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No. 10-1204

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

INTERMOUNTAIN INSURANCE SERVICE OF VAIL, LLC; THOMAS A. DAVIES, 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

CORRECTED REPLY BRIEF FOR THE APPELLANT

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SUMMARY OF ARGUMENT

Three recent developments since the Commissioner's opening brief was filed provide additional support for the Commissioner's position that basis misstatement can trigger the longer assessment period of § 6501(e)(1)(A). First, on January 26, 2011, the Seventh Circuit upheld the Commissioner's position in *Beard v. Commissioner*, 2011 WL 222249 (7th Cir. 2011), a case on all fours. *Beard* rejected the holdings of *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767, 775, 778 (9th Cir. 2009), and *Salman Ranch Ltd. v. United States*,

573 F.3d 1362 (Fed. Cir. 2009), and embraced, instead, *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968), and the dissent in *Salman Ranch*. In *Beard*, the Commissioner prevailed under what the court described as "the plain meaning of the statute." 2011 WL 222249 at *7. *Beard* also noted that it likely would have granted *Chevron* deference to Treasury's recent final regulations, discussed below, and its prior temporary regulations, had it been necessary to reach that issue. *Id.*

Second, effective December 14, 2010, the temporary regulations–Temp. Treas. Reg. §§ 301.6229(c)(2)-1T, 301.6501(e)-1T–were withdrawn and replaced with virtually identical final regulations. *See* T.D. 9511, 75 Fed. Reg. 78897 (Dec. 17, 2010). These regulations provide that, under I.R.C. §§ 6229(c) and 6501(e)(1)(A), "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 that "[i]n the case of amounts received or accrued that relate to 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. §§ 301.6229(c)(2)-1(a)(1)(iii), 301.6501(e)-1(a)(1)(iii) (emphasis in original). Since these regulations were issued in

compliance with the requirements of the Administrative Procedure Act ("APA"), the questions whether the temporary regulations (now withdrawn) were exempt from the notice-and-comment procedure, and whether the absence of notice-and-comment rulemaking precludes *Chevron* deference, discussed in our opening brief (pp. 33-37, 49-60), are moot.

Third, on January 11, 2011, the Supreme Court, in *Mayo Foundation for Medical Education and Research v. United States*, 2011 WL 66433 at *9 (Sup. Ct. 2011), confirmed that *Chevron*'s two-step analysis provides the proper framework for evaluating the validity of a Treasury regulation, regardless whether Congress's delegation of authority was general or specific. Thus, the final regulations here are entitled to *Chevron* deference.

Appellees and the amicus respond that the Commissioner cannot overrule the Supreme Court, *i.e.*, *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which contains a different interpretation of the ambiguous statutory language "omits from gross income" from the regulatory interpretation. This argument is fundamentally misconceived because the Supreme Court has repeatedly held that interpretation of ambiguous statutory language is for the agencies in

the first instance, not the courts. *Chevron* established 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." *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 740-741 (1996).

Under *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005), "the agency may, consistent with the court's holding, choose a different construction, since the agency remains the authoritative interpreter (within the limits of reason) of such statutes." *Id.* at 983. As demonstrated in our opening brief and below, Treasury reasonably chose a different construction of "omits from gross income" from that in *Colony*, and Treasury's construction accords with that of the Seventh Circuit in *Beard*.

ARGUMENT

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

As discussed in our opening brief (pp. 15-27), 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 Seventh Circuit adopted this interpretation in *Beard*, echoing the Fifth Circuit's holding in *Phinney*. *Beard* held that the Supreme Court's decision in *Colony*, which interpreted the language "omits from gross income" in the 1939 Code, was not controlling due to the addition in 1954 of two subsections–§ 6501(e)(1)(A)(i) and (ii)–to the extended assessment period. 2011 WL 222249 at *4-*6. The court further held, "Reading Section 6501(e)(1)(A) as a gestalt, the meaning is clear, and an inflation of basis should be considered an omission from gross income such that it triggers the extended six-year statute of limitations." *Id.* at *7. A number of trial courts have also so held. *Brandon Ridge Partners v. United States*, 100 A.F.T.R.2d (RIA) 5347 (M.D. Fla. 2007); *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), *Burks v. United States*, 2009 WL 2600358 (N.D. Tex. 2008), *appeal docketed*, No. 09-11061 (5th Cir. Oct. 26, 2009).

