Omissions From Gross Income and Retroactivity

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Regulations treating overstated basis as an omission from gross income for purposes of the extended statute of limitations have renewed attention on the retroactivity rule in the original 1954 version of section 7805(b) regulations, which authorized retroactive regulations.

However, because of the expansion of agency rulemaking discretion authorized long after the 1954 enactment of section 7805(b) by the Supreme Court's decisions in *Chevron* and *Brand X*, and the recent confirmation in *Mayo* that expanded agency discretion applies to tax regulations, it is unreasonable to conclude that Congress in enacting the original 1954 version of section 7805(b) intended to authorize retroactive application of the expanded agency discretion that was not authorized by the Supreme Court until many years later.

Thus, the traditional *Anderson, Clayton* factors for evaluating the propriety of retroactive regulations under section 7805(b) should be viewed as obsolete. Instead, retroactive tax regulations should be evaluated using the same standards that apply to retroactive regulations issued by any other agency, under the principles of *Bowen* and *Landgraf*. Under those principles, the overstated basis regulations are considered impermissibly retroactive.

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Background

Last December Treasury finalized temporary and proposed regulations, issued in September 2009, dealing with the special statutory rule[1] that extends from three years to six years the statute of limitations for assessing additional tax when a taxpayer omits from gross income an amount in excess of 25 percent of the gross income reported on the tax return.[2] The final regulations provide that an overstatement of basis that results in an understatement of gross income represents an omission from gross income for purposes of the special rule, even though the Supreme Court held in 1958 that identical language in the 1939 code should be interpreted to exclude those cases from being omissions from gross income.[3]

In a previous article, I discussed whether the omission from gross income regulations are substantively invalid and concluded that they are.[4]

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[1]Section 6501(e)(1)(A)(i); section 6229(c)(2).

[2]T.D. 9511, *Doc 2010-26662*, *2010 TNT 240-11*.

[3]*Colony Inc. v. Commissioner*, 357 U.S. 28 (1958).

[4]Patrick J. Smith, "*Brand X* and Omissions From Gross Income," *Tax Notes*, Feb. 1, 2010, p. 665, *Doc 2010-604*, *2010 TNT 22-5*. The determinative issue is whether the Supreme Court's use of legislative history in *Colony* in reaching its conclusion on the meaning of an omission from gross income means that the *Colony* decision should not be considered a holding under step one of the analytical framework set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984). If *Colony* is not viewed as a step one holding, it is subject to being overruled by an agency regulation reaching a contrary conclusion, under the authority of *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967 (2005). The government's position in connection with the omission from gross income regulations is that *Brand X* had the effect of removing legislative history from step one of the *Chevron* analysis. *See, e.g.*, Brief for the Appellant at 41-43, *Grapevine Imports Ltd. v. United States*, No. 2008-5090 (Fed. Cir. 2010). In the article cited above, I discussed why *Brand X* should not be viewed as having the effect the government advocates. It is simply not reasonable to view *Brand X* as having this effect when there was no discussion of this point in any of the four opinions in the case. The government took a different position regarding the role of legislative history at step one of the *Chevron* analysis in its brief in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*, in which the government relied heavily on legislative history, including committee reports, in response

(Footnote continued on next page.)

Three months after that article was published, a majority of the Tax Court reached the same conclusion, using essentially the same analysis that I had used.[5] The purpose of this report is to discuss an additional reason the regulations are invalid, namely, that they are impermissibly retroactive.

The final regulations provide that they apply to ''taxable years with respect to which the period for assessing tax was open on or after September 24, 2009,'' the date the temporary regulations were submitted to the *Federal Register*.[6] The preamble to the final regulations says the meaning of that effective date rule is that the regulations apply to tax years for which the period for assessing tax would be open, *taking into account the provisions of the regulations applying the six-year statute to 25 percent understatements of gross income resulting from basis overstatements*, on or after September 24, 2009.[7] Thus, the regulations are retroactive insofar as they revive government claims against taxpayers that would be barred under the interpretation of an omission from gross income adopted by the Supreme Court in *Colony*.

The issue of the regulations' validity is pending in cases in the courts of appeals for seven different circuits.[8] In some of those circuits, there are multiple pending cases that involve the issue. As of the time this report was written, an opinion had been issued in only one court of appeals, the Seventh Circuit.[9] The Seventh Circuit in *Beard v. Commissioner*[10] reversed the Tax Court and held that the interpretation set forth in the regulations is the interpretation that is required under a plain reading of the statute and that accordingly, the issue of whether the regulations are to be accorded deference need not be addressed.

