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No. 11-139

# In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

*v.*

HOME CONCRETE & SUPPLY, LLC, ET AL.

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

## REPLY BRIEF FOR THE UNITED STATES

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Respondents make little effort to tie their interpretation of 26 U.S.C. 6501(e)(1)(A) to the text of that provision. Rather, they rely on *Colony, Inc.* v. *Commissioner*, 357 U.S. 28 (1958) (*Colony*), which involved a predecessor statute rather than Section 6501(e)(1)(A) in its present form. Contrary to respondents' contentions, however, the statutory language has changed in important respects that the *Colony* Court had no occasion to consider, and the Court recognized in any event that the earlier version of the statute was ambiguous. Accordingly, neither text nor precedent foreclosed the Treasury Department from adopting, through notice-and-comment rulemaking, its current reasonable interpretation of the disputed statutory language.

### A. An Overstatement Of Basis Can Trigger Section 6501(e)(1)(A)'s Six-Year Assessment Period

#### *1. The statutory text is naturally construed to encompass an understatement of gross income attributable to an overstatement of basis*

Under Section 6501(e)(1)(A), the Internal Revenue Service (IRS) has six years from the filing of a return to assess additional taxes "[i]f 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 amount of unreported income at issue here—approximately $6 million—is "in excess of 25 percent of the amount of gross income stated in the return." Thus, the only question is whether respondents "omit[ted]" that "amount" from their "gross income" when they (i) overstated their bases in Home Concrete, (ii) subtracted those inflated amounts from their shares of the sale proceeds, and (iii) thereby reported gains from the sale of Home Concrete that were a tiny fraction of their actual gains. If the statutory terms are given their ordinary meaning, the $6 million difference between respondents' actual capital gains and their reported gains is naturally treated as "an amount" that was "properly includible" (*i.e.*, that ought to have been included) in respondents' "gross income," but that respondents instead "omit[ted]."

Respondents omitted that amount from their gross income by overstating their bases in Home Concrete, no less than if they had understated the partnership's sales price. When a taxpayer reports the capital gains from a property sale on Schedule D of his tax return, he does so by listing the property, its "[c]ost or other basis," and its "[s]ales price." See, *e.g.*, J.A. 128. The taxpayer's capital gain is then calculated by subtracting the basis from the sales

price. *Ibid.* It therefore does not matter which variable—sales price or basis—a taxpayer misrepresents on his return: a misstatement in either column results in an omission of an amount of the taxpayer's gross income. See Gov't Br. 15-16, 19-20.

Respondents do not contend that Section 6501(e)(1)(A) distinguishes between overstatements of basis and understatements of sales price. Respondents argue instead that Section 6501(e)(1)(A) is inapplicable so long as a taxpayer reports the fact of a property sale and acknowledges that he received *some* gross income from it. In respondents' view, a taxpayer "omits from gross income an amount properly includible therein" only when "an *item* of gross income" is "left out entirely" from the return. Br. 37 (emphasis added). The ordinary meaning of the statute's terms does not support, much less compel, that limitation. See Gov't Br. 18-19. If a taxpayer sells property for $10 million but misrepresents the sales price to be $1 million, he is naturally described as "omit[ting] from gross income an amount [*i.e.*, $9 million] properly includible therein," just as if he had failed entirely to report a $9 million sale.

***2. Statutory amendments enacted in 1954 reinforce the conclusion that an overstated basis can trigger the six-year period***

As respondents observe (Br. 23-25), the dispute between the parties in this case parallels to a significant degree the dispute concerning Section 6501(e)(1)(A)'s predecessor statute (26 U.S.C. 275(c) (1940)) that the Court resolved in *Colony*. The government argued in *Colony* that Congress's "use of the word 'amount' (instead of, for example, 'item') suggests a concentration on the quantitative aspect of the error—that is, whether or not gross income was understated by as much as 25%." 357 U.S. at 32. The taxpayer

countered that Congress's use of "the word 'omits,' * * * when it could have chosen another verb such as 'reduces' or 'understates,'" limited the statute "to situations in which specific receipts or accruals of income items are *left out* of the computation of gross income." *Id.* at 32-33.

