09-11061,09-60827

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

DANIEL S. BURKS, Tax Matters Partner
of Key Harbor Investment Partners,
Plaintiff-Appellant
v.
UNITED STATES OF AMERICA,
Defendant-Appellee

DANIEL S. BURKS, Tax Matters Partner
of DJB Investment Partners,
Plaintiff-Appellant
v.
UNITED STATES OF AMERICA,
Defendant-Appellee

COMMISSIONER OF INTERNAL REVENUE,
Petitioner
v.
MITA, Partner; JOHN F. LYNCH, A Partner
Other Than the Tax Matters Partner,
Respondents

ON APPEALS FROM THE ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS AND THE ORDER AND DECISION OF THE UNITED STATES TAX COURT

UNITED STATES'S PETITION FOR REHEARING EN BANC

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STATEMENT PURSUANT TO RULE 35(b)(1) OF THE FEDERAL RULES OF APPELLATE PROCEDURE

The panel's holding conflicts with *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968) (opinion by Tuttle, J.), creating an intra-circuit conflict, conflicts with two other circuit court decisions, creating an inter-circuit conflict, and presents a question of exceptional importance to the proper administration of federal tax laws: whether an understatement of income resulting from the overstatement of the basis of sold property can qualify as an omission from gross income for purposes of the extended, six-year assessment period, I.R.C. § 6501(e)(1)(A). The panel's holding that a basis overstatement cannot trigger the longer assessment period, though consistent with *Home Concrete v. United States*, 2011 WL 361495 (4th Cir. Feb. 7, 2011), *pet. for rehearing en banc pending*, and *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767, 778 (9th Cir. 2009), is in direct conflict with *Phinney* and with the Seventh and Federal Circuits' decisions in *Beard v. Commissioner*, 2011 WL 222249 (7th Cir. Jan. 26, 2011), *pet. for rehearing en banc pending*, and *Grapevine Imports, Ltd. v. United States*, 2011 WL 832915 (Fed. Cir. Mar. 11, 2011).

The issue presented has substantial administrative importance as well, having been raised in about 30 docketed cases, involving approximately $1 billion in taxes, interest, and penalties. Since basis overstatement is frequently used as a means of tax avoidance in complex tax shelter schemes that may not be identified during the general three-year period for tax assessment, the panel's adverse

holding significantly impairs the IRS's ability to pursue those schemes and results in the disparate treatment of similarly-situated taxpayers. Under the panel's decision, taxpayers who engaged in abusive tax shelters that are not discovered by the IRS within the general three-year assessment period and whose cases are heard in the Fifth Circuit (and in the Fourth and Ninth Circuits) will escape taxation, while similarly situated taxpayers whose cases are heard in the Seventh and Federal Circuits will not.

STATEMENT OF THE ISSUE

Whether an understatement of income resulting from an overstated tax basis of sold property can qualify as an omission from gross income giving rise to the extended, six-year period for tax assessment.

COURSE OF PROCEEDINGS AND DISPOSITION OF THE CASE

These TEFRA[1] partnership proceedings involve challenges to Notices of Final Partnership Administrative Adjustment ("FPAAs"), in which the IRS adjusted items reported on partnership returns. In both cases, the FPAAs were issued in time to toll the period for assessing tax if the extended, six-year assessment period applied, but were untimely under the general, three-year assessment period. Both cases were decided on summary judgment. The FPAA was held timely in *Burks*, but untimely in *MITA*. Taxpayers took an interlocutory

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

appeal in *Burks*, and the Government appealed in *MITA*. (Op. 3-5.) The cases were consolidated for oral argument and opinion. The panel (Judges DeMoss, Benavides, and Elrod) held that both FPAAs were untimely. Thus, it reversed *Burks* and affirmed *MITA*.

STATEMENT OF THE FACTS

Each case involves an abusive tax shelter designed to create artificial tax losses in order to offset substantial capital gains. (Op. 2-3 & n.1.) In each case the taxpayers–John and Vicki Lynch in *MITA* and Daniel and Janet Burks (and their trusts) in *Burks*–sold U.S. Treasury notes short and transferred the short- sale proceeds and the offsetting obligation to close the short sales to a partnership. Taxpayers then increased their bases in their partnership interests by the amount of the short-sale proceeds without reduction for the offsetting obligation to close the short sales.[2] When basis is overstated, "gross income is affected to the same degree as when a gross-receipt item of the same amount is completely omitted from a tax return." *Colony, Inc. v. Commissioner*, 357 U.S. 28, 32 (1958). By inflating the bases in their partnership interests, taxpayers in *MITA* and *Burks* sheltered capital gains of over $30 million and $5 million, respectively.

In both cases, the IRS issued FPAAs adjusting the partnership tax returns on

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

the grounds that the challenged transactions lacked economic substance. Both FPAAs were issued more than three years–but less than six years–after the taxpayers' tax returns were filed. In both cases, taxpayers urged that the adjustments in the FPAA were barred by the general, three-year assessment period. (Op. 3-4.) *See* I.R.C. § 6501(a). When, however, a taxpayer has omitted from gross income "an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return," the assessment period is six years. I.R.C. § 6501(e)(1)(A). Section 6229 has similar time periods for assessing taxes attributable to partnership items. The Government alleged that the six-year period applied.

The district court in *Burks* agreed with the Government. It relied on this Court's decision in *Phinney* as establishing that a basis overstatement can trigger the extended assessment period of § 6501(e)(1)(A). The Tax Court in *MITA*, on the other hand, held that the three-year period applied. It relied on *Colony,* which held that an overstated basis did not constitute an omission of gross income for purposes of the extended assessment period of the Internal Revenue Code of 1939.

On September 24, 2009, after the orders on appeal were entered, the Department of Treasury issued temporary regulations which "clarif[ied] that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)." T.D. 9466, 74 Fed. Reg. 49321, 49321 (2009). 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.* Treasury published a notice of proposed rulemaking contemporaneously with the temporary regulations. *See* Definition of Omission from Gross Income, 74 Fed. Reg. 49354 (proposed Sept. 28, 2009). After notice and comment, final regulations adopting the interpretation of "gross income" contained in the temporary and proposed regulations became effective December 14, 2010, and the temporary regulations were withdrawn. T.D. 9511, 75 Fed. Reg. 78897 (2010). On appeal, the Government relied, in part, on the final regulations.

The panel held the extended assessment period inapplicable and relied on *Colony*, which interpreted the 1939 Code. It ruled that neither the significant statutory changes in 1954,[3] nor this Court's decision in *Phinney* in 1968, limited *Colony*'s holding. (Op. 6-11, 17.) Relying on the Supreme Court's dicta in *Colony* that § 6501(e)(1)(A) was unambiguous (*id.* at 22), the panel held that the

[3] In the 1954 Code, Congress added two subsections to the provision governing the extended assessment period, I.R.C. § 6501(e)(1)(A). Section 6501(e)(1)(A)(i) defined "gross income" in the context of the sale of goods or services by a trade or business, so that in that context, "gross income" means gross receipts, undiminished by basis. In § 6501(e)(1)(A)(ii), Congress created a "safe harbor" for adequate disclosure by excluding from the 25% omission computation any amount adequately disclosed on the return (or a statement attached thereto).

regulations "are an unreasonable interpretation of settled law" and, therefore, are inapplicable to the taxpayers in these cases (*id.* at 24). The panel added that, even if § 6501(e)(1)(A) was ambiguous and *Colony* was inapplicable, "it is unclear whether the Regulations would be entitled to *Chevron* deference" because "the treasury promulgated determinative retroactive regulations following prior adverse judicial decisions on the identical issue." (*Id.* at 23 n.9.)