The Seventh Circuit held not only that *Colony* is not controlling under the current statutory provision, but that the addition of the special rule defining gross income in a trade or business as gross receipts for purposes of the 25 percent omission test had the effect of changing the required meaning of that test to the meaning advocated by the government, with no need for a regulation to achieve that result.[11] It is difficult to understand how statutory changes not directly affecting the specific statutory words at issue could transform a provision that taking into account legislative history, clearly favored the taxpayer, according to the Supreme Court in 1958, to a provision that now clearly favors the government, according to the Seventh Circuit.

In a prior article, I detailed the reasoning used by the Ninth Circuit[12] and the Federal Circuit[13] to conclude that the statutory change relied on by the Seventh Circuit did not change the meaning of the 25 percent omission test in any way that would make the *Colony* holding inapplicable.[14] I will not repeat that discussion here, but, as I suggested there, I believe the reasoning of the Ninth and Federal circuits on that point was correct, and accordingly, I believe the Seventh Circuit's holding is incorrect.

By choosing to base its decision on the grounds that the government's interpretation is supposedly required under the plain terms of the statute, the Seventh Circuit avoided the need to address the various arguments relating to the validity of the regulations. Those include whether Treasury violated the Administrative Procedure Act (APA) by failing to follow notice-and-comment procedures in issuing the temporary regulations, whether that failure was cured by the issuance of final regulations after providing for notice and comment on the

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to the taxpayers' argument that the case should be decided in their favor under step one of *Chevron*. Brief for the United States at 39-42.

In a second prior article, I asserted that the Justice Department's argument in support of the temporary regulations violated the principle that agency action may be upheld only on the grounds that the agency itself relied on in making its decision. I noted that the preamble to the temporary regulations did not purport to be overruling *Colony*, whereas the DOJ's briefs defended the temporary regulations as permissibly overruling *Colony*. Smith, ''Omissions From Gross Income and the *Chenery* Rule,'' *Tax Notes*, Aug. 16, 2010, p. 763, *Doc 2010-16074*, *2010 TNT 158-3*. Treasury has addressed that issue by explicitly expressing an intention to overrule *Colony* in the preamble to the final regulations.

[5]*Intermountain Insurance Service of Vail LLC v. Commissioner*, 134 T.C. 211 (2010), *Doc 2010-10163*, *2010 TNT 88-12*.

[6]Reg. section 301.6229(c)(2)-1(b); reg. section 301.6501(e)-1(e)(1).

[7]T.D. 9511.

[8]For a list of the pending cases, see Brief for the Appellant at ii, *Intermountain*, *Doc 2010-26094*, *2010 TNT 236-19*.

[9]After this report was completed, the Fourth Circuit issued its opinion in *Home Concrete & Supply LLC v. United States*, No. 09-2353 (4th Cir. 2011), *Doc 2011-2674*, *2011 TNT 26-7*. Two days later, the Fifth Circuit issued its opinion in *Burks v. United States*, No. 09-11061 (5th Cir. 2011), *Doc 2011-2857*, *2011 TNT 28-12*. A month later, the Federal Circuit issued its opinion in *Grapevine Imports*. Those opinions will be addressed in later footnotes.

[10]No. 09-3741 (7th Cir. 2011), *Doc 2011-1764*, *2011 TNT 18-10*.

[11]*Beard*, slip op. at 10-15.

[12]*Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 2009), *Doc 2009-13801*, *2009 TNT 115-10*.

[13]*Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009), *Doc 2009-17311*, *2009 TNT 145-13*.

[14]Smith, ''Omissions From Gross Income and the *Chenery* Rule,'' *supra* note 4, at 766-769.

temporary regulations,[15] and whether the regulations are impermissibly retroactive. Thus, the Seventh Circuit's decision has no direct bearing on the retroactivity issue, which is the primary subject of this article.[16]

The taxpayers in all the pending cases are challenging the validity of the omission from gross income regulations on multiple grounds, including their substantive validity and retroactivity. The principal retroactivity challenge is that the standard for permissible retroactivity of changes to statutes of limitations is particularly rigorous and that the regulations impermissibly revive government

[15]*See, e.g., United States v. Dean*, 604 F.3d 1275, 1280-1281 (11th Cir. 2010) ("We . . . find unpersuasive the argument that post-promulgation comments were sufficient to ameliorate the lack of pre-promulgation notice and comment. . . . The post-promulgation comments allowed by the Attorney General do not rectify the lack of pre-promulgation notice and comment."); *Paulsen v. Daniels*, 413 F.3d 999, 1005 (9th Cir. 2005) ("It is antithetical to the structure and purpose of the APA for an agency to implement a rule first, and then seek comment later.").

