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No. 10-1262

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

UTAM, LTD. and DDM MANAGEMENT, INC., Tax Matters Partner,
Petitioners-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant

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

BRIEF FOR THE APPELLANT

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

(A) Parties and Amici

The following parties, intervenors, and amici appeared in the Tax Court and appear in this Court:

Bausch & Lomb Incorporated

Commissioner of Internal Revenue

DDM Management, Inc.

UTAM, Ltd.

(B) Rulings under Review

The rulings under review are an order and decision pursuant to a memorandum opinion of the United States Tax Court (Judge Kroupa) entered on November 9, 2009, and reported unofficially at 98 T.C.M. (CCH) 422, and an order entered May 19, 2010, denying the Commissioner's motions to vacate the decision and reconsider the opinion. (A402-411, 459-461).[1]

(C) Related cases

This case was not previously before this Court or any other appellate court. The following cases pending in this and other

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[1] "A" references are to the separately-bound record appendix.

appellate courts present the same issues as this case: *Intermountain Ins. Serv. of Vail, LLC v. Commissioner*, D.C. Cir., No. 10-1204; *Wilmington Partners, L.P. v. Commissioner*, 2d Cir., No. 10-4183; *Home Concrete & Supply, LLC v. United States*, 4th Cir., No. 09-2353; *Burks v. United States*, 5th Cir., No. 09-11061; *Commissioner v. MITA*, 5th Cir., No. 09-60827; *Commissioner v. Equipment Holding Co.*, 5th Cir., 09-60866; *DSDBL, Ltd. v. Commissioner*, 5th Cir., No. 10-60706; *R and J Partners v. Commissioner*, 5th Cir., No. 10-60685; *Beard v. Commissioner*, 7th Cir., No. 09-3741; *Reynolds Properties, L.P. v. Commissioner*, 9th Cir., No. 10-72406; *Reynolds Properties, L.P. v. Commissioner*, 9th Cir. 10-73376; *Logan Farms II, LLC v. Commissioner*, 9th Cir., No. 10-73208; *Applied Technologies, LLC. v. Commissioner*, 9th Cir., No. 10-73299; *Salman Ranch, Ltd. v. United States*, 10th Cir., No. 09-9015; *Grapevine Imports, Ltd. v. United States*, Fed. Cir., No. 2008-5009.

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GLOSSARY

APA - Administrative Procedure Act, 5 U.S.C. § 550 *et seq*.

DDM - DDM Management, Inc., the tax matters partner of UTAM, Ltd.

FPAA - Notice of Final Partnership Administrative Adjustment

TEFRA - Tax Equity and Fiscal Responsibility Act of 1982

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JURISDICTIONAL STATEMENT

On October 13, 2006, the Commissioner of Internal Revenue mailed a Notice of Final Partnership Administrative Adjustment ("FPAA") to DDM Management, Inc. ("DDM"), the tax matters partner of UTAM, Ltd ("UTAM" or "the Partnership") for UTAM's 1999 tax year. On December 5, 2006, a timely petition for readjustment of partnership items was filed. (A6-34.) *See* § 6226(b)(1) of the Internal Revenue Code ("I.R.C.") of 1986 (26 U.S.C.). The Tax Court had jurisdiction pursuant to I.R.C. § 6226.

The Tax Court's order and decision was entered on November 17, 2009. (A411.) On December 8, 2009, the Commissioner filed timely motions to vacate the order and to reconsider the opinion (*see* Tax Ct. R. 161-162), which were denied on May 19, 2010. (A412-426, A459-461.) On August 17, 2010, the Commissioner filed a timely notice of appeal. (A5.) *See* I.R.C. § 7483. Jurisdiction is conferred on this Court by 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).

STATUTES AND REGULATIONS

The pertinent statutes and regulations are set forth in the Addendum.

STATEMENT OF THE CASE

This TEFRA partnership proceeding[2] involves a challenge to the timeliness of an FPAA, in which the Commissioner adjusted certain items reported on the partnership return. The case was decided on

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

cross-motions for summary judgment. (A3-4.) In a memorandum opinion reported at 98 T.C.M. (CCH) 422, the Tax Court held that the FPAA was untimely. (A402-410.)

