. *See also id.* ("We simply can't reasonably assert, a quarter-century after *Chevron* and, now, after *Brand X* that 'courts have traditionally determined the meaning of statutes,' majority op. note 12. . .").

The *Intermountain* majority erred in considering *Colony*'s analysis of the legislative history of § 275(c) of the 1939 Code in applying step one of *Chevron*. 2010 WL 1838297 at *7-*8. Reliance on legislative history to determine whether a statute is ambiguous is backwards. A judicial analysis of legislative history does not make an ambiguous statute unambiguous; it is the statutory ambiguity that occasions a court's resort to legislative history in the first place. *See, e.g., Colony*, 357 U.S. at 33 (since "it cannot be said that the language is unambiguous . . . we turn to the legislative history of § 275(c)").

In *Brand X*, the Court made it clear that an agency regulation was foreclosed only if the statutory language was unambiguous:

> A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from *the unambiguous terms of the statute* and thus leaves no room for agency discretion.

545 U.S. at 982 (emphasis added). *Brand X* also clarified that the *Chevron* step one analysis focuses on the statute's text, not its legislative history:

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

Id. at 986 (internal quotation marks omitted; emphasis added). As a district court explained, "In applying *Chevron*' s first step to the regulation at issue in *Brand X*, the Supreme Court did not ask merely whether Congress had 'spoken to the precise question at issue,' *Chevron*, 467 U.S. at 843, . . . but rather 'whether the statute's plain terms "directly addres[s] the precise question at issue." ' " *AARP v. E.E.O.C.*, 390 F. Supp. 2d 437, 445 (E.D. Pa. 2005), *aff'd on other grounds*, 489 F.3d 558 (3d Cir. 2007).

Even before *Brand X*, this Court tended to consider only the statutory language in the *Chevron* step one analysis. *See Bankers Life*, 142 F.3d at 983 ("While this circuit has examined legislative history during the first step of *Chevron*, . . . we now seem to lean toward reserving consideration of legislative history and other appropriate factors until the second *Chevron* step"). In a post-*Brand X* decision,

this Court stated: "Advancing to the first stage of the *Chevron* analysis, we consider whether the *plain meaning of the Code* either clearly supports or opposes" the regulation. *Square D Co. and Subs. v. Commissioner*, 438 F.3d 739, 744 (7th Cir. 2006) (emphasis added). Thus, after *Brand X*, the legislative history analyzed in *Colony* cannot preclude Treasury from construing the statutory language differently from the Supreme Court. *See Intermountain*, 2010 WL 1838297 at *15 (". . . *Colony*'s resort to legislative history in the first place shows a gap that the Secretary is ipso facto allowed to fill") (Halpern, J., concurring); *AARP*, 390 F. Supp. 2d at 448-450 (Third Circuit's interpretation of Age Discrimination in Employment Act, which interpretation was partially based on legislative history, did not foreclose contrary agency interpretation).

Furthermore, the legislative history analyzed in *Colony* does not bear the weight the *Intermountain* majority placed upon it. The Supreme Court did not characterize the legislative history of § 275(c) as "conclusive," but merely as "persuasive." 357 U.S. at 33. And, as discussed *supra* (pp. 20-21), the statutory changes in 1954, *i.e.*, the addition of the gross-receipts provision, I.R.C. § 6501(e)(1)(A)(i), and the adequate-disclosure provision, I.R.C. § 6501(e)(1)(A)(ii), limit the

significance of the legislative history discussed in *Colony*. *See* T.D. 9466, 74 Fed. Reg. at 49321 ("by amending the Internal Revenue Code, including the addition of a special definition of 'gross income' with respect to a trade or business, Congress effectively limited what ultimately became the holding in *Colon*y, to cases subject to section 275(c) of the 1939 Internal Revenue Code"). *See also Phinney*, 392 F.2d at 685 (construing *Colony* "[i]n light of the subsequent enactment of the 1954 Internal Revenue Code . . .").

