Omissions From Gross Income And the *Chenery* Rule

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In *Intermountain Insurance*, the Tax Court held that 2009 regulations providing that an understatement of basis constituted an omission from gross income for purposes of the special rule extending the statute of limitations on assessments to six years could not be upheld under *Brand X* because the Supreme Court's *Colony* decision adopting a contrary rule was a *Chevron* step-one holding and therefore could not be overruled by a regulation. In this article, the author contends that there is an additional reason why these regulations cannot overrule *Colony* — namely, the *Chenery* principle that agency action can be upheld only on the basis articulated by the agency at the time it acted. When the regulations were promulgated, the IRS did not claim to be overruling *Colony*, but claimed only to be overruling the recent circuit decisions holding that *Colony* remains applicable under current law. The author says the regulations can be upheld only if the rationale stated by the IRS is correct, and he argues that it is not.

Background

In September 2009 the IRS and Treasury issued temporary regulations on the special six-year statute of limitations provisions in sections 6501(e)(1)(A) and 6229(c)(2).[1] Under those statutory provisions, if a taxpayer or a 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 [the taxpayer's or partnership's] return," the statute of limitations for assessing the tax is extended to six years from the normally applicable period of three years.

The temporary regulations provide that in applying the special six-year statute of limitations provisions, "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income."[2] Under that interpretation, an omission from gross income would exist when a taxpayer includes in gross income gain on the sale of property but the amount of the gain is understated as a result of overstating the basis of the property. That interpretation of "omission from gross income" in the temporary regulations is at odds with the interpretation adopted earlier last year in decisions by the Ninth and Federal circuits.[3]

Both the Ninth and Federal circuits concluded that they were required to interpret the phrase "omission from gross income" in the six-year statute of limitations provisions to exclude an understatement of gross income resulting from an overstatement of basis. Under that interpretation, an omission from gross income exists when a taxpayer does not report any gain on a sale of property that was sold at a gain, but not when the understated gain is because of an overstatement of basis. Both courts concluded that the issue was controlled by the Supreme Court decision in *Colony, Inc. v. Commissioner*,[4] even though that decision dealt with a predecessor provision in the Internal Revenue Code of 1939 rather than with section 6501(e)(1)(A) under the 1954 Code.

In finding that the issue was controlled by *Colony*, both the Ninth and Federal circuits relied on the fact that the statutory language stating the 25 percent omission test in section 6501(e)(1)(A) is identical to the statutory language that was at issue in *Colony*. Both circuits concluded that the addition of other language in section 6501(e)(1)(A) that was not present in the provision at issue in *Colony* did not affect the interpretation of the language that was at issue.

However, in a passage in its opinion that unquestionably prompted the IRS and Treasury to draft the temporary regulations, the Ninth Circuit suggested that the IRS and Treasury *might* have the authority to prescribe regulations adopting an interpretation at variance with the interpretation adopted in *Colony*:

> However sensible the IRS's argument may be that a taxpayer can "omit . . . an amount" of gain by overstating its basis, this argument is foreclosed by *Colony*. The Court acknowledged that the statutory language was ambiguous, 357 U.S. at 33, but nonetheless rejected the same interpretation the IRS is proposing in this case. The IRS may have the authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code, even if its interpretation runs contrary to the Supreme Court's "opinion as to the best reading" of the provision. *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-983; *accord Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162, 170 (3d Cir. 2008). We do not.[5]

In a previous article[6] I argued that the Supreme Court decision in *Brand X* does not authorize the IRS and

[1]T.D. 9466 (Sept. 28, 2009), *Doc 2009-21297*, *2009 TNT 184-9*.

[2]Temp. reg. sections 301.6229(c)(2)-1T(a)(1)(iii), and 301.6501(e)-1T(a)(1)(iii).

[3]*Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 2009), *Doc 2009-13801*, *2009 TNT 115-10*; *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009), *Doc 2009-17311*, *2009 TNT 145-13*.

[4]357 U.S. 28 (1958).

[5]568 F.3d at 778.

[6]*See* Patrick J. Smith, "*Brand X* and Omissions From Gross Income," *Tax Notes*, Feb. 1, 2010, p. 665, *Doc 2010-604*, or *2010 TNT 22-5*.

