No. 11-139

In the Supreme Court of the United States

UNITED STATES OF AMERICA,
Petitioner,

v.

HOME CONCRETE & SUPPLY, LLC, ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR RESPONDENTS

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QUESTION PRESENTED

Whether the Internal Revenue Service has validly overruled this Court's holding in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958)—that an overstatement of the basis of sold property is not an "omission" from gross income—and retroactively reopened and extended the statute of limitations applicable to respondents' tax returns.

RULE 29.6 STATEMENT

Home Oil and Coal Company, Inc. is the only corporate respondent. There is no parent corporation or publicly held corporation that owns 10% or more of the stock of that company.

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INTRODUCTION

As every taxpayer knows, "[m]en must turn square corners when they deal with the Government." *Rock Island, Ark. & La. R.R. v. United States*, 254 U.S. 141, 143 (1920). If a taxpayer missed a deadline for requesting a refund from the Internal Revenue Service (IRS) under the applicable limitations period as interpreted by this Court, that would be the end of the matter. The ultimate question in this case is whether the rule of law runs both ways. In particular, the question is whether (or in what circumstances) the IRS may reopen and extend the time within which it must act under a statute of limitations, even when doing so would require the IRS retroactively to reject this Court's own interpretation of the statute.

The Internal Revenue Code requires the IRS to assess additional taxes within three years of the date a tax return is filed, unless a statutory exception applies. 26 U.S.C. § 6501. Three years is the default rule that applies in the vast majority of cases; it gives the IRS and its countless agents ample time to review a return and decide whether to audit it. The limitations period is extended to six years if the taxpayer "omits from gross income an amount properly includable therein" constituting more than 25% of the taxpayer's gross income on the return. *Id.* § 6501(e)(1)(A). Here, it is undisputed that the IRS missed the three-year deadline. The IRS argues, however, that the six-year limitations period applies, because respondents purportedly "omit[ted] from gross income" a triggering amount by overstating their basis in sold property.

This Court resolved the meaning of "omits from gross income" in this exact statutory context more than 50 years ago. The Court held that an

overstatement of basis does *not* result in an "omi[ssion]" from gross income, and that Congress gave the IRS an extra three years only when the taxpayer "fail[s] to report particular income receipts and accruals," and not "whenever gross income was understated." *Colony, Inc. v. Comm'r*, 357 U.S. 28, 35 (1958). *Colony* was the law, as understood by Congress, the courts, and the IRS for decades—until the IRS fell behind a few years ago in auditing taxpayers that had engaged in a type of partnership transaction that the IRS now believes lacked "economic substance." At that point, after losing in court on its argument that the statute does not mean what this Court held it does, the IRS took the extraordinary step of seeking retroactively to extend the statute of limitations by adopting the very interpretation that this Court rejected in *Colony*.

In defending that remarkable administrative action, the government pursues three basic strategies:

(1) It recycles the same arguments that this Court considered, and rejected, in *Colony* as to the meaning of statutory language that has not changed in any material way despite numerous amendments to, and reenactment of, the provision at issue;

(2) It suggests that certain 1954 amendments—which left the key "omits from gross income" language untouched—transform the meaning of that language, even though the *Colony* Court observed that the amended version of the statute was "in harmony with" its statutory holding; and

(3) It argues that a regulation issued in late 2010, which was designed to reverse the IRS's recent losses in court, effectively displaces *Colony* and

requires that the statutory language be given an entirely different meaning—retrospectively.

None of those arguments is persuasive. *Colony* conclusively resolved the meaning of the key statutory language and, indeed, concluded that Congress had "address[ed] itself to the specific situation" at issue here. 357 U.S. at 33. To the extent these issues were debatable then, they are now settled by *stare decisis* bolstered by congressional reenactment of the relevant language without change in 1986. The government's case therefore boils down to the recent Treasury regulation—and the IRS's own effort to *change* the law. That regulation by its terms applies only "to taxable years with respect to which the period for assessing tax *was open on or after September 24, 2009*." Treas. Reg. § 301.6501(e)-1(e) (2010) (emphasis added). The limitations period at issue here was not "open on or after September 24, 2009," because the three-year limitations period had expired in April 2003—at which time the law was this Court's decision in *Colony*. Even if the regulation could be read to apply retroactively, it is invalid. The IRS lacks the power retroactively to overrule a decision of this Court conclusively interpreting a statute in order to control the outcome of litigation to which the government is a party.

The government spills considerable ink about the allegedly abusive nature of the underlying transactions. The IRS has more than ample tools—and agents—at its disposal to identify and address such concerns. Here, the basis step-up about which the government complains was the subject of a valid election by respondents under 26 U.S.C. § 754—fully disclosed and apparent on the face of the partnership return. Moreover, the Court's resolution of the

statutory question presented will affect *all* taxpayers—including those who have engaged in transactions the IRS recognizes are legitimate—and a broad range of issues that have nothing to do with so-called "Son-of-BOSS" transactions. In addition, the startling theory of administrative law—and accountability—on which the government's brief rests has far-reaching implications beyond the tax context.

As Judge Wilkinson observed below, while agencies have unquestioned leeway to act within the bounds set by Congress and the courts, "it remains the case that agencies are not a law unto themselves." Pet. App. 20a (concurring). "No less than any other organ of government, they operate in a system in which the last words in law belong to the Congress and the Supreme Court." *Id.* The administrative action at issue here transgresses the bounds of any reasonable application of that bedrock constitutional principle. The judgment of the court of appeals should be affirmed.

STATEMENT OF THE CASE

A. Statutory History

1. In 1934, Congress enacted former-§ 275(c), which extended the three-year limitations period within which the IRS was generally required to assess income taxes to five years where "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." Pub. L. No. 73-216, § 275(c), 48 Stat. 680, 745 (1934) (reenacted in 53 Stat. 87 (1939)).

Litigation ensued over the proper scope of § 275(c). In *Uptegrove Lumber Co. v. Commissioner*—which involved a manufacturing company that included an

inflated cost item in its calculation of the cost of goods sold—the Third Circuit held that § 275(c) applies where a taxpayer fails "to include some receipt or accrual in his computation of gross income and not in a more general way to errors of whatever kind in that computation." 204 F.2d 570, 572 (1953). *Uptegrove* was followed by three other courts of appeals and the Court of Claims. *See Slaff v. Comm'r*, 220 F.2d 65 (9th Cir. 1955); *Davis v. Hightower*, 230 F.2d 549 (5th Cir. 1956); *Goodenow v. Comm'r*, 238 F.2d 20 (8th Cir. 1956); *Lazarus v. United States*, 142 F. Supp. 897 (Ct. Cl. 1956). The Sixth Circuit, by contrast, adopted the government's contrary interpretation of § 275(c). *See, e.g., Reis v. Comm'r*, 142 F.2d 900 (6th Cir. 1944).

The lower courts also divided over whether former-§ 275(c) applied when a taxpayer failed to include some income receipt or accrual in gross income but nevertheless *disclosed* that item somewhere else on the face of the return. *See, e.g., Slaff*, 220 F.2d at 66-67; *Uptegrove*, 204 F.2d at 573. *But see Ketcham v. Comm'r*, 142 F.2d 996, 997 (2d Cir. 1944).

2. In 1954, Congress revised and reenacted the Internal Revenue Code. Act of Jan. 6, 1954, ch. 736, 68A Stat. 3. As part of that revision, former-§ 275(c) was re-codified as § 6501(e)(1)(A) and titled "General rule." The key "omits from gross income" language was carried over unchanged. Congress also added two new subparagraphs to § 6501(e)(1)(A).

Subparagraph (i) provided that, "[i]n the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services … prior to diminution by the cost of such sales or services." 68A Stat. at 804 (§ 6501(e)(1)(A)(i)). That definition clarified the proper

computation rules that apply in the context of the sale of goods or services by certain businesses, like the manufacturing company in *Uptegrove*, for determining whether any actual omission exceeds the 25% threshold for the extended limitations period—in a way that *favored* taxpayers. Under Treasury regulations then in effect and considered by the *Uptegrove* court, the cost of goods sold and other items had been subtracted from gross receipts in the case of a trade or business to arrive at gross income. *See Uptegrove*, 204 F.2d at 571 (citing Treas. Reg. § 29.22(a)-5 (1943)).

Subparagraph (ii) clarified existing law and provided that items adequately disclosed on the return or in a statement attached thereto also shall not count in calculating "the amount omitted from gross income." 68A Stat. at 805 (§ 6501(e)(1)(A)(ii)).

3. A few years after the 1954 amendments, this Court granted certiorari in *Colony* to resolve the question whether an understatement of gross income resulting from an overstatement of basis in sold property constitutes an "'omi[ssion] from gross income [of] an amount properly includible therein'" under the former-§ 275(c). 357 U.S. at 30. The Court held, in an opinion authored by Justice Harlan, that an overstatement of basis is *not* an omission from gross income. *Id.* at 31-37. *Colony* was decided after the 1954 amendments, but on the basis of former-§ 275(c).

The taxpayer in *Colony* was a developer that subdivided and sold real property to individual buyers. 357 U.S. at 30. The taxpayer's federal income tax returns reported the amount realized from the sales of individual lots, subtracted the cost of the lots (*i.e.*, its basis in the property), and arrived at a figure for its net gain. *Id.*; *Colony, Inc. v. Comm'r*, 26 T.C. 30, 38-39

(1956). In calculating its basis in the lots, the taxpayer "erroneously includ[ed] in their cost certain unallowable items of development expense." 357 U.S. at 30. Because the taxpayer's basis was overstated, the return understated the gain from the transactions. *Id.*

Examining the "critical statutory language," this Court explained that the plain and ordinary meaning of "omit" is "'[t]o leave out or unmentioned; not to insert, include, or name,'" *id.* at 32, and observed that the government's interpretation would replace "omits" with "understates," *id.* at 35. The Court also considered the legislative history, which revealed Congress's "purpose … to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors." *Id.* at 36. The Court concluded 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.* at 33.

The Court further observed that the Commissioner's interpretation "not only would … read § 275(c) more broadly than is justified by the evident reason for its enactment," but would also "create a patent incongruity in the tax law," because it would treat errors related to overstated amounts affecting "gross income" (*e.g.*, basis or cost of goods sold) differently than "overstated deductions," though the amount of both types of errors are shown on the return and could have an equal impact on tax owed. *Id.* at 36-37 (citing *Uptegrove*, 204 F.2d at 573). Although the case was decided based on former-§ 275(c), the parties

brought the 1954 amendments to the Court's attention. The Court observed that its interpretation of § 275(c) was "in harmony with the unambiguous language" of § 275(c)'s successor, § 6501(e)(1)(A). *Id.* at 37.