ARGUMENT

1. The panel's determination that *Colony* controls this case is inconsistent with this Court's decision in *Phinney*, which interpreted the 1954 Code and held that the six-year assessment period applied where an omission from gross income resulted from an overstated basis. In *Phinney*, the tax return prepared for taxpayer's half-interest in community property correctly reported her share of proceeds of an installment note ($375,736.06), but mislabeled this income as payment for stock sold in 1958. On the return, taxpayer claimed a basis in the stock of $375,736.06 and reported a gain/loss of zero. 392 F.2d at 682.

Although not apparent from 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. Taxpayer's representative, relying on *Colony*, argued that "so long as the gross amount reported was not in error, there was no omission of 'an amount' from the return at all." 392 F.2d at 685. This Court disagreed and held that the six-year assessment period applied. It identified taxpayer's failure to

disclose the basis step-up as the critical error justifying application of the six-year assessment period (*id.*):

> 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.

The panel should have applied *Phinney*'s analysis to hold that the bases overstatements in *Burks* and *MITA* triggered the extended assessment period. Instead, it misconstrued *Phinney* as "involv[ing] a distinct fact pattern not presented in this appeal." (Op. 10.) That fact pattern was "a fundamental alteration to the nature of the item reported," which the panel characterized as "an almost direct omission." (*Id.*) But § 6501(e)(1)(A) does not render the extended assessment period applicable in cases of "an almost direct omission," *i.e.*, a misdescription of an income item, as occurred in *Phinney*. Rather, the extended assessment period applies when "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." I.R.C. § 6501(e)(1)(A). Since the amount of taxpayer's gross receipts in *Phinney* was correctly reported, the 25% threshold would not have been satisfied unless this Court had construed the basis

overstatement as an omission from gross income.

The panel also erred in trying to distinguish *Phinney* as a case turning on inadequate disclosure. (Op. 10.) The issue of adequate disclosure under § 6501(e)(1)(A)(ii) never arises unless there has been a substantial omission of gross income in the first place. Thus, this Court could not have concluded in *Phinney* that disclosure was inadequate unless it had made the preliminary determination that an overstated basis could result in a substantial omission of gross income under § 6501(e)(1)(A). The panel, therefore, put the cart before the horse in concluding that "disclosure of the item, despite the correctness[4] of the amount, provides the IRS with reasonable notice of the item being reported and the general limitations period should apply pursuant to *Colony*."[5] (Op. 10-11.) Plenary review by the full Court is required to harmonize the law of this circuit.

2. The panel's conclusion that "*Colony*'s holding with respect to the definition of 'omits gross income' remains applicable in light of the revisions to

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[4] The panel apparently meant to say "incorrectness," not "correctness."

[5] Furthermore, in concluding that the taxpayers' reporting a basis, "albeit in an incorrect amount," in *Burks* and *MITA* was a "circumstance [that] provides the IRS with sufficient notice to inquire into the correctness and validity of the item being reported" (Slip Op. 10), the panel went well outside the record. The district court in *Burks* had held that plaintiff had not established adequate disclosure and therefore was not entitled to summary judgment on this ground. (R1283.) The Tax Court in *MITA* did not reach the adequate-disclosure issue. Factual issues like adequate disclosure should be decided by the trial court in the first instance. *See, e.g.*, *Chapman v. National Aeronautics and Space Admin.*, 736 F.2d 238, 242 (5th Cir. 1984).

the Code" (Op. 12) is in direct conflict with the Seventh Circuit's decision in *Beard* and fails to give effect to statutory changes made in 1954, *i.e.*, the addition of the gross-receipts provision, § 6501(e)(1)(A)(i), and the adequate-disclosure provision, § 6501(e)(1)(A)(ii). As the Seventh Circuit stated in rejecting the Ninth Circuit's conclusion in *Bakersfield* that the statutory additions merely clarified existing law (*Beard*, 2011 WL 222249 at *6):

> [W]e don't believe a full rewriting was necessary in order to cast the language of Section 6501(e)(1)(A) in a different light, nor do we believe that Congress needed to redefine "omits" in order to clarify the existing law. . . . . [C]ongress, when revising the Code, was responding . . . to the confusion throughout the circuits. We do not find it hard to believe that Congress added subsections (i) and (ii) to Section 6501(e)(1)(A) with the belief that this would clarify a plain reading of the statute and quell the confusion. Indeed, . . . the additions did just that.

As the Seventh Circuit observed, the gross-receipts provision, § 6501(e)(1)(A)(i), "addresses the situation faced by the Court in *Colony* where there is an omission of an actual receipt or accrual in a trade or business situation," while § 6501(e)(1)(A)(ii) "is on all fours with *Colony*'s suggestion that Congress' intention in enacting the longer time period was to give the IRS a fighting chance in situations where the taxpayer's return doesn't provide a clue to the omission." *Beard*, 2011 WL 222249 at *4. The Seventh Circuit correctly concluded that the Court in *Colony* was "referring to this synchronicity with subsections (i) and (ii) when it concluded that its interpretation of legislative history gave the

'ambiguous' Section 275(c) [of the 1939 Code] a meaning harmonious with that of 'unambiguous' Section 6501(e)(1)(A)" of the 1954 Code. *Id.* The panel erred here in parting company with the Seventh Circuit and in holding that the significant statutory changes made in 1954 did not render *Colony* inapplicable. (Op. 17.)

Section 6501(e)(1)(A), with its two subsections, "should be read as a gestalt," as the Seventh Circuit correctly held. *Beard*, 2011 WL 222249 at *5. When so read, "the meaning is clear"—"an inflation of basis should be considered an omission from gross income such that it triggers the extended six-year" assessment period. *Id.* at *7. That is because "gross income" is a "key phrase in the statutory language," and "for situations not involving trade or business, . . . it makes logical sense to use the Code's general gross income definition when reading Section 6501(e)(1)(A)." *Id.* at *5. Further support for this interpretation of "gross income" is derived from § 6501(e)(1)(A)(i), the Seventh Circuit concluded (*id.* at *6):

> If the omissions from gross income contemplated by Section 6501(e)(1)(A) were only specific items such as receipts and accruals, then the special definition in subsection (i) would be, if not superfluous, certainly diminished. The addition of this subsection suggests that the definition of gross income for the purposes of Section 6501(e)(1)(A) is meant to encompass more than the types of specific items contemplated by the *Colony* holding.

Thus, Section § 6501(e)(1)(A)(i) was not added to the Code to clarify the 25%

omission calculation, as the panel erroneously concluded. (Op. 16-18). As the Seventh Circuit explained (*Beard*, 2011 WL 222249 at *7):

> Certainly, we should be mindful of the applicability of subsection (i) when calculating the 25%, and we should be equally mindful of this subsection and its interplay with the rest of Section 6501(e)(1)(A) and the entirety of the Code when determining what counts as an omission from gross income.

The panel erred in failing to follow the Seventh Circuit's well-reasoned analysis.

