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A. The statute – 26 U.S.C. § 6501(e)(1)(A) – "If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25% 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."

Note the same language in 26 U.S.C. § 6229(c)(2), which pertains to partnership returns: "If any partnership omits from gross income an amount properly includible therein which is excess of 25 percent of the amount of gross income stated in its return," the IRS has six years to assess any income tax "with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year" (§ 6229(a)).

B. The issue – Whether an understatement of income resulting from an overstatement of the tax basis of sold property can qualify as an omission from gross income for purposes of the extended, six-year assessment period of 26 U.S.C. § 6501(e)(1)(A).

C. The factual context – the highly-abusive Son-of-BOSS tax shelter, which relied on a partner's inflated basis in his partnership ("outside basis") to reduce gains or create an artificial loss; occurred primarily in 1999-2000

1. Description of Son-of-BOSS tax shelter – a partner contributes encumbered property to the partnership, which expressly assumes the associated obligation. The partner increases his outside basis by the value of the asset contributed to the partnership. *See* 26 U.S.C. § 722. The partner, however, does not reduce his outside basis under 26 U.S.C. § 752(a) and (b) to reflect the partnership's assumption of the associated obligation. That omission results in a vastly overstated

[1] The views expressed in this outline are those of the author.

basis, which either generates a large artificial tax loss or reduces the gain that would otherwise result from the sale of an asset

2. Notice 2000-44, 2000-2 C.B. 255 put the Son-of-BOSS shelter out of business; it informed taxpayers that the purported losses arising from these transactions are not allowable for federal income tax purposes and that penalties may be imposed on the participants.

3. Home Concrete facts – the limited liability company, taxed as a partnership, sold the assets of another business (which taxpayers Pierce, Chandler, and their grantor trusts had transferred to it); on its partnership return, the LLC accurately reported the sale proceeds, but significantly reduced the capital gain from $6.3 million to $69,125 due to an artificially-inflated basis

a. The artificially-inflated basis was attributable to a short sale, which is a sale of a security that the investor does not own. Typically this is done by borrowing shares from a broker. The short seller is obligated, however, to buy an equivalent number of shares in order to return the borrowed shares

b. Four partners had sold T-Notes short and had transferred the sale proceeds ($7,471,000) to Home Concrete, which assumed the offsetting obligation to close the short sales;

c. These partners stepped up their outside bases to include the short sale proceeds, but did not reduce their basis to reflect Home Concrete's assumption of the obligation to close the short sales on the theory that the obligation to close a short sale is a contingent obligation which is not taken into account for basis purposes.

i. Two appellate courts have recently rejected the argument that the obligation to close a short sale is a contingent obligation which is not taken into account for basis purposes. *Kornman & Associates, Inc. v. United States*, 527 F.3d 443 (5th Cir. 2008); *Marriott Internat'l Resorts v. United States*, 586 F.3d 962 (Fed. Cir. 2009).

ii. Under 26 C.F.R. § 1.752-1(a)(4)(ii), applicable to liabilities incurred or assumed by a partnership on or after June 24, 2003, an “obligation” is “any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code” and includes an obligation under a short sale.

d. Shortly thereafter, these partners transferred part of their partnership interests to another partner, which enabled Home Concrete to make an election under 26 U.S.C. § 754 to adjust the basis in its assets (“inside basis”) to equal the partners’ outside bases. In so doing, it received a basis bump of over $6 million.

e. Home Concrete then sold substantially all its assets to a TP for $10.6 million.

f. IRS issued a notice of final partnership administrative adjustment (“FPAA”) to Home Concrete

i. Timing of – issued less than six years but more than three years after the individual partners (and the partnership) had filed their returns.

ii. Contents – the IRS reduced to zero the short-term capital gain resulting from the T-Note transactions, reasoning that Home Concrete was a sham and lacked economic substance and was formed and used solely for tax avoidance purposes

4. The understatement of income was hard to discover

i. Neither the partnership return nor the partners’ returns disclosed the transfer of the short sale proceeds and the offsetting obligation to Home Concrete

ii. Returns did not disclose the fact that the basis step-up resulted from the partners’ asymmetric treatment of the short sale proceeds and the offsetting obligations to close the short sales.

iii. The examination of the returns of taxpayers (Pierce, Chandler, their grantor trusts), Home Oil, and related entities, resulted from information that the IRS obtained as a result of issuing a John Doe summons to Jenkens & Gilchrist, taxpayers' tax consultants and a now-defunct law firm.