The *Colony* Court stated that, although it was "inclined to think that the statute on its face lends itself more plausibly to the taxpayer's interpretation, it cannot be said that the language is unambiguous." 357 U.S. at 33. The Court therefore "turn[ed] to the legislative history of [Section] 275(c)," *ibid.*, and held that former Section 275(c) encompassed only "a taxpayer's omission to report some taxable item," *id.* at 36. In reaching that conclusion, however, the Court had no occasion to consider two changes that Congress had made to the statute in 1954. Those changes did not apply to the tax years at issue in *Colony*, but they provide strong contextual support for the government's reading of current Section 6501(e)(1)(A).

a. *First*, Congress added Section 6501(e)(2), which applies to estate and gift taxes and allows the IRS six years from the filing of a return to assess additional tax "if the taxpayer omits * * * *items* includible" in the gross estate. 26 U.S.C. 6501(e)(2) (emphasis added). Congress used the term "items" to indicate that, in the estate- and gift-tax contexts, the six-year period is not triggered by an alleged undervaluation of property. See Gov't Br. 23. By contrast, Sections 6501(e)(1)(A) and (B), which define the assessment period for income taxes, and Section 6501(e)(3), which defines the assessment period for excise taxes, all refer to the omission of "an amount" from gross income.

Respondents make no meaningful effort to explain why Congress would use the term "item" in some provisions and "amount" in others if it had intended for both terms to be given the same meaning. Instead, they argue (Br. 35 &

n.14) that in 1965, when Congress changed the heading of Section 6501(e) from "Omission from gross income" to "Substantial omission of items," it eliminated any distinction between omission of "amount[s]" and omission of "items." Excise Tax Reduction Act of 1965, Pub. L. No. 89-44, Tit. VIII, § 810(b)(2), 79 Stat. 169. Congress gave no reason for that "[c]lerical amendment" (*ibid.*) to the heading, however, and the general focus of the 1965 amendments was on the excise-tax provision in Subsection (e)(3) rather than the income-tax provision in Subsection (e)(1). In any event, "a sub[section] heading cannot substitute for the operative text of the statute." *Florida Dep't of Revenue* v. *Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 47 (2008). Indeed, the Internal Revenue Code provides that "descriptive matter" relating to the Code's contents shall not be given "any legal effect." 26 U.S.C. 7806(b). The shorthand terminology used in Section 6501(e)'s heading therefore does not negate the inference that would otherwise naturally be drawn from Congress's use of different terms in Sections 6501(e)(1)(A) and 6501(e)(2).

b. *Second*, the 1954 amendments added subparagraph (i) of Section 6501(e)(1)(A), which provides 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." 26 U.S.C. 6501(e)(1)(A)(i). At that time, the circuits were divided on whether a basis overstatement can give rise to an omission from gross income. See *Intermountain Ins. Serv. of Vail, LLC* v. *Commissioner*, 650 F.3d 691, 704-705 (D.C. Cir. 2011) (*Intermountain*), petition for cert. pending, No. 11-663 (filed Nov. 16, 2011); see also Gov't Br. 45-46. Virtually all of those lower-court cases involved trades or businesses that had overstated their cost of goods sold. See *id.* at 53 n.8. Congress

amended the statute to make clear that, for trade-or-business taxpayers, an overstatement of basis or cost of goods sold cannot trigger the six-year assessment period. The amendment would have been unnecessary if, as respondents contend, a basis overstatement cannot trigger the six-year period for *any* taxpayer.

Respondents argue that "[i]t 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 belt[]-and-suspenders component to its action." Br. 31. In interpreting statutes, however, this Court typically presumes that Congress amends its handiwork for a real and substantial reason. See *Babbitt* v. *Sweet Home Chapter of Cmtys. for a Great Or.*, 515 U.S. 687, 701 (1995). The historical backdrop against which the 1954 Congress acted reinforces that normal inference. Although the pre-1954 cases involving basis overstatements typically involved trade-or-business taxpayers, former Section 275(c) did not distinguish between those taxpayers and others. By establishing a special rule for trade-or-business taxpayers, subparagraph (i) reflected a departure from Congress's prior approach to the definition of appropriate assessment periods. That special rule makes sense, because unlike the one-time transaction at issue here, trades and businesses engage in repeated and routine sales where the bases or costs of goods sold are often easier for the government to gauge and businesses' miscalculations could frequently give rise to the extended assessment period.