[16]As noted above, the Fourth Circuit issued its opinion in *Home Concrete* after this report was completed. In that opinion, the Fourth Circuit agreed with the Ninth and Federal circuits that the holding in *Colony* remains applicable under the current statutory provision, despite the statutory changes not directly affecting the language of the 25 percent omission test. *Home Concrete*, slip op. at 10-11. The Fourth Circuit also rejected the government's reliance on the regulations for several reasons, including the court's conclusion that the regulations by their terms do not apply retroactively to revive claims by the government that would already have expired under *Colony*. *Id.* at 12-13. A concurring opinion strongly criticized the IRS for overreaching in issuing the regulations. *Id.* at 17-18. The aspect of the opinion that is most relevant to this article is an alternative holding on retroactivity.

As noted above, two days after the Fourth Circuit's opinion in *Home Concrete*, the Fifth Circuit issued its opinion in *Burks*. Like the Fourth Circuit, the Fifth Circuit agreed with the Ninth Circuit and Federal circuits that the holding in *Colony* remains applicable under the current statutory provision. *Burks*, slip op. at 13-18. The Fifth Circuit also agreed with the Fourth Circuit that the regulations do not by their terms apply retroactively and thus do not apply to the taxpayers in the case. *Id.* at 22-24. The Fifth Circuit also devoted considerable attention to a rejection of the government's reliance on an earlier Fifth Circuit decision, *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), which the government contended supported the government's interpretation. *Burks*, slip op. at 8-11. The Fifth Circuit concluded that the government's reading of *Phinney* was mistaken.

Both the Fourth Circuit in *Home Concrete* and the Fifth Circuit in *Burks* avoided the issue of whether the *Colony* decision's reliance on legislative history in interpreting the 1939 code provision affected *Colony*'s status as a *Chevron* step one holding for purposes of precluding the IRS from reaching a different conclusion under *Brand X*. Instead, both circuits relied on dictum in *Colony* stating that "the conclusion we reach is in harmony with the unambiguous language of section 6501(e)(1)(A)," 357 U.S. at 37, as the basis for concluding that the *Colony* reading is immune from being altered by regulations. *Home Concrete*, slip op. at 8-9, 14; *Burks*, slip op. at 9, 22. The Fifth Circuit noted that because of its conclusion on the other issues, it was not necessary to decide whether the regulations could be applied retroactively. *Burks*, slip op. at 24.

In a significant footnote, the Fifth Circuit went on to question whether the regulation would be entitled to deference even if *Colony* did not prevent that. *Id.* at 23-24 n.9. The court noted that the omission from gross income regulations were distinguishable from the regulation at issue in *Mayo* because, as the Supreme Court emphasized in *Mayo*, that regulation was issued with full notice and comment, whereas the omission from gross

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income regulations were initially issued as temporary regulations without prior notice and comment. The footnote concluded: "That the government allowed for notice and comment after the . . . regulations were enacted is not an acceptable substitute for pre-promulgation notice and comment," citing *United States Steel Corp. v. EPA*, 595 F.2d 207, 214-215 (5th Cir. 1979).

As noted above, a month after the decisions by the Fourth and Fifth Circuits, the Federal Circuit issued its opinion in *Grapevine*. That opinion was issued with surprising speed, since the oral argument took place only two months earlier, on January 12, 2011, the day after the *Mayo* opinion was released. While the Federal Circuit in *Grapevine Imports* agreed with the Seventh Circuit that the government should prevail, the Federal Circuit took a different approach.

In contrast to the Seventh Circuit, the Federal Circuit concluded that even taking into account legislative history, the statutory provision did not have a clear meaning, and thus left room for the position taken in the regulations. It rejected the government's position that legislative history cannot be considered in *Chevron* step one. Slip op. at 14 ("we turn to the traditional tools of statutory construction, e.g., legislative history, to see if they show a clear intent that is unclear from the text alone"). Nevertheless, the Federal Circuit seems to have accepted a modified version of the government's position that *Brand X* excludes legislative history from *Chevron* step one by taking the position that in applying *Brand X* to determine whether a prior judicial interpretation can be overruled by a subsequent contrary agency interpretation, a heightened standard as to the needed clarity of congressional intent is applied. Slip op. at 20.

While referring to language in the *Colony* opinion characterizing the legislative history as merely "persuasive," slip op. at 19-20, the Federal Circuit did not address the statement in *Colony* that the legislative 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." 357 U.S. at 36. That statement seems to be a clear expression that the *Colony* Court believed it had discerned congressional intent, which is the test under *Chevron* step one, and should accordingly preclude any subsequent alternative agency position.