Treasury to prescribe regulations overruling *Colony* because *Brand X* authorizes agencies to overrule a statutory interpretation previously adopted by a court *only* when the interpretation adopted by the court is properly characterized as an application of *step two* in the two-step analytical framework established by *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*[7] *Brand X* makes clear that, in contrast, an agency may not overrule a prior statutory interpretation adopted by a court if that prior interpretation represented an application of step one in the *Chevron* framework. A step-one holding is a holding that the particular statutory interpretation adopted by the court represents ''the only permissible interpretation,'' whereas a step-two holding is a holding only that the particular interpretation adopted by the court is ''the best reading'' of the statutory provision, among alternative reasonable interpretations.[8]

Under step one of the *Chevron* framework, ''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.''[9] In *Colony* the Supreme Court considered the statutory text and the relevant legislative history and concluded that ''this history shows to our satisfaction that *the Congress intended an exception to the usual three-year statute of limitations only in the restricted type of situation already described*,''[10] namely, ''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.''[11] Therefore, in the language used in *Chevron* to describe a step-one holding, the Court in *Colony* determined that ''Congress had an intention on the precise question at issue.''

Intermountain Insurance

Three months after my previous article was published, the Tax Court issued its supplemental opinion in *Intermountain Insurance Service of Vail, LLC v. Commissioner*, which was the first decision addressing the temporary regulations dealing with the understated basis issue.[12] A seven-member majority concluded that the temporary regulations are invalid, based on an analysis of *Brand X*, *Chevron*, and *Colony* that paralleled the analysis in my previous article.[13] Four concurring judges would have rejected the IRS position on the grounds that it was raised for the first time in a motion for reconsideration that was based on temporary regulations issued after the court's original decision in the case. Two concurring judges would have invalidated the temporary regulations based

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[7]467 U.S. 837 (1984).

[8]*Brand X*, 545 U.S. at 984.

[9]*Chevron*, 467 U.S. at 843 n.9. The Supreme Court's decisions dealing with the rule of lenity provide additional support for the conclusion that under *Brand X*, the determination whether a statutory provision is ''ambiguous,'' signifying a step-two holding, or ''unambiguous,'' signifying a step-one holding, is made only after employing every applicable tool of statutory construction, including consideration of legislative history. Under the rule of lenity, if a statutory provision relating to criminal law is determined by a court to be ambiguous, the ambiguity is resolved in favor of the criminal defendant. The rule of lenity is relevant in applying the *Brand X* test because in *Brand X* itself, the Court, in explaining its holding, addressed two of its prior decisions in which the rule of lenity was implicated, *Chapman v. United States*, 500 U.S. 453 (1991), and *Neal v. United States*, 516 U.S. 284 (1996). In *Chapman* the Court determined that the rule of lenity was not applicable to the statutory provision at issue because the provision was not ambiguous. In the course of its analysis to determine the meaning of the provision, the Court referenced legislative history. 500 U.S. at 460-461. Also, in rejecting the application of the rule of lenity, the Court noted that this principle applies only when ''after a court has seized *every thing from which aid can be derived*, it is still left with an ambiguous statute.'' 500 U.S. at 463 (citing prior cases; internal quotation marks omitted; emphasis added). In *Neal* the Court held that an agency could not overturn the interpretation adopted by the Court in *Chapman*. In *Brand X* the Court noted that *Neal* did not establish that an agency could *never* overrule a judicial interpretation of a statutory provision: ''*Chapman* . . . had held the relevant statute to be unambiguous. Thus, *Neal* established only that a precedent holding a statute to be unambiguous forecloses a contrary agency construction.'' 545 U.S. at 984. Other decisions by the Court confirm that a consideration of legislative history is part of the analysis to determine whether a statutory provision is ambiguous for purposes of the rule of lenity. *See*, *e.g.*, *Moskal v. United States*, 498 U.S. 103, 108 (1990) (''we have always reserved lenity for those situations in which a reasonable doubt persists about a statute's intended scope even after resort to 'the language and structure,

(Footnote continued in next column.)

legislative history, and motivating policies of the statute' ''); *United States v. Granderson*, 511 U.S. 39, 54 (1994) (''in these circumstances — where text, structure, and history fail to establish that the Government's position is unambiguously correct — we apply the rule of lenity and resolve the ambiguity in Granderson's favor''). Thus, the *Brand X* Court's explanation of its holding by reference to prior cases involving the rule of lenity confirms that a consideration of legislative history can likewise be part of the analysis leading to a step-one holding that cannot, under *Brand X*, be overruled by subsequent agency action. Under the rule of lenity, consideration of legislative history can be part of the analysis leading to the conclusion that the statutory provision is unambiguous, so that the rule of lenity is not applicable, just as, under *Chevron* and *Brand X*, consideration of legislative history can be part of the analysis leading to the conclusion that congressional intent is clear, so that the meaning of the provision is decided under *Chevron* step one, leaving no room for any contrary agency position.