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., Barnhart*, 535 U.S. at 221; *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). In *Smiley*, the regulation in issue was allegedly prompted by that case and similar cases in which the Comptroller of the Currency had participated as *amicus curiae*. It 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. 517 U.S. 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. It 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.

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* . . . 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 (*id.* at 171), the Court, nevertheless, upheld the Labor 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. And unlike the interpretation at issue in *Long Island Care*, the temporary regulations here 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 problems regarding *Colony*'s application of § 6501(e)(1)(A) outside the trade-or-business context occurred until 2007, when the Tax Court in *Bakersfield* and the Court of Federal Claims in *Grapevine Imports* applied *Colony* to block the application of the six-year assessment period to understated capital gain resulting from basis overstatements.

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. . .").[11] *See also Intermountain*, 2010 WL 1838297 at *11 (citing CC-2010-010 in support of conclusion that "the Secretary meant the temporary regulations to apply if either the 3-year or 6-year period of limitations were open on September 24, 2009, but that he was inartful in saying so") (Halpern, J., concurring). The temporary regulations, therefore, apply to this case.

There is no merit to the *Intermountain* majority's conclusion that the "plain meaning of the effective/applicability date provisions indicates that the temporary regulations do not apply. . . ." 2010 WL 1838297 at *5. As concurring Judge Halpern stated in that case (*id.* at *10):

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[11] 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 regulation, even though interpretation was set forth in an internal agency document); *Auer*, 519 U.S. at 461 (agency's interpretation of its regulations is "controlling unless plainly erroneous or inconsistent with the regulation") (internal quotation marks omitted); *Board of Trustees of Knox County Hosp. v. Shalala*, 135 F.3d 493, 499 (7th Cir. 1998) ("substantial deference" owed to agency's interpretation of its own regulations).

> Since the temporary regulations do not define the term "applicable period for assessing tax" (by stating whether the regulation itself is to be taken into account in determining the applicable period), the meaning of the term is less than plain, so it must be construed. What ground is there, then, for the majority to conclude that the effective date language of the temporary regulations precludes their application to this case? In other words, how can it construe the expression "the applicable period for assessing tax" to mean "the 3-year period for assessing tax"?

The *Intermountain* majority responded that the three-year period applies because the appellate courts in *Salman Ranch* and *Bakersfield* have said so. 2010 WL 1838297 at *19 n.12. The majority, however, ignored the fact that an authority "equivalent to those of the appellate court decisions" in *Salman Ranch* and *Bakersfield* (*Intermountain*, 2010 WL 1838297 at *19 n.12), *i.e.*, the Fifth Circuit, has held the three-year period inapplicable in circumstances similar to those present here. *See Phinney,* 392 F.2d at 685 (identifying failure to disclose basis step-up as the critical error justifying application of six-year assessment period).

And as the *Intermountain* majority seemed to recognize (2010 WL 1838297 at *19 n.12), its answer – that the three-year assessment period applies because two appellate courts have said so – begs the question. The temporary regulations were issued to clarify the

ambiguous statutory language at issue here, yielding a result different from that of the appellate courts in *Salman Ranch* and *Bakersfield* (*see* T.D. 9466, 74 Fed. Reg. 49321) – a course the Supreme Court has specifically authorized agencies to take. *See* discussion of *Brand X, supra*, pp. 49-53. Indeed, the majority seemed to recognize the inherent weakness of its conclusion that the regulations were inapplicable, as it described this only as "a plausible ground" for denying the Commissioner's motions. *Id.* at *6.

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.[12] *Gehl Co. v.*

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

Commissioner, 795 F.2d 1324, 1331 (7th Cir. 1986); *Snap-Drape, Inc. v. 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. *See Intermountain*, 2010 WL 1838297 at *10-*11 (Halpern, J., concurring).

To be sure, Treasury's failure to limit regulations to prospective application is judicially reviewable, but only for abuse of discretion. *Gehl*, 795 F.2d at 1332; *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. *Gehl*, 795 F.2d at 1332; *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. *See also Gehl*, 795 F.2d at 1332.