Appellees seek (Br. 24-25) to distinguish *Phinney*, discussed in our opening brief (pp. 22-25), on the ground that the taxpayer there had grossly mischaracterized the nature of the income by incorrectly

describing the 1958 stock sale. *Phinney* cannot be so distinguished because the six-year assessment period of § 6501(e)(1)(A) does not become applicable by virtue of a mere mischaracterization of an income item. Section 6501(e)(1)(A) conditions the applicability of the extended assessment period on the taxpayer's omission from gross income of an amount exceeding 25% of the amount of gross income stated in the return. Thus, the Fifth Circuit could not have applied the six-year assessment period without concluding that a basis overstatement could give rise to that extended assessment period. Since the executor's return correctly reported taxpayer's gross receipts from the installment note, the 25% threshold would not have been satisfied unless the basis overstatement was taken into account.

Indeed, the Fifth Circuit 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. Thus, as the Fifth and Seventh Circuits have held, a basis overstatement can give rise to the application of the six year assessment period.

B. Recently-issued final regulations confirm the Commissioner's statutory interpretation

1. The Commissioner's reliance on the final regulations is proper

As discussed above, effective December 14, 2010, the temporary regulations were withdrawn and were replaced with virtually identical final regulations. Apparently realizing that the issuance of final regulations moots their arguments concerning the alleged procedural infirmities of the temporary regulations, both the appellees and the amicus attempt to prevent the Commissioner from relying on the final regulations. Appellees rely (Br. 9) on the rule against raising a new argument for the first time in the reply brief. The amicus relies (Am. Br. 3-4) on the Commissioner's failure to submit an amended or supplemental brief or a letter of supplemental authorities (*see* Fed. R. App. P. 28(j)) citing the final regulations. Both arguments are meritless.

First, our reliance on the final regulations is not a "new argument," but is merely additional authority supporting the argument, advanced in our opening brief, that understated income resulting from an overstated basis of sold property can qualify as an omission of gross income for purposes of the six-year-assessment period. As appellees recognize (Br. 9), the Commissioner could not rely on the final regulations in his opening brief, as these regulations did not then exist.[1] Appellees are well aware of the final regulations, and had ample opportunity to address their validity; instead, they have briefed the case as if the final regulations did not exist, and continue to attack the validity of the temporary regulations. (Br. 33-37.)

Moreover, it is well settled that the appellate courts will consider significant intervening legal developments, even where an appellate decision has already been entered. *See, e.g.*, *United States v. Byers*, 740 F.2d 1104, 1115 n.11 (D.C. Cir. 1984). Since no appellate decision has been entered, there is even more reason to consider intervening developments–the issuance of final regulations.

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[1] Contrary to appellees' speculation (Br. 9), the Department of Justice, which represents the Commissioner in this proceeding, cannot control the fact or timing of the issuance of regulations by the Department of Treasury, a coordinate executive branch of government.

The amicus's argument that the Commissioner had to file an amended or supplemental brief, or a Rule 28(j) letter, to rely on the final regulations defies credulity. The Commissioner could not file a new brief without leave of court. Filing a letter was also inappropriate, as Rule 28(j) provides a mechanism for apprising the court of significant legal developments *after* briefing is complete. *See* Fed. R. App. P. 28(j) ("If pertinent and significant authorities come to a party's attention after the party's brief has been filed. . ."). There was no need for the Commissioner to submit a letter because he had the opportunity to address the final regulations in this reply brief, as did appellees and the amicus in their briefs.[2]

2. The final regulations are entitled to *Chevron* deference

In *Mayo* the Supreme Court recently held that *Chevron*'s two-step analysis provides the proper framework for evaluating the validity of a Treasury regulation, regardless whether Congress's delegation of

[2] Since the Tax Court decided the validity of the temporary regulations upon the Commissioner's motions to vacate and reconsider, appellees rely (Br. 26-26) on the abuse of discretion standard for reviewing denials of these motions. As the Tax Court recognized (A80-81), reconsideration is warranted when, as here, the controlling law changes. *See, e.g.*, *McGrath v. Potash*, 199 F.2d 166, 167 (D.C. Cir. 1952).

authority was general or specific. The Court stated: "The principles underlying our decision in *Chevron* apply with full force in the tax context." 2011 WL 66433 at *9.

Chevron applied even though the regulations at issue in *Mayo*, like those here, were promulgated pursuant to the Treasury Department's general authority under 26 U.S.C. § 7805(a). The Court repudiated statements in two of its pre-*Chevron* decisions–*Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981), and *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982)–that Treasury regulations were owed less deference when adopted under general authority than when issued under a specific grant of authority:

> Since *Rowan* and *Vogel* were decided, however, the administrative landscape has changed significantly. We have held that *Chevron* deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority." *Mead*, 533 U.S., at 226-227. Our inquiry in that regard does not turn on whether Congress's delegation of authority was general or specific.