[10]*Colony*, 357 U.S. at 33 (emphasis added).

[11]*Id.*

[12]134 T.C. No. 11 (May 6, 2010) (reviewed by the court), *Doc 2010-10163, 2010 TNT 88-12*.

[13]The taxpayer's supplemental briefs in *Intermountain Insurance* did not address the issue of whether legislative history can be considered as part of a *Chevron* step-one analysis and did not cite the language in *Chevron* making clear that ''traditional tools of statutory interpretation,'' such as legislative history, are part of the *Chevron* step-one inquiry.

on the failure of the IRS and Treasury to comply with the notice and comment requirements of the Administrative Procedure Act.[14]

Chenery Precludes Overruling of *Colony*

My principal purpose in this article is to identify an additional reason for concluding that the temporary regulations cannot be upheld under *Brand X* as an overruling of *Colony*. The additional reason is the fundamental administrative law principle established by the Supreme Court's two *Chenery* decisions in the 1940s. That rule provides that the propriety of an agency action must be determined by a reviewing court only on the basis of the agency's articulated reason for the action at the time the agency acted, and not on some alternative reason subsequently put forward by the agency's counsel in the litigation.[15]

When the IRS and Treasury issued the temporary regulations, they did not claim to be overruling *Colony*. They claimed only to be overruling the decisions of the Ninth and Federal circuits, which held that *Colony* remains applicable under the current statute of limitations provisions.

The preamble to the temporary regulations included the following discussion:

> Relying on the Supreme Court's opinion in *Colony v. Commissioner*, 357 U.S. 28 (1958), which dealt with an omission from gross income in the context of a trade or business, the United States Courts of Appeals for the Ninth Circuit and Federal Circuit recently construed section 6501(e)(1)(A) in cases outside the trade or business context contrary to the interpretation provided in these temporary regulations, holding that an omission does not occur by an overstatement of basis. *Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 2009); *Salman Ranch Ltd v. United States*, 573 F.3d 1362 (Fed. Cir. 2009). *The Treasury Department and the Internal Revenue Service disagree with these courts that the Supreme Court's reading of the predecessor to section 6501(e) in Colony applies to sections 6501(e)(1)(A) and 6229(c)(2).* When Congress enacted the 1954 Internal Revenue Code, it was aware of the disagreement among the courts that existed at the time regarding the proper scope of section 275(c) of the 1939 Internal Revenue Code. *The changes that Congress enacted as part of the 1954 Internal Revenue Code predated the Supreme Court's opinion in Colony and were intended to resolve the matter for the future. Therefore, by amending the Internal Revenue Code, including the addition of a special definition of gross income with respect to a trade or business, Congress effectively limited what ultimately became the holding in Colony, to cases subject to section 275(c) of the 1939 Internal Revenue Code.* Moreover, under section 6501(e)(1)(A) of the 1954 Internal Revenue Code, which remains in effect under the 1986 Internal Revenue Code, when outside of the trade or business context, the definition of gross income in section 61 applies. In this regard, the Treasury Department and the Internal Revenue Service agree with the opinions in *Home Concrete & Supply, LLC v. United States*, 599 F. Supp.2d 678, 690 (E.D.N.C. 2008) (overstatement of basis can constitute an omission from gross income for purposes of the six-year period of limitations) and *Brandon Ridge Partners v. United States*, 2007-2 U.S.T.C. (CCH) paragraph 50,573, 100 A.F.T.R.2d (RIA) 5347, 5351-53 (M.D. Fla. 2007) (same).
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> Consistent with the Ninth Circuit's suggestion in *Bakersfield*, these temporary regulations clarify what constitutes an omission from gross income under sections 6501(e)(1)(A) and 6229(c)(2), as amended in connection with the enactment of the 1954 Internal Revenue Code and continuing in effect under the 1986 Internal Revenue Code. *The reasonable interpretation of the provisions of sections 6501(e)(1)(A) and 6229(c)(2) provided in these temporary regulations, acknowledged by both the Ninth and Federal Circuits to be ambiguous, is entitled to deference even if the agency's interpretation may run contrary to the opinions in Bakersfield and Salman Ranch. See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-983 (2005); *Swallows Holding, Ltd. v. Commissioner*, 515 F.3d 162, 170 (3d Cir. 2008).[16]