According retroactive effect to the regulations in this case would not produce an unduly harsh result, upset any justified reliance, or frustrate the policy of treating similarly situated taxpayers similarly.[13] To the contrary, it would treat taxpayers' tax liabilities the same as those of the taxpayers in *Phinney*, *Brandon Ridge*, *Home Concrete*, and *Burks*, whose liabilities were held subject to the six-year assessment period in cases predating the regulations. Nor can appellees 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 Government's consistent position that an overstated basis must be taken into account in determining the applicability of the six-year assessment period in cases where basis overstatement results in understated gross income. They cannot point to anything they would have done differently had they known of the effect of the Treasury regulations when they engaged in the short-sale transactions. *See Rodriguez*, 511 F.3d at 1155. As discussed *supra*,

[13] 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. As of that date, the tax years at issue in the instant case were "open," assuming the applicability of the six-year statute.

pp. 26-27, Congress's failure to overrule *Colony* does not mean 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.

The propriety of applying the temporary regulations to years predating their issuance is further supported by *Rodriguez*, a recent Federal Circuit case holding that the application of an amended regulation to a pre-amendment claim did not have an unlawful retroactive effect. *Rodriguez* involved a claim for dependency and indemnity compensation ("DIC") filed in 1996 by a disabled veteran's surviving spouse. Her entitlement to benefits depended on the interpretation of the language "entitled to receive" in 38 U.S.C. § 1318. Decisions in 1997 and 1998 by the United States Court of Appeals for Veterans Claims ("Veterans Court") had interpreted this language to permit DIC claimants to pursue a "hypothetical entitlement" approach.

In 2000, the Department of Veterans Affairs issued an amended regulation precluding this approach.

In 2005, the Veterans Court ruled that the amended regulation could not be applied retroactively to Rodriguez's 1996 claim because it eliminated a substantive right that existed when the claim was filed. Although the Federal Circuit recognized that the amended regulation eliminated benefits available under the "hypothetical entitlement" approach, it reversed the Veterans Court's determination. 511 F.3d at 1153. It reasoned that "the nature and extent of the change to the law was not substantial" because since 1990, the Department had consistently interpreted the statutory language as precluding the hypothetical entitlement approach. Thus, the 2000 amendment was not a sharp or unexpected change in the law. *Id.* at 1154.

The Federal Circuit added that the amended regulation did not meaningfully alter the consequences of past events because the cases adopting the hypothetical entitlement approach had not been decided when Rodriguez filed her claim. 511 F.3d at 1155. Finally, the court concluded that applying the amended regulation retroactively did not upset considerations of fair notice, reasonable reliance, and settled expectations. Rodriguez "had fair notice of the Department's

interpretation beginning the day she first filed her claim" and she could "hardly argue that she had 'settled expectations' regarding the law, given the multiple changes to the interpretation of the statute that occurred while her claim was pending." *Id.* at 1156.

Here, as in *Rodriguez*, any change in the law resulting from the temporary regulations is insubstantial because the Commissioner has consistently interpreted "gross income" in I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A) to include an understatement of income resulting from a basis overstatement. As in *Rodriguez*, the temporary regulations did not meaningfully alter the consequences of past events. The appellees did not rely to their detriment on the availability of the three-year assessment period as they commenced this action before the appellate decisions in *Salman Ranch* and *Bakersfield*. "While those holdings may have injected new hope into [appellees'] case, merely continuing to pursue a claim does not constitute a significant connection to past events. . . ." 511 F.3d at 1155.

Finally, the new regulations did not upset considerations of fair notice, reasonable reliance, and settled expectations. The appellees had notice of the Commissioner's interpretation of the statutory language on the day they filed their complaint, as this interpretation

was enunciated over 40 years ago in *Phinney* and in recent cases, and they can hardly argue that they had "settled expectations" regarding the law given the recent conflicting judicial interpretations. Thus, applying the temporary regulations here is proper.