3. The panel compounded its error by concluding (Op. 21) that the final Treasury regulations were inapplicable. The panel's reasoning, which was based on the supposedly "unambiguous language of section 6501(e)(1)(A)" (*Colony*, 357 U.S. at 37), conflicts not only with the Federal Circuit, but with the reasoning of the Ninth Circuit as well.[6] Unlike the panel, the Federal Circuit found "the relevant text of § 6229 and § 6501 . . . ambiguous as to Congress's intent concerning treatment of a taxpayer's overstated basis." *Grapevine*, 2011 WL 832915 at *8. Because the Court in *Colony* stated that "it cannot be said that the language ['omits from gross income'] is unambiguous" (357 U.S. at 33), the Federal Circuit concluded that "*Colony* [was] no bar to our finding that the text of the relevant statutes, standing alone, is ambiguous as to the disposition of this issue." *Id.* (footnote omitted). The Federal Circuit added, "Even incorporating the

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[6] As discussed above, it is our position that the plain meaning of § 6501(e)(1)(A) supports the applicability of the six-year assessment period when a substantial omission of gross income results from a basis overstatement. But if this Court disagrees, then the statute is ambiguous, as discussed below.

legislative history into our analysis of the statutory text, we do not think Congress's intent was so clear that no reasonable interpretation could differ." *Id.* at *9.

Similarly, the Ninth Circuit in *Bakersfield* (a pre-regulation case) held the relevant statutory language to be ambiguous, and refused to rely on *Colony*'s characterization of § 6501(e)(1)(A) as unambiguous because "[t]he Court expressly avoided construing the 1954 Code. . . ."[7] 568 F.3d at 778. Thus, the panel erred in relying on *Colony*'s statement that § 6501(e)(1)(A) is "unambiguous."

Since the critical statutory language—"omits from gross income"—was (and still is) ambiguous, Treasury could validly interpret that language differently from the Supreme Court. *Chevron*[8] 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

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[7] This ambiguity occasioned the Ninth Circuit's observation that "[t]he 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." *Bakersfield*, 568 F.3d at 778 (internal quotation marks omitted).

[8] *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

U.S. 735, 740-741 (1996). Thus, "the agency may, consistent with the court's holding, choose a different construction [from that of the court], since the agency remains the authoritative interpreter (within the limits of reason) of such statutes." *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 983 (2005).

4. The panel's suggestion that, "even if the statute was ambiguous and *Colony* was inapplicable," the regulations would not be entitled to deference because they were promulgated "during the pendency of the suit . . . following adverse judicial decisions on the identical issue" (Op. 23 n.9), ignores the numerous Supreme Court cases holding that the promulgation of regulations in response to litigation is no impediment to giving them *Chevron* deference. *See Mayo Foundation v. United States*, 131 S. Ct. 704, 712-713 (2011); *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); *Grapevine*, 2011 WL 832915 at *13. As the Court explained in *Morton*, 467 U.S. at 836 n.21:

> 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 Mayo, 131 S. Ct. at 712 (finding it "immaterial" for purposes of *Chevron*

deference that regulation at issue was prompted by litigation). Thus, the final regulations are entitled to *Chevron* deference. *Grapevine*, 2011 WL 832915 at *11. *See also Beard*, 2011 WL 222249 at *7 ("we would have been inclined to grant the temporary regulation *Chevron* deference, just as we would be inclined to grant such deference to T.D. 9511").[9]

5. The regulatory definition of "gross income" is a permissible construction of the statutory language because it is consistent with the Code's general definition of "gross income" to include gain on the sale of property (I.R.C. § 61(a)), and is also consistent with the statutory method of computing such gain (I.R.C. § 1001(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).

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[9] The panel relied on *Chock Full O' Nuts v. United States*, 453 F.2d 300, 303 (2d Cir. 1971), for the principle that the Commissioner cannot "promulgate retroactive regulations during the course of litigation" to provide himself with a defense based on their presumptive validity. (Slip Op. 23 n.9.) But, in light of later Supreme Court holdings giving *Chevron* deference to regulations adopted during litigation, *Chock Full O'Nuts* is no longer a viable precedent. Furthermore, the panel compounded its error by misstating that the Commissioner here only "allowed for notice and comment after the final Regulations were enacted." (*Id.* at 24 n.9.) In fact, although the temporary Treasury regulations were issued simultaneously with a notice of proposed rulemaking, and went into effect immediately, the final regulations were not promulgated until *after* notice and comment. Thus, *U.S. Steel Corp. v. EPA*, 595 F.2d 207, 214-15 (5th Cir. 1979), on which the panel relied, is inapposite.

The regulatory definition is also supported by the addition to the Code in 1954 of § 6501(e)(1)(A)(i), which demonstrated Congress's intent to treat trade-or-business income and non-trade-or-business income according to different rules. *See* T.D. 9466, 74 Fed. Reg. at 49,321-49,322; *Grapevine*, 2011 WL 832915 at *10. Thus, the regulations are valid. *Grapevine*, 2011 WL 832915 at *10 ("the Treasury regulations . . . are reasonable, even though they depart from the judicial interpretation of *Colony* and *Salman Ranch*"[10]). The panel, therefore, erred in failing to apply the regulations to this case.

CONCLUSION

This petition for rehearing en banc should be granted. On rehearing, this Court should vacate the panel's determination, affirm the district court order in *Burks*, and reverse the Tax Court order and decision in *MITA*.

Respectfully submitted,

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[10] *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009).

CERTIFICATE OF SERVICE

I hereby certify that on May 28, 2011, I electronically filed the foregoing petition for rehearing *en banc* with the Clerk of the Court for the United States Court of Appeals for the Fifth Circuit by using the appellate CM/ECF system. Participants who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that some of the participants in the case are not registered CM/ECF users. I have mailed the foregoing document by First-Class Mail, postage prepaid to the following non-CM/ECF participant:

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ECF CERTIFICATIONS

Pursuant to Fifth Circuit Rule 25.2.1, I hereby certify on this 28th day of March, 2011, that (i) any required privacy redactions have been made, (ii) the electronic submission is an exact copy of the paper document, and (iii) the document has been scanned for viruses with a commercial virus scanning program and is free of viruses.

/s/ JOAN I. OPPENHEIMER
JOAN I. OPPENHEIMER
Attorney for the United States

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.

. . . . .

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.

. . . .

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

United States Court of Appeals
Fifth Circuit
FILED
February 9, 2011

Lyle W. Cayce
Clerk

No. 09-11061

DANIEL S. BURKS, Tax Matters Partner of Key Harbor Investment Partners,

Plaintiff - Appellant

v.

UNITED STATES OF AMERICA,

Defendant - Appellee

DANIEL S. BURKS, Tax Matters Partner of DJB Investment Partners,

Plaintiff - Appellant

v.

UNITED STATES OF AMERICA,

Defendant - Appellee

Appeal from the United States District Court
for the Northern District of Texas

Cons w/ No. 09-60827

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

MITA, Partner; JOHN F. LYNCH, A Partner Other Than the Tax Matters Partner

Respondents

Appeal from the United States Tax Court

Before DEMOSS, BENAVIDES, and ELROD, Circuit Judges.

HAROLD R. DEMOSS, JR., Circuit Judge:

This consolidated appeal requires us to determine whether an overstatement of basis constitutes an omission from gross income for purposes of the Tax Code, 26 U.S.C. § 6501(e)(1)(A), which extends the tax assessment period from three to six years. Because we conclude that an overstatement of basis is not an omission from gross income for purpose of the relevant statute, the Commissioner was limited to three years to pursue unpaid tax claims against the taxpayers. We further find that the recently promulgated Treasury Regulations do not apply to the taxpayers. We thus affirm the tax court's judgment in favor of the taxpayer, and reverse the district court's judgment in favor of the government.