The foregoing discussion in the preamble to the temporary regulations leaves no doubt that what the IRS and Treasury claimed to be doing in the temporary regulations was to overrule the conclusion reached by both the Ninth and Federal circuits that the *Colony* holding remains applicable under the statute of limitations provisions in section 6501(e)(1)(A). There is nothing in the preamble that suggests that the action taken by the IRS and Treasury in issuing the temporary regulations represented acceptance by the IRS and Treasury that the Ninth and Federal circuits were correct in concluding that the

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[14]While I agree with the two concurring judges in their conclusion that the issuance of the temporary regulations violated the Administrative Procedure Act, a discussion of that aspect of the case is beyond the scope of this article.

[15]*See SEC v. Chenery Corp.*, 318 U.S. 80, 87-88, 92, 94 (1943); *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947). (''When the case was here before, we emphasized a simple but fundamental rule of administrative law. That rule is to the effect that a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency.'') For a discussion of the *Chenery* principle, see Kevin M. Stack, ''The Constitutional Foundations of Chenery,'' 116 *Yale L.J.* 952 (2007). For recent cases applying the *Chenery* principle, see, *e.g.*, *American Equity Investment Life Insurance Co. v. SEC*, 572 F.3d 923, 934 (D.C. Cir. 2009); *Landstar Express America, Inc. v. Federal Maritime Commission*, 569 F.3d 493, 499 (D.C. Cir. 2009); *American Farm Bureau Federation v. EPA*, 559 F.3d 512, 522 (D.C. Cir. 2009); *GHS Health Maintenance Organization, Inc. v. United States*, 536 F.3d 1293, 1302 (Fed. Cir. 2008); *Oregon Natural Desert Association v. Bureau of Land Management*, 531 F.3d 1114, 1141 (9th Cir. 2008); *Hasan v. Department of Labor*, 545 F.3d 248, 251 (3d Cir. 2008); *Parker v. Astrue*, 597 F.3d 920, 922, 925 (7th Cir. 2010); and *Carpio v. Holder*, 592 F.3d 1091, 1103 (10th Cir. 2010).

[16]*Supra* note 1 at 49,321-49,322 (emphasis added).

Colony holding remains applicable under section 6501(e)(1)(A). Correspondingly, there is nothing in the preamble that suggests a decision by the IRS and Treasury to overrule *Colony* based on agreement with the Ninth and Federal circuits that the *Colony* holding remains applicable under section 6501(e)(1)(A).

The positions expressed by the IRS in its supplemental briefs in *Intermountain Insurance* are consistent with the foregoing position expressed in the preamble to the temporary regulations. Those briefs contend that *Brand X* supports the ability of the IRS and Treasury to overrule the Ninth and Federal circuits in their holdings that *Colony* remains applicable under section 6501(e)(1)(A).[17] The briefs argue extensively for the position rejected by the Ninth and Federal circuits that the additions to section 6501(e)(1)(A) that were not present in the corresponding provision of the 1939 code make the *Colony* holding inapplicable under section 6501(e)(1)(A). The briefs nowhere argue that if the Ninth and Federal circuits were correct in concluding that the *Colony* holding remains applicable under section 6501(e)(1)(A), *Brand X* gives the IRS and Treasury authority to overrule *Colony* itself.

In contrast, however, to the IRS supplemental briefs in the Tax Court in *Intermountain Insurance*, the briefs that have been filed by the Justice Department in the various circuit cases in which the issue is presented do not limit the *Brand X* contention to the claim that the IRS and Treasury had the authority to overrule the Ninth and Federal circuits on the issue of whether the *Colony* holding remains applicable under section 6501(e)(1)(A). Instead, the Justice Department briefs in those cases give much more emphasis to the argument that *Brand X* authorizes the IRS and Treasury to overrule *Colony* itself, even though the preamble to the temporary regulations made no claim to be overruling *Colony*.[18] Under *Chenery* the latter argument by the Justice Department, that *Brand X* authorizes the IRS and Treasury to overrule *Colony*, cannot be sustained, because the IRS and Treasury clearly did not maintain that position in the preamble to the temporary regulations.