CONCLUSION

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

Respectfully submitted,

JOHN A. DiCICCO
Acting Assistant Attorney General

GILBERT S. ROTHENBERG
Acting Deputy Assistant Attorney General

MICHAEL J. HAUNGS (202) 514-4343
JOAN I. OPPENHEIMER (202) 514-2954
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

JUNE 2010

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JOAN I. OPPENHEIMER
Attorney for the Commissioner of Internal Revenue

June 17, 2010

CIRCUIT RULE 31(e) CERTIFICATION

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

____
JOAN I. OPPENHEIMER
Counsel for the Commissioner

CERTIFICATE OF SERVICE

It is hereby certified that fifteen copies of this brief in paper form were sent to the Clerk via FedEx on June 17, 2010, and that service of this brief has been made on counsel for the appellees by sending two paper copies thereof and one copy in diskette form by FedEx, on June 17, 2010, in an envelope, properly addressed to him as follows:

Adam S. Fayne, Esq.
Arnstein & Lehr L.L.P.
Suite 1200
120 S. Riverside Plaza
Chicago, IL 60606-2913

JOAN I. OPPENHEIMER
Attorney

STATUTORY ADDENDUM

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

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.

. . . . .

CERTIFICATION REQUIRED BY SEVENTH CIRCUIT RULE 30(d)

This Appendix contains all of the materials required by Seventh Circuit Rule 30(a) and (b).

JOAN I. OPPENHEIMER
Attorney

CHI JR-Haines 660 JJC/VB

UNITED STATES TAX COURT

WASHINGTON, DC 20217

ADM. RECORDED SERVICE CAL. STAT. S/T. JUDGE Haines FILES

KENNETH H. AND SUSAN W. BEARD,)
Petitioners,)
v.) Docket No. 13372-06.
COMMISSIONER OF INTERNAL REVENUE,)
Respondent.)

ORDER AND DECISION

On August 11, 2009, the Court filed its Memorandum Findings of Facts and Opinion in the above-docketed case. See Beard v. Commissioner, T.C. Memo. 2009-184.

Upon due consideration, it is

ORDERED: That Petitioners' Motion for Summary Judgement filed on September 11, 2007, is granted. It is further

ORDERED AND DECIDED: That the adjustments set forth in the Notice of Deficiency mailed to petitioner on April 13, 2007, with respect to the tax year ended December 31, 1999, are barred due to the expiration of the statute of limitations on assessment and collections.

(Signed) Harry A. Haines
Judge

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T.C. Memo. 2009-184

UNITED STATES TAX COURT

KENNETH H. AND SUSAN W. BEARD, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13372-06. Filed August 11, 2009.

Robert E. McKenzie and Adam S. Fayne, for petitioners.

Thomas D. Yang, for respondent.

MEMORANDUM OPINION

HAINES, Judge: In a notice of deficiency sent April 13, 2006, respondent determined that petitioner Kenneth Beard (Mr. Beard) had overstated his basis in two S corporations sold during the taxable year 1999, thus causing an understatement of gross income by more than 25 percent of the amount stated in

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petitioners' return.[1] The issue for decision is whether, under those circumstances, petitioners omitted income, giving rise to an extended 6-year period of limitations. This issue has been presented by petitioners' motion for summary judgment under Rule 121 and respondent's notice of objection, and supplemental briefs from both parties.

Background

For purposes of the pending motion, the following facts have been assumed. At the time they filed their petition, petitioners resided in Illinois. Mr. Beard was a majority shareholder in two S corporations, MMCD, Inc. (MMCD), and MMSD, Inc. (MMSD). Mr. Beard had a 76-percent stock ownership interest in each entity.

On August 24, 1999, petitioners entered into short sales whereby they borrowed U.S. Treasury notes from a third party and sold them for cash to another third party. These sales generated $12,160,000 in cash.