I.

Appellee United States of America and Petitioner Commissioner of the Internal Revenue Service (IRS) (collectively "the government") assert that Appellants Daniel Burks, M.I.T.A., and John E. Lynch (collectively "taxpayers"

or "the taxpayers") utilized the "Son of BOSS"[1] tax shelter to create artificial tax losses in order to offset capital gains. In a Son of BOSS scheme, partners engage in various long and short sale transactions and transfer the resulting obligations to the partnership thereby improperly inflating the basis in the partnership assets. *See e.g., Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1343 (Fed. Cir. 2006) (outlining steps of transactions used to inflate basis in assets). The partners do not reduce the basis by the liabilities assumed by the partnership. *See id;* I.R.S. Notice 2000-44, 2000-2 C.B. 255 (describing prohibited transactions used to create an artificial basis). When basis is overstated, "gross income is affected to the same degree as when a gross-receipt item of the same amount is completely omitted from a tax return." *Colony, Inc. v. Comm'r*, 357 U.S. 28, 32 (1958).

The Tax Equity and Fiscal Responsibility Act of 1982 "established 'a single unified procedure for determining the tax treatment of all partnership items at the partnership level, rather than separately at the partner level.'" *Kornman & Assocs., Inc. v. United States*, 527 F.3d 443, 446 n.1 (5th Cir. 2008) (quoting *Callaway v. Comm'r*, 231 F.3d 106, 108 (2d Cir. 2000)). Generally, taxes must be assessed and collected within three years of the filing of the tax return. *See* 26 U.S.C. §§ 6501(a), 6229(a). The limitations period is extended to six years when the taxpayer "omits from gross income an amount properly includible therein . . . in excess of 25 percent of the amount of gross income stated in the return." 26 U.S.C. § 6501(e)(1)(A).

In the present cases, the IRS issued Final Partnership Administrative Adjustments (FPPAs) adjusting the partnership tax returns filed by the taxpayers on the grounds that the challenged transactions lacked economic

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[1] "'BOSS' is an acronym for 'Bond and Option Sales Strategy.'" *Kornman & Assocs., Inc. v. United States*, 527 F.3d 443, 446 n.2 (5th Cir. 2008). Son of BOSS is an abusive tax shelter that is a "variation of the slightly older BOSS tax shelter." *Id.* (citation omitted).

substance.[2] *See Kalmath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 543 (5th Cir. 2009) ("The economic substance doctrine allows courts to enforce the legislative purpose of the [Tax] Code by preventing taxpayers from reaping tax benefits from transactions lacking in economic reality."). The FPPAs were filed more than three years but less than six years after the taxpayers' individual tax returns were filed with the IRS. The taxpayers moved for summary judgment before the district court and tax court on the grounds that the government had issued the FPAAs after the expiration of the general three year limitations period for assessing tax against the various partners. In both matters, the government conceded that the three year limitations period had expired but asserted that an extended six year limitations period applied because the partners had omitted gross income in excess of 25% from their tax returns in violation of § 6501(e)(1)(A) when they overstated their basis.

In *United States v. Burks* (09-11061), the district court held that this court's decision in *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), established that an overstatement of basis was an omission from gross income for purposes of § 6501(e)(1)(A). The district court thus denied Burks's motion for summary judgment. This court granted Burks permission to file an interlocutory appeal.

In *Commissioner v. M.I.T.A.* (09-60827), the tax court relied on the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28, 32 (1958), and cases construing that decision to support its finding that an overstatement of basis did not constitute an omission from gross income for

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[2] The issue before this court is a purely legal one—whether an overstatement of basis constitutes an omission from gross income for purposes of § 6501(e)(1)(A). The merits of the underlying transactions are not before this court on appeal. The district court and tax court have not yet determined that the taxpayers' reporting positions are unsupportable.

purposes of § 6501(e)(1)(A). The tax court further found that *Phinney* did not directly address the issue facing the court. Because the tax court held that the three year limitations period applied, it granted the taxpayers' motion for summary judgment. The government timely appealed.

II.

On appeal, the taxpayers argue that an overstatement of basis does not constitute an omission from gross income as established by the Supreme Court in *Colony v. Commissioner* and thus the three year limitations period applies. The government argues that this court's decision in *Phinney v. Chambers* established that the six year limitations period applies to an overstatement of basis for purposes of § 6501(e)(1)(A). The government contends that *Colony* applies only in the context of a trade or business engaged in the sale of goods or services. The government also argues that application of *Colony* to the revised statute renders § 6501(e)(1)(A) subsections (i) and (ii) superfluous.[3] Finally, the government asserts that recently enacted Treasury Regulations purporting to define "omission from gross income" as encompassing an overstatement of basis are determinative and apply retroactively to the present matters. We consider each in turn.

A.

This court reviews de novo a court's determination on a motion for summary judgment. *See Staff IT, Inc. v. United States*, 482 F.3d 792, 797 (5th Cir. 2007); *Ford Motor Co. v. Tex. Dep't of Transp.*, 264 F.3d 493, 498 (5th Cir. 2001). Summary judgment is proper when "the movant shows that there is no

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[3] 26 U.S.C. § 6501(e)(1)(A)(i), (ii) has since been amended such that subsections (i) and (ii) now appear at § 6501(e)(1)(B)(i), (ii). There have been no amendments to the text of the subsections and thus the amendments do not affect our analysis. All references to subsections (i) and (ii) are as to the text of the statute prior to the recent amendments in effect at the time of this appeal.

genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." FED. R. CIV. P. 56(a).

B.

The taxpayers argue that the Supreme Court's decision in *Colony v. Commissioner*, holding that an overstatement of basis was not an omission from gross income such that the extended limitations period applied, is controlling in the present matters.

In *Colony*, the Court held that an overstatement of basis did not constitute an omission from gross income for purposes of § 275(c) of the 1939 Tax Code, the predecessor to § 6501(e)(A)(1). 357 U.S. at 36. Section 275(c) stated that a five year (now six year) statute of limitations applied when a taxpayer "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." *Id.* at 29.[4] The taxpayer in *Colony* had understated gross income by overstating the basis in land the taxpayer had sold. *Id.* at 30. The Court began its analysis by focusing on the plain language of the statute. "In determining the correct interpretation of § 275(c) we start with the critical statutory language, 'omits from gross income an amount properly includible therein.'" *Id.* at 32.

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[4] 26 U.S.C. 275 stated in relevant part:

> (a) General rule. The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.
>
> (c) Omission from gross income. If the taxpayer 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, 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 5 years after the return was filed.

Colony, Inc. v. Comm'r, 357 U.S. 28, 29 n.1 (1958).

The taxpayers argued that the term "omits" was commonly defined as "to leave out or unmentioned; not to insert, include, or name" and thus by the plain language of the statute only the complete omission of an item of income triggered application of the extended limitations period. *Id.* at 32-33. The Court stated it was "inclined" to agree with the taxpayers' argument, however it held that "it cannot be said that [§ 275(c)] is unambiguous" and turned to the legislative history of the statute. *Id.* at 33.