The Commissioner filed motions to vacate the decision and to reconsider the opinion. These motions were based on recently-issued temporary Treasury regulations providing that an overstated basis in sold property can qualify as an omission from gross income for purposes of the six-year assessment period of § I.R.C. § 6501(e)(1)(A). (A412-426.) The Tax Court denied the motions. (A5.)

STATEMENT OF THE FACTS

A. The underlying transactions

The challenge to the timeliness of the FPAA arises in the context of "the now infamous Son of BOSS tax shelter."[4] *American Boat Co., LLC. v. United States*, 583 F.3d 471, 473 (7th Cir. 2009). A 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

[4] 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.

443, 446 n.2 (5th Cir. 2008) (internal quotation marks omitted). In such a shelter, a partner contributes 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 gain that would otherwise result from the sale of an asset.

In this case, David Morgan ("Morgan") owned an insurance business he planned to sell. (A81-83.) This insurance business, formed in 1985 and called "Success Life," merged in 1994 into UTA Management, an S corporation that Morgan solely owned. (A185, A278-279.) On January 18, 1999, Morgan formed UTAM, a limited partnership, and caused UTA Management's assets to be contributed to it. UTA Management received a 99% limited partnership interest in UTAM, which continued the business previously conducted by UTA Management and Success Life. (A280.) DDM Management, Inc., an S

corporation owned by Morgan, his wife, and his three children, received a 1% general partnership interest in UTAM. (A280.)

On July 12, 1999, Morgan entered into a contract to sell his insurance business to American Annuity Group, Inc., an unrelated party. (A81-82.) The sale closed on October 19, 1999. Morgan received $27,848,493 for his stock in UTA Management, which represented a 99% interest in UTAM.[5] (A82-83.) As discussed *infra*, p. 7, for tax purposes, Morgan's stock sale was treated as the sale of UTA Management's assets. (A96.) Since the tax consequence of an S corporation's activities are borne by its shareholders (*see* I.R.C. § 1366), Morgan stood to incur a capital gain of at least $24,600,855 on this sale, as UTA Management's assets had a basis not exceeding $3,247,638. (A98.)

In an effort to avoid paying taxes on this substantial gain, before the sale closed Morgan employed the services of tax lawyer Erwin Mayer of Jenkens & Gilchrist ("J&G"), a now defunct law firm, to recommend a tax shelter.[6] (*See* A83-85, A249-251, A281.) J&G

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[5] DDM received $350,000 for its 1% interest in UTAM. (A82-83.)

[6] Opinion letters by three J&G lawyers, including Mayer, in Son-of-BOSS transactions ultimately led to J&G's demise. *American Boat*, 583 F.3d at 477. Mayer was indicted for his role in these transactions.

(continued...)

recommended that Morgan engage in the short sale of Treasury Notes ("T-Notes").[7] (A85-86, A280-281.) According to J&G, a taxpayer who sold T-Notes short and transferred to a partnership the sale proceeds and the obligation to close the short sale would be entitled to increase his outside basis by the amount of the short sale proceeds, without adjustment for the offsetting obligation. (A256-257.)

Morgan and his wife ("taxpayers") engaged in the recommended short sale transactions. On September 21, 1999, through their single-member limited liability companies, they sold short T-Notes bearing a face amount of $38,000,000, for which they received cash proceeds of $37,857,494. (A88-89.) The cash proceeds and the offsetting obligations to close the short sales were transferred to UTA

[6](...continued)
See id. On October 19, 2010, he pled guilty to several charges, including conspiracy under 18 U.S.C. § 371 to defraud the United States and to commit tax evasion in connection with the design, marketing, implementation, and defense of fraudulent tax shelters while a J&G shareholder. *See United States v. Mayer*, No. S3 09 CR 581 (WHP) (S.D.N.Y.).

[7] 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).

Management on September, 22, 1999, which transferred them to UTAM the following day. (A27, A54, A90-91.) UTAM closed the short sales on September 29, 1999, by purchasing replacement T-Notes with a face amount of $38,000,000, for which it paid $38,281,389. (A91.)