A few days before the Federal Circuit decision in *Grapevine*, the taxpayers in *Beard* filed a petition for rehearing *en banc* with the Seventh Circuit. The petition was based on the decisions of the Fourth and Fifth circuits, especially the Fifth Circuit, because the panel opinion in *Beard* had relied on the earlier Fifth Circuit decision in *Phinney* as supporting the government's position. Two days later, the Seventh Circuit requested that the government file an answer to the petition. Such a request is not an automatic step in the case of petitions for rehearing and may suggest there is a good chance the petition will be granted.

claims for which the statute of limitations had already expired before the regulations were issued.[17]

While I entirely agree with those taxpayers that the regulations' relationship to a statute of limitations is an important part of why they are impermissibly retroactive, I want to focus on an additional consideration: The government is improperly relying on legal authority that does not properly reflect developments in the law concerning both retroactivity and the scope of agency authority.

The government's defense of the regulations' retroactivity fails to properly account for the effect of the Supreme Court's *Chevron* and *Brand X* decisions on the scope of agency rulemaking authority and on the retroactivity analysis for regulations. The government's position likewise fails to properly consider the Supreme Court's retroactivity case law, particularly *Landgraf*, the landmark 1994 decision on statutory retroactivity.[18] In any other area of federal law, retroactivity analysis is based on *Landgraf*, and there is no reason that should not be the case for the review of retroactive tax regulations as well. As the Supreme Court recently noted in *Mayo*, ''we are not inclined to carve out an approach to administrative review good for tax law only.''[19]

Mayo also rejected any distinction between tax regulations issued under section 7805(a) and tax regulations issued under more specific statutory authority — despite the Court's earlier decisions supporting the existence of such a distinction — because of the change in the legal landscape caused by *Chevron*.[20] For retroactivity, the legal landscape has likewise changed.

Statutory Provisions on Retroactivity

In response to taxpayers' arguments that the omission from gross income regulations are impermissibly retroactive, the government places considerable weight on the fact that those regulations are governed by the original 1954 version of section 7805(b) rather than section 7805(b) as it was amended in 1996.[21] The 1954 version of section 7805(b) provided that Treasury ''may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.'' Thus, the original version of the statute by its terms clearly authorized retroactive regulations.

In contrast, the amended 1996 version of section 7805(b) provides that as a general rule, no regulation may apply to any tax period ending before the earliest of the date the regulation was filed with the *Federal Register*, the date a proposed or temporary version of the regulation was filed with the *Federal Register*, or the date a notice substantially describing the expected contents of the regulation was issued to the public.[22] However, the 1996 version of section 7805(b) applies only to regulations under statutory provisions enacted on or after July 30, 1996.[23] Because sections 6501(e)(1) and 6229(c)(2) were both enacted before July 30, 1996, regulations under those provisions are governed by the 1954 version of section 7805(b).

The portion of the House Ways and Means Committee report explaining the reasons for the amendment to section 7805(b) consists of a single sentence: ''The Committee believes that it is generally inappropriate for Treasury to issue retroactive regulations.''[24] The committee report provides no explanation of the reason for the effective date rule, which makes the change applicable only to regulations under statutory provisions enacted on or after the date of the amendment's enactment, and thus does not attempt to reconcile the effective date provision with the proposition that ''it is generally inappropriate for Treasury to issue retroactive regulations.'' It might be inferred that Congress concluded that there would already be regulations for most existing statutory provisions and that any changes to those regulations would generally be modest in scope.[25]

Chevron and *Brand X*

The question whether the omission from gross income regulations are impermissibly retroactive is closely tied to the nature of their substantive content. The government maintains that their substantive content represents a mere clarification of an uncertain area of the law and that any retroactive

[17]*See, e.g.*, Brief for the Appellees at 38, *Commissioner v. M.I.T.A. Partners*, No. 09-60827 (5th Cir. 2010), *Doc 2010-14405*, *2010 TNT 126-12*; Brief for the Appellee at 26-29, *Beard*.

[18]*Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

[19]*See Mayo*, 131 S. Ct. 704, 713 (2011).

[20]*Id.*

[21]*See, e.g.*, T.D. 9511.

[22]There are a few relatively limited exceptions to this general rule set forth in section 7805(b)(2) through (7).

[23]Taxpayer Bill of Rights 2, P.L. 104-168, section 1101(b).

[24]H.R. Rep. No. 104-506, at 44 (1996).