Respondents further argue that Congress could not have intended "to change the 'General rule' in former [Section] 275(c) that it left untouched by adding a subparagraph addressing only a particular situation." Br. 32. The government's position in this case, however, does not depend on the premise that the 1954 Congress *intentionally* changed

the law with respect to non-trade-or-business taxpayers. Congress enacted the 1954 amendments four years before this Court's decision in *Colony*. As explained above, those amendments contained provisions that would be anomalous if the omission of an *item* of gross income were necessary to trigger Section 6501(e)(1)(A)'s six-year assessment period. The most natural inference is that Congress believed in 1954 that non-trade-or-business taxpayers were *already* subject to the extended assessment period if they substantially understated their gross income, including by overstating their bases in sold property. To be sure, the Court in *Colony* subsequently determined that this reading of former Section 275(c) was incorrect. But the 1954 Congress's apparent misunderstanding of pre-1954 law provides no legitimate ground for refusing to consider the full statutory context in construing current Section 6501(e)(1)(A).

#### *3. Congress has not acted since the 1954 amendments to change the general rule that an overstated basis can trigger the six-year period*

This Court in *Colony* observed, with respect to the phrase "omits from gross income an amount properly includible therein" in former Section 275(c), that "it cannot be said that the language is unambiguous." 357 U.S. at 33. After resolving that ambiguity in the taxpayer's favor, the Court noted at the end of its opinion that its conclusion was "in harmony with the unambiguous language of [Section] 6501(e)(1)(A) of the Internal Revenue Code of 1954." *Id.* at 37. In an accompanying footnote, the Court reproduced the text of the amended provision, including subparagraph (i). *Id.* at 37 n.3.

In characterizing new Section 6501(e)(1)(A) as "unambiguous," the *Colony* Court could not have been referring to the portion of the text that was common to both the 1939

and 1954 Codes. That reading would mean that "within the span of just four pages of the U.S. Reports," the Court described the same language "as both ambiguous and unambiguous." *Intermountain*, 650 F.3d at 703. Rather, it makes far more sense to read the concluding reference to "the unambiguous language of [Section] 6501(e)(1)(A)" as an allusion to new subparagraph (i). Subparagraph (i) prevents an overstatement of the cost of goods or services sold by a trade or business like Colony from triggering the six-year period, because such an overstatement does not affect the calculation of the trade-or-business taxpayer's gross income. The Court's disposition of *Colony* therefore was "in harmony with" the outcome that Section 6501(e)(1)(A)(i) would have mandated. 357 U.S. at 37.[1]

For that reason, respondents are wrong in suggesting (Br. 33) that Congress's failure to amend Section 6501(e)(1)(A) in the years since *Colony* supports their position. By enacting new subparagraph (i) four years before the *Colony* decision, Congress had already made clear that post-1954 trade-or-business taxpayers should for these purposes be treated differently from other post-1954 taxpay-

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[1] The taxpayer at issue in *Colony* was a real estate developer that was subdividing farm land into residential lots and selling those lots to individual buyers. Respondents' contention (Br. 32 & n.7) that *Colony* did not involve the sale of goods by a trade or business is therefore misplaced. Although land is not normally considered a good, when property is held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business, those transactions are treated for tax purposes as sales of goods rather than as sales of capital assets. See 26 U.S.C. 1221(a)(1); Treas. Reg. 1.1221-1(b); 26 U.S.C. 117(1)(A) (1952). Consistent with that principle, the taxpayer in *Colony*, both on its tax returns and during the litigation before the Tax Court, "described itself as a taxpayer in a trade or business with income from the sale of goods or services." *Intermountain*, 650 F.3d at 703; see Gov't Br. 52-53.