On August 25, 1999, petitioners used this cash to buy more Treasury notes in two transactions of $5,700,000 and $6,460,000. On the same day petitioners transferred to MMCD and MMSD the purchased Treasury notes of $5,700,000 and $6,460,000, respectively, together with the short positions (the obligation

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended, and all Rule references are to the Tax Court Rules of Practice and Procedure. Amounts are rounded to the nearest dollar.

following the short sale to replace the borrowed securities). On the same day MMCD and MMSD sold their Treasury notes and closed the short positions on the Treasury notes for $7,500,000 and $8,500,000, respectively.

On August 29, 1999, Mr. Beard sold his entire interest in MMCD and in MMSD to Unicom, an unrelated third-party purchaser, for $6,574,939 and $7,638,211, respectively.

On April 11, 2000, petitioners jointly filed their 1999 Federal income tax return. On their Schedule D, Capital Gains and Losses, petitioners claimed a cost basis of $6,161,351 in MMCD and $7,638,463 in MMSD and net gains from the sales of the shares of $413,588 and $992,748, respectively. Petitioners also reported gross proceeds from the sale of Treasury notes of $12,125,340, a cost basis of $12,160,000, and a resulting net loss of $34,660. There is no indication on Schedule M-2, Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed, of the 1999 income tax return of either MMCD or MMSD that the S corporations had assumed the liability to cover the short position in Treasury notes.

On April 13, 2006, respondent issued a notice of deficiency reducing petitioners' bases in the MMCD and MMSC stock by

$5,700,000 and $6,460,000, respectively.[2] The result was a $12,160,000 increase in the capital gain from the sale. Respondent contends that the bases in the MMCD and MMSC stock were inflated because they were not reduced by the liability to close the short position.

On July 11, 2006, petitioners filed a timely petition with this Court. On September 11, 2007, petitioners filed a motion for summary judgment on the ground that the notice of deficiency was issued after the period of limitations had expired. Petitioners contend that overstatement of basis is not an omission from gross income for purposes of the extended period of limitations under section 6501(e)(1)(A).

On February 19, 2008, respondent filed his notice of objection to petitioners' motion, agreeing that the material facts necessary to determine whether petitioners actions constitute an omission from gross income are not in dispute. Respondent contends, however, that there is a genuine issue of fact as to whether the notice of deficiency was timely issued under section 6501(e).

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[2]Respondent also disallowed $155,858 of petitioners' itemized deductions.

Discussion

Summary judgment is intended to expedite litigation and avoid unnecessary and expensive trials. Fla. Peach Corp. v. Commissioner, 90 T.C. 678, 681 (1988). The Court may grant summary judgment when there is no genuine issue of material fact and a decision may be rendered as a matter of law. Rule 121(b); Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992), affd. 17 F.3d 965 (7th Cir. 1994); Zaentz v. Commissioner, 90 T.C. 753, 754 (1988). The moving party bears the burden of proving that there is no genuine issue of material fact. Dahlstrom v. Commissioner, 85 T.C. 812, 821 (1985); Naftel v. Commissioner, 85 T.C. 527, 529 (1985). The Court will view any factual material and inferences in the light most favorable to the nonmoving party. Dahlstrom v. Commissioner, supra at 821; Naftel v. Commissioner, supra at 529.

Under the general rule set forth in section 6501(a), the Internal Revenue Service is required to assess the tax (or send a notice of deficiency) within 3 years after a Federal income tax return is filed. Section 6501(e)(1)(A) extends the limitations period to 6 years "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".

Section 6501(e)(1)(A) was first enacted as section 275(c) of the Revenue Act of 1934 (1934 Revenue Act), Ch. 277, 48 Stat.

745. See Badaracco v. Commissioner, 464 U.S. 386, 392 (1984). In 1954 Congress made several changes to this provision. See H. Rept. 1337, 83d Cong., 2d Sess. A414 (1954); S. Rept. 1622, 83d Cong., 2d Sess. 584-585 (1954). Section 6501(e)(1)(A)(i) provides an exception to the general definition of gross income, stating that

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

Also, section 6501(e)(1)(A)(ii) provides a "safe harbor" for a taxpayer who otherwise has made a substantial omission, stating that

> 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.