[25]The most extensive commentary on the 1996 amendment sheds no light on the reason for the effective date provision. *See* Benjamin J. Cohen and Catherine A. Harrington, ''Is the Internal Revenue Service Bound by Its Own Regulations and Rulings?'' 51 *Tax Law.* 675, 696-707 (1998).

effect is therefore permissible.[26] However, the government also claims that the authority for the regulations' substantive content is provided by *Chevron* and *Brand X*.[27]

One of the significant problems with the government's position is that the statutory provision authorizing retroactive tax regulations predates by decades the Supreme Court decisions that provide the authority on which the government relies for the substantive content of the regulations. Whatever Congress may have intended in authorizing retroactive regulations in the 1954 version of section 7805(b), there are some results that it clearly could not have intended in that original version of the statute. Congress obviously could not have intended in 1954 that section 7805(b) allow retroactive regulations exercising the degree of agency discretion authorized by *Chevron* and *Brand X*, for the simple reason that *Chevron* was not decided until 30 years later and *Brand X* was not decided until more than 50 years later.

However, it is not only that *Chevron* and *Brand X* were decided many years after the 1954 version of section 7805(b) was enacted that removes regulations issued under the authority of those decisions from permissible retroactivity under the original version of the statute. Retroactivity is also foreclosed because the extreme breadth of agency discretion authorized by *Chevron* and *Brand X* is impossible to reconcile with permissible retroactive application of regulations that exercise that broad discretion.

Chevron holds that unless it can be determined that Congress had a specific intent on the particular issue of statutory construction, in which case that intent represents the only permissible interpretation of the statutory provision, any reasonable interpretation by the agency charged with enforcing the statute will be controlling. *Chevron* does not require that the agency position be the best reading of the statutory provision at issue, only that it be a reasonable or permissible approach within a potential range of permissible alternatives. *Chevron* allows an agency to make a purely policy-based choice among the range of potential permissible alternatives.[28] That type of policy-based rulemaking is antithetical to the retroactive application of rules that exercise such broad discretion.

The traditional view that judicial decisions are properly retroactive while legislation is ordinarily prospective is based on the principle that judicial decisions say what the law is, not what the law should be, whereas legislation says what, as a matter of policy, the law should (and therefore will) be. ''The principle that statutes operate only prospectively, while judicial decisions operate retroactively, is familiar to every law student.''[29] It is the application to agency actions of that view that judicial decisions merely say what the law is that unquestionably provided the rationale for the authorization of retroactive regulations in the original version of section 7805(b).[30] However, when agency rulemaking is based on a policy choice, as *Chevron* clearly permits, that agency decision is much more like legislation than a judicial decision, and it thus lacks the justification for retroactive application that judicial decisions have.

Likewise, the Supreme Court's holding in *Brand X* that agencies are permitted to overrule judicial interpretations of statutory provisions, as long as the judicial interpretation did not represent a holding that the interpretation adopted by the court was the only permissible one, is an application of *Chevron* that illustrates the breadth of agency discretion *Chevron* authorizes. It is inconceivable that Congress contemplated that degree of agency discretion in authorizing retroactive regulations in the 1954 version of section 7805(b). Moreover, it was not until January that the Supreme Court made clear in *Mayo* that *Chevron*, and thereby necessarily *Brand X*, in fact applies to regulations issued under the authority of section 7805(a).

The *Anderson, Clayton* Factors

In further support of its contention that the omission from gross income regulations are not impermissibly retroactive, the government also relies on various court of appeals decisions considering the validity of retroactive tax regulations under the 1954 version of section 7805(b).[31] The most recent of those decisions, *Snap-Drape*,[32] was issued in 1996, the same year as the amendment to section 7805(b). Even though *Snap-Drape* was decided

[26] *See, e.g.*, Brief for the Appellant at 66, *Intermountain*.

[27] *Id.* at 37, 39.

[28] *Chevron*, 467 U.S. at 866 (''When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail.'').

[29] *Rivers v. Roadway Express Inc.*, 511 U.S. 298, 311-312 (1994) (internal quotation marks omitted).

[30] *See, e.g.*, *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 135 (1936) (''The regulation . . . is no more retroactive in its operation than is a judicial determination construing and applying a statute to a case in hand.'').

[31] *See, e.g.*, Brief for the Appellant at 63-65, *Intermountain*.

[32] *Snap-Drape Inc. v. Commissioner*, 98 F.3d 194 (5th Cir. 1996), *Doc 96-29056*, *96 TNT 213-8*.

nearly 2½ years after the Supreme Court's landmark *Landgraf* decision on the retroactivity of statutory provisions, it makes no reference either to *Landgraf* or to *Bowen*, the Supreme Court's important 1988 decision on retroactive regulations.[33]

The only recent (at the time) Supreme Court retroactivity decision cited in *Snap-Drape* was *Carlton*,[34] a tax case dealing with the retroactivity of a statutory provision. *Carlton* itself cited neither *Landgraf* nor *Bowen*, even though *Landgraf* had been decided just a few months earlier. Instead, the Fifth Circuit's retroactivity analysis in *Snap-Drape* relied on a 1977 Fifth Circuit decision dealing with retroactivity in the context of tax regulations, *Anderson, Clayton & Co.*,[35] which in turn relied on considerably earlier case law.