4. In 1965, seven years after *Colony*, Congress changed the heading of § 6501(e) from "Omission from Gross Income" to "Substantial Omission of Items," and added § 6501(e)(3), relating to excise taxes. Pub. L. No. 89-44, § 810(b), 79 Stat. 136, 169 (1965). Congress did not change the key phrase "omits from gross income an amount properly includible therein."

In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, 648, which created a single, unified procedure for determining the tax treatment of all partnership items at the partnership level. TEFRA added § 6229(c)(2), which contains language substantively identical to that of former-§ 275(c) at issue in *Colony*, but applies only to partnerships. Section 6229(c)(2) does not contain the language that appears in subparagraphs (i)-(ii) of § 6501(e)(1)(A).

In 1986, Congress re-enacted the Internal Revenue Code as revised, retaining the phrase "omits from gross income" without change. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 2, 100 Stat. 2085, 2095; *see also* Staff of the Joint Comm. on Taxation, Summary of Conference Agreement on HR 3838 (Tax Reform Act of 1986) 79 (Comm. Print 1986) (explaining that the law "reenacts the provisions of the 1954 Code—as in effect on the date of the enactment of the bill—together with amendments made by the conference agreement").

All told, since *Colony*, the critical statutory language interpreted in *Colony* has remained

untouched, through a total of six substantive amendments to § 6501(e) and the 1986 reenactment.[1]

B. Regulatory Background And Son-Of-BOSS

In January 1956, after the 1954 amendments and before this Court's decision in *Colony*, the Commissioner issued final regulations under § 6501(e)(1)(A) that simply tracked the text of the statute as amended. *See* T.D. 6172, 1956-1 C.B. 565. Those regulations remained unchanged until 2009, when the regulations at issue here were issued in temporary and proposed form. *See infra* at 14-15.

For decades following *Colony*, the IRS recognized and followed *Colony* without question. In 1976, the IRS recognized *Colony* as "[t]he landmark" case construing § 6501(e), while acknowledging that *Colony*'s holding is "in harmony with" § 6501(e)(1)(A). IRS Gen. Couns. Mem. 36856 (Sept. 21, 1976). As late as July 2000—three months *after* the returns at issue here were filed—the Commissioner reiterated his view that "the extended statute of limitations provided in the case of a 25% omission is limited to when *specific receipts or accruals are left out* of the computation of gross income." Non-Docketed Service Advice Review (NSAR) 11419, 2000 WL 34423427 (July 10, 2000) (emphasis added). That view changed abruptly in the 2000s, not because of any epiphany concerning the meaning of § 6501(e), but because of the advent of a

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[1] Pub. L. No. 89-44, § 810(a), (b), 79 Stat. 136, 169 (1965); Pub. L. No. 91-172, § 101(g)(3), 83 Stat. 487, 525 (1969); Pub. L. No. 91-614, § 102(d)(8), 84 Stat. 1836, 1842 (1970); Pub. L. No. 94-455, § 1307(d)(2)(F)(vi), 90 Stat. 1520, 1728 (1976); Pub. L. No. 108-357, § 413(c)(28), 118 Stat. 1418, 1509 (2004); Pub. L. No. 111-147, § 513(a), 124 Stat. 71, 111 (2010).

transaction called “Son-of-BOSS” and the IRS’s failure to timely review returns reporting such transactions.[2]

In August 2000, four months after respondents’ returns were filed, the IRS issued Notice 2000-44, 2000-2 C.B. 255 (published Sept. 5, 2000), which set forth, in some detail, the IRS’s position that tax consequences claimed by taxpayers in connection with certain partnership transactions (generally referred to as “Son-of-BOSS” transactions) were contrary to the spirit of the Code. The IRS does not deny that a literal application of the Code’s partnership-basis provisions produces the result that taxpayers claim, but it contends—and several courts have held—that the Code’s language can be disregarded in these circumstances under the judicially-created “economic substance” doctrine. *See* U.S. Br. 3-4. In the ensuing months and years, the IRS took several steps to identify and educate its examiners about transactions fitting the Son-of-BOSS pattern. *See infra* at 52-53.

In 2004, Congress amended § 6501 by adding a new subsection (c)(10), which provides that, in the case of a “listed” transaction like “Son-of-BOSS,” the limitations period for assessing tax does not expire until one year after the taxpayer submits certain information. American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, § 814(a), 118 Stat. 1418. If the taxpayer fails to furnish the required information, the limitations period remains open indefinitely. Section 6501(c)(10) is

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[2] General Counsel Memoranda and NSARs are internal guidance for IRS personnel issued by the IRS’s National Office. Like private letter rulings, they are not binding on the government, but are evidence of the IRS’s views and practice. *Hanover Bank v. Comm’r*, 369 U.S. 672, 686-87 (1962); *see also Boulware v. Comm’r*, 552 U.S. 421, 431 (2008) (citing NSAR).

not retroactive, and the IRS does not contend that it applies to the returns at issue here.[3]

Meanwhile, the IRS began an aggressive program of asserting tax deficiencies related to Son-of-BOSS and similar transactions, even when the three-year limitations period had expired. The IRS began to argue, for the first time in the more than 50 years since this Court decided *Colony*—and contrary to the guidance the IRS had issued since *Colony*—that this Court's holding in *Colony* applies only in the context of the sale of goods or services by a trade or business and not to a taxpayer's basis in property. The Tax Court promptly rejected that statutory argument, and the Ninth Circuit affirmed. *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767, 778 (9th Cir. 2009). The Federal Circuit agreed. *Salman Ranch Ltd. v. United States*, 573 F.3d 1362, 1372 (Fed. Cir. 2009).

C. Facts Relevant To This Litigation

Respondents, small business owners in Salisbury, North Carolina, unwittingly became swept up in this chain of events when they decided in 1999 to sell a small co-family business called Home Oil & Coal Company, Inc. (Home Oil). JA 24. Home Oil had been in operation for more than 50 years before the transactions at issue in this case. JA 114-19. Respondents Robert Pierce and Stephen Chandler became the principal owners and day-to-day managers of Home Oil in 1985. *Id.* Over the years, Home Oil

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[3] Section 6501(c)(10) is effective for tax years with respect to which the period for assessing a deficiency "did not expire" before October 22, 2004. 118 Stat. at 1581.

changed the focus of its business from heating oil and coal to concrete and building supplies. JA 115-16.

By 1999, Pierce and Chandler were the only two shareholders of Home Oil. JA 118-19. Pierce, who owned approximately 81% of the outstanding shares, decided to retire and sell the business. Pet. App. 2a. Given the importance of the sale for himself and his family, Pierce—a small business owner who was far from expert in such matters—sought financial planning assistance from several highly recommended financial and legal professionals. *Id.*; JA 24-25. On advice from those professionals, the following transactions occurred prior to the sale of the business:

(1) Home Concrete & Supply, LLC was formed on April 15, 1999. Home Concrete's initial members were Pierce, Chandler, Home Oil, and two trusts for the benefit of Pierce's children (collectively, the "partners").

(2) On May 13, 1999, each partner commenced a short sale of Treasury notes.

(3) On May 17, 1999, each partner contributed the proceeds from the short sales of Treasury notes, together with the short Treasury note positions and margin cash, to Home Concrete as capital contributions.

(4) On May 18, 1999, Home Concrete closed its Treasury note short positions by purchasing Treasury notes in the open market.

(5) On June 11, 1999, Home Oil transferred substantially all of its business assets to Home Concrete as a capital contribution.

(6) On June 14, 1999, each partner transferred a percentage of its membership interests in Home Concrete to Home Oil as a capital contribution to Home Oil.

(7) In connection with such transfers, Home Concrete made an election pursuant to 26 U.S.C. § 754 to step up the basis of its assets.

(8) On August 31, 1999, Home Concrete sold substantially all of its assets to a third party for a gross sales price of $10,623,348.

See JA 25-29.[9]

Home Concrete timely filed its partnership tax return on or before April 17, 2000. JA 29, 124. That return reported the sale of Home Concrete's assets, including the gross sales price ($10,623,348), the partnership's original basis ($4,542,824.36), the election to adjust its basis, and the resulting stepped-up basis ($10,527,350.53). JA 143, 150, 151. Home Concrete also attached Form 8594 (Asset Acquisition Statement Under Section 1060), on which it reported the third-party purchaser's information and the fair market value of the sold assets. JA 143.

The partners also filed their respective federal income tax returns for the 1999 tax year on or before April 17, 2000. JA 29, 30, 152, 189, 217, 274, 288. Each

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9 The government repeatedly (and erroneously) refers to the "sale of Home Concrete" and "the partnership's sale price" instead of the sale of the *assets* of the partnership. The distinction is significant. By selling *property*—here capital assets—Home Concrete was required to (and did) complete Form 4797, Sales of Business Property, and, among other things, describe the specific property sold, its sale price, the cost or basis of the property, and the resulting gain or loss. JA 139-42.

partner reported his, her, or its portion of the gain from the sale of the partnership's assets on the relevant return. JA 179, 198, 233, 281, 295. Each partner that had engaged in short sale transactions further disclosed that "during the year the proceeds of a short sale not closed by the taxpayer during this tax year were received." JA 204, 258.

Despite its public pronouncement in Notice 2000-44, and notwithstanding respondents' substantial disclosures, the IRS and its agents inexplicably waited nearly *six years* to even begin auditing Home Concrete's 1999 return. In a letter dated February 23, 2006, the IRS notified Pierce that Home Concrete's return had "been selected for examination" because of a "Notice 2000-44 Transaction." Add. 19a-21a. Six months later, on September 7, 2006, the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA), in which the IRS asserted that respondents' claimed basis in the sale of Home Concrete's assets was too high. JA 95-97. The IRS has never alleged that the 1999 returns were fraudulent.

D. The New Treasury Regulations

In September 2009, after the government had lost several Son-of-BOSS cases on statute of limitations grounds and was still litigating others (including this case), the Department of the Treasury withdrew its longstanding regulations tracking the text of § 6501 and issued new temporary regulations under §§ 6501 and 6229, purporting to limit the statutory language at issue in *Colony* to situations involving the sale of goods or services by a trade or business. *See* T.D. 9466, 2009-43 I.R.B. 551 (Sept. 24, 2009), *reprinted in* 74 Fed. Reg. 49,321 (Sept. 28, 2009). As relevant here, Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) defined gross income—

outside the sale of goods or services in a trade or business—as "the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property." "Consequently," the regulation asserted, "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)." 74 Fed. Reg. at 49,323. In a provision titled "Effective/applicability date," Treasury provided that the new regulation would "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." *Id.* (Temp. Treas. Reg. § 301.6501(e)-1T(b)).