Presumably the decision by the IRS and Treasury to rely on *Brand X* as authority only for overruling the Ninth and Federal circuits, rather than as authority for overruling the Supreme Court, was carefully considered, and presumably that decision was based, in part at least, on a judgment that overruling the Supreme Court would be less likely to be sustained in court than overruling two circuit courts. Apparently the Justice Department reached a different conclusion from the IRS and Treasury as to the approach that was more likely to be sustained in court. In light of those considerations, it is entirely appropriate that the *Chenery* principle should be applied in these circumstances to bar reliance on a rationale different from the rationale that was invoked by the IRS and Treasury when the regulations were issued.

The Circuit Cases Were Step-One Holdings

The only genuine *Brand X* issue concerning the temporary regulations, in light of *Chenery* and the rationale presented by the IRS and Treasury in the preamble to the temporary regulations, is whether the IRS and Treasury were correct in their claim in the preamble that *Brand X* authorizes regulations overruling the conclusion by the Ninth and Federal circuits that the holding in *Colony* remains applicable under section 6501(e)(1)(A). That assertion could be sustained only if the conclusions by the Ninth and Federal circuits are properly characterized as *Chevron step-two* holdings. The question is therefore whether the circuits considered their conclusion *the only permissible* conclusion on the issue, or merely *the best* among alternative reasonable conclusions.

Regarding that question, based on the language used by both the Ninth and Federal circuits, it seems clear that the conclusions should be viewed as step-one holdings under *Chevron*. As explained below, the circuits clearly viewed the conclusion as *the only permissible* interpretation of the provision, and not merely as *the best* among alternative reasonable interpretations.

The principal argument that the IRS, Treasury, and Justice Department have made in support of the position that the *Colony* holding does not apply under section 6501(e)(1)(A) is that the addition of the special rule in section 6501(e)(1)(A)(i) altered the meaning of the 25 percent omission rule in section 6501(e)(1)(A) as compared with the meaning of the corresponding rule in the 1939 code, even though the statutory wording of the omission test itself did not change.[19] The special rule added in the 1954 code states:

> 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 such return) prior to diminution by the cost of such sales or services.

Again, the government argues that the addition of that special rule has the effect of rendering superfluous the general 25 percent omission rule if the general rule is given the *Colony* interpretation, and that under the statutory construction rule against superfluities[20] the addition

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[17]*See* ''Respondent's Brief in Support of Motion to Vacate Order'' and ''Decision at 14-18, 26-33; Respondent's Reply Brief in Support of Respondent's Motion to Vacate Order and Decision'' at 12 n.3.

[18]*See, e.g.*, ''Brief for the Appellee'' at 52-57, *Home Concrete & Supply, LLC v. United States*, No. 09-2353 (4th Cir. Apr. 30, 2010); ''Reply Brief for the Appellant'' at 22-23, 24-27, *Salman Ranch, Ltd. v. Commissioner*, No. 09-9015 (10th Cir. June 1, 2010); ''Brief for the Petitioner'' at 48-49, 52-53, *Commissioner v. MITA*, No. 09-60827 (5th Cir. Mar. 3, 2010); and ''Brief for the Appellant'' at 49-54, *Commissioner v. Beard*, No. 09-3741 (7th Cir. June 18, 2010).

[19]*See, e.g.*, T.D. 9466, *supra* note 1 (''by amending the Internal Revenue Code, including the addition of a special definition of 'gross income' with respect to a trade or business, Congress effectively limited what ultimately became the holding in *Colony*, to cases subject to section 275(c) of the 1939 Internal Revenue Code'').

[20]*See, e.g.*, *Hibbs v. Winn*, 542 U.S. 88, 101 (2004) (''the rule against superfluities complements the principle that courts are to interpret the words of a statute in context'' (quoting authority for the principle that ''a statute should be construed so that

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of the special rule means that the *Colony* interpretation of the 25 percent omission rule cannot be correct under section 6501(e)(1)(A) of the 1954 code.[21] There are several serious flaws in the government's argument on that point, as the Ninth and Federal circuits correctly recognized.

As both circuits made clear, the first significant problem with the government's argument is that the operative language of the 25 percent omission test in section 6501(e)(1)(A) is identical to the statutory language that was at issue in *Colony*.[22] The second fundamental problem identified by the circuits is that it is wrong to say that applying the *Colony* interpretation of the 25 percent omission rule to section 6501(e)(1)(A) has the effect of rendering the special rule in 6501(e)(1)(A)(i) superfluous.

The government's argument of superfluity would be correct only if the special rule in section 6501(e)(1)(A)(i) had precisely the same effect as the holding in *Colony*. The government in fact makes that claim as an alternative way of expressing its argument.