2011 WL 66433 at *9. Accordingly, the amicus's contention (Br. 17) that interpretive regulations are outside *Chevron*'s ambit is meritless.

Any argument that *Chevron* deference is unavailable in the absence of notice-and-comment rulemaking is moot since notice-and-comment rulemaking preceded promulgation of the final regulations. Apparently realizing that fact, the amicus argues (Br. 18-19) that any opportunity for public participation in the regulatory process was "illusory" due to the Commissioner's alleged unwillingness to abide by prior adverse judicial decisions.

But the interpretation in the final regulations is not a uniformly "rejected litigating position" (Am. Br. 19); the Seventh Circuit recently embraced it in *Beard*. And, as discussed in our opening brief (pp. 45-48), prior judicial interpretations of an ambiguous statute do not preclude giving *Chevron* deference to an agency's different, but reasonable, statutory construction. As the Supreme Court stated, "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. . . .*" *Brand X*, 545 U.S. at 982 (emphasis added). The Supreme Court has repeatedly given *Chevron* deference to regulations in which the agency construction of an ambiguous statute was inconsistent with prior judicial constructions. *See, e.g.*, *Mayo*, 2011

WL 66433 at *8; *Barnhart v. Walton*, 535 U.S. 212, 221 (2002); *Smiley*, 517 U.S. at 740-741; *United States v. Morton*, 467 U.S. 822, 836 n.21 (1984).

Appellees attempt (Br. 45) to distinguish these cases on the ground that they did not involve an agency currently engaged in litigation or in promulgating rules that embodied its rejected litigating position. This distinction lacks merit. *Morton* was a suit against the Government for recovery of money withheld from an air force officer's salary pursuant to a writ of garnishment. After the Claims Court ruled against the Government, amended regulations–5 C.F.R. § 581.305, as amended by 48 Fed. Reg. 26280-26281 (1983)–were issued which "squarely address the question presented by this case" and "definitively resolve" it. 467 U.S. at 834, 835 (footnote omitted). The Supreme Court reversed the Claims Court's determination (which had been affirmed by the Federal Circuit), on the basis of the amended regulations, ruling that their promulgation after commencement of the action was "of no consequence" to the question whether the Court should defer to the regulation. *Id.* at 836 n.21.

Similarly, *Mayo*, a tax refund suit against the Government, involved the validity of a "regulation [that] had been promulgated after

an adverse judicial decision." 2011 WL 66433 at *8. The Supreme Court ruled that "[u]nder *Chevron*, . . . deference to an agency's interpretation of an ambiguous statute does not turn on such considerations." *Id.* Indeed, the Court noted that it had "expressly invited the Treasury Department to 'amend its regulations' if troubled by the consequences of [the Court's] resolution of [a] case." *Id.*, quoting *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 838 (2001). *See also Commissioner v. Estate of Hubert*, 520 U.S. 93, 122 (1997) ("nothing prevents the Commissioner from announcing by regulation the very position she advances in this litigation") (O'Connor, J., concurring).[3] Thus, Treasury's promulgation of final regulations while engaged in litigation does not preclude giving these regulations *Chevron* deference.

3. The final regulations are valid

The regulations readily pass muster under *Chevron*, as they are consistent with and supported by the express language of the Internal Revenue Code. The regulations provide that, in general, the term

[3] In light of the recent Supreme Court cases giving *Chevron* deference to regulations adopted during litigation, *Chock Full O'Nuts v. United States*, 453 F.2d 300, 303 (2d Cir. 1971), cited by amicus (Am. Br. 28 & n.73) for the principle that the Commissioner cannot promulgate retroactive regulations during litigation to provide himself with a defense based on their presumptive validity, is no longer viable.

"gross income" in §§ 6229(c)(2) and 6501(e)(1)(A) "has the same meaning as provided in section 61(a)" of the Code. Treas. Reg. §§ 301.6501(e)-1(a)(1)(iii), 301.6229(c)(2)-1(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).

Because gain is determined mathematically, by subtracting basis from the amount realized (*see* I.R.C. § 1001(a)), Treasury 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, even though it felt constrained by *Colony* to reject the Commissioner's position, the Ninth Circuit recently characterized the interpretation of the statutory language that is now incorporated in the regulations as both "reasonable" and "sensible." *Bakersfield*, 568 F.3d at 775, 778. And the Seventh Circuit recently upheld the Commissioner's interpretation of § 6501(e)(1)(A) as following from its "plain meaning," without even having to consider the regulations. *Beard*, 2011 WL 222249 at *7.