The temporary regulations were issued without any notice-and-comment period. Instead, the government simultaneously issued temporary and proposed regulations with identical text and requested comments within 90 days. 74 Fed. Reg. at 49,354. During this 90-day comment period, the IRS issued a Chief Counsel Notice purporting to interpret the "effective date" provision to mean that the regulations are applicable when the limitations period, *as interpreted in the regulations*, remains "open." CCN-2010-001 (Nov. 23, 2009), *available at* http://www.irs.gov/pub/irs-ccdm/cc-2010-001.pdf.

The government began arguing in ongoing litigation that the temporary regulations were an "intervening 'change in the law'" applicable to pending cases in which the three-year statute of limitations undeniably had closed under this Court's interpretation in *Colony*. The *en banc* Tax Court unanimously rejected the government's reliance on the regulations, holding that the regulations, by their terms, do not apply to tax

years that had closed under the statute as interpreted by *Colony*, and that in any event the regulations are invalid and not entitled to deference. *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 134 T.C. 211, 224-25 (2010) (denying government's motion to vacate and reconsider), *rev'd*, 650 F.3d 691 (D.C. Cir. 2011).[4]

In December 2010, the government withdrew the temporary regulations and issued virtually identical final regulations. T.D. 9511, 2011-1 C.B. 455 (Dec. 15, 2010), *reprinted in* 75 Fed. Reg. 78,897 (Dec. 17, 2010).[5]

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[4] Two concurring judges concluded that the temporary regulations were invalid for failing to comply with the APA's notice-and-comment requirements. 134 T.C. at 243-44.

[5] Although it is nearly identical to the temporary regulation, the final regulation introduces an inconsistency that underscores the arbitrary nature of the IRS's action. After the temporary regulation was issued, but before the final regulation was promulgated, Congress amended § 6501(e)(1), reorganizing a portion of § 6501(e)(1)(A), and once again leaving intact the phrase "omits from gross income." *See* Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, § 513, 124 Stat. 111. Although the temporary regulation cites § 6501(e)(1)(A) (which contains the general rule concerning "omits from gross income"), *see* Temp. Treas. Reg. § 301.6501(e)-1(a)(1)(iii), the final regulation states that "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6501(e)(1)(A)(i)." 75 Fed. Reg. at 78,899. The reference to § 6501(e)(1)(A)(i) in the final rule thus creates an anomaly. If it was intended to be a reference to the pre-March 2010 version of the statute (which applies in this case), it would make no sense. In that version, § 6501(e)(1)(A)(i) is the subparagraph that applies to the sale of goods or services by a trade or business. So the final regulation would purport to make overstatements of the cost of goods sold in a trade or business an "omission" from gross income—directly contradicting the government's interpretation of subparagraph (i) as well as subparagraph (a)(1)(ii) of the

The final regulations state that they "appl[y] to taxable years with respect to which the period for assessing tax *was open* on or after September 24, 2009." Treas. Reg. § 301.6501(e)-1(e) (emphasis added). The preamble to the regulations asserts that the regulations "are not retroactive" because they "do not reopen closed tax years." 75 Fed. Reg. at 78,898.

E. Decisions Below

In December 2006, respondents filed suit in district court, alleging that their tax-reporting positions were correct and that, in any event, the IRS was barred by the three-year limitations periods in §§ 6501(a) and 6229(a) from assessing any tax for the 1999 tax year. *See* JA 9. On cross-motions, the district court granted partial summary judgment to the government. Although the court agreed "that the language of § 275(c)" interpreted by this Court in *Colony* "is virtually identical" to § 6501(e)(1)(A), it held that the addition of subparagraph (i) changed what "omits from gross income" means in cases *not* involving the sale of goods or services by a trade or business. Pet. App. 34a.

The Fourth Circuit reversed. It concluded that this Court "in *Colony* straightforwardly construed the phrase 'omits from gross income,' unhinged from any dependency on the taxpayer's identity as a trade or

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regulation. If, on the other hand, the IRS meant to reference the statute as amended in 2010, it refers to the provision specifying the computational 25% threshold—and would make the regulations purely *prospective*, because the March 2010 amendment by its terms does not apply to this case. *See supra* at n.3. Either way, the reference to § 6501(e)(1)(A)(i) in the final regulation demonstrates the hastiness with which the IRS acted in promulgating the final regulations and underscores the arbitrary nature of its rule.

business selling goods or services." *Id.* at 10a. Rejecting the government's attempt to "press[] another path around *Colony*" by way of its new regulation, the court explained that: (1) the regulation does not apply by its plain terms, because the period for assessing tax for the 1999 tax year was not "open" on September 24, 2009; (2) *Chevron* deference is not warranted because *Colony* had found Congress's intent on the specific issue was clear; and (3) the regulation could not in any event be applied retroactively to this case, because it would "change the law governing the taxpayer's 1999 returns and thereby subject them to liability to which they would not have been subject under pre-regulation law." *Id.* at 12a-16a.

Although the court of appeals did not need to reach respondents' alternative argument that the taxpayers adequately disclosed the amounts on their returns for purposes of § 6501(e)(1)(A)(ii), the court noted that Home Concrete "reported the basic components of the transactions"; "the taxpayers' individual" returns disclosed that the short sales were "not closed" during 1999; the partnership return included its "§ 754 election form [which] gave, for each partnership asset, an itemized accounting of the partnership's inside basis, the amount of the basis adjustment, and the post-election basis"; and the return "[o]n its face" also showed the sale of the Treasury Bonds with the cost, sales price, and resulting gain. *Id.* at 4a.

Judge Wilkinson joined the court's opinion in full but wrote separately to elaborate on why *Colony* is best viewed as a "*Chevron* step one" decision, and why

the agency's new interpretation is not entitled to any deference. *See id.* at 18a-19a (concurring).[6]

SUMMARY OF ARGUMENT

The statutory question presented should sound familiar to this Court. More than 50 years ago, the Court held that an overstatement of basis does *not* result in an "omi[ssion]" from gross income, and that Congress intended to give the IRS extra time for making tax assessments under the statute of limitations at issue here only when the taxpayer "fail[s] to report particular income receipts and accruals"—not "whenever gross income [i]s understated." *Colony*, 357 U.S. at 35. Principles of *stare decisis* coupled with congressional reenactment of the same language foreclose the government's amnesic attempt to relitigate the same statutory question today as if it reaches the Court on a blank slate. For decades following *Colony*, Congress, the courts, and the IRS all understood that this Court's interpretation of the key language at issue governed. Under that settled interpretation, the statute of limitations for respondents' tax returns expired in April 2003.

The government's case therefore comes down to the regulation issued by Treasury in 2010—while this case was on appeal—in an effort to overrule this Court's statutory interpretation in *Colony* after a string of losses in the lower courts on the meaning of the

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[6] The government has abandoned any reliance in this case on § 6229(c)(2), which governs a partnership's tax returns. *See supra* at 8; U.S. Sur-Reply at 14 (E.D.N.C. Apr. 19, 2007) (ECF No. 21). As explained by *amicus curiae* Bausch & Lomb Inc., however, the problems with the government's position in this case are only magnified when it comes to § 6229(c)(2).

statutory language at issue. While the IRS's power is indeed broad, the agency has yet to reach the point—if it ever could in our constitutional system—where it can override the settled decisions of this Court and retroactively reopen and extend a closed limitations period for the purpose of taking penal action against taxpayers. For several reasons, the government's attempt to achieve that result here should be rejected.

By its own terms, the regulation applies only "to taxable years with respect to which the period for assessing tax *was open on or after September 24, 2009*." The limitations period for respondents' returns was *not* "open on or after September 24, 2009," because the three-year limitations period expired in April 2003 under the law in effect at that time (*i.e.*, this Court's decision in *Colony*). At best, the regulation sends conflicting signals on whether it applies retroactively, and that alone is fatal to the agency's argument that the regulation reaches back to the returns at issue. A law that is ambiguous concerning its retroactive effect is "unambiguously *prospective*." *INS v. St. Cyr*, 533 U.S. 289, 320 n.45 (2001) (emphasis added); *see Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988). No measure of agency deference can change that.

If the regulation applied by its terms to the returns at issue, it would be invalid. This Court's decision in *Colony* left no ambiguity for the IRS to "interpret." Although it seems artificial to try to view *Colony* through the lens of *Chevron U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984), Justice Harlan wrote with great prescience and clarity for the Court in explaining—in language that closely tracks the *Chevron* step one test—that Congress "*address[ed] 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." *Colony*, 357 U.S. at 33 (emphasis added). Especially given Congress's reenactment of the key statutory language after *Colony*, there is no gap for the agency to fill, much less any basis to adopt the very interpretation that this Court rejected in *Colony*.

Furthermore, the IRS lacks the power, as a matter of statutory and constitutional law, retroactively to overrule a decision of this Court conclusively interpreting a statute. Congress has authorized the IRS to promulgate retroactive rules for *certain* purposes, but it has not authorized the kind of extraordinary retroactive rule at issue in this case. And even if the agency had such authority, the regulation at issue here would not be entitled to deference because it was set in stone before any opportunity for notice and comment, blatantly seeks to reverse the Commissioner's losses in pending litigation to which the agency was a party, and—for the reasons stated by this Court in *Colony*—is not a reasonable interpretation of the statute.

The IRS, like all agencies, enjoys deference within its proper areas of expertise. But as Judge Wilkinson observed below, the agency action at issue in this case "pass[es] the point where the beneficial application of agency expertise gives way to a lack of accountability and risk of arbitrariness." Pet. App. 20a (concurring).

ARGUMENT

I. THE THREE-YEAR STATUTE OF LIMITATIONS APPLIES UNDER THE SETTLED LAW IN PLACE BEFORE THE RECENT TREASURY REGULATIONS

In April 2000, when respondents filed their returns for the 1999 tax year, the law was settled that an overstatement of basis does not constitute an "omi[ssion] from gross income" within the meaning of § 6501(e)(1)(A). This Court so held in *Colony*, interpreting identical statutory language, and the IRS had accepted that reading of *Colony* for decades. The government now recycles the same statutory arguments that it advanced—and this Court rejected—in *Colony*, even though the "critical statutory language" that was the subject of this Court's holding has been reenacted by Congress in the decades since *Colony*. 357 U.S. at 32. The government also argues that the addition of a subparagraph in the 1954 amendments impliedly eviscerated *Colony*'s unqualified holding, even though this Court in *Colony* was well aware of the addition and stated that its holding was "in harmony with" § 6501(e)(1)(A). *Id.* at 37. The government's arguments should be rejected.

A. As This Court Held In *Colony*, An Overstatement Of Basis Is Not An "Omission" From Gross Income

1. In *Colony*, Congress's selection of the word "omits" instead of "reduces or understates"—combined with other indicia of Congress's intent—led this Court to conclude 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.* at 33. That interpretation was correct.