However, it is not the case that the special rule in section 6501(e)(1)(A)(i) has precisely the same effect as the *Colony* holding. Both the Ninth and Federal circuits recognized that the effect of the special rule is different from the effect of the holding in *Colony* not only in scope (namely concerning the categories of gross income that are subject to the rule compared to the scope of the holding in *Colony*), but also in the manner in which it operates.

The categories of gross income that are subject to the special rule in section 6501(e)(1)(A)(i) are clearly not the same categories of gross income that are covered by the *Colony* holding. The special rule applies only in the case of gross income ''from the sale of goods or services'' in a trade or business. Therefore, it does not apply to gross income from any sale of property that does not occur in the context of a trade or business.

Also, the special rule does not apply in the case of gross income in a trade or business resulting from the sale of land or buildings, because land and buildings are never ''goods,'' even for a taxpayer who is engaged in the trade or business of selling land or buildings.[23] The latter point, that land and buildings are never ''goods,'' seems to have been almost universally overlooked in the litigation on this issue.[24] In fact, the IRS has, in at least one case, explicitly but incorrectly argued that a taxpayer engaged in the business of selling land is thereby selling goods.

The Tax Court, in its opinion in *Bakersfield*, quoted the following statement from the government's brief in that case:

> In *Colony, Inc.*, the Supreme Court had before it a case of a sale of goods or services, as the taxpayer's principal business was the development and sale of lots in a subdivision.[25]

Because the facts in *Colony* involved sales of land, in a trade or business of selling land, the factual situation in *Colony* did not involve the sale of goods and would not have been covered by the special rule in section 6501(e)(1)(A)(i), even if it had been governed by the 1954 code rather than the 1939 code. Therefore, the statement by the IRS that is quoted by the Tax Court in *Bakersfield* is clearly not correct that the business of selling land involves the sale of goods, and is likewise incorrect that the facts in *Colony* would have been subject to the special rule in section 6501(e)(1)(A)(i).

The government argued in the Ninth and Federal circuits that the scope of the special rule in section 6501(e)(1)(A)(i) is identical to the scope of the holding in *Colony*[26] based on the premises that the type of gross income at issue in *Colony* would have been subject to the special rule in section 6501(e)(1)(A)(i), and that the holding in *Colony* was limited to that type of gross income. While the circuits accurately stated that the second premise is incorrect, they did not mention that the first premise is also incorrect.

Regarding the government's incorrect premise that the *Colony* holding should be considered as limited to the sale of goods or services in a trade or business, the Ninth Circuit in *Bakersfield* responded: ''*There is no ground* for suggesting that the Court intended the same language in

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effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant'')).

[21]*See Bakersfield*, 568 F.3d at 775 (''the IRS argues that applying *Colony* to section 6501(e)(1)(A) generally would render subparagraph (i) superfluous''); and *Salman*, 573 F.3d at 1371 (''according to the government, to conclude, as Appellants do, that the *Colony* gross receipts test applies under section 6501(e) to every sort of sale is to make redundant Congress's reference to that same test as applying 'in the case of a trade or business').

[22]*Bakersfield*, 568 F.3d at 775 (''Congress did not change the language in the body of section 6501(e)(1)(A), which is identical to the language in section 275(c) that the Supreme Court construed in *Colony*. As a general rule, we construe words in a new statute that are identical to words in a prior statute as having the same meaning.''); and *Salman*, 573 F.3d at 1373. (''Most importantly, the 'omits from gross income an amount properly includible therein' language is identical in the 1939 and 1954 Codes. . . . *Colony* represents an interpretation of the very same language that is now found in section 6501(e)(1)(A).'')

[23]*Black's Law Dictionary*, 762 (9th ed. 2009), defines ''goods'' as follows: ''Tangible or movable personal property other than money; esp., articles of trade and items of merchandise.'' The IRS has consistently maintained under the inventory provisions of the code (sections 471 and 472) that land and buildings are not ''merchandise'' or ''goods'' and that accordingly land and buildings are not eligible for inventory treatment, and the courts have agreed with that position. *See*, *e.g.*, *W.C. & A.N. Miller Development Co. v. Commissioner*, 81 T.C. 619 (1983); *Homes by Ayres v. Commissioner*, 795 F.2d 832 (9th Cir. 1986).

[24]For the only identification of this point in the litigation on this issue, see ''Reply Brief of Appellants'' at 2 n.5, *Home Concrete & Supply, LLC v. United States*, No. 09-2353 (4th Cir. June 1, 2010).