Appellees and the amicus do not directly challenge the regulations' reasonableness. Their challenge to the regulations' validity rests on their assertion that the Supreme Court in *Colony* held the statutory language to be unambiguous, thus leaving no statutory gap for a regulation to fill. (Br. 38-43; Am Br. 20-23.) They are wrong; the Court found the statutory language to be ambiguous and therefore resorted to legislative history to determine its meaning. *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)").[4]

Appellees respond (Br. 40) that a *Chevron* step-one analysis encompasses not only the statutory language, but also its legislative history and traditional tools of statutory construction. While some

[4] To be sure, the Supreme Court, while characterizing the language "omits from gross income" in the 1939 Code as ambiguous, in dicta described § 6501(e)(1)(A) of the Internal Revenue Code of 1954 as "unambiguous." *Colony*, 357 U.S. at 37. The Ninth Circuit refused to rely on this characterization, however, because "[t]he Court expressly avoided construing the 1954 Code. . . ." *Bakersfield*, 568 F.3d at 778. Moreover, since the language "omits from gross income," which the Court described as ambiguous, carried over into § 6501(e)(1)(A) of the 1954 Code, the Court's observation in *Colony* as to the "unambiguous language of § 6501(e)(1)(A)" must have referred to the addition, in the 1954 Code, of a gross receipts provision and an adequate-disclosure provision not present in the 1939 Code. *See Beard*, 2011 WL 222249 at *8-*9.

cases support this argument, these cases typically predate *Brand X*.[5] In *Brand X*, the Court held 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). *See also id.* at 986 (focusing on "the statute's plain terms" in the *Chevron* step-one analysis).

As concurring Judge Halpern suggested in the court below, *Brand X*'s reference to "the unambiguous terms of the statute" may be "a direction to lower courts to distinguish pre-*Brand X* precedents that

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[5] *See Am. Bankers Ass'n v. Nat'l Credit Union Admin.*, 271 F.3d 262, 267 (D.C. Cir. 2001); *Natural Res. Def. Council, Inc. v. Browner*, 57 F.3d 1122, 1126-1127 (D.C. Cir. 1995). After *Brand X*, this Court continued to consider legislative history in *Chevron* step one without considering the effect of *Brand X* on this use of legislative history. *See Catawba County, N.C. v. E.P.A*, 571 F.3d 20, 35 (D.C. Cir. 2009); *Sierra Club v. EPA*, 551 F.3d 1019, 1027 (D.C. Cir. 2008), *cert. denied sub nom. American Chemistry Council v. Sierra Club*, 130 S. Ct. 1735 (2010). This Court, of course, is obliged to follow Supreme Court precedent–*Brand X*–rather than obsolete decisions of prior panels that failed to consider the effect of *Brand X* on *Chevron* step-one analysis. *See Atlantic Thermoplastics Co., Inc. v. Faytex Corp.*, 970 F.2d 834, 838 n.2 (Fed. Cir. 1992) ("[a] decision that fails to consider Supreme Court precedent does not control if the court determines that the prior panel would have reached a different conclusion if it had considered controlling precedent"); *Wilson v. Taylor*, 658 F.2d 1021, 1035 (5th Cir. 1981) (same).

resorted to legislative history from those relying on plain-language analysis as a way of distinguishing between precedents that allow for their own regulatory supersession from those that do not." (A115.) As he also explained (A114), the statutory ambiguity that occasioned *Colony*'s resort to legislative history also authorized Treasury to issue regulations:

> The fundamental problem in this area . . . is that legislative history is a "traditional tool of statutory interpretation" most commonly used when the language of a statute is ambiguous on some point. But if the language of a statute is ambiguous, *Chevron* tells us to read that ambiguity as a delegation of authority to fill the resulting gap with a regulation. Looked at this way, *Colony*'s resort to legislative history in the first place shows a gap that the Secretary is ipso facto allowed to fill. If so, then the Supreme Court's sentence "it cannot be said that the language is unambiguous" . . . triggered not only that Court's own look at legislative history, but the authority of the Secretary to issue the regulation we have before us.

Thus, under *Chevron*, as construed by *Brand X*, only "the statute's plain terms" are considered in *Chevron*'s step one.[6] 545 U.S. at 982.