The Fifth Circuit in both cases said that the IRS and Treasury's decision to apply a new regulation retroactively under the authority of the 1954 version of section 7805(b) is evaluated under an abuse of discretion standard, and it listed four factors to be considered in that evaluation. Those factors will be discussed later.

Because the *Anderson, Clayton* factors for evaluating the validity of retroactive tax regulations do not reflect the significant guidance on retroactivity issues provided by the Supreme Court in *Landgraf* and *Bowen*, and likewise do not reflect the effect of *Chevron* and *Brand X* as discussed above, the analysis in that case simply cannot be accepted as an accurate statement of the current law on retroactivity. *Anderson, Clayton* reflected a judicial attitude toward retroactivity that was clearly repudiated in *Bowen* and *Landgraf*.

The judicial attitude reflected in *Anderson, Clayton* was based on a presumption in favor of retroactivity, whereas *Bowen* and *Landgraf* clearly reflect a presumption against retroactivity. A significant body of law on retroactivity has developed under *Landgraf*. That body of law must be taken into consideration in any retroactivity analysis, including retroactivity analysis under the 1954 version of section 7805(b).

Bowen and *Landgraf*

In *Bowen*, the Supreme Court held that the Department of Health and Human Services did not have statutory authority to issue retroactive regulations and that the regulations at issue were therefore invalid. In the course of its discussion of retroactivity, the Court stated: ''Retroactivity is not favored in the law. Thus, congressional enactments and administrative rules will not be construed to have retroactive effect unless their language requires this result.''[36]

The circumstances in *Bowen* are distinguishable from those relating to the omission from gross income regulations, because of the authorization for retroactive regulations provided by the 1954 version of section 7805(b). However, as discussed above, that authorization, which predated *Chevron* and *Brand X* by many years, cannot reasonably be viewed as encompassing retroactive application for the broad scope of rulemaking authority permitted by those cases. The scope of agency authority provided by *Chevron* and *Brand X* is clearly necessary to the government's claim that the omission from gross income regulations are substantively valid, entirely apart from the retroactivity issue.

The negative attitude toward retroactivity reflected in the *Bowen* Court's blanket statement that ''retroactivity is not favored in the law'' cannot be viewed as limited to situations in which retroactive regulations are not statutorily authorized. It must also be considered applicable when the scope of the statutory authorization for retroactive regulations is unclear, as with the 1954 version of section 7805(b), taking into account later developments in the law as noted above. In 1991 a prominent commentator noted: ''Existing law on retroactivity of tax regulations needs to be reconsidered in light of the Supreme Court's decision in *Bowen*.''[37]

Two decades later, that reconsideration to reflect important Supreme Court decisions on retroactivity outside the tax context, such as *Bowen* and *Landgraf*, has not yet taken place. The 1996 amendment to section 7805(b) is probably one reason.[38] However, the retroactivity issue raised by the omission from gross income regulations requires that that reconsideration no longer be postponed.

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[33]*Bowen v. Georgetown University Hospital*, 488 U.S. 204 (1988).

[34]*United States v. Carlton*, 512 U.S. 26 (1994).

[35]*Anderson, Clayton & Co. v. United States*, 562 F.2d 972 (5th Cir. 1977).

[36]488 U.S. at 208.

[37]Michael Asimow, ''Public Participation in the Adoption of Temporary Tax Regulations,'' 44 *Tax Law.* 343, 350 n.37 (1991). The government cites another part of that article in its briefs in the various courts of appeals cases dealing with the omission from gross income regulations. *See, e.g.*, Brief for the Appellant at 59-60, *Intermountain*.

[38]Another likely reason the judicial attitude toward retroactivity reflected in *Bowen* and in *Landgraf* has not yet been taken into account in tax cases is ''tax myopia,'' the insularity of the tax community in mistakenly believing that developments in the law outside of tax have no potential relevance for tax and can therefore be ignored. *See* Paul L. Caron, ''Tax Myopia, or Mamas Don't Let Your Babies Grow Up to Be Tax Lawyers,'' 14 *Va. Tax Rev.* 517 (1994); Kristin E. Hickman, ''The Need for *Mead*: Rejecting Tax Exceptionalism in Judicial Deference,'' 90 *Minn. L. Rev.* 1537, 1541 (2006).

The issue in *Landgraf* was whether a 1991 amendment to the Civil Rights Act of 1964 that increased the liability for damages in employment discrimination cases should be applied to cases that were pending in court on the date the amendment was enacted. The Supreme Court concluded that it should not be so applied.