UTAM reported a loss of $83,134 from the T-Note transactions on its 1999 partnership return, filed August 15, 2000. (A72, A94-95.) The tax consequences of the sale of the insurance business were reported on UTA Management's S corporation return for the 1999 tax year, which contained an I.R.C. § 338(h)(10) election to have Morgan's stock sale treated as the sale of UTA Management's assets. (A96-97.) UTA Management reported that this sale resulted in a long-term capital loss of $12,412,012, which loss equaled the difference between the amount realized from the sale of its assets ($31,942,421) and its purported basis ($44,361,895) in them. (A98.) This high basis resulted from UTA Management's asymmetric treatment of the short-sale transactions. Relying on J&G's tax opinion letter, UTA Management had increased its basis in its assets by the amount of the short-sale proceeds received from taxpayers and contributed to UTAM, without reduction for the offsetting obligation to close the short sales, which UTAM had assumed and fulfilled. (A32, A97, A256-257, A281.) Taxpayers' 1999 tax return,

filed on October 16, 2000, reported a flow-through loss of $12,412,012 from UTA Management. (A98-99.)

B. The Tax Court litigation

The IRS learned of Morgan's participation in an abusive tax shelter through a John Doe summons issued to J&G. (A261, A266, A268.) On October 13, 2006, which was within the six-year period to assess taxpayers' tax liabilities (*see* I.R.C. § 6501(e)(1)(A)), the IRS mailed an FPAA pertaining to UTAM's taxable year ending October 19, 1999.[8] (A35.) In it, the IRS, *inter alia*, reduced the outside partnership basis from $41,136,945 to zero. (A41.) The IRS reasoned, *inter alia*, that the purported partnership was formed and used solely for tax avoidance purposes by artificially overstating the purported partners' bases in their partnership interests and that the partnership transactions "lacked economic substance, and, in fact and substance, constitute[ ] an economic sham for federal income tax purposes." (A42.) The IRS added that since the short-sale proceeds and the obligation to close the short sales were offsetting, UTA Management, which had

[8] As one commentator observed, "[B]ecause of the complexity of many tax shelters, these schemes go largely undetected by IRS auditors until after the Internal Revenue Code's (I.R.C.) [three-year] statute of limitations expires." Matthew Roche, Comment, *Son of BOSS and the Troubling Legacy of* Colony, Inc. v. Commissioner, 58 Cath. U. L. Rev. 263, 263 (Fall 2008).

increased its outside basis by the short-sale proceeds, should also have decreased this basis when UTAM assumed the obligation to close the short sales.[9] (A43.)

The appellees commenced this action and alleged, *inter alia*, that the adjustments in the FPAA were barred by the general three-year period for tax assessments, I.R.C. § 6501(a). (*See* A8.) 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). The appellees contended that the six-year period was inapplicable because a basis overstatement is not an omission of gross income under § 6501(e)(1)(A). They relied on *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which interpreted § 275(c) of the Internal Revenue Code of 1939. (*See* A391-392.) Alternatively, they contended that the safe harbor for adequate disclosure (I.R.C.

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[9] A partner's contribution of sale proceeds to a partnership increases his outside basis by the amount of the proceeds. I.R.C. § 722. A partnership's assumption of the obligation to close the short sale decreases the contributing partner's outside basis by the amount of the liability assumed (I.R.C. §§ 733(1), 752(b)) and, at the same time, increases his basis by his proportionate share of the assumed liability (I.R.C. §§ 722, 752(a)). When the partnership satisfies the liability, a partner's outside basis is decreased by his proportionate share of this liability. I.R.C. § 752(b).

§ 6501(e)(1)(A)(ii)) applied here because UTAM and its partners had adequately disclosed the nature and amount of the omitted income. (A392.)

On September 24, 2009, before the issuance of the Tax Court memorandum decision, the Department of Treasury issued temporary regulations interpreting the phrase "omits from gross income" contained in I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2).[10] These regulations "clarify that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)." T.D. 9466, 74 Fed. Reg. 49321, 49321 (Sept. 28, 2009). 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), 301.6229(c)(2)-1T(a)(1)(iii) (26 C.F.R.).

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[10] References in this brief to I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2) are to the version of those provisions applicable to 1999, the tax year in issue. *See* 26 U.S.C. §§ 6501(e)(1)(A), 6229(c)(2) (2000 ed.). In 2010, these sections were amended by the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 112.

The temporary regulations "appl[ied] to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." *Id.* §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b).

On November 9, 2009, the Tax Court issued an opinion upholding the applicability of the three-year assessment period. It relied on *Colony*, as well as *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009), a recent decision holding that, under the Internal Revenue Code of 1986, an understatement of income resulting from an overstated tax basis of sold property does not qualify as an omission from gross income for purposes of the six-year assessment period. (A406-410.) It did not consider the effect of the new temporary regulations.