Respondent argues that the overstatement of basis in a context outside of the sale of goods or services should constitute an omission from gross income and thus trigger the 6-year limitations period under section 6501(e)(1)(A).[3]

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[3]Respondent also argues, alternatively, that petitioners' transfer of Treasury notes to the S corporations should be recast as bona fide and that petitioners' two S corporations omitted income from their returns by failing to report the close of their short positions. See sec. 1.1233-1(a)(1), Income Tax Regs. In a short sale, the timing of gain or loss recognition remains open (continued...)

In Colony, Inc. v. Commissioner, 357 U.S. 28, 33, 37 (1958), the Supreme Court, interpreting section 275(c) of the 1934 Revenue Act, the predecessor of section 6501(e), held that the extended period of limitations applies to situations where specific income receipts have been "left out" in the computation of gross income and not when an understatement of gross income resulted from an overstatement of basis. The facts of Colony dealt with a taxpayer who developed and sold lots in a subdivision. Id. at 30-31.

In Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. 207 (2007), affd. 568 F.3d 767 (9th Cir. 2009), a partnership (Bakersfield) which owned oil and gas property used the Internal Revenue Code's partnership termination and transfer provisions to increase its basis in that property before selling it to a third party in 1998.[4] The Commissioner issued a notice of final

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[3](...continued) until the seller closes the sale by replacing the borrowed property. Hendricks v. Commissioner, 51 T.C. 235, 241 (1968), affd. 423 F.2d 485 (4th Cir. 1970). Respondent contends that, if petitioners' bases in the S corporations were increased by their transfer of Treasury notes to MMCD and MMSD, the S corporations should have recognized gain of $12,160,000 when they closed the short sale obligation. Respondent's reasoning is flawed, however, as his analysis does not take into account the transfer of petitioners' short sale obligation to MMCD and MMSD, which lowered petitioners' bases in both S corporations by the same amount their bases were raised through the transfer of the Treasury notes. See Rev. Rul. 95-45, 1995-1 C.B. 53. Ultimately, respondent's alternative argument results in the same overstatement of basis issue present in the notice of deficiency.

[4]Specifically, four of the seven partners in Bakersfield took the following steps to increase Bakersfield's zero basis in (continued...)

partnership administrative adjustment (FPAA) almost 6 years after Bakersfield filed its return for 1998, and Bakersfield contended that the FPAA was untimely under Colony. Because Bakersfield did not omit any income receipt or accrual in its computation of gross income, we held that the Supreme Court's decision in Colony applied and Bakersfield's overstatement of basis did not trigger the extended limitations period. Bakersfield Energy Partners, LP v. Commissioner, supra at 215-216. As part of our holding, we stated that neither "the language or the rationale of Colony, Inc. can be limited to the sale of goods or services by a trade or business." Id. at 215.

Respondent contends that Bakersfield was wrongly decided and that Colony should be limited to cases where the taxpayer is

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[4](...continued) its oil and gas property: (1) The four partners formed a new partnership, Bakersfield Resources, L.L.C. (Resources); (2) the four partners sold their partnership interests in Bakersfield to Resources for $19,924,870. The four partners held a collective majority stake in Bakersfield and thus caused a technical termination of the Bakersfield partnership and the formation of a new partnership in which Resources held a majority interest under sec. 708(b)(1)(B); (3) the new Bakersfield partnership elected to increase its basis in partnership assets by the $19,924,870 sale price of the partnership interests sold to Resources following the transfer of partnership interest pursuant to secs. 754 and 743. Bakersfield allocated $16,515,194 of its new $19,924,870 basis to its oil and gas property and the rest to its other assets; (4) Bakersfield sold its oil and gas property to a third party for $23,898,611.

involved in the sale of goods and services.[5] First, respondent argues that Colony's interpretation of section 275(c) of the 1934 Revenue Act is not binding because its successor statute, section 6501(e)(1)(A), is materially different (the materiality argument). Second, respondent argues that Colony interpreted section 275(c) of the 1934 Revenue Act as having the same meaning as section 6501(e)(1)(A)(i) and thus Colony should apply only to taxpayers who realize gross receipts from sales or services in the course of a trade or business (the interpretation argument).