As even the government acknowledges, the plain and ordinary meaning of the verb "omit" is "to leave out" or "to fail to include or mention." *See* U.S. Br. 18-19 (and authorities cited therein); *Colony*, 357 U.S. at 32-33; Pet. App. 18a (Wilkinson, J., concurring). A taxpayer thus does not "omit" gross income where he includes every sales price or gross receipt but overstates his basis. As this Court explained in *Colony*, the legislative history unmistakably confirms that Congress intended that reading. 357 U.S. at 33-35. The government nevertheless proceeds in this case as if this Court's interpretation in *Colony* has no more force than a taxpayer's reading of the Code, simply repeating the same arguments that this Court considered and rejected in *Colony*. Those arguments are no more persuasive now than they were in 1958.

a. Just as it did in *Colony*, the government relies principally on the Code's definition of "gross income." S*ee* Brief for U.S., *Colony*, 357 U.S. 28 (1958) (No. 306), 1958 WL 91876, at *15-16 (U.S. *Colony* Br.). Then, as now, the definition of "gross income" expressly included "gains … derived from … dealings in property." 26 U.S.C. § 22(a) (1940); 26 U.S.C. § 61(a)(3) (2006). Then, as now, the government argued that an overstatement of basis was an omission from gross income, because the term "gross income" includes gain from the sale of property. *Colony* squarely rejected that argument. This Court acknowledged that "where a cost item 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."

357 U.S. at 32. The Court, however, held that this interpretation fails to take account of "the word 'omits,' which Congress selected when it could have chosen another verb such as 'reduces' or 'understates,' either of which would have pointed significantly in the Commissioner's direction." *Id.*

b. The government also argues that § 6501(e)(1)(A) "must be interpreted in light of Congress's reasons for extending the assessment period involving omissions from gross income," which (the government says) was that "substantial omissions from gross income … are often difficult to detect." U.S. Br. 24. It contends that basis overstatements are hard to discover—like omissions of income items, but "[u]nlike (for example) a potentially improper deduction, which provides a natural trigger for IRS inquiry." *Id.* Once again, this Court rejected precisely this argument in *Colony*.

Colony involved a basis overstatement. This Court squarely rejected the government's premise that such errors are more analogous to omissions of income items than to "overstated deductions." 357 U.S. at 36. The Court explained that the extended limitations period was intended for circumstances "where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors." *Id.* at 36. "In such instances the return on its face provides no clue to the existence of the omitted item." *Id.* In contrast, "when, *as here*, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return"—as opposed to the omission of "some taxable item" altogether—"the Commissioner is at no such disadvantage." *Id.* (emphasis added). In fact, the Court concluded that the government's interpretation

would introduce a "patent incongruity" into the tax law that Congress could not have intended, by treating overstated basis differently than overstated *deductions*, *id.*—which the IRS correctly concedes cannot constitute an omission from gross income. A deduction, like basis, appears as an amount on the face of a return. An overstated deduction is no less "difficult to detect" than an overstated basis.

The government now asks the Court not only to resurrect that very same "patent incongruity," but to adopt a new one. The government argues that an understatement of gross income attributable to an overstatement *of the cost of goods sold in a trade or business* would be subject to the three-year limitations period, while sales of *other property* in the same context could be subject to the six-year limitations period. That reading is untenable.

Colony involved a taxpayer engaged in the sale of *real property*, so it would make no sense to conclude that *Colony*'s interpretation of the key statutory language was limited to overstatement *of the cost of goods sold*. And although Congress clarified in the 1954 amendments how to calculate *gross income* concerning the sale of goods or services in "the case of a trade or business," § 6501(e)(1)(A)(i), in doing so it did not touch the general rule established by § 6501(e)(1)(A)—and confirmed by *Colony*—that an overstatement of basis does not result in an *omission* from gross income (however calculated).[7]

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[7] One court has remarked that the taxpayer in *Colony* "described itself as a taxpayer in a trade or business with income from the sale of goods or services." *Intermountain Ins. Serv. of Vail, LLC v. Commissioner*, 650 F.3d 691, 703 (D.C. Cir. 2011). That is incorrect. This Court's decision recognizes that the

Moreover, reporting sales of property (involving "basis") requires more detailed disclosures than sales involving cost of goods sold—including specific descriptions of the property, acquisition date, sale date, sale price, cost basis (including adjustments for depreciation, improvements, and sale expenses), and gain or loss. Because the extended limitations period was intended to apply when the IRS "is at a special disadvantage in detecting errors," *Colony*, 357 U.S. at 36, it would be nonsensical for Congress to grant the IRS six years in a "basis" case while limiting the IRS's time to three years for a "cost of goods sold" case.[8]

c. The government tries to bolster this already-rejected argument by using the tax returns here as an example, and asserting that those returns did not give the IRS any fair chance to detect the alleged deficiency. U.S. Br. 25. Far from supporting its position, the returns simply confirm the conclusions this Court reached in *Colony*. Respondents' returns gave the IRS far more than a "clue" as to the legal dispute that ultimately developed:

(1) Home Concrete's return is marked "initial return" on its first page, showing that the partnership was created in 1999. JA 124.

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underlying transaction concerned the sale of *real property*, 357 U.S. at 30, as did the parties' briefs in the case, *see* Br. for Petr., *Colony*, 357 U.S. 28 (1958) (No. 306), 1958 WL 91875, at *3 (Petr. *Colony* Br.); U.S. *Colony* Br. 4.

[8] The government repeatedly conflates two distinct concepts: "basis"—at issue in *Colony*—and "cost of goods sold"—at issue in cases like *Uptegrove*. "Basis" is the cost of property (*e.g.*, a capital asset), and is determined on an asset-by-asset basis. "Cost of goods sold" is used to account for the costs of inventory when it is sold, and is determined in the aggregate.

(2) The Form 8594 attached to the Home Concrete return clearly shows a sale of the partnership's assets as well as the total sales price of $10,623,348. JA 143-44.

(3) There was a substantial elective basis adjustment shown on the § 754 election schedule conspicuously attached to the Home Concrete return. JA 150, 151. The returns here disclosed an election that increased Home Concrete's basis in its assets by *more than 150%*.[9]

(4) Schedule D to the Home Concrete return shows that it reported the sale of U.S. Treasury Bonds with proceeds of $7,472,405, a notably large transaction outside the scope of what might be

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[9] The IRS has understood for decades that § 754 elections (or non-elections) may operate to shift, defer, or eliminate tax liability in problematic ways. When partnership interests are transferred, § 754 permits, but does not require, the partnership to adjust its "inside" basis in its assets to match the partners' "outside" basis. Congress adopted that election in 1954 to address practical problems created by the prior rules, which had required that inside basis be adjusted according to fair market value (and therefore often required an appraisal of partnership assets). The potential for tax-shifting or avoidance was well-understood at the time, and has been continuously studied since. *E.g.*, William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 24.11[8] (2005) ("The wisdom of making basis adjustments elective has been debated since the election first appeared in 1954."). Congress has chosen to impose limitations but not eliminate the election entirely, because the realistic alternatives present even greater problems. For example, Congress amended the law in 2004 to *require* the election when a partnership has a substantial built-in loss, to minimize the extent to which existing tax losses can be shifted from outgoing to incoming partners. Pub. L. No. 108-357 § 833(b).

expected from a relatively small concrete company. JA 128.

(5) The Home Concrete return shows over $21 million in revenue—$3.7 million from gross receipts (JA 124), $10.6 million from the sale of assets (JA 143), and $7.4 million from the sale of Treasury notes (JA 128)—yet only a minimal taxable gain, because of the basis increase produced by the § 754 election.

(6) The Home Concrete return shows $8,693,414 in distributions to its partners. JA 126. This is a large amount to distribute in the first year of a partnership's existence.

(7) The individual partners attached statements to their respective returns disclosing that:

> "DURING THE YEAR THE PROCEEDS OF A SHORT SALE NOT CLOSED BY THE TAXPAYER DURING THIS TAX YEAR WERE RECEIVED."

JA 204, 258 (emphasis in original).[10]

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[10] Home Concrete realized a short-term capital gain of $113,362 as a result of the short sales. JA 28. This gain was reported by Home Concrete on Schedule D, line 1(f). JA 128. There was nothing "misleading" about this disclosure. U.S. Br. 17. Under the category for short-term capital gains and losses recognized on assets held for one year or less, Schedule D provides a column for "Date acquired" and another column for "Date sold," under which the corresponding dates should be listed with regard to a particular short-term capital asset. JA 128. The individual partners opened the short sales, which are disclosed on their respective returns, on May 13, 1999. JA 26, 204, 258. Home Concrete purchased Treasury bonds to close the short sales on May 18, which is indicated in the "Date acquired" column on

The fact that the IRS did not examine the returns until long after the three-year period expired had nothing to do with the disclosures, or lack thereof, on the returns. The IRS simply failed to examine respondents' returns for nearly six years. Congress reserved the extended statute of limitations in § 6501(e)(1)(A) for situations where the "omission to report some taxable item" puts the IRS "at a special disadvantage in detecting errors." *Colony*, 357 U.S. at 36. It was not designed to help the IRS where, as here, the agency's failure to detect the alleged error is due to its own failure to timely act on disclosed facts.