The Commissioner filed motions to vacate the Tax Court decision and to reconsider its opinion in light of the temporary regulations. (A412-424.) The Tax Court denied the motions on the basis of its reviewed, *i.e.*, en banc, opinion in *Intermountain Ins. Serv. of Vail, LLC v. Commissioner*, 2010 WL 1838297 (T.C. 2010), *appeal docketed*, No. 10-1204 (D.C. Cir. July 30, 2010). (A459-461.)

In *Intermountain*, seven of the thirteen participating judges held that the temporary regulations were inapplicable to the partnership's

1999 tax year. 2010 WL 1838297 at *6. The Tax Court also held 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 issued a separate concurring opinion in *Intermountain*, stating that they were "persuaded by neither of the majority's analyses. . . ." 2010 WL 1838297 at *9. They concluded that the temporary regulations were invalid under the Administrative Procedure Act ("APA") because they had been issued without notice and comment. *Id.* at *17-*22. The remaining four judges preferred to "defer discussion of the difficult and divisive issues" regarding the regulations' validity and applicability. *Id.* at *9. They concurred in denying the Commissioner's motions in *Intermountain* "on narrower grounds relating to motions to vacate and reconsider or untimely motions to amend pleadings." *Id.*

The Commissioner now appeals, and this appeal has been consolidated for argument with the appeal in *Intermountain*. During the pendency of these appeals, the temporary regulations were replaced

with largely identical final regulations. *See* T.D. 9511, 75 Fed. Reg. 78897 (Dec. 17, 2010).

SUMMARY OF ARGUMENT

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

This conclusion is supported by *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), which interpreted *Colony* in light of the 1954 statutory changes. *Phinney* 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.

2. The correctness of the Fifth Circuit's statutory interpretation in *Phinney* is confirmed by recent final regulations, effective December 14, 2010, which replaced the temporary regulations that were issued on September 24, 2009. The final 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* Treas. Reg. § 301.6501(e)-1(a)(1)(iii). These regulations, which are consistent with the Code's general definition of "gross income," are reasonable and are entitled to *Chevron* deference.

The regulations apply to this case even though they were issued after the Tax Court's original decision. The regulations "appl[y] to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009." Treas. Reg. § 301.6501(e)-1(e)(1).

The six-year limitations period is one of several assessment periods in the Internal Revenue Code. Since this six-year period had not expired when the FPAA was issued for UTAM's 1999 tax year, and since the Tax Court's adverse decision in this case is not yet final within the meaning of I.R.C. § 7481, taxpayers' 1999 tax year is still open. Therefore, the regulations apply. Furthermore, although the regulations are not retroactive, they would validly apply to this case even if they were, because a retroactive regulation interpreting I.R.C. § 6501(e)(1) is expressly permitted by the applicable version of § 7805(b), which presumes that regulations apply retroactively unless otherwise provided.

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 a substantial omission of gross income, 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).

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 that is inadequately disclosed. Third, the Government's statutory interpretation is confirmed by recent 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 (Sept. 28, 2009). Final regulations adopting this interpretation became effective December 14, 2010. T.D. 9511, 75 Fed. Reg. 78897 (Dec. 17, 2010).

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).

Since "gross income" is not defined in § 6501 (except as to gross income of a trade or business), 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 district court decisions, which are on all fours with this case, have so held. *See 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); *Brandon Ridge Partners v. United States*, 100 A.F.T.R.2d (RIA) 5347 (M.D. Fla. 2007).[11]

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[11] We discuss some appellate decisions to the contrary at pp. 25-

(continued...)

Section 6501(e)(1)(A)(i) also supports the Commissioner's position. 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. . . .

Section 6501(e)(1)(A)(i) thus "provides an exception–in the case of a trade or business–to the general meaning of 'gross income' as stated in section 6501(e)." *Insulglass Corp. v. Commissioner*, 84 T.C. 203, 210 (1985). Under this exception, "'gross income' is equated with gross receipts in the case of income from "the sale of goods or services" by "a trade or business." (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).

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[11](...continued)
26, *infra*.