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[6] Even if legislative history is considered in the step-one analysis, the *Colony* Court did not conclude that its interpretation of "omits from gross income" was the only permissible interpretation of the statute, as appellees erroneously contend. (Br. 43.) It characterized the legislative history of § 275(c) of the 1939 Code only as "persuasive," not "conclusive." 357 U.S. at 33. And, as discussed in our opening brief

(continued...)

Indeed, the *Intermountain* majority acknowledged that it had "found no opinion in which a court considered legislative history when applying *Brand X*. . . . (A93 n.19.)

Since *Colony* held that the statutory language was ambiguous, "such an ambiguity . . . lead[s] us inexorably to *Chevron* step two, under which [the courts] may not disturb an agency rule unless it is arbitrary or capricious in substance, or manifestly contrary to the statute." *Mayo*, 2011 WL 66433 at *7 (internal quotation marks omitted). *Accord Household Credit Service, Inc. v. Pfennig*, 541 U.S. 232, 242 (2004). Far from being arbitrary, capricious, or manifestly contrary to the statute, the regulatory definition of "gross income" is consistent with, and supported by, the definition of "gross income" in I.R.C. § 61.[7] It is, therefore, valid.

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[6](...continued)
(p. 21), the statutory changes in 1954 limit the significance of this legislative history. *See also* T.D. 9466, 74 Fed. Reg. 49321 (Sept. 28, 2009).

[7] *Cuomo v. Clearing House Ass'n, L.L.C.*, 129 S. Ct. 2710, 2715 (2009), on which appellees rely (Br. 40), is factually distinguishable. There, the regulatory interpretation of the term "visitorial powers," contained in the National Bank Act was invalidated in a 5-4 decision because the Court "could discern the outer limits of the term 'visitorial powers' even through the clouded lens of history," and the regulation exceeded those limits. *Id.* at 2715. That is not the case here.

4. *Colony*'s contrary interpretation of the statutory language does not affect the deference due the regulations

Appellees and the amicus also argue that the Commissioner cannot overrule the Supreme Court, *i.e.*, *Colony*. (Br. 44-47; Am. Br. 23--25.) This argument is fundamentally misconceived since "the agency's decision to construe [a] statute differently from a court does not say that the court's holding was legally wrong" or have the effect of overruling it. *Brand X*, 545 U.S. at 983. As the Supreme Court explained in *Brand X*, "the agency may, consistent with the court's holding, choose a different construction [from that of the Supreme Court], since the agency remains the authoritative interpreter (within the limits of reason) of such statutes." *Id*.

The cases on which appellees rely–*Neal v. United States*, 516 U.S. 284 (1996); *Maislin Industries, U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116 (1990), and *Lechmere, Inc. v. NLRB*, 502 U.S. 527 (1992) (Br. 46)–were distinguished in *Brand X* on the ground that they precluded a regulation from trumping a court's determination *only* when the statute was unambiguous. *See, e.g.*, 545 U.S. at 982, 984. That is not the case here.

Further, *Hernandez-Carrera v. Carlson*, 547 F.3d 1237, 1242 (10th Cir. 2008), *cert. denied*, 134 S. Ct. 1011 (2009), discussed in the Commissioner's opening brief (p. 40), 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." *Id.* 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"). Appellees and the amicus fail to address these cases.

5. The Treasury Department complied with the APA and other requirements of administrative law in issuing the final regulations

Although the Commissioner's position is that the regulations are interpretive and thus exempt from the APA's requirements (*see* Op. Br. 52-60), he nevertheless followed its notice-and-comment procedure (*see* 5 U.S.C. § 553(b)) in issuing final regulations. A notice of proposed rulemaking was published contemporaneously with the temporary regulations. Definition of Omission from Gross Income, 74 Fed. Reg. 49354 (proposed Sept. 28, 2009.) This notice, published on September

28, 2009, established December 28, 2009, as the deadline for comments and requests for a public hearing. *Id.* Notwithstanding the pendency of 35-50 cases involving the subject matter of the regulation, only one comment was received, and no public hearing was requested. T.D. 9511, 75 Fed. Reg. at 78897.

This comment "questioned the application of the regulations, characterizing them as retroactive, and recommended that they be applied only prospectively." T.D. 9511, 75 Fed. Reg. at 78897-78898. The Preamble to the final regulations reflects Treasury's careful consideration of this comment (*id.* at 78898):

> The Treasury Department and the Internal Revenue Service disagree with the characterization of the regulations as retroactive. The final regulations have been clarified to emphasize that they only apply to open tax years, and do not reopen closed tax years as suggested by the commentator.