The Court engaged in an extended analysis of the retroactivity issue. It noted that there was an ''apparent tension''[39] between ''two seemingly contradictory statements found in [the Court's] decisions concerning the effect of intervening changes in the law.''[40] The first of those statements was ''the rule that 'a court is to apply the law in effect at the time it renders its decision.'''[41] That rule would seem to support fully retroactive application of all changes in the law. That is the retroactivity rule that generally applies to changes in the law resulting from judicial decisions. The second of the two seemingly contradictory statements was the principle expressed in *Bowen* that ''retroactivity is not favored in the law.''[42]

In resolving that apparent tension, the Court made clear that ''the long line of cases applying the presumption against retroactivity'' — that is, the line of ''cases that had applied the antiretroactivity canon'' — represented the controlling principle.[43] Although *Landgraf* dealt with statutory retroactivity rather than retroactive regulations, it prominently featured quotations from *Bowen* and in fact viewed that decision as a primary representative of the anti-retroactivity principle, even though *Bowen* dealt directly with the retroactivity of regulations.

Landgraf makes clear that in cases involving a statutory retroactivity issue, the first question is whether Congress expressed a clear intention on whether the statutory provision would operate retroactively. If so, that determination is controlling. If not, the second question is whether the challenged application of the provision is in fact genuinely retroactive: ''While statutory retroactivity has long been disfavored, deciding when a statute operates 'retroactively' is not always a simple or mechanical task.''[44]

The Supreme Court provided the following guidance on when retroactivity exists:

> A statute does not operate ''retrospectively'' merely because it is applied in a case arising from conduct antedating the statute's enactment, or upsets expectations based in prior law. Rather, the court must ask whether the new provision attaches new legal consequences to events completed before its enactment. The conclusion that a particular rule operates ''retroactively'' comes at the end of a process of judgment concerning the nature and extent of the change in the law and the degree of connection between the operation of the new rule and a relevant past event. Any test of retroactivity will leave room for disagreement in hard cases, and is unlikely to classify the enormous variety of legal changes with perfect philosophical clarity. However, retroactivity is a matter on which judges tend to have ''sound . . . instinct[s],'' and familiar considerations of fair notice, reasonable reliance, and settled expectations offer sound guidance.[45]

The second step of the *Landgraf* retroactivity analysis as it has been applied in subsequent decisions looks primarily to the foregoing passage for guidance. For example, in *Princess Cruises*,[46] the Federal Circuit applied the foregoing guidance from *Landgraf* in the form of a three-part test for deciding whether an agency action should be considered impermissibly retroactive:

> Thus, the court must consider not only in a bright-line fashion whether a rule, regulation, or decision ''creates a new obligation, imposes a new duty, or attaches a new disability, in respect to transactions or considerations already past,'' but must also consider more comprehensively [1] the ''nature and extent of the change of the law,'' [2] ''the degree of connection between the operation of the new rule and a relevant past event,'' and [3] ''familiar considerations of fair notice, reasonable reliance, and settled expectations.''[47]

In comparison to the *Landgraf* factors, the *Anderson, Clayton* factors for evaluating the retroactivity of tax regulations are as follows:

> (1) whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters that law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent

[39] *Landgraf*, 511 U.S. at 263.
[40] *Id.* at 264.
[41] *Id.*
[42] *Id.*
[43] *Id.* at 278.
[44] *Id.* at 268.
[45] *Id.* at 269-270 (citations and footnote omitted).
[46] *Princess Cruises Inc. v. United States*, 397 F.3d 1358 (Fed. Cir. 2005), *Doc 2005-2573*, *2005 TNT 26-8*.
[47] *Id.* at 1362-1363 (numbers added to correspond to the three factors applied).

> Code provisions; (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether according retroactive effect would produce an inordinately harsh result.[48]

The first *Anderson, Clayton* factor somewhat resembles an amalgamation of the first and third *Landgraf* factors as listed in *Princess Cruises*. The initial part of the first *Anderson, Clayton* factor ("whether or to what extent the taxpayer justifiably relied on settled prior law or policy") is somewhat similar to the third *Landgraf* factor ("familiar considerations of fair notice, reasonable reliance, and settled expectations"), but the *Anderson, Clayton* factor unambiguously turns on individualized reliance by the particular party challenging retroactivity, whereas the corresponding *Landgraf* factor does not contain such an unambiguous individualized reliance test. The role played by reliance under *Landgraf* will be discussed below.