The court found "in that history persuasive evidence that Congress was addressing itself to the specific situation where a taxpayer actually omitted some income receipt or accrual in his computation of gross income, and not more generally to errors in that computation arising from other causes." *Id.* The Court thus found that the extended limitations period did not apply where gross receipts had been reported, despite gross income having been under-reported. *Id.* The Court concluded:

> We think that in enacting § 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting 'gross income' or one, such as overstated deductions, affecting other parts of the return.

Id. at 36.

The government asserts that this court's decision in *Phinney v. Chambers* limited *Colony*'s holding requiring an actual omission of income pursuant to the plain meaning of the term "omits," because the revised statute § 6501(e)(1)(A)(ii) established adequate disclosure as the critical factor when determining whether there was an omission from gross income. *See Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505, 509 (2007) ("In the wake of *Colony*, a judicial debate erupted over whether the 1954 version of [S]ection 6501(e)(1)(A) is triggered only where an item of income is entirely omitted from a return.").

In *Phinney*, this court was tasked with determining whether misreporting the nature of an item on a tax return constituted an omission from gross income for the purposes of § 6501(e)(1)(A). 392 F.2d at 681-83. The transaction at issue in *Phinney* involved the sale of community property owned by the taxpayer and her deceased spouse. *Id.* at 681. The taxpayer and her spouse each owned a 50% share in a note for stock, which had been sold under an installment plan. *Id.* at 681. The taxpayer and the fiduciary of the deceased taxpayer's spouse each filed tax returns. *Id.* at 681-82. The spouse's tax return reported a gain from the sale of the stock and correctly listed the transaction as an installment sale. *Id.* The taxpayer's tax return incorrectly listed the installment sale transaction as the sale of a stock and reported no gain or loss. *Id.* at 682.

The question before the court was whether the taxpayer omitted from gross income an "amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return." *Id.* at 683 (citation omitted). Focusing on the item reported, *Phinney* found that the nature of the item was misrepresented such that there was no adequate disclosure of the transaction. *Id.* at 684. "The basic difficulty with the taxpayer's position here is that [the] taxpayer simply didn't give the government a chance to make a 'challenge' to the taxpayer's contention, because the taxpayer made no such contention on the return it filed." *Id.* The taxpayer's return reported an

installment sale "under a different heading and under an incorrect designation." *Id.*

Citing to *Colony*, the court held that there was "[n]o better illustration" for the need for adequate disclosure as required in § 6501(e)(1)(A)(ii). *Id.* at 685.

> [T]he enactment of [§ 6501] subsection (ii) . . . 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 the nature of an item of income which places the commissioner at a special disadvantage in detecting errors.

Id. (internal marks omitted). The court concluded that "if an item of income is shown on the face of the return or an attached statement that is not shown in a manner sufficient to enable the [S]ecretary by reasonable inspection of the return to detect the errors then it is the omission of 'an amount' properly includable in the return." *Id.*

We do not read *Phinney* as limiting *Colony*'s holding.[5] In *Colony*, the court noted that its conclusion was "in harmony with the unambiguous language of § 6501(e)(1)(A)." 357 U.S. at 37. A fair reading of *Colony* and *Phinney* supports our finding that both an actual omission of an amount from the tax return or a fundamental misstatement of the nature of an item reported in a tax return that places the Commissioner at a disadvantage in detecting the error may result in application of the extended limitations period. *See id*; *Phinney*, 392 F.2d at 685 ("[T]he six year statute is intended to apply where there is either a complete *omission of an item* of income . . . or *misstating of the nature of an item* of income

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[5] The Seventh Circuit in *Beard* incorrectly read our decision in *Phinney* as limiting *Colony*'s holding. *See Beard v. Comm'r*, – F.3d –, No. 09-3741, 2011 WL 222249, at *4-5. (7th Cir. Jan. 26, 2011) As discussed above, the Seventh Circuit failed to note the distinct factual pattern presented in *Phinney*, where the taxpayers had misstated the very nature of the item so that the IRS would not have had any reasonable way of detecting the error on the tax return. That is not the case here.

which places the [C]ommissioner at a special disadvantage in detecting errors.") (internal mark omitted) (emphasis added). The holdings in both cases support the underlying purpose of the Code: to provide the IRS with additional time to detect errors or omissions when the nature of the omission places the "government at a special disadvantage." *See Taylor v. United States*, 417 F.2d 991, 993 (5th Cir. 1969) ("[Section 6501(e)(1)(A)] provides that an item of income is 'omitted' if the item is not shown in a manner sufficient to enable the Government, upon a reasonable inspection, to detect the error. . . . [T]he Government is not to be penalized by a taxpayer's failure to reveal the facts.").

The facts in *Phinney* demonstrate that the taxpayer's return did not merely misstate an amount but rather misrepresented the very nature of the item reported such that the IRS could not have reasonably known what was actually being reported, an almost direct omission. *Phinney*, 392 F.2d at 684. We hesitate to read *Phinney* as applicable to a misstatement of an amount of income when the nature of the item is correctly reported because the error arguably qualifies as an "omission" in that it omits the truth or accuracy of the amount reported. Such a result renders the general three year limitations period meaningless.

Phinney involved a distinct fact pattern not presented in this appeal. The taxpayers in the present matters did not misstate the nature of an item such that the IRS was at a disadvantage in detecting the error because it could not reasonably know what was actually being reported. Rather, the nature of the item—the basis—was included in the tax return, albeit in an incorrect amount. This circumstance provides the IRS with sufficient notice to inquire into the correctness and validity of the item being reported. *See Colony*, 357 U.S. at 36 (finding that the extended limitations period applies when "the return on its face provides no clue to the existence of the omitted item"). Absent a fundamental alteration to the nature of the item reported, disclosure of the item, despite the

correctness of the amount, provides the IRS with reasonable notice of the item being reported and the general limitations period should apply pursuant to *Colony*.

Our holding is consistent with other courts' analysis regarding the applicability of *Colony* in the context of Son of BOSS tax shelters. These courts have generally found that an overstatement of basis does not constitute an omission from gross income for purposes of § 6501(e)(1)(A) such that the extended limitations period applied, because of the similarity of the language and meaning of § 275(c) and § 6501(e)(1)(A). *See, e.g., Home Concrete & Supply, LLC v. United States (Home Concrete II)*, — F.3d —, No. 09-2353, 2011 WL 361495, *5 (4th Cir. Feb. 7, 2011) (finding that because the legislative history of § 275(c) is "equally compelling" with respect to § 6501(e)(1)(A) and that because there are no material differences in the language of the statutes, "we are not free to construe an omission from gross income as something other than a failure to report "some income receipt or accrual") (quotations omitted); *Salman Ranch Ltd v. United States (Salman Ranch II)*, 573 F.3d 1362, 1373-74, 1377 (Fed. Cir. 2009) (finding that "[t]he meaning of 'omits' in today's parlance appears to be no different than its meaning at the time of the *Colony* decision" and further noting that in the years since *Colony* had been decided Congress had not indicated that its holding was inapplicable to the revised statute despite ongoing debate surrounding the decision); *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767, 771-72 (9th Cir. 2009) (finding that the 1939 Code was so substantially similar to the 1954 Code that *Colony* was controlling); *UTAM, Ltd. v. Comm'r*, 98 T.C.M. (CCH) 422, at *3 (2009) (rejecting the government's reliance on *Phinney* because under the facts before it the Commissioner was not at a disadvantage in "identifying the error in the reporting of the transaction" when the return adequately identified the nature of the item at issue); *Intermountain Ins. Serv. of Vail v. Comm'r (Intermountain I)*, 98 T.C.M. (CCH) 144, at *2-3