That Congress defined "gross income" under § 6501(e)(1)(A)(i) as gross receipts irrespective of basis in the case of trades and businesses shows 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). 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), *appeal docketed* (Fed. Cir. June 27, 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'").[12] An interpretation that renders § 6501(e)(1)(A)(i)

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[12] Notwithstanding this recognition, the *Grapevine* court held that

(continued...)

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). Thus, the statutory language supports 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 v. Chambers*

Notwithstanding the current statutory language, 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

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[12](...continued)
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.

Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.) and contained in I.R.C. § 6501(e)(1)(A) during the tax year in issue.[13]

The Supreme Court found this statutory language to be ambiguous. *See* 357 U.S. at 33 ("it cannot be said that the [statutory] language is unambiguous"). After examining the legislative history, the Court concluded that "in enacting § 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two [now three] 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

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[13] 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).

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–the exact fact pattern of *Colony*–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.

Due to these amendments, the Fifth Circuit in *Phinney v. Chambers* concluded that the extended assessment period was no longer limited to the complete omission of an income receipt or accrual from the tax return. 392 F.2d at 685. *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 had 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).

The Fifth Circuit identified the failure to disclose the basis step-up as the critical error justifying application of the six-year 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 a basis overstatement 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 *Phinney*'s logic, 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 think these decisions are wrong as a matter of statutory interpretation. Indeed, the Ninth Circuit did not even cite *Phinney*, and while the Federal Circuit acknowledged *Phinney* in a footnote, it 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). Since *Phinney* (in our view) is more persuasively reasoned than *Bakersfield* and *Salman Ranch*, it should be followed here.

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

As explained above, the Ninth Circuit and the Federal Circuit recently departed from the 40-year-old precedent of *Phinney* to hold that an omission from gross income under § 6501(e)(1)(A) does not occur by reason of an overstated 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),"[14] 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. After an opportunity for public comment and

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[14] 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 gross income. I.R.C. § 6229(c)(2).

further consideration by the Secretary,[15] the temporary regulations were replaced with largely identical final regulations. T.D. 9511, *supra*. The regulations are a reasonable exercise of the Secretary's authority to clarify ambiguous language in statutes he administers. As the Ninth Circuit itself recognized in *Bakersfield*, "The IRS may have the authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code even if its interpretation runs contrary to the Supreme Court's 'opinion as to the best reading' of the provision." 568 F.3d at 778, quoting *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-983 (2005).

The regulations interpret the phrase "omission from gross income" contained in I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2) and "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 regulations, "any basis overstatement that leads to

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[15] The IRS received only one written comment from the public in response to the notice of proposed rulemaking. No public hearing was requested, and therefore none was held. T.D. 9511, 75 Fed. Reg. at 78897.

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.*

Treas. Reg. § 301.6501(e)-1(a)(1)(iii) (26 C.F.R.) provides (75 Fed. Reg. at 78899 (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 Treas. Reg. § 301.6229(c)(2)-1(a)(1)(iii). The regulations "appl[y] to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009." Treas. Reg. §§ 301.6229(c)(2)-1(b), 301.6501(e)-1(e). The regulations are valid, are entitled to

Chevron deference, and apply to the tax year at issue here. They therefore warrant reversal of the Tax Court's determination.

1. *Chevron* governs the review of the regulations

The two-step process established in *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), governs in determining the regulations' 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 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).

In *United States v. Mead Corp.*, 533 U.S. 218 (2001), the Court refined its *Chevron* analysis and 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. This reference to regulations having the "force of law" is not confined to so-called "legislative" regulations *i.e.*, regulations issued pursuant to "expressly delegated authority or responsibility to . . . fill a particular gap," 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 regulations' validity 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); *Hosp. Corp. of Am. & Subs. v. Commissioner*, 348 F.3d 136, 140-141 (6th Cir. 2003). *See also Bankers Life*, 142 F.3d at 979-984 (giving *Chevron* deference to interpretive regulation issued with notice-and-comment procedures). Thus, there is ample precedent for giving *Chevron* deference to the new regulations.

2. The regulations are valid

The regulations are valid under *Chevron*. The statutory language construed by the regulations–"omits from gross income an amount properly includible therein" (I.R.C. §§ 6229(c)(2), 6501(e)(1)(A))–was held by the Supreme Court to be ambiguous. *Colony*, 357 U.S. at 33. The Federal Circuit and the Ninth Circuit agreed. *Salman Ranch*, 573 F.3d at 1367; *Bakersfield*, 568 F.3d at 778.