ers. *Colony* itself involved a business entity, and the Court's observation about the manner in which the case would have been decided under the 1954 amendments is best understood as reflecting awareness of that specific provision. And while subparagraph (i) makes clear that an overstatement of basis cannot trigger the six-year assessment period in the trade-or-business context, both subparagraph (i) and Section 6501(e)(2) indicate that a different rule applies to non-trade-or-business taxpayers. See pp. 4-7, *supra*. Because the Court in *Colony* had no occasion to consider the application of then-new Section 6501(e)(1)(A) to taxpayers other than trades or businesses, Congress's failure to amend the provision in subsequent years does not support respondents' position. See *Intermountain*, 650 F.3d at 705.[2]

Respondents assert that "[w]hen Congress reenacted [Section] 6501 as part of the 1986 Code, it did so against the backdrop" of "cases applying *Colony*'s holding" to Section 6501(e)(1)(A). Br. 33. But none of the cases that respondents cite (see *id.* at 33 n.13) addressed the question whether an overstatement of basis triggers the extended six-year assessment period in Section 6501(e)(1)(A). They all addressed the distinct question whether a taxpayer that had omitted a substantial amount of gross income from his return could nevertheless invoke the statutory safe harbor for disclosure because his return was "adequate to apprise the

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[2] As in *Colony*, resolution of the question presented here would be easier if Section 6501(e)(1)(A) either required the omission of an "item" of gross income or applied by its terms to "understatements" of gross income. See 357 U.S. at 32-33; pp. 3-4, *supra*. But the recognition that Congress could have spoken more clearly is the beginning rather than the end of the interpretive inquiry.

Secretary of the nature and amount of [the omitted] item," 26 U.S.C. 6501(e)(1)(A)(ii).[3]

In 1982, Congress enacted a parallel provision for partnership returns, 26 U.S.C. 6229(c)(2), which applies when "any partnership omits from gross income an amount properly includible therein." That provision is not at issue here because this case involves only omissions from individual partners' returns (subject to Section 6501(e)(1)(A)) and not omissions from Home Concrete's partnership return (subject to Section 6229(c)(2)). Respondents suggest (Br. 34-35), however, that because Section 6229(c)(2) lacks any analogue to subparagraph (i) of Section 6501(e)(1)(A), subparagraph (i) must not be germane to Section 6501(e)(1)(A)'s proper construction. That argument lacks merit.

When Congress enacted Section 6229(c)(2), it adopted the same general rule as in Section 6501(e)(1)(A) and reasonably presumed that the two provisions would be interpreted *in pari materia*. See *Intermountain*, 650 F.3d at 705. The Treasury Department has adopted that approach, see Pet. App. 51a-52a, to ensure that partners are not "treated differently based on the happenstance of whether the transaction is reported on a partnership return rather than on a partner's return." 74 Fed. Reg. 49,321 (Sept. 28, 2009). No canon of statutory construction required the Department either to give different meanings to Sections 6229(c)(2) and Section 6501(e)(1)(A) or to ignore probative

[3] See *Benderoff* v. *United States*, 398 F.2d 132, 135 (8th Cir. 1968); *Myers* v. *United States*, No. 71-126, 1972 WL 3167, at *10 (S.D. Cal. July 20, 1972); *Bishop* v. *United States*, 338 F. Supp. 1336, 1349 (N.D. Miss. 1970); *University Country Club, Inc.* v. *Commissioner*, 64 T.C. 460, 469 (1975); *Quick's Trust* v. *Commissioner*, 54 T.C. 1336, 1346 (1970); cf. *Russell F. Davis, Inc.* v. *United States*, 170 F. Supp. 185, 186 (N.D. Ind. 1959) (addressing a basis misstatement under former Section 275(c)).

contextual evidence bearing on the proper construction of Section 6501(e)(1)(A).

#### *4. The statutory purpose strongly supports extending the period for discovery of a basis overstatement*

a. Relying on *Colony*, respondents argue (Br. 24-25) that there is no reason to treat an overstated basis differently from an overstated deduction, which can also be difficult to detect. Contrary to respondents' suggestion (*ibid.*), however, the difference in treatment does not create any "patent incongruity" in the tax laws. *Colony*, 357 U.S. at 36. Although overstatements of basis and overstatements of deductions may both result in understatement of *taxable* income, only the former can affect the taxpayer's calculation of *gross* income. And the distinction between the two concepts is deeply ingrained in the Internal Revenue Code. See, *e.g.*, 26 U.S.C. 63(a). In limiting Section 6501(e)(1)(A)'s six-year assessment period to cases involving substantial omissions from "gross income," Congress chose to encompass only a subset of all cases in which a taxpayer substantially understates his taxable income. But since overstatements of basis *do* result in omissions from gross income, Congress's decision not to sweep more broadly provides no justification for declining to give the statutory text its natural meaning.