Treasury also addressed the commentator's reliance on the 1996 amendments to I.R.C. § 7805(b), which were the basis for the commentator's argument that the allegedly retroactive effective date was impermissible. Treasury responded that the 1996 amendments are inapplicable to regulations under Sections 6229(c)(2) and 6501(e)(1), as these statutes predated the amendments' effective date. *Id.*

The amicus argues (Br. 12-13) that the issuance of temporary regulations before notice and comment contaminates the final regulations, which *were* issued following notice and comment. But the Internal Revenue Code explicitly authorizes temporary regulations (§ 7805(e)) and requires that "[a]ny temporary regulation . . . shall also be issued as a proposed regulation" (§ 7805(e)(1)). The amicus cites no authority in support of the strange proposition that Treasury's contemporaneous publication of temporary regulations and a notice of proposed rulemaking, as statutorily required, served to invalidate regulations issued pursuant to this notice of proposed rulemaking.

The cases on which the amicus relies–*New Jersey v. EPA*, 626 F.2d 1038 (D.C. Cir. 1980); *U.S. Steel Corp. v. EPA*, 595 F.2d 207 (5th Cir. 1979); *Advocates for Highway and Auto Safety v. Federal Highway Admin.*, 28 F.3d 1288 (D.C. Cir. 1994)–are inapposite as they do not involve a notice of proposed rulemaking published contemporaneously with a temporary regulation. In *New Jersey* and *U.S. Steel*, the courts rejected the agency's reliance on the good-cause exception to the APA's notice-and-comment procedure (*see* 5 U.S.C. 553(B)) and held that provision for post-promulgation public comment did not cure pre-promulgation noncompliance with the APA. Here,

Treasury followed the APA's notice-and-comment procedure in issuing final regulations.

Advocates is also inapposite. It involved post-promulgation attempts to cure "defects in an original notice" of rulemaking, which did not provide an opportunity for public comment. 28 F.3d at 1292. Holding that the agency's tardy request for comments "is not necessarily fatal," this Court expressed "concern . . . that an agency is not likely to be receptive to suggested changes once the agency puts its credibility on the line in the form of final rules." *Id.* (internal quotation marks omitted). It "therefore place[d] the burden on the agency to make a compelling showing that the defects of its earlier notice were cured by the later one." *Id.* at 1292.

In this case, Treasury never "put[ ] its credibility on the line in the form of final rules" (*id.*) prior to soliciting public comment. To the contrary, it solicited public comment over a year before promulgating final regulations. Therefore, the burden of proof placed on the agency in *Advocates* (which this Court held that the agency satisfied, *id.* at 1293) is inapplicable here.

The amicus's further argument (Am. Br. 13-15) that Treasury lacked an open mind when it promulgated the final regulations is

meritless. Treasury's strong views concerning the need for regulations interpreting the statutory term "gross income" does not demonstrate lack of openmindedness, as the amicus erroneously contends. (Am. Br. 15.) An agency need not–and likely *cannot*–issue a notice of proposed rulemaking with a blank mind:

> Consider, for example, the assertions of an agency head that he discerns abuses that may require corrective regulation. One can hypothesize beginning an adjudicatory proceeding with an open mind, indeed a blank mind, a tabula rasa devoid of any previous knowledge of the matter. In sharp contrast, one cannot even conceive of an agency conducting a rulemaking proceeding unless it had delved into the subject sufficiently to become concerned that there was an evil or abuse that required regulatory response. It would be the height of absurdity, even a kind of abuse of administrative process, for an agency to embroil interested parties in a rulemaking proceeding, without some initial concern that there was an abuse that needed remedying. . . .

Association of Nat'l Advertisers, Inc. v. FTC, 627 F.2d 1151, 1176 (D.C. Cir. 1979) (Leventhal, J., concurring).

Nor is lack of openmindededness demonstrated by Treasury's failure explicitly to address, in the preamble to the final regulations, arguments made in briefs filed by taxpayers in pending cases, none of whom filed comments in the rulemaking proceeding. The amicus cites

no authority requiring the agency to address arguments made in documents that are not part of the rulemaking proceeding, and we are aware of none.