The regulations resolve this ambiguity by providing that, in general, the term "gross income" "has the same meaning as provided in

section 61(a)" of the Internal Revenue Code, and that, in the case of the disposition of property, "*gross income* means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property." Treas. Reg. § 301.6501(e)-1(a)(1)(iii) (emphasis in original). *Accord* Treas. Reg. § 301.6229(c)(2)-1(a)(1)(iii). These regulations are reasonable because they are consistent with, and supported by, the general definition of "gross income" in I.R.C. § 61. 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)." Treas. Reg. § 301.6501(e)-1(a)(1)(iii).

Indeed, the Ninth Circuit has characterized the Commissioner's interpretation of the statutory language, incorporated in the regulations, as both "reasonable" and "sensible." *Bakersfield*, 568 F.3d at 775, 778. And three district courts upheld the Commissioner's interpretation of the statutory language in cases predating the regulations, as did the Court of Federal Claims in *Salman Ranch*. *See Brandon Ridge, supra; Home Concrete, supra; Burks, supra.*

3. *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"). *Accord Bakersfield*, 568 F.3d at 778; *see also Mayo Foundation for Medical Educ. and Research v. United States*, 568 F.3d 675, 683 (8th Cir. 2009), *cert. granted*, 130 S. Ct. 3353 (2010) ("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, the Tenth Circuit held that, under *Brand X*, "a subsequent, reasonable agency interpretation of an ambiguous statute . . . is due deference notwithstanding the Supreme Court's earlier contrary interpretation of the statute." 547 F.3d at 1242. *See also American Equity Inv. Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 173-174 (D.C. Cir. 2010) (" It is irrelevant that this court might have reached a different– or better–conclusion than the SEC").

The Tax Court in *Intermountain*, however, was "hesitant to contradict the Supreme Court's ruling in *Colony*." 2010 WL 1838297 at *22 n.14. It relied (*id.*) on *Rodriguez de Quijas v. Shearson/American Exp., Inc.*, 490 U.S. 477, 484 (1989), where the Court 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."

But *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 Tax Court in *Intermountain* also erred in considering *Colony*'s analysis of the legislative history of § 275(c) of the 1939 Code in applying *Chevron*'s step one. 2010 WL 1838297 at *7-*8. To begin with, 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 ambiguity of the statute 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)"). And if a statute is ambiguous, under *Chevron* and *Brand X*, an agency can validly issue a regulation interpreting that statute in a

manner different from that previously offered by the Supreme Court (or any lower courts).

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 one district court has observed, "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). *Brand X* also established that where a court's holding states merely the "best" interpretation of a statute, not the "only permissible" interpretation, that decision does not foreclose a later, differing agency interpretation. *Brand X*, 545 U.S. at 985; *see AARP*, 390 F. Supp. 2d at 442, 448.

In *Colony*, the Court did not state that its interpretation of "omits from gross income" was the only possible interpretation. The Court recognized that the language was susceptible of differing interpretations, and it therefore examined legislative history to determine the best possible meaning. *See* 357 U.S. at 33-36. In light of *Brand X*, the legislative history analyzed in *Colony* cannot preclude the Treasury Department from construing the statutory language differently from the Supreme Court, as concurring Judge Halpern recognized. *See* 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"). *See also AARP*, 390 F. Supp. 2d at 448-450 (Third Circuit's interpretation of the Age Discrimination in Employment Act, which interpretation was partially based on legislative history, did not foreclose contrary agency interpretation).

Furthermore, even if it were considered, the legislative history analyzed in *Colony* does not bear the heavy 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*, p. 24, 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 . . .").

4. 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 v. Walton*, 535 U.S. 212, 221 (2002); *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 Walton, 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); *Motorola* 436 F.3d at 1366. *See also Commissioner v. Estate of Hubert*, 520 U.S. 93, 122 (1997) ("[N]othing prevents the Commissioner from announcing by regulation the very position she advances in this litigation") (O'Connor, J., concurring).

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 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, moreover, even more reason to defer to the regulations at issue here than there was to defer to the agency interpretation in *Long Island Care*, as the regulations were published in the Federal Register and do not follow a history of fluctuating agency interpretations. Indeed, 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, the section 61 definition of gross income applies). . . ." T.D. 9511, 75 Fed. Reg. at 78897. 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 application of the six-year assessment period to understated capital gain resulting from basis overstatements.