[25]128 T.C. 207, 215 (2007).

[26]*See Bakersfield*, 568 F.3d at 775 (''the IRS argues that *Colony*, read correctly, interpreted section 275(c) as having the same meaning as section 6501(e)(1)(A)(i) and applying only to taxpayers in a trade or business''); *Salman*, 573 F.3d at 1371 (''in the government's view, the [trial] court properly construed *Colony*'s holding narrowly by defining 'gross income' as gross receipts of a trade or business from sales of goods or services'').

section 275(c) to apply differently to taxpayers in a trade or business than to other taxpayers.''[27] The Federal Circuit in *Salman* responded similarly: ''*We do not discern any basis* for limiting *Colony*'s holding concerning the 'omits from gross income' language of section 275(c) to sales of goods or services by a trade or business.''[28]

The second reason why the government is incorrect in its claim that the special rule in section 6501(e)(1)(A)(i) would be rendered superfluous if section 6501(e)(1)(A) were interpreted in accordance with *Colony* is because the *operation* of the special rule is entirely different from the *operation* of the holding in *Colony*. As the Ninth and Federal circuits recognized, the most obvious difference between the operation of the special rule and the operation of the holding in *Colony* is that the special rule affects *both* the numerator and the denominator of the 25 percent omission test, whereas the holding in *Colony* affects *only* the numerator in that test, and has no effect on the denominator.

The numerator in the 25 percent omission test is the gross income that was omitted from the gross income reported on the tax return, whereas the denominator is the total gross income that was *not* omitted, but was instead properly included in the gross income reported on the tax return. In a business involving the sale of goods, the effect on the denominator in the 25 percent test of applying the special rule in section 6501(e)(1)(A)(i) and using gross receipts, rather than the normal section 61 meaning of gross income (gross receipts less cost of goods sold), will ordinarily be substantial.

The Ninth Circuit responded to the government's superfluity argument:

> We are not convinced that applying *Colony* to the 1954 Code would render section 6501(e)(1)(A)(i) superfluous. . . . Because section 6501(e)(1)(A)(i) changes the definition of ''gross income'' for taxpayers in a trade or business, it potentially affects both the numerator (the omission from gross income) and the denominator (the total gross income stated in the return). *Colony*'s holding, however, affects only the numerator, by defining what constitutes gross income.
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> When there is no dispute about the amount of gross income omitted, the denominator, the total amount of gross income stated in the return, determines whether the omission meets the 25 percent threshold that triggers the six-year limitations period. . . . Thus, in a case where there is no dispute regarding the amount of gross income omitted, whether a taxpayer's omissions constitute more than 25 percent of the gross income stated in the return may depend on whether subparagraph (i)'s definition of ''gross income applies.'' In such cases, subparagraph (i) may be dispositive, whether or not we accept the IRS's interpretation of *Colony*.
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> We therefore do not render subparagraph (i) superfluous by applying *Colony*'s holding to the same statutory language in the 1954 Code.[29]

The Federal Circuit had the following response to the same government argument:

> We do not view subparagraph (i) of section 6501(e)(1)(A), the gross receipts provision, as superfluous under our reading of the statute. . . . Our reading of section 6501(e)(1)(A), which is based on *Colony*, is that the language ''omits from gross income'' does not extend to an alleged overstatement of basis in property. We do not see how this reading of the statutory language renders subparagraph (i) superfluous, and neither does the Ninth Circuit. . . . Put most simply, we do not see how subparagraph (i), which explains how ''gross income'' is calculated when a trade or business is involved, is made superfluous by saying that an overstatement of basis is not an omission from gross income.
>
> The legislative history of section 6501(e)(1)(A)(i) is consistent with our observation that subparagraph (i) is not rendered superfluous by our reading of section 6501(e)(1)(A). Congress added subparagraph (i) to resolve a conflict between the IRS and taxpayers about how to calculate gross income in the case of a trade or business. . . . Under section 275(c), it was unclear whether, in calculating ''gross income'' in the case of a trade or business, the IRS should deduct certain business expenditures, such as the cost of sales or services. In response, Congress enacted subparagraph (i), which made it clear that ''gross income'' in the case of a trade or business was calculated prior to diminution by the cost of such sales or services. . . . In light of this conflict, we believe that Congress enacted subparagraph (i), not to define ''omits from gross income an amount properly includible therein,'' but to assist the IRS in its calculation of whether any omitted gross income exceeded 25% of the gross income stated in the return.[30]

In the foregoing discussions, the circuit courts do not give any indication that the courts thought that they were merely choosing *the best* reading among alternative potential reasonable conclusions. Instead, the discussions by the circuits make clear that those courts considered their conclusion the only permissible conclusion. Consequently, those conclusions must be considered *Chevron* step-one holdings and cannot be overruled by the IRS and Treasury under the authority of *Brand X*.