b. Respondents contend (Br. 26-29) that their own returns demonstrate the absence of any need for an extended assessment period because those returns gave the IRS all the information it needed to evaluate respondents' gross-income calculations. Even where Section 6501(e)(1)(A)'s general rule applies, however, subparagraph (ii) renders the six-year period inapplicable if the omitted amount was adequately disclosed on the return or on an attached statement. See Gov't Br. 24-25. The district court found that

respondents could not take advantage of that safe harbor because their returns did not adequately disclose the substance of their transactions. See J.A. 98-112. The court of appeals did not overturn that conclusion, and respondents have not urged the Court to affirm the judgment below on the alternate ground that subparagraph (ii) was satisfied.[4] As the case comes to this Court, it must therefore be assumed that respondents did *not* sufficiently apprise the IRS of the omitted $6 million in capital gains.

Respondents also assert that the IRS "waited nearly six years" before examining their returns. Br. 51. The extended assessment period, however, is not limited to cases in which the IRS requires additional time to discover a taxpayer's misstatements *once the IRS has focused upon the taxpayer's return*. In this case, as in many Son-of-BOSS and other tax-shelter cases, the IRS focused on particular taxpayers only after (and because) the tax-shelter promoter identified those taxpayers as shelter participants. In such circumstances, Section 6501(e)(1)(A) increases the likelihood that the period for assessing additional tax will remain open when the IRS receives information that causes it to investigate a return that, on its face, gave the agency no reason to believe that substantial amounts of gross income had been omitted.[5]

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[4] Although the individual partners' returns disclosed "a short sale not closed by the taxpayer," Resp. Br. 28 (quoting J.A. 204, 258; emphasis omitted), the returns did not alert the IRS that the partners had transferred to the Home Concrete partnership the obligation to close the short sale. And nothing on Home Concrete's return indicated that its "step up" in its basis—which is permissible in many circumstances, see 26 U.S.C. 743(b)(1), 754—was tied to the partners' asymmetric treatment of the short sale transactions.

[5] In 2004, Congress amended the statute to address transactions that the IRS has identified as tax-avoidance transactions, see 26 U.S.C.

### B. The Recent Treasury Regulation Resolves Any Statutory Ambiguity By Specifying That An Overstatement Of Basis Triggers The Six-Year Assessment Period

Respondents make little effort to show that the recent Treasury regulation, Treas. Reg. 301.6501(e)-1, reflects an unreasonable interpretation of the statutory text. Rather, respondents and their amici argue that *Colony* left no statutory ambiguity for the government to resolve; that until recently the government had treated *Colony* as dispositive of the question presented here; and that in any event the regulation was invalidly promulgated, does not apply to this case, and is impermissibly retroactive. Those arguments lack merit.

#### *1.* **Colony** ***does not control the interpretation of current Section 6501(e)(1)(A)***

a. The Court in *Colony* did not decide the meaning of Section 6501(e)(1)(A), which did not apply to the tax years at issue in that case. See 357 U.S. at 32, 37. Because the Court construed the statute as it existed before the 1954 amendments, it did not consider the implications of current Sections 6501(e)(1)(A)(i) and 6501(e)(2) for the interpretation of the extended-assessment-period provision. The statutory context has changed since *Colony*, and those changes bear on the proper interpretation of current Section 6501(e)(1)(A). See *Intermountain*, 650 F.3d at 703. By contrast, in adopting the recent regulation, the Treasury Department could consider the implications of adjacent statutory provisions that the *Colony* Court had no occasion to address.

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6501(c)(10), but that amendment does not apply to this case (or any other pending Son-of-BOSS case, as far as the government is aware). See Gov't Pet. Reply Br. 4-5.