5. The regulations apply to this case

The regulations "appl[y] to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009." Treas. Reg. §§ 301.6229(c)(2)-1(b), 301.6501(e)-1(e). The phrase "period for assessing tax" includes all the assessment periods that Congress

has provided, including the six-year assessment period. Thus, "the final regulations apply to taxable years with respect to which the six year period for assessing tax under section 6229(c)(2) or 6501(e)(1) was open on or after September 24, 2009." T.D. 9511, 75 Fed. Reg. at 78898.

Taxable years are "open on or after September 24, 2009" if, *inter alia*, they "are the subject of any case pending before any court of competent jurisdiction (including the United States Tax Court and Court of Federal Claims) in which a decision had not become final (within the meaning of section 7481). . . ." *Id.* Section 7481 provides that when an appeal is taken from a Tax Court decision, that decision is not final until the appeal has been determined and the time for seeking Supreme Court review has expired, or, if Supreme Court review is granted, until the Supreme Court has decided the case. *See also Wapnick v. Commissioner*, 365 F.3d 131, 132 (2d Cir. 2004). Thus, a "decision" is not "final" under § 7481 until the last bell has rung in the last court.

Here, the FPAA was issued on October 13, 2006, within six years of the October 16, 2000, filing of taxpayers' 1999 tax return. (A35, A99.) Since the Tax Court decision being challenged in this appeal is

obviously not yet final within the meaning of § 7481, the period for assessing taxpayers' tax liability for 1999 is still open, and the regulations apply.

The *Intermountain* majority erroneously interpreted the applicability provisions of the temporary regulations, which provided that the regulations "applied to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b). As discussed above, "the applicable period" of limitations is not simply the general three-year limitations period, but also includes the special six-year period. T.D. 9511, 75 Fed. Reg. at 78898. As concurring Judge Halpern stated :

> 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"?

2010 WL 1838297 at *10.

The majority responded that the three-year period applies because the appellate courts in *Salman Ranch* and *Bakersfield* have said so. 2010 WL 1838297 at *2, *5. The majority, however, ignored Fifth Circuit authority, which is "equivalent to those of the appellate court decisions" in *Salman Ranch* and *Bakersfield* (*id.*) and which held the three-year period *in*applicable in circumstances similar to those present here. *See Phinney,* 392 F.2d at 685. The majority also failed to recognize that there are several limitations periods in the Internal Revenue Code, including the six-year period of § 6501(e)(1). The expiration of the three-year period does not "close" a tax year if a longer limitations period applies.

And as the majority seemed to recognize (2010 WL 1838297 at *22 n.12), its answer–that the three-year assessment period applies because two appellate courts have said so–begs the question. The regulations were issued to clarify the ambiguous statutory language at issue here, yielding a result different from that of the 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. 42-43. 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. 2010 WL 1838297 at *6.

Although the regulations are not retroactive, even if they were, they would still be valid. Indeed, 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," establishes a presumption that regulations apply retroactively unless otherwise specified.[16] *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); *Gehl Co. v. Commissioner*, 795 F.2d 1324, 1331 (7th Cir. 1986). Since the regulations do not specify that they apply prospectively only, their application encompasses the 1999 tax year, as concurring Judge

[16] 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 here.

Halpern correctly concluded in *Intermountain*. 2010 WL 1838297 at *11.

To be sure, Treasury's failure to limit regulations to prospective application is judicially reviewable, but only for abuse of discretion. *Likins-Foster*, 840 F.2d at 647; *Gehl*, 795 F.2d at 1332; *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. 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.

Appellees cannot 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. They cannot point to anything they would have done differently had they known of the effect of the Treasury regulations when the transactions in this case occurred. *See Rodriguez v. Peake*, 511 F.3d 1147, 1155 (Fed. Cir. 2008).

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. *See supra*, pp. 28-29. 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, even if the regulations are

considered retroactive, the Secretary did not abuse his discretion in making them so.