D. *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958)

1. Statute in *Colony* – § 275(c) of the Internal Revenue Code of 1939, which contains the same language as 26 U.S.C. § 6501(e)(1)(A) - "omits from gross income an amount properly includible therein . . ."

2. Facts – taxpayer understated business income from selling residential lots by overstating the cost bases of these lots; base were overstated by erroneously including in their cost certain unallowable items of development expense

3. US position

a. The 1939 Code defines "gross income" as including gains from any source, and provides that gains are computed by subtracting the property's cost from the amount realized on the sale or other disposition of the property.

b. Overstated basis results in an omission from gross income just as much as if the gross receipts are understated and should be treated the same.

4. Taxpayer position – emphasized the word "omits"; argued that the extended assessment period is limited to situations in which specific receipts or accruals of income items are left out of the computation of gross income

5. Sup. Ct. found the language "omits from gross income . . ." to be ambiguous and resorted to legislative history to interpret it.

6. Holding – the ambiguous language referred to the "specific situation where a taxpayer actually omitted some income receipt or accrual in his computation of gross income, and not more generally to errors in that computation arising from other causes." 357 U.S. at 33

7. Rationale – Congress, in enacting § 275(c) "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." 357 U.S. at 36.

E. Developments after *Colony*

1. Adoption of the 1954 Code, which amended the extended assessment period to include two subsections that were not in the 1939 Code (Richard Rice will discuss this)

2. *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968) – a murky case involving basis overstatement

a. Fifth Circuit identified the failure to disclose the basis step-up as the critical error justifying application of the six-year assessment period

b. According to a subsequent Fifth Circuit case (*Burks v. United States*, 633 F.3d 347, 353 (5th Cir. 2011)), *Phinney* involved not only a misstated amount but also a misrepresentation of "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."

3. 35-50 Son-of-BOSS cases presenting the same issue as this case – US loses in the Tax Court, where most cases are brought, and in the Court of Federal Claims; US wins in two district courts – this case and one other case (*Burks v. United States*)

a. *Home Concrete* – District Court held that 1954 amendments to the Code rendered *Colony* inapplicable

b. Dist. Ct. accepts Government's position that when a taxpayer overstates its basis in property, it omits gross income

c. Dist. Ct. rationale – definition of "gross income" as all income from whatever source derived, including gains from dealings in property (26 U.S.C. § 61(a)); definition of gains from the dealings in property as the excess of the amount realized over the adjusted basis (26 U.S.C. § 1001(a))

4. US loses first appellate cases involving this issue: *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009); *Salman Ranch Ltd v. United States*, 576 F.3d 1362 (Fed. Cir. 2009)

a. US efforts to distinguish *Colony* on the basis of statutory amendments in 1954 proved unsuccessful

b. *Bakersfield Energy* – 9th Circuit characterized the US position as both "reasonable" and "sensible" (568 F.3d at 775, 778) and stated, "The IRS may have the authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code even if its interpretation runs contrary to the Supreme Court's opinion as to the best reading of the provision" (*id.* at 778) (internal quotation marks omitted).

F. Case law background to development of regulations

1. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) – emphasized the principle of deference to administrative interpretations of ambiguous statutes; agencies, not courts, fill statutory gaps

a. Two-step procedure for determining the validity of an agency's statutory construction

i. Determine if statute is clear; if so, "the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."

ii. If "Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."