The similarity of the temporary and final regulations also does not demonstrate lack of openmindedness, as the amicus seems to contend.[8] (Am. Br. 13.) This Court has held that "an agency's failure to make any [changes in a regulation] does not mean that its mind was closed." *Advocates*, 28 F.3d at 1292. *Accord Mortgage Investors Corp. of Ohio v. Gober*, 220 F.3d 1375, 1378 (Fed. Cir. 2000) (rejecting contention that Department of Veterans Affairs had "'demonstrably closed its mind to public comment' by promulgating a final rule that

[8] The amicus also makes the inconsistent argument (Br. 15-16) that an APA violation results when, as here, the wording of the applicability/effective date provision of the temporary regulations and that of the final regulations differs. This argument is specious as the wording difference is minimal. 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." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b). The final 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 wording of the final regulation is plainly a logical outgrowth of the temporary regulation. Indeed, later in its brief, the amicus concedes (Br. 27) that "[o]ther than removing the word 'applicable' . . . the effective date provision remains the same in the final regulations."

was virtually identical to the interim final rule, even after comment had been received").

An agency demonstrates its openmindedness by considering the pubic comments submitted. *See* 5 U.S.C. § 553(c) (requiring agency to "consider[ ] . . . the relevant material presented"); *Advocates*, 28 F.3d at 1293 ("A review of the comments submitted and the responses made persuades us that the agency approached the pre-promulgation comments with the requisite open mind"); *Associated Fisheries of Maine v. Daley*, 954 F. Supp. 383, 388 (D. Maine), *aff'd*, 127 F.3d 104 (1st Cir. 1997) (rejecting argument that agency had mind set to change rule and singlemindedly pursued its goal without considering comments; administrative record shows comments were considered).

The evidence here shows that Treasury "approached the pre-promulgation comments with the requisite open mind." *Advocates*, 28 F.3d at 1293. Treasury made an extensive response to the only pre-promulgation comment. Responding to the commentator's characterization of the proposed regulations as retroactive, a characterization with which Treasury and the IRS disagreed, Treasury clarified the final regulations "to emphasize[ ] that they only apply to open tax years and do not reopen closed tax years as suggested by the

commentator." T.D. 9511, 75 Fed. Reg. at 78898. Treasury added that the commentator's characterization of the regulations as impermissibly retroactive was based on its misapprehension of the applicable law. *Id.*

The amicus also asserts (Br. 9-10) that the regulations cannot be upheld because the grounds upon which they were issued differ from those on which the Commissioner's appellate counsel defends them. The amicus is wrong. In the preamble to the final regulations, Treasury stated that it was exercising its authority under *Brand X* to adopt a different interpretation of the ambiguous statutory language from that adopted in *Colony*:

> In part, the Tax Court in *Intermountain* concluded that the Supreme Court's opinion in *Colony* was the only permissible interpretation of the statutory language in question ("omits from gross income"). The Treasury Department and the Internal Revenue Service disagree with *Intermountain*. The Supreme Court stated in *Colony* that the statutory phrase "omits from gross income" is ambiguous, meaning that it is susceptible to more than one reasonable interpretation of it. Under the authority of . . . *Brand X* . . . , the Treasury Department and the Internal Revenue Service are permitted to adopt another reasonable interpretation of "omits from gross income," particularly as it is used in a new statutory setting.

T.D. 9511, 75 Fed. Reg. at 78897. Treasury's position that, under *Brand X*, an agency can adopt a different interpretation of an

ambiguous statute from that adopted by the Supreme Court is identical to the position taken in this appeal. *See* Op. Br. 39-41.

6. The final regulations apply to this case

The final 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 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). In other words, a "decision" is not "final" under § 7481 until the last bell has rung in the last court.[9]

The position taken in the final regulations–that the applicable period is not necessarily the 'general' three-year limitations period" and that "[t]he expiration of the three-year period does not "close" a taxable year if a longer period applies" (T.D. 9511, 75 Fed. Reg. at 78898)–is reasonable. In the Internal Revenue Code, Congress has provided a number of limitations periods, any one of which may be applicable in a given situation. To apply the effective-date provisions of the temporary regulations, one must start with the premise that a six-year limitations period may apply, rather than automatically foreclosing that possibility

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[9] The amicus errs in contending (Br. 28) that Treasury's reference to I.R.C. § 7481 in the preamble to the regulations "would create a 'patent incongruity' in the law by treating taxpayers differently based on the forum in which their case was docketed. . . ." To the contrary, the preamble makes it clear that the definition of an open tax year applies to all docketed cases, regardless of their forum:

> [T]he final regulations apply to taxable years with respect to which the six year period for assessing tax . . . was open on or after September 24, 2009. This *includes but is not limited to, all taxable years . . . that are subject of any case pending before any court of competent jurisdiction . . . in which a decision had not become final* (within the meaning of section 7481). . . .

T.D. 9511, 75 Fed. Reg. at 78898 (emphasis added).

by assuming, as appelles do, that the three-year limitations period applies.