Even when there is no express statutory authority for retroactive rulemaking, the courts have held that the general prohibition on retroactive agency rulemaking is inapplicable to rules that merely clarify existing law. *See, e.g.*, *First Nat'l Bank of Chicago v. Standard Bank & Trust*, 172 F.3d 472, 478 (7th Cir. 1999); *Levy v. Sterling Holding Co.*, 544 F.3d 493, 506 (3d Cir. 2008); *Orr v. Hawk*, 156 F.3d 651, 654 (6th Cir. 1998). As the Seventh Circuit stated:

> [A] clarification of an unsettled or confusing area of law does not change the law, but restates what the law according to the agency is and has always been; it is no more retroactive in its operation than is a judicial determination construing and applying a statute to a case in hand.

First Nat'l Bank, 172 F.3d at 478 (internal quotation marks omitted). When, as here, a regulation merely clarifies existing law, it can constitutionally be applied to pre-promulgation conduct. *Levy*, 544 F.3d at 506; *Orr*, 156 F.3d at 654.

The propriety of applying the regulations to years predating their issuance is further supported by *Rodriguez*, a recent Federal Circuit case holding that 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 relied on the Department's consistent interpretation of the statutory language as precluding the hypothetical entitlement approach and on the fact that the cases adopting the hypothetical

entitlement approach were decided after Rodriguez filed her claim. *Id.* at 1154-1155.

Here, as in *Rodriguez*, any change in the law resulting from the 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 understated income resulting from a basis overstatement. The appellees did not rely to their detriment on the availability of the three-year assessment period; 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. . . ." *Rodriguez*, 511 F.3d at 1155. Thus, applying the regulations here is proper.[17]

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[17] It is unnecessary for this Court to consider concurring Judge Halpern's opinion in *Intermountain* that the issuance of the temporary regulations without notice and comment rendered them invalid, because the temporary regulations were removed and replaced with final regulations. 75 Fed. Reg. 78899-78900. The final regulations fully complied with the APA's notice-and-comment requirements.

CONCLUSION

The Tax Court's order and decision is incorrect and should be reversed. The case should be remanded to the Tax Court for consideration of the question whether the omitted income was adequately disclosed.

Respectfully submitted,

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I hereby certify that on January 6, 2011, I electronically filed the foregoing brief with the Clerk of the Court for the United States Court of Appeals for the District of Columbia Circuit by using the appellate CM/ECF system.

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ADDENDUM

Internal Revenue Code of 1986 (26 U.S.C. 2000 ed.):

Sec. 6229. **Period of Limitations for Making Assessments**.

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

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

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

. . . . .

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

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

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

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

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

. . . . .

Sec. 6501. **Limitations on Assessment and Collection**.

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

. . . . .

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

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

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

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

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

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Treas. Reg. § 301.6229(c)(2)-1 **Substantial omission of income**

(a) **Partnership return**– (1) **General rule**. (i) If any partnership omits from the gross income stated in its return an amount properly includible therein and that amount is described in clause (i) of section 6501(e)(1)(A), subsection (a) of section 6229 shall be applied by substituting "6 years" for "3 years."

(ii) For purposes of paragraph (a)(1)(i) of this section, the term *gross income*, as it relates to a trade or business, means the total of the amounts received or accrued from the sale of goods or services, to the extent required to be shown on the return, without reduction for the cost of those goods or services.

(iii) 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 6229(c)(2).

(iv) An amount shall not be considered as omitted from gross income if information sufficient to apprise the Commissioner of the

nature and amount of the item is disclosed in the return, including any schedule or statement attached to the return.

(b) **Effective/applicability date**. This section applies to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009.

Treas. Reg. § 301.6501(e)-1 **Omission from return**

(a) **Income taxes**– (1) **General rule**. (i) If a taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Internal Revenue Code an amount properly includible therein that is in excess of 25 percent of the gross income so stated, the tax may be assessed, or a proceeding in court for the collection of that tax may be begun without assessment, at any time within 6 years after the return was filed.

(ii) For purposes of paragraph (a)(1)(i) of this section, the term *gross income*, as it relates to a trade or business, means the total of the amounts received or accrued from the sale of goods or services, to the extent required to be shown on the return, without reduction for the cost of those goods or services.

(iii) 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).

(iv) An amount shall not be considered as omitted from gross income if information sufficient to apprise the Commissioner of the nature and amount of the item is disclosed in the return, including any schedule or statement attached to the return.

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(e) **Effective/applicability date**– (1) **Income taxes**. Paragraph (a) of this section applies to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009.

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