(2009) (applying *Colony* and holding that an overstatement of basis was not an omission from gross income); *cf. Benson v. Comm'r*, 560 F.3d 1133, 1136 (9th Cir. 2009) (finding six year limitations period applied when failure to report "did not result from an overstatement of basis or other technical miscalculation"); *Grapevine Imports*, 77 Fed. Cl. at 510 (holding that "the meaning of the word 'omits,' has as much application to the 1954 version of the statute, as it did the 1934 version, for, in both, that word is pivotal," and further finding no compelling reason to hold that the common understanding of the term "omits" had "shifted" since *Colony* and revisions to the Code); *but see Beard v. Comm'r*, – F.3d –, No. 09-3741, 2011 WL 222249, at *6 (7th Cir. Jan. 26, 2011) (creating a circuit split by finding that *Colony* was not controlling and holding that "an overstatement of basis can be treated as an omission from gross income"); *Home Concrete & Supply, LLC v. United States (Home Concrete I)*, 599 F. Supp. 2d 678, 687 (E.D.N.C. 2008) (finding that an overstatement of basis was an omission from gross income for purposes of § 6501(e)(1)(A), *rev'd*, — F.3d —, 2011 WL 361495 (2011); *Brandon Ridge Partners v. United States*, No. 8:06-cv-1340, 2007 WL 2209129, at *8 (M.D. Fla. July 30, 2007) (unpublished) (finding that *Phinney* compelled application of the extended limitations period because the taxpayers' tax returns did not adequately disclose the relevant transactions); *Salman Ranch Ltd v. United States (Salman Ranch I)*, 79 Fed. Cl. 189, 201-202 (2007), *rev'd*, 573 F.3d 1362 (Fed. Cir. 2009). *Salman Ranch (I)* and *Home Concrete (I)* have subsequently been overturned by the Federal Circuit and Fourth Circuit, respectively.

The government does not argue that these cases are distinguishable from the present matters, but rather asserts that they were wrongly decided. We disagree and find that *Colony*'s holding with respect to the definition of "omits gross income" remains applicable in light of the revisions to the Code. As such, an overstatement of basis that adequately appraises the Commissioner of the

nature of the item being reported does not constitute an "omission from gross income" for purposes of § 6501(e)(1)(A). The taxpayers in the present matters disclosed the nature of the items on their tax returns sufficient to notify the Commissioner of the item being reported. We join the Fourth, Ninth, and Federal Circuits by finding that *Colony*'s holding with respect to the definition of "omits from gross income" remains applicable in light of the revisions to the Code.

C.

The government alternatively argues that *Colony* does not control the present matters because application of *Colony* to § 6501(e)(1)(A) subsections (i) and (ii) would render these subsections superfluous. The government argues that *Colony*'s finding that the ambiguous language found in § 275(c) was "in harmony" with the unambiguous language found in § 6501(e)(1)(A) was necessarily tied to these subsections.

Section 6501(e)(1)(A) was first enacted as § 275(c) of the Revenue Act of 1934, 48 Stat. 745. *See Badaracco v. Comm'r*, 464 U.S. 386, 392 (1984). Congress amended the statute in 1954, renumbering it as § 6501(e)(1)(A) and adding two subsections. *See* H.R. REP. NO. 83-1337, 4561 (1954).[6] Although courts have held

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[6] At the time of the appeal the revised statute read:

> (e) Substantial omission of items
>
> (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 and 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 a tax may be begun without assessment, at any time within 6 years after the return was filed. For the purposes of this subparagraph

that the language in the two statutes is virtually identical,[7] there is disagreement over the validity of *Colony* in light of the revisions.

Subsection (i) provides: "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." 26 U.S.C. § 6501(e)(1)(A)(i).

Some courts have held that subsection (i) limits application of *Colony* to cases involving a trade or business. *See, e.g., Beard*, 2011 WL 222249 at *4 (finding that subsection (i) applies only when there is an omission of a receipt or accrual from a trade or business); *Salman Ranch (I)*, 79 Fed. Cl. at 200 (finding *Colony* applicable only in the case of business and trade income); *Home Concrete (I)*, 599 F. Supp. 2d at 684 ("Subsection (i) redefines gross income for purposes of § 6501(e)(1)(A) in cases involving a trade or business."); *Brandon Ridge Partners*, 2007 WL 2209129, at *7 (finding that application of *Colony* outside the

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> (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.

26 U.S.C. § 6501(e).

[7] *See, e.g., Badaracco v. Comm'r*, 464 U.S. 386, 392 (1984) (noting that § 6501 was "first introduced" as § 275(c)); *Salman Ranch Ltd v. United States (Salman Ranch II)*, 573 F.3d 1362, 1379 (Fed. Cir. 2009) (describing § 275(c) as the predecessor to § 6501); *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678, 684 (E.D.N.C. 2008) ("It is correct to say that the language of § 275(c) is virtually identical to a portion of § 6501(e)(1)(A).").

context of a trade or business "would render § 6501(e)(1)(A) superfluous"); *see also CC & F W. Operations Ltd. P'ship v. Comm'r*, 273 F.3d 402, 406 n.2 (1st Cir. 2001) (declining to reach the issue but noting that whether *Colony*'s "main holding" applies in light of subsection (i) "is at least doubtful" because the implication is that *Colony* does not apply to other types of income).

Other courts have found *Colony* applicable to all taxpayers in light of the revised statute. *See, e.g., Home Concrete (II)*, 2011 WL 361495, at *4 (finding that *Colony* "straightforwardly construed the phrase 'omits from gross income,' unhinged from any dependency on the taxpayer's identity as a trade or business selling goods or services"); *Salman Ranch (II)*, 573 F.3d at 1372-73 ("*Colony* "interpreted the language of § 275(c) based upon what it viewed as congressional intent and purpose, without ever mentioning the taxpayer's trade or business."); *Bakersfield*, 568 F.3d at 778 (finding that *Colony* "did not even hint that its interpretation of § 275(c) was limited to cases in which the taxpayer was engaged in a 'trade or business'"); *UTAM*, 98 T.C.M. (CCH) 442, at *3 ("Neither the language nor the rationale of *Colony* can be limited to the sale of goods or services by a trade or business."); *Intermountain (I)*, 98 T.C.M. (CCH) 144, at *3 n.5 (declining to "diminish" *Colony*'s holding); *Grapevine Imports*, 77 Fed. Cl. at 511 (declining to find that application of *Colony* was limited to transactions involving the sale of goods or services by a trade or business).

The government argues that Congress would not have included the phrase "in the case of a trade of business" and "amounts received or accrued from the sale of goods or services" if it had not intended for the definition of gross income for purposes of § 6501(e)(1)(A)(i) to apply outside the context of trade or business engaged in the sale of goods or services. The government further asserts that taxpayers' construction of the term "omits" without reference to the term "gross income" focuses only on one component of the calculation, thus excluding

consideration of one of the two figures that result in gain (the calculation of basis) and therefore renders the gross receipts provision meaningless.

Bakersfield offered a comprehensive analysis when disagreeing with the government's argument. 568 F.3d at776. The court held that when comparing the two amounts needed to calculate gross income for purposes of § 6501(e)(1)(A), the gross income omitted with the gross income as stated in the return, the court found that whether an amount was omitted was a separate issue from whether the amount omitted exceeded 25% of the taxpayer's gross income. *Id.* at 776.