B. The Government's Attempt To Sidestep And Rewrite *Colony* Is Unavailing

The government argues that a subparagraph added in the 1954 amendments somehow renders *Colony*'s interpretation of "omits from gross income" defunct or limits *Colony*'s holding to the sale of goods or services by a trade or business. Neither of these arguments is persuasive. Congress amended former-§ 275(c) in several respects in 1954. In every instance, the change favored taxpayers and limited the application of the six-year statute of limitations to situations in which the Commissioner truly was at a special disadvantage to detect errors. Congress did not make the broad brush change in the trigger for the six-year statute of limitations that the government hypothesizes—*to the detriment of taxpayers*. More fundamentally, the

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Schedule D. JA 27, 128. Home Concrete then used the Treasury Bonds to close the short sales that had been opened by the individual partners, which is indicated in the "Date sold" column on Schedule D. JA 128. Respondents' returns thus reflect the short sale accurately, just as required by the IRS's own forms.

government's effort to side-step *Colony* based on the 1954 amendments is fatally undermined by the fact that this Court in *Colony* observed that its interpretation of the critical language was "in harmony with" the 1954 amendments. 357 U.S. at 37.

a. The government's argument that subparagraph (i) changes the meaning of "omits from gross income" is refuted by the statute's terms and structure. Section 6501(e)(1)(A)—which includes the "omits from gross income language—is entitled "General rule." The government describes subparagraphs (i) and (ii) as "*exceptions* to the general rule." U.S. Br. 20 (emphasis added). Congress, however, which knows well how to delineate "exceptions," did no such thing here. *Compare*, *e.g.*, 26 U.S.C. § 446 (stating "[e]xceptions" to a "[g]eneral rule"); *id.* § 451 (listing "[g]eneral rule" and then "[s]pecial rule[s]" addressed to particular situations). Moreover, subparagraph (i) does not even address the crucial "omits from gross income" language interpreted in *Colony*. It simply defines what "gross income" means for particular sales "in the case of a trade or business." *Id.* § 6501(e)(1)(A)(i).

b. There is no credible basis for the government's assertion that "[t]he principal effect of subparagraph (i) is to eliminate the possibility that a trade or business could trigger the six-year assessment period by overstating its basis in sold property." U.S. Br. 21. Subparagraph (i) applies only to sales of "goods or services," not "property" generally. Although the subparagraph is consistent with the result reached in pre-*Colony* cases involving the sale of goods or services by a trade or business like *Uptegrove*, it also settled that a Treasury regulation (discussed in *Uptegrove*) defining gross income in the context of the

sale of goods by certain businesses did not apply for the computational purpose of determining when an actual "omission" triggered the 25% threshold. *See Uptegrove*, 204 F.2d at 571; Add. 18a. In any event, there is no basis to read subparagraph (i)'s explication of what qualifies as "gross income" in a particular context as an effort to rewrite what constitutes an "*omission* from gross income" in all others.[11]

It is not unusual for Congress to spell out the application of a general rule to a specific fact pattern, even if there would be a belts-and-suspenders component to its action. But it would be unusual, if not unprecedented, for Congress to nullify a general rule that it leaves unchanged simply by adding a subsection addressing a specific fact pattern. And it would be even more unheard of for Congress to do so without leaving behind in the text, legislative history, or otherwise any meaningful evidence that it intended to achieve that counter-intuitive result.

c. The government now contends that the inferences it wants to draw are necessary to give the

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[11] In *Intermountain*, the court of appeals concluded that "Congress intended subsection (i) to resolve that debate [in the lower courts over former-§ 275(c)] in the taxpayer's favor, *though only in the trade or business context.*" 650 F.3d at 704 (emphasis added). There is no evidence, however, that subparagraph (i) was designed to change the general rule in a way that *disfavored* taxpayers in all other contexts. What we *do* know is that this Court concluded that its decision in *Colony*—a case involving the sale of real property, not the sale of goods and services by a trade or business—was "in harmony with" the 1954 amendments. 357 U.S. at 37. The Court could not have reached that conclusion if it viewed subparagraph (i) as *changing* what constitutes an "omission from gross income" for taxpayers other than a trade or business involved in the sale of goods or services.

amendment "'real and substantial effect,'" because the computational function concededly served by subparagraph (i) supposedly is "irrelevant to the issue that had spawned a circuit split" before *Colony*. U.S. Br. 22-23. The government's argument (at 21) that subparagraph (i) created a "special rule" rests on the mistaken premise that the definition of "gross income" is determinative of whether there has been an "omi[ssion]" from gross income—an argument that was considered and rejected in *Colony*. Because subparagraph (i) concededly is *not* rendered superfluous under the taxpayer's interpretation, U.S. Br. 22, there is no reason to adopt the bizarre theory proposed by the government: that Congress intended *sub silentio* to change the "General rule" in former-§ 275(c) that it left untouched by adding a subparagraph addressing only a particular situation.

d. Finally, *Colony* cannot be limited in the way the government contends because *Colony* involved the sale of real property, which the government correctly acknowledges is neither a "good" nor a "service." U.S. Br. 52. Nor is it "inventory," as the government now contends, under well-established case law and the IRS's long-standing position. *See W.C. & A.N. Miller Dev. Co. v. Comm'r*, 81 T.C. 619, 628 & n.5 (1983) (citing 1921 IRS published ruling and 1928 Board of Tax Appeals opinion). Because subparagraph (i) would not have applied on the facts of *Colony*, it is inconceivable that this Court's statement that its interpretation of § 275(c) was "in harmony with" § 6501(e)(1)(A) embraced the government's reading of the subparagraph—which would wipe out *Colony*.

The government states (at 49) that "[t]he Court in *Colony*, of course, had no need to consider the effect of

the 1954 amendments." In *Colony*, however, both parties relied on the 1954 amendments. *See* Petr. *Colony* Br. 23-24; U.S. *Colony* Br. 23-24. The Solicitor General specifically argued that the 1954 amendments "confirm[ed]" that "the courts below correctly held that § 275(c) was applicable to the case at bar." U.S. *Colony* Br. at 24. In reaching the opposite conclusion, the Court in *Colony* necessarily rejected that argument.[12]

C. Congress Has Ratified This Court's Interpretation In *Colony*

1. The 1954 amendments were not designed to address this Court's decision in *Colony* because they were enacted several years before *Colony* was decided. If Congress had disagreed with *Colony*—or *Colony*'s statement that the Court's decision was "in harmony with" the 1954 amendments—Congress had decades to act. Not only has Congress never acted to overrule this Court's interpretation in *Colony*, it has repeatedly amended the provision at issue—and affirmatively reenacted it in 1986—leaving the operative language unchanged. *See supra* at 8-9.

When Congress reenacted § 6501 as part of the 1986 Code, it did so against the backdrop of *Colony* and cases applying *Colony*'s holding to the 1954 Code.[13]

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[12] The government notes (at 46-47) that the Senate and House Reports accompanying the 1954 amendments refer to "changes in existing law." Those reports simply list all the changes to the language of subsection (e); they by no means suggest that the law was changed in the way the government contends.

[13] *See, e.g.*, *Benderoff v. United States*, 398 F.2d 132, 137 (8th Cir. 1968); *Univ. Country Club, Inc. v. Comm'r*, 64 T.C. 460, 469 (1975); *Quick Trust v. Comm'r*, 54 T.C. 1336, 1347 (1970), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); *Myers v. United States*, 30

Such congressional ratification, coupled with principles of *stare decisis*, resolves any doubt as to the continuing vitality and controlling force of *Colony*. *See Forest Grove Sch. Dist. v. T.A.*, 557 U.S. 230, 129 S. Ct. 2484, 2492 (2009); *Lorillard v. Pons*, 434 U.S. 575, 580 (1978). Indeed, as this Court has stated, "[c]onsiderations of *stare decisis* have special force in the area of statutory interpretation," because "Congress remains free to alter what [the Court] ha[s] done." *Patterson v. McLean Credit Union*, 491 U.S. 164, 172-73 (1989); *see also, e.g.*, *John R. Sand & Gravel Co. v. United States*, 552 U.S. 130, 139 (2008) (quoting *Patterson*).

2. Congress also re-enacted the phrase "omits from gross income" when it created § 6229(c)(2) in 1982, which extends the limitations period to six years when a *partnership* "omits from gross income" an amount in excess of 25% of the *partnership*'s gross income. Congress is presumed to have adopted *Colony*'s interpretation of the language it reenacted. *See Jerman v. Carlisle, McNellie, Rini, Kramer & Ulrich LPA*, 130 S. Ct. 1605, 1616 (2010). Congress did not include in § 6229(c)(2) the language in § 6501(e)(1)(A)(i) that the government argues limits *Colony*'s holding. Yet the Commissioner contends that § 6229(c)(2) should be given the same interpretation as § 6501(e)(1)(A). *See generally* Br. of Bausch & Lomb Inc. as *Amicus Curiae* Supporting Respondents. That position makes it all the more implausible for the government to ascribe any significance to subparagraph (i). The more significance the

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A.F.T.R.2d (RIA) 5332 (S.D. Cal. 1972); *Bishop v. United States*, 338 F. Supp. 1336, 1352 (N.D. Miss. 1970), *aff'd*, 1972 U.S. App. LEXIS 10892 (5th Cir. 1972); *Russell F. Davis, Inc. v. United States*, 170 F. Supp. 185, 186 (N.D. Ind. 1959).

government tries to attach to subparagraph (i) now, the more significant it must be that Congress did not include that subparagraph in § 6229(c)(2).

3. Congress's post-*Colony* change in 1965 to the heading of § 6501—from "Omission from Gross Income" to "Substantial Omission of *Items*"—underscores that Congress understood and affirmatively endorsed the *Colony* holding. 79 Stat. at 169 (emphasis added). A subchapter heading is one of the "'tools available for the resolution of a doubt about the meaning of a statute.'" *Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 47 (2008) (citation omitted). If Congress had intended the interpretation now advanced by the government, it hardly would have changed the heading in a way that fits naturally with this Court's decision in *Colony*—but directly contradicts the government's position that Congress did *not* have in mind the omission of "items."[14]

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[14] The government's reliance (at 49) on § 6501(e)(2) is misplaced. Congress added paragraph (2) as part of the 1954 amendments, to cover estate and gift taxes. Unlike § 6501(e)(1)(A), (e)(2) specifically refers to the omission of "items" includible in the gross estate or total gifts. In the government's view, Congress's failure to change the word "amount" in § 6501(e)(1) (retained from former-§ 275(c)) to the new phrasing it used in § 6501(e)(2) lends support to its interpretation by negative implication. This Court in *Colony*, however, considered Congress's "use of the word 'amount' (instead of, for example, 'item')," and concluded that Congress intended to give the IRS more time only "where, because of a taxpayer's omission to report some taxable item, the Commission is at a special disadvantage in detecting errors." 357 U.S. at 36. The far more relevant point when it comes to Congress's use of "item" is Congress's change to the heading for § 6501(a)(1) in 1965, which must be viewed as an affirmative endorsement of this Court's statutory holding in *Colony*.

In short, even if *Colony* somehow could be read as having left the door open on the proper reading of the statutory language at issue, Congress's subsequent actions against the backdrop of *Colony* have closed it.

II. THE 2010 TREASURY REGULATION DOES NOT—AND CANNOT—COMPEL A DIFFERENT RESULT HERE

After two courts of appeals had rejected the IRS's argument that *Colony* does not foreclose the interpretation that the government advances here, the IRS sought to address the problem by wiping out *Colony*. So it issued a regulation adopting the very reading of the key "omits from gross income" language that this Court had rejected in *Colony*. The government promptly invoked that regulation on appeal in this case, in an effort to overcome the fundamental flaws in its statutory interpretation of § 6501(e)(1)(A). The new regulation cannot change the result here, for several independent reasons.