To argue, as appellees and amicus do (Br. 28-29; Am. Br. 26), that the applicable period for assessing tax expired before the effective date of the regulations, is to assume the premise to be proved–that the applicable assessment period is three years. But the applicability of the three-year assessment period is the very thing at issue in these cases, and no final determination has been made. Several courts deciding this issue before the regulations were promulgated have held that the six-year assessment period applied in circumstances identical to those here. *See Phinney, supra*; *Brandon Ridge, supra*; *Home Concrete, supra*; *Burks, supra*. Although the Tax Court disagreed with these cases and held that the three-year assessment period applied, its order and decision was not a "final order" under § 7481, and the final regulations apply.[10]

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[10] Finally, as explained in our opening brief (pp. 63-65), although the regulations are not retroactive, they would still be valid even if they were. *See, e.g.*, I.R.C. § 7805(b) (26 U.S.C. 1994 ed.); *Rodriguez v. Peake*, 511 F.3d 1147, 1154 (Fed. Cir. 2008). Indeed, the Supreme Court has authorized retroactive rulemaking when, as here, there is an "express statutory grant." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 209 (1988). The courts have repeatedly upheld the validity of retroactive regulations when the Treasury Department did not abuse its discretion in issuing them. Neither appellees nor the amicus

(continued...)

C. If this Court reverses, it should remand for a determination whether the omitted income was adequately disclosed

Appellees urge (Br. 57-60) that if this Court determines that a basis overstatement can give rise to an omission of gross income under § 6501(e)(1)(A), it should, nevertheless affirm the Tax Court decision in their favor on the alternate ground that they adequately disclosed the nature and amount of their omitted income and therefore are protected from the six-year assessment period. *See* I.R.C. § 6501(e)(1)(A)(ii) (providing safe harbor from six-year assessment period when omitted gross income "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"). To be eligible for the safe harbor, an amount must be shown on the face of the return or in an attached statement "in a manner sufficient to enable the secretary by reasonable inspection of the return to detect the errors. . . ." *Phinney*, 392 F.2d at 685.

Appellate courts do not decide factual issues in the first instance. *See Pullman-Standard v. Swint*, 456 U.S. 273, 291-292 (1982) ("[F]actfinding is the basic responsibility of district courts, rather than

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[10](...continued)
attempts to demonstrate an abuse of discretion here.

appellate courts, and . . . the Court of Appeals should not have resolved in the first instance this factual dispute which had not been considered by the District Court"). *Accord In re Sealed Case*, 552 F.3d 841, 844 (D.C. Cir. 2009). Thus, "when a district judge . . . fails to make findings with respect to a material issue, appellate courts normally vacate the judgment and remand for the judge to make those findings." *Id.* at 845 (internal quotation marks omitted). *Accord Jarrell v. United States*, 753 F.2d 1088, 1092 (D.C. Cir. 1985); *Segar v. Smith*, 738 F.2d 1249, 1280 (D.C. Cir. 1984).

In this case, since the Tax Court upheld the applicability of the three-year assessment period, it did not consider appellees' alternate contention that the safe harbor for adequate disclosure applies. This contention is in dispute. In opposing the motion for summary judgment, the Commissioner argued that Intermountain had failed to adequately disclse the nature and amount of the omitted gross income, $1.7 million, on its return by failing to disclose, in substance or by implication, that its basis in the sold assets had been artificially inflated by using a basis-inflating tax shelter. (Doc. 30 at 15-24.) The Commissioner argued that the critical facts underlying the basis-inflating tax shelter transactions were not disclosed anywhere on the

partnership return. (*Id.* at 23.) These allegations, if established, would defeat appellees' safe-harbor argument. *See Brandon Ridge*, 100 A.F.T.R.2d at 5355-5356 (safe harbor inapplicable when facts concerning stepped-up basis were inadequately disclosed on returns).

Accordingly, if this Court reverses the Tax Court's determination, it should remand this case for further proceedings. *See, e.g.*, *United States v. Rhodes*, 145 F.3d 1375, 1383-1384 (D.C. Cir. 1998) (whether various factors warranted downward departure from sentencing guidelines was for district court to consider in the first instance on remand).

Respectfully submitted,

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FEBRUARY 2011

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/s/ JOAN I. OPPENHEIMER
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Attorney for the Appellant

February 1, 2011

CERTIFICATE OF SERVICE

I hereby certify that on February 1, 2011, I electronically filed the foregoing corrected reply 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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/s/ JOAN I. OPPENHEIMER
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Attorney

ADDENDUM

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ADDENDUM

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.

. . . .

(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.

. . . .