467 U.S. at 842-843 (footnotes omitted).

b. "[A] court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency." *Id.* at 844 (footnote omitted).

c. In *Chevron* the Court thus presumed "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)

d. How do you determine whether a statute is ambiguous? Do you rely on the statutory language alone? *See Chevron*, 467 U.S. at 843 n.9 ("If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect.")

2. *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005) ("*Brand X*")

a. 9th Circuit had declined to apply *Chevron* because it thought the FCC's interpretation of the Communications Act was foreclosed by the conflicting construction of the Act it had adopted in a prior case.

b. Supreme Court disagreed; "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." *Id.* at 982.

3. *Mayo Found. for Medical Educ. and Research v. United States*, 131 S. Ct. 704 (2011) - presented question of validity of an interpretive Treasury regulation

a. Rejects *National Muffler Dealers*' multi-factor analysis, which was previously used to determine the validity of Treasury regulations (*National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979))

b. "The principles underlying our decision in *Chevron* apply with full force in the tax context." 131 S. Ct. at 713.

c. *Chevron*'s two-step analysis provides the proper framework for evaluating the validity of all Treasury regulations, regardless whether Congress's delegation of authority was general or specific

i. General delegation of authority - 26 U.S.C. § 7805(a)) – "[T]he Secretary shall prescribe all needful rules and regulations for the enforcement of this title. . . ."

ii. Example of specific delegation of authority – 26 U.S.C. § 1503- "In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502. . . ."

4. *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996) – issuance of regulations in response to litigation is no impediment to giving them *Chevron* deference

a. The regulation in issue was proposed after the trial court's dismissal of the complaint and adopted after the California Supreme Court affirmed that dismissal

b. Notwithstanding these undisputed facts and the promulgation of the regulation over 100 years after the enactment of the relevant statute, the Supreme Court gave *Chevron* deference to the regulation.

5. *United States v. Morton*, 467 U.S. 822 (1984)

a. Regulations were issued after Court of Claims' entry of judgment against the Government.

b. Sup. Ct. gave regulations *Chevron* deference and reversed the judgment on the basis of these regulations

c. Court stated that the promulgation of the regulations after commencement of the action was "of no consequence" to the question whether they were entitled to deference. *Id.* at 836 n.21.

d. The Court explained (*id.*):

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

G. The temporary regulations

1. Timing – issued on Sept. 24, 2009 (simultaneously with proposed regulations) about ten months after the US had won *Home Concrete* in the district court and prior to appellate briefing – T.D. 9466, 74 Fed. Reg. at 49321; 26 C.F.R. §§ 301.6501(e)-1T(a)(1)(iii), 301.6229(c)(2)-1T(a)(1)(iii)

2. Contents – Regulations "clarify that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)." T.D. 9466, 74 Fed. Reg. at 49321. Since, in the case of the sale of property, "gross income" under § 61 means the excess of the amount realized over the adjusted basis of the property, under the temporary regulations, "any basis overstatement that leads to an understatement of gross income under section 61(a) constitutes an

omission from gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2)." *Id*.

3. Application – "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).

4. Statutory authority – 26 U.S.C. § 7805(e)

a. Authorizes temporary regulations

b. Provides that any temporary regulation shall also be issued as a proposed regulation

c. Provides that any temporary regulation shall expire within 3 years from the date of issuance.

d. Implication – notice and comment not necessary to their validity

5. "Interpretive"regulations (*e.g.*, rules promulgated pursuant to Treasury's general rule-making authority, I.R.C. § 7805(a)), are exempt from notice-and-comment requirements of the Administrative Procedure Act, 5 U.S.C. § 553(b)(3)(A)

6. US position – temporary regulations are entitled to *Chevron* deference

a. *United States v. Mead Corp*., 533 U.S. 218 (2001) – presented question of the deference to be accorded certain tariff classification rulings

i. Sup. Ct., refining its *Chevron* analysis, determined that *Chevron* deference was available to *any* administrative implementation of a statutory provision "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law," and "the agency interpretation claiming deference was promulgated in the exercise of that authority." *Id.* at 226-227.