A. *Colony* Conclusively Resolved the Statutory Question Presented

This Court's decision in *Colony* definitively declared "what the law is" with respect to the key statutory question at issue. *Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 177 (1803). The government emphasizes a statement near the outset of this Court's statutory analysis in *Colony* that "it cannot be said that the language is unambiguous." 357 U.S. at 33; *see* U.S. Br. 10, 13, 48, 51. It is true that the Court recognized a possible ambiguity in the text (when read in a vacuum) if "one touches lightly on the word 'omits' and bears down hard on the words 'gross income." 357 U.S. at 32. The government overlooks that the Court said that it

was "inclined to think that the statute on its face lends itself more plausibly to the taxpayer's interpretation." *Id.* In any event, the critical point—also overlooked by the government—is that the Court then consulted other tools of statutory interpretation, including the legislative history, and concluded that Congress *had* definitively answered the statutory question presented. *See id.* at 33-37. In other words, based on all available evidence, the Court concluded that Congress's intent was *un*ambiguous.

Justice Harlan wrote for the Court with considerable prescience, and clarity, in explaining the Court's statutory interpretation in *Colony*. Tracking language that this Court would adopt four decades later in *Chevron* for determining when Congress's intent resolved the matter, he explained 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.* at 33 (emphasis added); *compare with Chevron*, 467 U.S. at 842-43 (When "Congress has *directly spoken to the precise question at issue*," that is the end of the matter and "the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.") (emphasis added). Applying the traditional tools of statutory construction, this Court in *Colony* concluded that Congress had "directly spoken to the precise question at issue," and had instructed that an "omission from gross income" occurred *only* where an item of gross income had been left out entirely.

This Court has relied upon legislative history in finding that Congress's intent is unambiguous. *See,*

e.g., *General Dynamics Land Sys., Inc. v. Cline*, 540 U.S. 581, 587-90 (2004); *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133, 137 (2000). Even if this Court decided today that courts should not consult legislative history under *Chevron*'s first step, there is no basis for an agency to disregard a pre-*Chevron* decision of this Court declaring Congress's intent simply because the Court—consistent with existing modes of statutory interpretation—consulted the legislative history and found it "persuasive." 357 U.S. at 33. While legislative history may have fallen out of favor in some quarters since this Court decided *Colony*, principles of *stare decisis* do not lose their force simply because a particular tool of statutory construction is no longer *en vogue*. For purposes of *stare decisis*, the statutory holding must govern.

If it were appropriate or necessary to try to dissect *Colony* through a *Chevron* lens, therefore, Judge Wilkinson was correct that *Colony* is best characterized as a "step one" case. *See* Pet. App. 18a (Wilkinson, J., concurring); *see also 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."). There is thus no room for the agency to overrule *Colony* by "reinterpreting" the statute, because there is no gap for the agency to fill. For that reason alone, the government's reliance (at 50-51) on *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005), is misplaced. Congress's ratification of this

Court's interpretation removes any doubt that the agency is not free to adopt a different one.[15]

B. By Its Own Terms, The Regulation Does Not Apply To The Tax Returns At Issue

1. Even if there were a gap for the agency to fill with respect to the meaning of "omits from gross income," the recent Treasury regulation on which the government relies in this case does not apply. That regulation applies only "to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009." Treas. Reg. § 301.6501(e)-1(e). The plain language of the regulation directs attention to whether the limitations period "was open" in September 2009 and, in particular, whether the "period for assessing tax" "was open" at that time. As explained, the governing law as of September 24, 2009 was this Court's decision in *Colony*. *See supra* at 22-36. The ordinary three-year limitations period therefore applied—and had long-since expired under existing law. The period for assessing respondents' tax

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[15] *Brand X* did not involve an agency's attempt to supplant a statutory holding of this Court. An agency's decision to override an interpretation of a circuit court is at least consistent with the non-acquiescence doctrine under which agencies may decide not to follow the law of a particular circuit. In the constitutional scheme, however, there is something different, and more "disrupt[ive]," about an agency seeking to override a decision of *this* Court. Pet. App. 21a (Wilkinson, J., concurring); *cf. Brand X*, 545 U.S. at 1003 (Stevens, J., concurring). Even assuming, *arguendo*, that the rule of *Brand X* may be extended to Supreme Court decisions, there would have to be no doubt that this Court actually intended to leave room for an agency to override the Court's decision. *Colony* is not susceptible to such an interpretation.

liability thus was not—in any sense—"open on or after September 24, 2009."

The government's contrary argument relies on language that appears in a preamble to the regulation, which asserts that a taxable year is "open" if it is the "subject of any case pending before any court of competent jurisdiction … in which a decision had not become final." 75 Fed. Reg. at 78,898. That is dangerous nonsense. Of course, in some sense a *case* remains open until the exhaustion of all appeals. A *limitations period* that has expired prior to the institution of litigation, however, remains expired and does not become "open" again merely because a case was filed. Were it otherwise, the government could never lose on statute of limitations grounds, because it could always simply file an action after the limitations period has expired and then claim that the limitations period is "open" merely because of pending litigation.

The government says (at 34-35) that the regulation's applicability clause must be read in light of its "substantive provisions," and that in determining whether the period was "open," the Court must apply the Commissioner's new interpretation of "omits from gross income," under which the "period" would be six years, not three. The regulation does not ask whether the limitations period "*would have* been open" in September 2009; it asks whether it "*was* open" on that date, an inquiry that naturally calls for application of the existing law on that date. Tenses matter. *Cf. Cullen v. Pinholster*, 131 S. Ct. 1388, 1398 (2011) (relying on Congress's use of past tense); *Carr v. United States*, 130 S. Ct. 2229, 2237 (2010) (giving effect to Congress's consistent use of the present tense, and contrasting Congress's use of "the past-perfect tense

… when coverage of preenactment events is intended"); *Carcieri v. Salazar*, 555 U.S. 379, 382 (2009) (concluding that phrase "now under Federal jurisdiction" refers to tribes under federal jurisdiction at the time of the statute's enactment).

At a minimum, the regulation does not clearly mandate retroactive application. Indeed, the very same preamble on which the government relies also states that the regulations "are not retroactive." 75 Fed. Reg. at 78,898. The text of the regulation (including the preamble) can in no way be said to mandate the retroactive application of the rule. That is fatal to the government's argument. Just as Congress must speak clearly when it wants to legislate retroactively, "administrative rules will not be construed to have retroactive effect unless their language *requires* this result." *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988) (emphasis added).

2. Perhaps appreciating that the rule's own text is insufficient to make it retroactive, the government suggests that the regulations are not retroactive "in the relevant sense" because they merely "clarify" the law. *See* U.S. Br. 40; *see also* Opp. to Pet. for Cert. at 15 n.4, *Beard v. Comm'r* (No. 10-1553). That argument is unavailing. This Court in *Colony* had settled the meaning of "omits from gross income" as excluding overstatements of basis on the ground they did not constitute omissions. *Supra* at XX. *That* was the law when respondents filed their 1999 tax returns. Indeed, until the new Treasury regulation, it was the nearly uniform view of the courts that *Colony*'s holding

applied to § 6501(e)(1)(A).[16] The regulation did not "clarify" that law; it sought to completely revamp it.

As explained above, *Colony* conclusively resolved the statutory question presented. Even assuming the statute was susceptible to the agency's interpretation, the regulation nonetheless would have effected a substantive change in then-existing law. *See Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735, 744 n.3 (1996) (recognizing that an agency regulation changing a prior interpretation of a statute may constitute an impermissibly retroactive change in the law). This Court's statutory holding in *Colony* had been the law for more than 50 years and had been recognized by the IRS. *See supra* at 9. There was no confusion about the

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[16] *See Benderoff*, 398 F.2d at 137; *White v. Comm'r*, 991 F.2d 657, 661-62 (10th Cir. 1993); *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009); *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767, 776 (9th Cir. 2009); *see also Rhone-Poulenc Surfactants & Specialties, L.P. v. Comm'r*, 114 T.C. 533, 557 (2000); *Quaker State Oil Refining Corp. v. United States*, 24 Cl. Ct. 64 (1991), *aff'd*, 994 F.2d 824 (Fed. Cir. 1993); *Myers*, 30 A.F.T.R. 2d (RIA) 5332; *Bishop*, 338 F. Supp. at 1352; *Russell F. Davis, Inc.*, 170 F. Supp. at 186. *But see Beard v. Comm'r*, 633 F.3d 616, 620 (7th Cir. 2011). *CC&F Western Operations Ltd. Partnership v. Commissioner*, cited by the government (at 41), is not to the contrary. That case did not involve a basis overstatement, was decided more than a year after respondents filed their returns, and merely questioned in dicta whether *Colony*'s interpretation carried over to § 6501. 273 F.3d 402 (1st Cir. 2001). The government relied below on the Fifth Circuit's decision in *Phinney v. Chambers*, 392 F.2d 680 (5th Cir 1968), for the proposition that *Colony*'s holding is limited to the sale of goods or services by a trade or business. *See* U.S. Br. (4th Cir. Apr. 30, 2010) at 12-13, 19, 26, 28-33, 35, 49, 58, 66-67, 75, 81. As that court has explained, however, *Phinney* did not so hold. *See Burks v. United States*, 633 F.3d 347, 352-53 (5th Cir. 2011); *id.* at 353 n.5.

statutory question presented after *Colony*—until the IRS issued the regulation at issue.

For those reasons (and others), the lower court decisions relied upon by the government (at 40-41) in arguing that the change at issue is merely a "clarification" are readily distinguishable. Those cases are nevertheless pertinent in one important respect: they recognize that "an enacting body's description of an amendment as a 'clarification'" is by no means controlling. *Levy v. Sterling Holding Co.*, 544 F.3d 493, 507 (3d Cir. 2008), *cert. denied*, 129 S. Ct. 2827 (2009) (citation omitted). Otherwise, "an agency could make a substantive change merely by referring to a new interpretation as a 'clarification.'" *Pope v. Shalala*, 998 F.2d 473, 483 (7th Cir. 1993), *overruled on other grounds by Johnson v. Apfel*, 189 F.3d 561 (7th Cir. 1999). That is precisely what the IRS attempts here.

The government also contends (at 41-42) that there is no "relevant" retroactivity problem here because the application of an enlarged statute of limitations is a mere "procedural rule[]," and "the regulation does not bear on the legality of petitioners' primary conduct." The government is mistaken. This Court has recognized that "extending a statute of limitations after the pre-existing period of limitations has expired impermissibly revives a moribund cause of action." *Hughes Aircraft Co. v. United States*, 520 U.S. 939, 950 (1997). Application of the new regulation to the returns at issue here would have a retroactive effect of the most direct and disfavored kind; it would "'attach[] a new disability, in respect to transactions … already past'" by "impermissibly reviv[ing]" the IRS's cause of action and eviscerating an affirmative defense that respondents previously possessed. *Hughes*, 520 U.S. at

947-48, 950 (quoting *Landgraf v. USI Film Prods.*, 511 U.S. 244, 269 (1994)).[17]

3. The government's resort (at 31-32) to *Auer v. Robbins*, 519 U.S. 452, 461 (1997), cannot bridge this gap. U.S. Br. 31-32. First, as with a statute, a regulation that is "ambiguous with respect to retroactive application" must be construed "to be unambiguously prospective." *St. Cyr*, 533 U.S. at 320 n.45. There is "no ambiguity in such a [rule] for an agency to resolve." *Id.* Administrative deference principles cannot change that result. *See id.* (refusing to defer to agency interpretation of statute that was "ambiguous with respect to retroactive application").