> Because § 6501(e)(1)(A)(i) changes the definition of 'gross income' for taxpayers in a trade or business, it potentially affects both the numerator (the omission from gross income) and the denominator (the total gross income stated in the return). *Colony*'s holding, however, affects only the numerator, by defining what constitutes an omission from gross income.
>
> When there is no dispute about the amount of gross income omitted, the denominator, the total amount of gross income stated in the return, determines whether the omission meets the 25% threshold that triggers the six-year limitations period. For taxpayers not in a trade or business, the denominator is the amount of gross income (gross receipts minus basis); for taxpayers in a trade or business, the denominator is the total amount of money received without any reduction for basis (gross receipts).

Id. at 776-77. Thus, when the amount omitted (the numerator) is not in dispute, applicability of the extended limitations period turns on whether the court was obliged to apply subsection (i)'s definition of "gross income" for a trade or business when determining the amount of gross income stated in the return (the denominator). *Id.* at 777 (citing *Hoffman v. Comm'r*, 119 T.C. 148, 148, 150 (2002)). However, when the circumstances involve the sale of goods or services by a trade or business, whether subsection (i) applies is the dispositive issue

"because it determine[s] whether the omitted amount of gross income constitute[s] more than 25% of the gross income stated in the return, wholly aside from *Colony*'s holding regarding what constitutes an omission from gross income." *Id.*

The court further noted that Congress did not alter the language in § 6501(e)(1)(A). *Id.* at 775. "Although the IRS would have us infer that Congress's addition of subparagraph (i) casts the language in the body of § 6501(e)(1)(A) in a different light, we can equally infer that Congress in 1954 intended to clarify, rather than rewrite, the existing law." *Id.* at 776. The court concluded:

> [Congress] could have expressly added a definition of 'omits' if it wanted to overrule the cases that concluded, as the Supreme Court later did in *Colony*, that 'omits' does not include an overstatement of basis. Instead, Congress allowed the preexisting general definition of 'omits' to carry forward into the successor provision, and additionally provided for a special definition of 'gross income' in the case of a 'trade or business.'

Id. "[T]he fact remains that *Colony* represents an interpretation of the very same language that is now found in § 6501(e)(1)(A), and in the years since *Colony*, Congress has not indicated that the Court's interpretation of the language of § 275(c) should not apply to § 6501(e)(1)(A)." *Salman Ranch (II)*, 573 F.3d at 1373.

Salman Ranch (II) held that, by its terms, the language of subsection (i) states how gross income is calculated for purposes of § 6501(e)(1)(A) when the income arises from a trade or business engaged in the sale of goods or services. 573 F.3d at 1373. *Colony* "did not speak to the calculation of 'gross income' . . . [r]ather, it identified the situations in which a taxpayer 'omits from gross income an amount properly includible therein.'" *Id.* at 1375. The court held that subparagraph (i), "which explains how 'gross income' is calculated when a trade

or business is involved," is not made superfluous simply by finding that an overstatement of basis is not an omission from gross income. *Id.*

Salman Ranch further held that the legislative history of § 6501(e)(1)(A) supported a finding that subsection (i) was not rendered superfluous by application of *Colony*. *Id.* at 1375-76. "Congress added subparagraph (i) to resolve a conflict between the IRS and taxpayers about how to calculate gross income in the case of a trade or business." *Id.* (citing *Hearings Before the Senate Comm. on Finance on H.R. 8300 (part 2)*, 83rd Cong. 984 (1954) (letter of Harry N. Wyatt) (discussing "disagreement evidenced by the case law between the [IRS] and some of the courts as to whether . . . [i]n the case of a business, the term 'gross income' should be construed as gross receipts and gross sales, or as net receipts and net sales"). *Salman Ranch* held that, "[i]n light of this conflict, we believe that Congress enacted subparagraph (i) . . . to assist the IRS in its calculation of whether any omitted gross income exceeded 25% of the gross income stated in the return." *Id.* at 1376.

We agree with the analysis presented in *Bakersfield* and *Salman Ranch (II)* and hold that a fair reading of § 6501(e)(1)(A)(i) supports our finding that subsection (i) was intended to define gross income for the sale of goods or services by a trade or business as gross receipts from those sales. Under the Code, gross income of a trade or business is usually calculated by subtracting the cost of goods sold from the gross receipts of the sale. 26 U.S.C. § 61(a). Subsection (i) provides an alternative to this customary definition in the context of sales of goods or services by a trade or business by defining "gross income" as gross receipts rather than gross receipts less the cost of goods sold. *See* § 6501(e)(1)(A)(i). Thus, pursuant to § 6501(e)(1)(A), in order for an omission from gross income to arise in the context of sales of goods or services by a trade or business, the return must omit a receipt. As such, subsection (i) is not rendered superfluous by application of *Colony* outside of the context of a trade or business.

D.

The government further argues that in enacting § 6501(e)(1)(A)(ii), Congress intended that an item could be omitted from gross income without it having been entirely omitted from the face of the return. *See Phinney*, 392 F.2d at 685. Subsection (ii) states:

> 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.

26 U.S.C. § 6501(e)(1)(A)(ii). Subsection (ii) thus provides a "safe harbor" for omissions of amounts which, though not included in the gross income as stated in the tax return, are adequately disclosed such that the IRS has sufficient notice.

> [F]rom the plain language of (ii), it is possible for an amount to be 'omitted from gross income' and disclosed on the face of the return. Subsection (ii) simply makes it possible for a taxpayer to be protected if the taxpayer discloses the amount in a way sufficient to alert the IRS to the substance and size of the item omitted. If a taxpayer omits an amount from gross income yet includes the item which causes the amount to be omitted on the taxpayer's return in such a way that the IRS is apprised of the 'nature and amount' of the item, then that item is not considered 'omitted' for purposes of § 6501(e)(1)(A). However, where a taxpayer includes an item on a return in such a way that the IRS is not apprised of the 'nature and amount' of the item, then that item has been 'omitted' from gross income for purposes of § 6501(e)(1)(A), even though it is included on the face of the return.

Home Concrete (I), 599 F. Supp 2d at 686; *see also Salman Ranch (II)*, 573 F.3d at 1376 (finding that the adequate disclosure provision is related to *Colony*'s expression that Congress's intent in enacting § 275(c) was to afford the Commissioner additional time to investigate returns where an item has been omitted such that *Colony* has not been rendered moot) (citing *Colony*, 357 U.S. at 36). As discussed *infra*, subsection (ii) is in harmony with both this court's decision in *Phinney* and the Supreme Court's decision in *Colony*. Thus, it is proper for this court to apply *Colony* in light of the revised statute. The government does not assert that the taxpayers failed to report any receipt or accrual in its computation of gross income. Rather, the government contends only that the taxpayers overstated their basis in the sale of assets. As such, the taxpayers' errors do not trigger the extended limitations period.

III.

Finally, the government argues that recently promulgated Treasury Regulations clarify that the definition of "omits from gross income" as found in § 6501(e)(1)(A) includes an overstatement of basis, thus the regulations are determinative.