ii. This reference to regulations having the "force of law" is not confined to legislative regulations, but applies equally to regulations issued pursuant to an agency's "generally conferred authority" to interpret and enforce the law. *Id*. at 229

b. *Barnhart v. Walton*, 535 U.S. 212 (2002)

i. *Chevron* deference given to an agency's regulatory interpretation that was "reached . . . through means less formal than 'notice and comment' rulemaking. . . ." *Id.* at 221.

ii. Factors upon which Sup. Ct. based its determination that *Chevron* deference was appropriate – "the interstitial nature of the legal question, the related expertise of the Agency, the importance of the question to administration of the statute, the complexity of that administration, and the careful consideration the Agency has given the question over a long period of time." *Id.* at 222.

c. Several circuit courts have given temporary Treasury regulations *Chevron* deference. See *Allen v. United States*, 173 F.3d 533, 537-38 (4th Cir. 1999); *McDonnell v. United States*, 180 F.3d 721, 722-23 (6th Cir. 1999); *Miller v. United States*, 65 F.3d 687, 689-90 (8th Cir. 1995).

H. The final regulations

1. Published Dec. 17, 2010, after notice and comment, and after the case was fully briefed and argued in the Fourth Circuit – T.D. 9511, 75 Fed. Reg. 78897 (Dec. 17, 2010) – largely identical to the temporary regulations

2. Issuance after notice and comment rendered moot any arguments that the regulations should receive less deference because they were temporary and promulgated without notice and comment

3. US position – the final regulations cleared up any doubt as to whether they applied to this and similar cases.

a. Regulations state they "apply 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).

b. Preamble to the regulations explained, "The three-year limitations period is one of several limitations periods in the Internal Revenue Code, including the six-year limitations period under sections 6229(c)(2) and 6501(e)(1)," and "[t]he expiration of the three-year period does not 'close' a taxable year if a longer period applies."

I. Conclusion

1. *Home Concrete* in the Fourth Circuit and the Supreme Court was largely a conflict between *Colony*, on which Home Concrete relied, and the regulations, on which the Government primarily relied.

2. Although there have been and will be other cases involving a conflict between regulatory and judicial interpretations of a statute, the circumstances here were unique

a. In *Colony*, the prior judicial interpretation was by the Supreme Court and pre-dated *Chevron*

b. Thus, the courts had to decide whether *Colony* should be construed as a *Chevron* step one case or a *Chevron* step two case when the Supreme Court in *Colony* described the relevant statute as ambiguous and then resorted to legislative history to determine its meaning. If *Colony* was a *Chevron* step one case, the statute, as construed by the Court, was clear, and regulation was foreclosed. On the other had, if *Chevron* was a *Chevron* step two case, the only relevant question under *Chevron* was whether the regulation was reasonable.

c. The *Home Concrete* majority ultimately construed the case as a *Chevron* step one case:

"As the Government points out, the Court in *Colony* stated that the statutory language at issue is not 'unambiguous.' 357 U.S., at 33. . . . But the Court decided that case nearly 30 years before it decided *Chevron*. There is no reason to believe that the linguistic ambiguity noted by *Colony* reflects a post-*Chevron* conclusion that

Congress had delegated gap-filling power to the agency. At the same time, there is every reason to believe that the Court thought that Congress had 'directly spoken to the question at hand,' and thus left '[no] gap for the agency to fill.'" 132 S. Ct. at 1844, quoting *Chevron*, 467 U.S. at 842-843. Thus, the judicial interpretation in *Colony* controlled, and regulation was foreclosed.

3. Because of the unique circumstances present here, the invalidation of the regulation by a narrow 5-4 majority is not likely, in my view, to have much effect on the adoption of future regulations or on the judicial evaluation of these regulations.