Second, the Commissioner's interpretation exceeds the bounds of any conceivable deference. The government's interpretation is flatly inconsistent with the plain text of the regulation and any reasonable meaning of the phrase "was open." *Auer*, 519 U.S. at 461. The Tax Court has aptly called the government's position "irreparably marred by circular, result-driven logic and wishful notion that the … regulations should apply to this case because [the taxpayer] was involved in what [the government] believes was an abusive transaction." *Intermountain Ins. Serv. of Vail, LLC v. CIR*, 134 T.C. 211, 219 (2010) (*en banc*), *rev'd*, 650 F.3d 691 (D.C. Cir. 2011). No measure of agency deference can sustain an interpretation of a rule that conflicts with the rule's own text and creates such a result.

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[17] The harsh retroactive effect of extending a limitations period to resurrect time-barred actions has been widely acknowledged. *See, e.g., Lieberman v. Cambridge Partners, L.L.C.*, 432 F.3d 482, 489 (3d Cir. 2005); *In re Enter. Mortgage Acceptance Co., Sec. Litig.*, 391 F.3d 401, 406-07, 410 (2d Cir. 2004); *Chenault v. United States Postal Serv.*, 37 F.3d 535, 539 (9th Cir. 1994).

Third, the rationales for *Auer* deference are strained beyond the breaking point in these circumstances. The government is a party here—and issued both temporary and proposed final regulations simultaneously, without notice and comment—so there is "reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question." *Auer*, 519 U.S. at 462. In addition, unlike the situation in *Auer*, the agency here can claim no relevant expertise, as compared to the courts, as to limitations periods. *See Gonzales v. Oregon*, 546 U.S. 243, 256-57 (2006). Finally, deferring to an agency in these circumstances would raise serious separation-of-powers concerns by "permit[ting] the person who promulgates a law to interpret it as well." *Talk Am., Inc. v. Michigan Bell Tel. Co.*, 131 S. Ct. 2254, 2266 (2011) (Scalia, J., concurring); *see also* John F. Manning, *Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*, 96 Colum. L. Rev. 612 (1996).

C. In Any Event, The Regulation Is Invalid

Assuming that the regulation must be interpreted on its own terms to apply retroactively to the circumstances here, it is invalid.

1. If The Regulation Must Be Given Retroactive Effect, It Is *Ultra Vires*

An agency may not engage in retroactive lawmaking *at all* unless Congress has unmistakably authorized it to do so. *Bowen*, 488 U.S. at 208. Before 1996, Congress authorized the Commissioner "to correct any ruling, regulation, or Treasury decision retroactively, but empowered him, in his discretion, to *limit* retroactive application to the extent necessary to

avoid inequitable results." *Automobile Club of Michigan v. Comm'r*, 353 U.S. 180, 184 (1957) (emphasis added); *id.* (construing § 3791(b) of 1939 Code, now codified as relevant in 26 U.S.C. § 7805(b)(5)). That authority was generally designed to allow Treasury to *ameliorate* the otherwise retroactive effect of changes in its *own* internal rules. It does not authorize Treasury retroactively "to correct" a decision of *this* Court and then apply the new rule in a way that would create "inequitable results."

In 1996, Congress changed the law in a way that favors taxpayers and *restricts* the Commissioner's authority to promulgate retroactive rules. That year, Congress—while leaving § 7805(b)(5) in place—added a new provision (§ 7805(b)(1)) that generally prohibits retroactive regulations related to the tax laws with limited exceptions not relevant here. That prohibition reflects Congress's view that "it is generally inappropriate for Treasury to issue retroactive regulations." H.R. Rep. No. 104-506, at 44 (1996); *see* Benjamin J. Cohen & Catherine A. Harrington, *Is the Internal Revenue Service Bound by Its Own Regulations and Rulings?*, 51 Tax Law. 675, 698-99 (1998) (discussing legislative efforts to prohibit retroactive rulemaking by Treasury).

The 1996 amendments to § 7805 state that the new provisions "shall apply with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment." Pub. L. No. 104-168, § 1101(b), 110 Stat. 1452, 1469 (1996); 26 U.S.C. § 7805 (note). The government argues that the old version of § 7805(b) applies to *all* post-1996 regulations, unless the underlying Code section was enacted after July 30, 1996. U.S. Br. 42-43. That reading would reduce to a

whimper Congress's stated intent generally to *prohibit* retroactive Treasury regulations affecting taxpayers.

The more natural reading—and the only reading that is consistent with Congress's stated intent and the distinction it drew between substantive tax regulations and those relating to internal agency matters—is that the phrase "enacted on or after" modifies "*regulations* related to statutory provisions"—not just "statutory provisions." *See Black's Law Dictionary* 1280 (9th ed. 2009) ("positive law" includes "enacted law—the codes statutes, and regulations"); *Burks v. United States*, 633 F.3d 347, 350 (5th Cir. 2011) ("recently enacted Treasury Regulations"); *Transpac Drilling Venture 1982-12 v. Comm'r*, 147 F.3d 221, 228 (2d Cir. 1998) ("other regulations enacted"); Internal Revenue Manual § 1.15.2.4 (Mar. 12, 2010), *available at* http://www.irs.gov/irm/part1/irm_01-015-002.html ("[s]pecific laws and regulations were enacted"). Thus, § 7805(b)(1) prohibits retroactivity as to all regulations enacted after July 30, 1996 if they relate to "statutory provisions"—as opposed to *internal* Treasury matters, where retroactivity is permitted.[18]

At a minimum, even if the Commissioner otherwise has statutory authority retroactively to enact the kind of regulation at issue, the Commissioner's attempt retroactively to change the law in the extraordinary circumstances here is an abuse of discretion—and thus *ultra vires*, *see Automobile Club of Michigan*, 353 U.S.

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[18] Congress *has* authorized the IRS to "provide that any regulation may take effect or apply retroactively to prevent abuse." 26 U.S.C. § 7805(b)(3). But the agency did not attempt to invoke that authority in issuing the regulation here, and thus may not defend the regulation on that ground in this Court. *See SEC v. Chenery Corp.*, 318 U.S. 80, 95 (1943).

at 184-85—for the same basic reasons that the agency is not entitled to any deference in this case.

2. The Regulation Is Not Entitled To *Chevron* Deference

In any event, the regulation is not entitled to deference under *Chevron* and *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704, 711 (2011), for at least two reasons.

First, the regulation impermissibly attempts to dictate the outcome of pending litigation in which the agency is a party. This Court has long recognized that "[d]eference to what appears to be nothing more than an agency's convenient litigating position" is "entirely inappropriate." *Bowen*, 488 U.S. at 213; *see also Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971). The history of the regulation at issue here makes clear that it was issued to advance the agency's litigating position in cases in which the agency was a party—and, indeed, was a transparent attempt to reverse the tide of one loss after another on its implausible reading of the statute in the face of this Court's construction of the same language in *Colony*.[19]

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[19] This is not the first time that the Treasury has tried to utilize retroactive regulations to decide pending litigation in which it was a party. The Treasury issued Regulation § 1.752-6 in similar circumstances, in an attempt to expand the meaning of the term "liability" for purposes of § 752. Like the regulations at issue here, Regulation § 1.752-6 was almost uniformly rejected by the courts that considered it. *See, e.g.*, *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 526 (2009); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636, 671 (2008), *aff'd*, 608 F.3d 1366 (Fed. Cir. 2010); *Sala v. United States*, 552 F. Supp. 2d 1167, 1197 (D. Colo. 2008); *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608, 625 (E.D. Tex. 2006).

The government's reliance (at 39-40) on *Mayo*, *Smiley*, and *United States v. Morton*, 467 U.S. 822 (1984), is misplaced. None of those decisions involved a regulation that purported to change *well settled law* in the midst of litigation in which the agency was a party. *See Smiley*, 517 U.S. at 744 n.3 ("There might be substance to this point if the regulation replaced a prior agency interpretation—which, as we have discussed, it did not."); *see also Burks*, 633 F.3d at 360 n.9 (explaining that *Mayo* did not involve 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."). Whatever leeway an agency has to issue regulations in the midst of pending litigation, the extraordinary agency conduct at issue here passes the breaking point.

Second, the agency's interpretation cannot be sustained under *Chevron* step two because the agency's stated rationale for its choice of "reasonable" interpretations is based on a mistaken premise. As explained above, this Court conclusively interpreted the key statutory language at issue here in *Colony*, rejecting the same arguments advanced by the agency in support of its regulations. Moreover, Congress, by its actions in the decades since *Colony*, has ratified this Court's statutory holding. Even assuming that the statute was susceptible to more than one reasonable interpretation at the time of *Colony*, it is not susceptible to the Commissioner's interpretation today—and therefore fails *Chevron*'s second step. If that step is to have any vitality, it should apply in this case to prevent the IRS's unreasonable action here.

3. The Regulation Is Procedurally Defective

The temporary regulation was issued without the requisite notice and comment—a practice Treasury apparently employs with some frequency. *See* Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack Of) Compliance With Administrative Procedure Act Rulemaking Requirements*, 82 Notre Dame L. Rev. 1727, 1730 (2007). The regulation thus flouts the requirements of the Administrative Procedures Act (APA), 5 U.S.C. § 553.

The APA's notice-and-comment requirement is grounded on the commonsense notion that an agency should provide notice and obtain comments *before* deciding what rule is appropriate, and not to issue the rules first, only to go through the motions of notice and comment after the agency has made up its mind. Anyone familiar with the inertias of the administrative state knows that notice and comment is a virtually meaningless charade if carried out in such fashion. *Cf. Ramaprakash v. FAA*, 346 F.3d 1121, 1122 (D.C. Cir. 2003) ("Learned Hand once remarked that agencies tend to 'fall into grooves, and when they get into grooves, then God save you to get them out.") (Roberts, J.) (alteration and citation omitted). The fact that Congress authorized agencies to bypass the notice-and-comment requirement where immediate guidance is necessary underscores that Congress did not intend to authorize agencies to dispense with that requirement as they see fit in *non*-emergency circumstances like those the IRS faced in 2009. *See* 5 U.S.C. § 553(b)(B); *see generally* Br. of Prof. Hickman as *Amicus Curiae* in Support of Respondents.