In any event, only a judicial decision "hold[ing] that its construction follows from the unambiguous terms of the statute" "displaces a conflicting agency construction." *National Cable & Telecomms. Ass'n* v. *Brand X Internet Servs.*, 545 U.S. 967, 982-983 (2005). The Court in *Colony* found the text of former Section 275(c) to be ambiguous. And "[a]lthough the Court found 'persuasive' evidence in the legislative reports * * * , it did not hold there was no other reasonable interpretation of the history." *Salman Ranch, Ltd.* v. *Commissioner*, 647 F.3d 929, 938 (10th Cir. 2011) (*Salman Ranch II*) (quoting *Colony*, 357 U.S. at 33), petition for cert. pending, No. 11-582 (filed Nov. 7, 2011); see *Intermountain*, 650 F.3d at 702; *Grapevine Imports, Ltd.* v. *United States*, 636 F.3d 1368, 1379 (Fed. Cir. 2011) (*Grapevine*) (same), petition for cert. pending, No. 11-163 (filed Aug. 5, 2011). *Colony* is thus precisely the sort of judicial construction of an ambiguous statute that does *not* foreclose a different agency interpretation.

b. Respondents contend (Br. 42) that for a half-century after *Colony*, until the extensive litigation over Son-of-BOSS shelters, it was well settled that a basis overstatement could not trigger the extended six-year assessment period. None of the pre-2009 decisions that respondents cite for that proposition (Br. 42 n.16), however, held that a basis overstatement could not trigger the six-year period. Rather, so far as the government is aware, *Phinney* v. *Chambers*, 392 F.2d 680 (5th Cir.), cert. denied, 391 U.S. 935 (1968), was the only pre-2009 court of appeals decision that addressed the application of Section 6501(e)(1)(A) to an understatement of gross income that resulted from an overstatement of basis. In *Phinney*, a return filed on behalf of the taxpayer accurately reported the amount of a particular gross receipt, but misrepresented that amount to be the proceeds of a sale of stock rather than (as was actually the

case) a receipt from the collection of a note evidencing an installment sale. See *id*. at 682. The return also reported a stepped-up basis equal to the purported stock-sale price (approximately $375,000) and therefore reported no taxable gain on that amount. *Id*. at 682, 685.

Relying on *Colony*, the taxpayer contended that the six-year assessment period was inapplicable because, "so long as the gross amount reported was not in error, there was no omission of 'an amount' from the return at all." *Phinney*, 392 F.2d at 685. In rejecting that interpretation of Section 6501(e)(1)(A), the court of appeals explained that, due to the return's mischaracterization of the nature of the income item (*i.e.*, as a receipt from a stock sale rather than from an installment note), the government had been denied an adequate opportunity to contest the taxpayer's claim to a stepped-up basis. See *id*. at 684-685. The court in *Phinney* did not announce a categorical rule that an "omi[ssion] from gross income" occurs whenever an overstatement of basis results in an understatement of gross income. Cf. *Burks* v. *United States*, 633 F.3d 347, 355 (5th Cir. 2011), petition for cert. pending, No. 11-178 (filed Aug. 11, 2011). But the court clearly viewed Section 6501(e)(1)(A) as applicable to at least some overstatement-of-basis cases, and it rejected the taxpayer's contention that accurate reporting of an amount of gross receipts forecloses application of the six-year assessment period.

It was then nearly 40 years before any court held that an overstated basis cannot trigger the six-year period. See *Bakersfield Energy Partners, LP* v. *Commissioner*, 128 T.C. 207 (2007), aff'd, 568 F.3d 767 (9th Cir. 2009); but see *Brandon Ridge Partners* v. *United States*, No. 8:06-1340, 2007 WL 2209129, at *8 (M.D. Fla. July 30, 2007) (holding that an overstated basis can trigger the six-year period). And while the Ninth Circuit in *Bakersfield* con-

cluded that *Colony*'s holding applies to the current Section 6501(e)(1)(A), the court suggested that, because the Court in *Colony* had found the language of former Section 275(c) to be ambiguous, "[t]he IRS may have the authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code." 568 F.3d at 778. The IRS therefore moved to promulgate such regulations, first in temporary and then in final form, while the lower courts continued to reach differing conclusions over whether a basis overstatement can give rise to an omission from gross income.[6]