Conclusion

Under the *Chenery* rule the government cannot rely on an argument that *Brand X* authorizes the temporary regulations as an overruling of the *Colony* holding, because the IRS and Treasury, in the preamble to the temporary regulations, did not claim to be overruling

[27] 568 F.3d at 778 (emphasis added).
[28] 573 F.3d at 1372 (emphasis added).
[29] *Bakersfield*, 568 F.3d at 776-777.
[30] *Salman*, 573 F.3d at 1375-1376.

Colony. Instead, the only *Brand X* argument that could potentially be invoked, consistent with *Chenery*, as support for the temporary regulations is the argument expressed in the preamble to the temporary regulations that *Brand X* authorizes the IRS and Treasury to issue regulations overruling the conclusion reached by the Ninth and Federal circuits that the *Colony* holding remains applicable under section 6501(e)(1)(A). That argument must be rejected, however, because both the Ninth and Federal circuits made clear that they considered the conclusion that the *Colony* holding remains applicable as being *the only permissible* conclusion, rather than simply *the best* conclusion among reasonable alternatives. Therefore, the conclusion by those courts that *Colony* remains applicable under section 6501(e)(1)(A) is a *Chevron* step-one holding that cannot be overruled under *Brand X*.

Partnership Disguised Sales: *G-I Holdings* Is Not Dicta

By Richard G. Jacobus

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In the recent *G-I Holdings* decision, a district court construed and applied the partnership disguised sale statute, section 707(a)(2)(B), for the first time in the 25 years since its enactment. Despite reports to the contrary, the court's disguised sale analysis is not dicta, but rather persuasive authority.

Introduction

Blake D. Rubin, Andrea Macintosh Whiteway, and Jon G. Finkelstein criticize the district court's decision in *G-I Holdings*, the first judicial application of the 25-year-old partnership disguised sale statute, section 707(a)(2)(B).[1] They contend the court's disguised sale analysis is ''entirely dicta.''[2] The record in *G-I Holdings* refutes this claim.

Relevant Facts of *G-I Holdings*

The critics summarize many — though far from all — of the relevant facts in *G-I Holdings*.[3] Incompleteness aside, the accuracy of their summary is assumed for present purposes.[4]

The Disguised Sale Ruling Is Not Dicta

Dicta is commonly defined as ''a statement in a judicial opinion that could have been deleted without

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[1]*In re G-I Holdings Inc.*, 2009 WL 4911953 (D.N.J. 2009), *Doc 2009-25898*, *2009 TNT 225-18*; Rubin, Whiteway, and Finkelstein, ''Partnership Disguised Sales: *G-I Holdings* Misses the Mark,'' *Tax Notes*, May 3, 2010, p. 553, *Doc 2010-7727*, or *2010 TNT 86-6*.

[2]Rubin et al., *supra* note 1, at 553; *see also* Monte A. Jackel, ''Partnerships in the Courts: Case Law Update,'' *Tax Notes*, Jan. 18, 2010, p. 387, *Doc 2009-28356*, or *2010 TNT 11-11* (''technically dicta''); Richard M. Lipton, Todd D. Golub, and Patricia W. McDonald, ''A Tale of Two Cases: *G-I Holdings* and *Virginia Historic Tax Credit Fund* — Can They Both Be Right?'' 112 *J. Tax'n* 154, n.2 (Mar. 2010) (same).

[3]*See, e.g.*, ''Final Pretrial Order'' (FPO), Case No. 2:02-cv-03082, entered Dec. 4, 2008 (Docket No. 250). All record citations herein to *G-I Holdings*, No. 2:02-cv-03082 (D.N.J.), are *available at* http://pacer.njd.uscourts.gov/.

[4]As used herein, the terms ''Partnership'' or ''RPSSLP'' refer to the putative partnership at issue. The ''1990 Transaction'' refers to the disputed events of February 12, 1990, including the Partnership's formation and the accompanying Credit Suisse loan. Other terminology follows the usages employed by Rubin, et al., *supra* note 1.