On September 28, 2009, the Treasury issued Temporary Regulations §§ 301.6501(e)-1T(b) and 301.6229(c)(2)-1T(b), pursuant to 26 U.S.C. § 7805(a). Section 7805(a) of the Tax Code authorizes the Treasury Department to promulgate "all needful rules and regulations for the enforcement of this title." 26 U.S.C. § 7805(a). The Temporary Regulations were simultaneously issued as proposed regulations and were issued as final regulations effective December 14, 2010 (the Regulations). *See* Treas. Reg. §§ 301.6501(e)-1, 301.6229(c)(2)-1.[8] The

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[8] Although the Temporary Regulations were in effect at the time the government and taxpayers sought appellate review, because any difference between the Temporary and final Regulations are not material to our review, this opinion cites to the final version of the Regulations.

Regulations define "omission from gross income" as including "an understated amount of gross income resulting from an overstatement . . . of basis for purposes of sections 6501(e)(1)(A) and 6229(c)(2)." *Id.* at §§ 301.6501(e)-1(a)(iii) and 301.6229(c)(2)-1(a)(iii). The Regulations provide:

> 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)(i).

Treas. Reg. § 301.6501(e)-1(a)(iii). The Regulations limit *Colony*'s applicability to circumstances where the taxpayer is a trade or business engaged in the sale of goods or services. *Id.* at § 301.6501(e)-1(a)(ii), (iii); T.D. 9511, 75 Fed. Reg. 78897, 78897 (Dec. 17, 2010). The Regulations also expressly disagree with the recent decisions in *Bakersfield* and *Salman Ranch (II)* applying *Colony* to the revised statute. *See* 75 Fed. Reg. 78897.

The government asserts that this court must afford the Regulations force of law deference and because the Regulations purport to apply retroactively they control the outcome of the present matters. *See Chevron, U.S.A., Inc. v. Nat'l Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984) (setting forth the standard for force of law deference, which affords agency regulations controlling weight, unless they are arbitrary, capricious, or contrary to the underlying statute). The taxpayers argue that the Regulations are an unreasonable interpretation of an unambiguous statute and contrary to Congressional intent. *See Nat'l Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 476-77 (1979) (pre-*Chevron*

case applying a more limited standard of reasonableness to a treasury regulation). Finally, the taxpayers assert that the Regulations cannot apply retroactively because such action would re-open previously time-barred claims.

Because we hold that § 6501(e)(1)(A) is unambiguous and its meaning is controlled by the Supreme Court's decision in *Colony*, we need not determine the level of deference owed to the Regulations. The Regulations attempt to define "omits from gross income" for purposes of the revised statute. However, the government cites to no authority refuting prior case law that has held § 6501(e)(1)(A) to be unambiguous with respect to the definition of "omits." *See Colony*, 357 U.S. at 37 (finding that "without doing more than noting the speculative debate between the parties as to whether Congress manifested an intention to clarify or to change the 1939 Code" when Congress enacted § 6501 of the 1954 Tax Code, "we observe that the conclusion we reach is in harmony with the unambiguous language of § 6501(e)(1)(A)); *Salman Ranch (II)*, 573 F.3d at 1374 (finding the phrase "omits from gross income" identical in both statutes); *Bakersfield*, 568 F.3d at 775-76 (applying *Colony*'s definition of "omits from gross income" because it had construed language identical to the revised statute). The Regulations attempt to "trump" what is established precedent on what constitutes an "omission from gross income" for purposes of § 6501(e)(1)(A). *See Home Concrete (II)*, 2011 WL 361495, at *7 (declining to apply the Regulations retroactively because the Supreme Court stated in Colony that § 6501(e)(1)(A) is unambiguous as to the very issue to which the regulation purports to speak").

Moreover, the Regulations state that they "apply to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009." T.D. 9511, 75 Fed. Reg. 78897, 78897 (Dec. 17, 2010). The government argues that this provision applies to taxable years for which the limitations period did not expire with respect to the tax year at issue before September 24, 2009. The Regulations state that "'the applicable period' is not the 'general'

three-year limitation period . . . [because] the three-year period does not 'close' a taxable year if a longer period applies." *Id.* at 78898. The government thus makes a circular argument that the Regulations apply to the taxpayers because the statute of limitations remains open under the language of the newly promulgated Regulations. *See Home Concrete (II)*, 2011 WL 361495, at * 6 (finding that such argument "attemps to redraft [ ] § 6501" because Congress specifically set forth the circumstances under which the extended limitations period applies and thus "the IRS's argument that the period for assessing tax is open-or indeed may be re-opened . . . so long as litigation is pending is contrary to the clearly and unambiguously expressed intent of Congress and must fail") (citations omitted); *Intermountain Ins. Serv. of Vail, LLC. v. Comm'r (Intermountain II)*, 134 T.C. No. 11, at *1 (2010) (declining to engage in a "hypothetical" inquiry to determine the applicable limitations period because when urging the same argument, the government's interpretation was "irreparably marred by circular, result-driven logic").[9]

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[9] Although we hold that § 6501(e)(1)(A) is unambiguous and its meaning is controlled by the Supreme Court's decision in *Colony*, we note that even if the statute was ambiguous and *Colony* was inapplicable, it is unclear whether the Regulations would be entitled to *Chevron* deference under *Mayo Foundation for Medical Research v. United States*, 131 S. Ct. 704, 711 (2011). *See, e.g., Home Concrete & Supply, LLC v. United States*, — F.3d —, No. 09-2353) 2011 WL 361495, *7 (4th Cir. Feb. 7, 2011) (declining to afford the Regulations *Chevron* deference because the statute is unambiguous as recognized by the Supreme Court in *Colony*). In *Mayo*, the Court held that the principles underlying its decision in *Chevron* "apply with full force in the tax context" and applied *Chevron* to treasury regulations issued pursuant to 26 U.S.C. § 7805(a). *Id.* at 707. Significantly, in *Mayo* the Supreme Court was not faced with a situation where, during the pendency of the suit, the treasury promulgated determinative, retroactive regulations following prior adverse judicial decisions on the identical legal issue. "Deference to what appears to be nothing more than an agency's convenient litigating position" is "entirely inappropriate." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988). The Commissioner "may not take advantage of his power to promulgate retroactive regulations during the course of a litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations." *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971).

Moreover, *Mayo* emphasized that the regulations at issue had been promulgated following notice and comment procedures, "a consideration identified . . . as a significant sign that a rule merits *Chevron* deference." 131 S. Ct. at 714. Legislative regulations are generally

Because the Regulations are an unreasonable interpretation of settled law, we find that they are not applicable to the taxpayers in the present matters. As such, we need not determine whether the Regulations may apply retroactively.

IV.

For the foregoing reasons, we affirm the tax court's judgment in favor of the taxpayers in matter 09-60827, *Commissioner v. M.I.T.A.* We reverse the district court's grant of summary judgment in favor of the government in matter 09-11061, *United States v. Burks*, and remand for further proceedings consistent with this opinion.

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subject to notice and comment procedure pursuant to the Administrative Procedure Act. *See* 5 U.S.C. § 553(b)(A). Here, the government issued the Temporary Regulations without subjecting them to notice and comment procedures. This is a practice that the Treasury apparently employs regularly. *See* Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1158-60 (2008) (noting that the treasury frequently issues purportedly binding temporary regulations open to notice and comment only after promulgation and often denies the applicability of the notice and comment procedure when issuing its regulations because that requirement does not apply to regulations that are not a significant regulatory action, while continuing to assert that the regulations are entitled to legislative regulation level deference before the courts). That the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for pre-promulgation notice and comment. *See U.S. Steel Corp. v. U.S. EPA*, 595 F.2d 207, 214-15 (5th Cir. 1979).