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[6] Respondents cite (Br. 9, 42) two internal IRS documents—a 1976 General Counsel memorandum and a 2000 memorandum from district counsel in Philadelphia—in which the IRS purportedly took a different view of Section 6501(e)(1)(A). By statute, and as the concluding sentences of the documents themselves recite, those memoranda "may not be used or cited as precedent." 26 U.S.C. 6110(k)(3); see *Rhone-Poulenc Surfactants & Specialties, L.P.* v. *Commissioner*, 114 T.C. 533, 543 (2000), appeal dismissed, 249 F.3d 175 (3d Cir. 2001). In any event, neither document addressed the question whether a basis overstatement can give rise to an omission from gross income. And the 1976 General Counsel memorandum quoted with apparent approval a Tax Court decision specifically rejecting the proposition that "if a *type* of income is revealed in a tax return, there is sufficient disclosure, even though the amount is understated." IRS GCM 36856, 1976 WL 39111, at 11 (quoting *William Thomas*, 42 T.C.M. (P-H) ¶ 73,261, at 1190 (1973)). Although the documents cited *Colony* as relevant to the interpretation of Section 6501(e)(1)(A), that provision includes subparagraph (ii), the safe harbor for disclosure. Because *Colony* addressed the adequacy of disclosure under former Section 275(c), the decision has been cited extensively in litigation involving current Section 6501(e)(1)(A)(ii). See pp. 9-10 & n.3, *supra*.

### 2. *The final regulation was validly promulgated, applies to this case, and is entitled to deference*

a. Respondents argue (Br. 50) that the Treasury Department's temporary regulation was procedurally invalid under the Administrative Procedure Act, 5 U.S.C. 553, because it was adopted without notice-and-comment procedures. But the temporary regulation is not at issue here. In December 2010, after notice-and-comment rulemaking, the Department withdrew the temporary regulation and replaced it with the current final rule. See *Intermountain*, 650 F.3d at 709. Even assuming that an earlier procedural violation could conceivably taint the final rule, but see *ibid.*, the Department's "searching consideration" of the single comment that it received during the comment period leaves "no doubt that [it] kept the requisite open mind." *Id.* at 709-710 (internal quotation marks and citation omitted).

b. This case is governed by the final regulation, which "applies to taxable years with respect to which the period for assessing tax was open on or after September 24, 2009." Treas. Reg. 301.6501(e)-1(e). Respondents do not dispute that the determination whether the period was "open" depends on whether the IRS had three or six years to assess additional income taxes. Rather, respondents argue (Br. 39-40) that this Court must ignore the regulation's substantive provisions in construing the rule's applicability clause, because it was settled law at the time the regulation was adopted that *Colony* dictated a three-year period. That argument rests on a mistaken premise. "Because *Colony* never applied to [S]ection 6501(e)(1)(A) * * *, there was no *settled* law for the regulations to change." *Intermountain*, 650 F.3d at 709; see *CC & F W. Operations Ltd. P'ship* v. *Commissioner*, 273 F.3d 402, 406 n.2 (1st Cir. 2001) ("Whether *Colony*'s main holding carries over to [S]ection 6501(e)(1) is at least doubtful."); *Phinney*,

392 F.2d at 684-685. Indeed, an important purpose of the final rule was to clarify the proper resolution of several pending cases that had produced disagreement in the lower courts.

In arguing that the final rule does not apply to this case, respondents ignore not only the regulation's substantive provisions but also the Treasury Department's interpretation of the regulation's applicability clause. In the preamble to the final regulation, the Department explained that, in determining whether the "period for assessing tax * * * was open on or after September 24, 2009," the relevant "period for assessing tax" in cases involving basis overstatement is six rather than three years because "[t]he expiration of the three-year period does not 'close' a taxable year if a longer period applies." Pet. App. 63a; see *Intermountain*, 650 F.3d at 708. Respondents contend that "the agency here can claim no relevant expertise, as compared to the courts, as to limitations periods." Br. 45. But the Department has obvious expertise in clarifying the intended temporal coverage of its own regulation, and the subject matter of the rule (which defines the period within which the IRS may make an *administrative* assessment of additional tax, rather than the period within which suit may be filed in court) is likewise squarely within the agency's sphere of authority. Deference to the Department's interpretation of the applicability clause is particularly appropriate because the Department issued that explanation contemporaneously with the rule itself, in the *Federal Register* preamble. Deferring to such a contemporaneous agency clarification cannot "encourage[] the agency to enact vague rules which give it the power, in future adjudications, to do what it pleases." *Talk Am., Inc.* v. *Michigan Bell Tel. Co.*, 131 S. Ct. 2254, 2266 (2011) (Scalia, J., concurring); cf. John F. Manning, *Constitutional Structure and Judicial Defer-*