III. THE COMMISSIONER HAS AMPLE TOOLS AT HIS DISPOSAL TO IDENTIFY AND TIMELY ADDRESS PERCEIVED TAX SHELTER TRANSACTIONS

The government's policy arguments for why it needed a six-year period here are better directed to Congress than this Court. They are also unpersuasive. As discussed, the extended six-year limitations period is designed to provide the IRS with additional time only where it "is at a special disadvantage in detecting errors" because "the return on its face provides no clue to the existence of the omitted item." *Colony*, 357 U.S. at 36. Here, the returns on their face disclosed all the facts necessary for the IRS to determine whether a closer look was warranted. *See supra* at 26-28. The problem was not the IRS's *inability* to detect clues from the returns; it was that the Commissioner's agents waited nearly six years before they even *examined* the returns. Add. 19a. In any event, Congress has provided the IRS with ample tools to address perceived tax-shelter transactions generally, and alleged Son-of-BOSS transactions, specifically.

The IRS has broad authority under the Code to prescribe the type and form of information that taxpayers must provide for virtually any transaction. *E.g.*, 26 U.S.C. § 6011(a) (requiring "a return or statement according to the forms and regulations prescribed by the [IRS]" that "shall include therein the information required by such forms or regulation"). The agency also has broad examination authority to obtain documents and sworn testimony from taxpayers and third parties. *E.g.*, 26 U.S.C. § 7602(a).

Moreover, Congress has enacted several provisions requiring taxpayers and their advisors to disclose

participation in listed transactions. *E.g.*, 26 U.S.C. §§ 6011, 6111, 6112, 6707, 6707A, 6708. Failure to comply with these reporting obligations extends the limitations period for assessment. For example, § 6501(c)(10) requires a taxpayer to self-report its participation in a listed transaction. The failure to self-report tolls the statute of limitations until such information is furnished to the IRS. Similarly, § 6501(c)(8) provides that in the case of information required to be reported with respect to certain foreign transactions, the statute of limitations for assessment of tax shall extend until three years "after the date on which the Secretary is furnished the information" required to be reported under such section." Section 7609(e) suspends the limitations period indefinitely if a taxpayer fails to respond to a summons issued in connection with a listed transaction.

More specifically, in the wake of "Son-of-BOSS," the IRS immediately took several steps to identify and address perceived tax-shelter transactions. For example, the IRS: (1) issued regulations modifying reporting obligations for listed transactions (Temp. Treas. Reg. § 1.6011-4T, *reprinted in* 67 Fed. Reg. 64,799, 64,802-05 (Oct. 22, 2002)); (2) issued letters to several parties that it believed had promoted Son-of-BOSS transactions (2001 TNT 250-1 (Dec. 28, 2001)); (3) issued a report to Treasury on listed transactions and Notice 2000-44 (2001 TNT 250-11 (Dec. 28, 2001)); (4) issued a Partnership Audit Technique Guide addressing tax shelters and Notice 2000-44 (2003 TNT 241-26 (Dec. 16, 2003)); and (5) issued a "Son-of-BOSS Toolkit" to its agents detailing how to identify the transactions on a tax return. The IRS took each of

these steps before April 2003, when the limitations period for the returns at issue here expired.

* * * * *

What the Commissioner has attempted to do here is truly remarkable: retroactively overrule a decision of this Court conclusively resolving the meaning of a statutory provision in order to enlarge a limitations period for the purpose of altering the course of ongoing litigation in which the agency is a party. As Judge Wilkinson aptly observed below, the government's position calls for "something of an inversion of the universe and to pass the point where the beneficial application of agency expertise gives way to a lack of accountability and risk of arbitrariness." Pet. App. 20a (concurring). Neither *Chevron* nor any other principle of agency deference provides any reason for this Court to countenance such an unsettling agency action.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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§ 6501. Limitations on assessment and collection

* * *

(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.

* * *

(2) Estate and gift taxes

In the case of a return of estate tax under chapter 11 or a return of gift tax under chapter 12, if the taxpayer omits from the gross estate or from the total amount of the gifts made during the period for which the return was filed items includible in such gross estate or such total gifts, as the case may be, as exceed in amount 25 percent of the gross estate stated in the return or the total amount of gifts 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. In determining the items omitted from the gross estate or the total gifts, there shall not be taken into account any item which is omitted from the gross estate or from the total gifts stated in the return if such item 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), (e)(2) (1958)

§ 6501. Limitations on assessment and collection.

* * *

(e) Omission From Gross Income.

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 or his delegate of the nature and amount of such item.

* * *

(2) Estate and gift taxes.

In the case of a return of estate tax under chapter 11 or a return of gift tax under chapter 12, if the taxpayer omits from the gross estate or from the total amount of the gifts made during the year items includible in such gross estate or such total gifts, as the case may be, as exceed in amount 25 percent of the gross estate stated in the return or the total amount of gifts 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. In determining the items omitted from the gross estate or the total gifts, there shall not be taken into account any item which is omitted from the gross estate or from the total gifts stated in the return if such item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

* * *

26 U.S.C. § 275(a), (c) (1940)

§ 275. Period of limitation upon assessment and collection.

Except as provided in section 276—

(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.

* * *

26 U.S.C. § 61 (2006)

§ 61. Gross income defined

(a) General definition

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) Cross references

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

26 U.S.C. § 22(a) (1940)

§ 22. Gross income—(a) General definition.

"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and Judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

26 U.S.C. § 7805(b)(1), (b)(5), note (2006)

§ 7805. Rules and regulations

* * *

(b) Retroactivity of regulations

(1) In general

Except as otherwise provided in this subsection, no temporary, proposed, or final regulation relating to the internal revenue laws shall apply to any taxable period ending before the earliest of the following dates:

(A) The date on which such regulation is filed with the Federal Register.

(B) In the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register.

(C) The date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public.

* * *

(5) Internal regulations

The limitation of paragraph (1) shall not apply to any regulation relating to internal Treasury Department policies, practices, or procedures.

* * *

EFFECTIVE DATE OF 1996 AMENDMENT

Section 1101(b) of Pub. L. 104-168 provided that:

"The amendment made by subsection (a) [amending this section] shall apply with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment of this Act [July 30, 1996]."

* * *

26 U.S.C. § 6229 (1982)

* * *

§ 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.

* * *

(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".

* * *

Pub. L. No. 99-514, 100 Stat. 2085 (1986)

SEC. 2. INTERNAL REVENUE CODE OF 1986.

(a) REDESIGNATION OF 1954 CODE.—The Internal Revenue Title enacted August 16, 1954, as heretofore, hereby, or hereafter amended, may be cited as the "Internal Revenue Code of 1986".

(b) REFERENCES IN LAWS, ETC.—Except when inappropriate, any reference in any law, Executive order, or other document—

(1) to the Internal Revenue Code of 1954 shall include a reference to the Internal Revenue Code of 1986, and

(2) to the Internal Revenue Code of 1986 shall include a reference to the provisions of law formerly known as the Internal Revenue Code of 1954.

* * *

TREASURY REGULATION § 301.6501(e)-1 (2010)

§ 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)(i).

* * *

(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.

* * *

TEMPORARY TREASURY REGULATION § 301.6501(e)-1T (Sept. 2009)

§ 301.6501(e)-1T Omission from return (temporary).

(a) *Income taxes*—(1) *General rule.* (i) If the 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.

(2) [Reserved]

(b) *Effective/applicability date.* The rules of this section apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009.

(c) *Expiration date.* The applicability of this section expires on or before September 24, 2012.

26 C.F.R. § 301.6501(e)-1(a)
(in effect from 1956 to Sept. 2009)

§ 301.6501(e)–1 Omission from return.

(a) *Income taxes*—(1) *General rule.* (i) If the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Code an amount properly includible therein which 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 such tax may be begun without assessment, at any time within 6 years after the return was filed.

(ii) For purposes of this subparagraph, 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 such sales or services. An item shall not be considered as omitted from gross income if information, sufficient to apprise the district director of the nature and amount of such item, is disclosed in the return or in any schedule or statement attached to the return.

* * *

26 C.F.R. § 29.22(a)-5 (1949)

§ 29.22(a)-5 *Gross income from business.* In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. But see § 29.23 (m)-1(f).

* * *

Internal Revenue Service

Department of the Treasury

Date: February 23, 2006

	Taxpayer Identification Number: 56-2136387
	Form: 1065
Home Concrete & Supply, LLC Robert L. Pierce TMP 2812 Shady Ave. Wilmington, NC 28409	Tax Period(s): 1999
	Person to Contact: William C. Maier Jr.
	Contact Telephone Number: 408.817.6307
	Contact Fax Number: 408.817.6795
	Employee Identification Number: 77-02014

Dear Mr. Pierce,

Your federal return for the period(s) shown above has been selected for examination.

What You Need To Do

Please call me on or before March 9, 2006. I can be contacted from 8am PST to 5pm PST at the contact telephone number provided above.

Letter 2205-A (Rev. 10-2005)
Catalog Number 37456E

What We Will Discuss

During our telephone conversation, we will discuss:

- Items on your return that I will be examining.
- Types of documentation I will ask you to provide.
- The examination process.
- Any concerns or questions you may have.
- The date, time and agenda for our first meeting.

The issues listed below are the preliminary items identified for examination. During the course of the examination, it may be necessary to expand or contract the list of items. If this should occur, I will advise you of the change.

• Notice 2000-44 Transaction	•	•
•	•	•

Someone May Represent You

You may have someone represent you during any part of this examination. If you want someone to represent you, please provide me with a completed Form 2848, *Power of Attorney and Declaration of Representative*, at our first appointment.

If you prefer, you may mail or fax the form to me prior to our first appointment. You can get this form from our office, or from our web site at www.irs.gov, or by calling 1-800-829-3676. If you decide that you wish to get representation after the examination has started, we will delay further examination activity until you can secure representation.

Letter 2205-A (Rev. 10-2005)
Catalog Number 37456E

Your Rights As A Taxpayer

We have enclosed Publication 1, *Your Rights as a Taxpayer*, and Notice 609, *Privacy Act Notice.* We encourage you to read the Declaration of Taxpayer Rights found in Publication 1. This publication discusses general rules and procedures we follow in examinations. It explains what happens before, during, and after an examination, and provides additional sources of information.

Thank you for your cooperation, and I look forward to hearing from you by March 9, 2006,

Sincerely,

s/ William C. Maier Jr.

William C. Maier Jr.
Internal Revenue Agent

Enclosures:
Publication 1
Notice 609
Form 4564 Information Document Request one

Letter 2205-A (Rev. 10-2005)
Catalog Number 37456E