The Commissioner raised these same arguments with regard to Bakersfield in the Court of Appeals for the Ninth Circuit. Bakersfield Energy Partners, LP v. Commissioner, 568 F.3d at 775. Addressing the materiality argument, the Court of Appeals for the Ninth Circuit noted that Congress did not change the language in the body of section 6501(e)(1)(A), which is identical to the

[5]Several cases have questioned the continuing viability of Colony, Inc. v. Commissioner, 357 U.S. 28 (1958) in the light of the 1954 amendments to sec. 6501(e)(1)(A). For example, in CC & F W. Operations Ltd. Pship. v. Commissioner, 273 F.3d 402, 406 n.2 (1st Cir. 2001), affg. T.C. Memo. 2000-286, the Court of Appeals for the First Circuit stated that "Whether Colony's main holding carries over to section 6501(e)(1) is at least doubtful", suggesting that the Supreme Court's gross income test applies only to sales of goods and services covered by sec. 6501(e)(1)(A), but not to other types of income. That position, however, was not adopted by other Courts of Appeals. Most recently, the Court of Appeals for the Federal Circuit determined that there was no "basis for limiting Colony's holding concerning the 'omits from gross income' language of I.R.C. § 275(c) to sales of goods or services by a trade or business." Salman Ranch Ltd v. United States, __ F.3d __ (Fed. Cir., July 30, 2009) (slip op. at 20).

language in section 275(c) of the 1934 Revenue Act that the Supreme Court construed in Colony.[6] Id. at 775-776. Addressing the interpretation argument, the Court of Appeals noted that the Supreme Court expressly avoided construing the 1954 Code and "did not even hint" that its interpretation of section 275(c) of the 1934 Revenue Act was limited to cases in which the taxpayer was engaged in a trade or business. Id. at 778.

We believe that it would be inappropriate to "distinguish and diminish the Supreme Court's holding in Colony". Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. at 215. The principles of Colony apply where a taxpayer overstates his basis. In both Colony and Bakersfield the taxpayers artificially inflated their bases in assets that were subsequently sold. Although Colony dealt with the sale of land and Bakersfield with the sale

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[6]The Court of Appeals for the Ninth Circuit also dismissed the Commissioner's sub-argument that applying Colony to the 1954 Code would render sec. 6501(e)(1)(A)(i) superfluous:

> Section 6501(e)(1)(A) requires a comparison of two numbers: (1) the "gross income" omitted with (2) the "gross income" stated in the return. If the first number divided by the second number is greater than 25%, then the 6-year limitations period applies. Because § 6501(e)(1)(A)(i) changes the definition of "gross income" for taxpayers in a trade or business, it potentially affects both the numerator (the omission from gross income) and the denominator (the total gross income stated in the return). Colony's holding, however, affects only the numerator, by defining what constitutes an omission from gross income.

Bakersfield Energy Partners, LP v. Commissioner, 568 F.3d 767, 776 (9th Cir. 2009), affg. 128 T.C. 207 (2007).

of oil and gas property, in neither case did the taxpayer fail to report gross income on a return for purposes of the extended limitations period.

We assume that petitioners overstated the bases of their S corporations on their 1999 return. Under Colony and Bakersfield, petitioners did not omit income from their return such as would subject them to the extended period of limitations. Accordingly, petitioners' motion for summary judgment will be granted.

In reaching these holdings, the Court has considered all arguments made and, to the extent not mentioned, concludes that they are moot, irrelevant, or without merit.

To reflect the foregoing,

An appropriate order and decision will be entered.