*ence to Agency Interpretations of Agency Rules*, 96 Colum. L. Rev. 612, 689-690 (1996).

c. Respondents argue that the final rule is not entitled to deference because it "impermissibly attempts to dictate the outcome of pending litigation in which the agency is a party." Br. 48. This Court has made clear, however, that *Chevron* deference is not rendered inappropriate simply because it was litigation, including litigation to which the agency was a party, that disclosed the need for a regulation. See *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704, 712 (2011); *Smiley* v. *Citibank (S.D.), N.A.*, 517 U.S. 735, 741 (1996); *United States* v. *Morton*, 467 U.S. 822, 836 n.21 (1984). Respondents attempt to distinguish *Mayo*, *Smiley*, and *Morton* on the ground that those cases did not "involve[] a regulation that purported to change *well settled law*." Br. 49. But if (as the government contends) the Treasury Department's construction of Section 6501(e)(1)(A) is not foreclosed by *Colony*, neither precedent nor logic suggests that lower-court decisions adverse to the government can deprive a reasonable agency interpretation of the deference to which it would otherwise be entitled. In any event, Section 6501(e)(1)(A)'s application to cases involving basis overstatements was unsettled when the regulation was adopted, and the rule resolved that uncertainty by codifying the interpretation that the Treasury Department had consistently advanced in prior adjudicative proceedings.

***3. The final regulation is not impermissibly retroactive***

Respondents also argue (Br. 40-43) that the final regulation is impermissibly retroactive. In this and similar cases involving Son-of-BOSS shelters, however, the Treasury Department has consistently maintained that it has six years to assess additional taxes when a taxpayer omits a

substantial amount from his gross income by overstating his basis in property. The purpose of the regulation was not to change the law, but simply to codify the Department's pre-existing interpretation of Section 6501(e)(1)(A). Moreover, the regulation does not bear on the legality of respondents' primary conduct, but simply clarifies the procedural rules governing enforcement of respondents' pre-existing tax liabilities.

In any event, the Treasury Department is authorized to "prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied *without retroactive effect*." 26 U.S.C. 7805(b) (Supp. III 1956) (emphasis added).[7] Under Section 7805(b), a regulation applies retroactively unless the Department in its discretion decides otherwise. See *Dixon* v. *United States*, 381 U.S. 68, 79-80 (1965); *Automobile Club* v. *Commissioner*, 353 U.S. 180, 184 (1957). To the extent that the final regulation at issue here has any retroactive effect, it is a permissible exercise of the Department's authority to promulgate retroactive rules. See *Salman Ranch II*, 647 F.3d at 943; *Grapevine*, 636 F.3d at 1382.

In 1996, Congress amended Section 7805(b) to limit the Treasury Department's authority to adopt regulations with retroactive effect, but those amendments apply only "with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment of this Act." Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1101(b), 110 Stat. 1469. That limitation is not relevant here because the regulation at issue relates to 26 U.S.C. 6501(e)(1)(A), which was enacted as part of the 1954 amendments to the Code. The 1996 legislation did not limit the Department's

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[7] In its opening brief (at 42), the government mistakenly cited 26 U.S.C. 7805(b)(8) (1996), rather than 26 U.S.C. 7805(b) (Supp. III 1956), as the applicable statute in this case.

authority to promulgate retroactive rules relating to pre-existing statutes. See, *e.g.*, *Howard E. Clendenen, Inc.* v. *Commissioner*, 207 F.3d 1071, 1074 (8th Cir. 2000).

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For the foregoing reasons and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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*Solicitor General*

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