The second part of the first *Anderson, Clayton* factor ("whether or to what extent the putatively retroactive regulation alters that [prior] law") is quite similar to the first *Landgraf* factor ("the nature and extent of the change in the law"), but the *Landgraf* factor does not tie that consideration to reliance in the way the corresponding *Anderson, Clayton* factor does. As discussed below, the first *Landgraf* factor weighs heavily against permitting retroactive application of the omission from gross income regulations. The other *Anderson, Clayton* factors do not track the *Landgraf* factors, and nothing in the *Anderson, Clayton* factors resembles the second *Landgraf* factor ("the degree of connection between the operation of the new rule and a relevant past event").

However, as noted earlier, the most significant difference between *Landgraf* analysis and *Anderson, Clayton* analysis is not the individual factors, but rather the overriding judicial attitude toward retroactivity. As noted above, *Anderson, Clayton* analysis begins with a presumption in favor of permitting retroactivity, whereas *Landgraf* analysis begins with a presumption against permitting retroactivity.

Taxpayers in several of the pending cases on the omission from gross income regulations have cited *Landgraf*, but only for relatively limited points. Some have cited cases applying *Landgraf* as support for the principle that changes that lengthen statutes of limitations are impermissibly retroactive if the statute of limitations would already have expired under the prior law.[49] In the various pending cases, the taxpayer in *Grapevine Imports* has made the most extensive use of *Landgraf*.

However, none of the taxpayers in any of those cases has cited *Landgraf* to challenge the continued vitality of *Anderson, Clayton* analysis for tax regulations subject to the 1954 version of section 7805(b).[50] In its reply briefs in some of the pending cases, the government notes that the taxpayers had not challenged the contention in its opening briefs that the regulations are permissively retroactive under the abuse of discretion standard articulated in *Anderson, Clayton*.[51]

Because the substantial expansion of agency discretion under *Chevron* and *Brand X* did not take place until many years after the 1954 enactment of the original version of section 7805(b), that version of the statute cannot reasonably be viewed as an authorization for the IRS and Treasury to retroactively exercise the expanded agency discretion allowed by those decisions. And because *Anderson, Clayton* analysis reflects neither the effect of the *Chevron/Brand X* expanded agency discretion on the permissibility of retroactive regulations nor the changed judicial attitude toward retroactivity reflected in *Bowen* and *Landgraf*, it must be considered obsolete. As with retroactivity in any other area of federal law, *Landgraf* should be the basis for retroactivity analysis in tax, including the analysis of retroactivity under the 1954 version of section 7805(b).

The Government Relies on *Landgraf* Authority

Although the government does not explicitly acknowledge the relevance of *Landgraf* to the retroactivity analysis of the omission from gross income regulations, it places considerable weight on *Rodriguez*,[52] a Federal Circuit decision that applies the *Landgraf* analysis in evaluating the propriety of retroactive regulations. *Rodriguez* dealt with a retroactivity challenge to an agency position regarding veterans benefits.

The importance the government ascribes to *Rodriguez* is shown by the fact that in several of the pending cases outside the Federal Circuit, the government submitted supplemental authority letters directing the courts' attention to *Rodriguez*, even though that decision does not represent binding

[48] 562 F.2d at 972.

[49] *See, e.g.*, Brief for the Appellees at 38, *M.I.T.A. Partners*; brief for the Appellee at 26-29, *Beard*.

[50] One taxpayer has cited the amendment to section 7805(b) as demonstrating "Congressional hostility" to retroactive tax regulations. *See* Brief for the Appellees at 42, *M.I.T.A. Partners*.

[51] *See, e.g.*, Reply Brief for the Appellant at 9, *Grapevine Imports*.

[52] *Rodriguez v. Peake*, 511 F.3d 1147 (Fed. Cir. 2008).

precedent in those circuits and it was decided long before the government's initial appellate briefs in those cases were filed.[53] Also, the government's opening brief to the District of Columbia Circuit in *Intermountain* (which was filed after the supplemental authority letters noted above) includes an extended discussion of *Rodriguez*,[54] even though it is not binding precedent in the D.C. Circuit.

Rodriguez applied the three-factor test developed by the Federal Circuit in *Princess Cruises* for evaluating whether agency regulations have an impermissible retroactive effect and it concluded that the agency action at issue was not impermissibly retroactive. As noted above, the three-factor test in *Princess Cruises* was based on *Landgraf*. However, the government's extended discussion of *Rodriguez* in its opening brief in *Intermountain* omits any mention of *Princess Cruises*, *Landgraf*, or the three-factor test derived from *Landgraf* that the Federal Circuit adopted in *Princess Cruises* and applied in *Rodriguez*.[55]

In contrast, in the government's opening and reply briefs for the Federal Circuit in *Grapevine Imports*, which were filed much earlier than its opening brief for the D.C. Circuit in *Intermountain*, the government does cite *Princess Cruises* in connection with *Rodriguez*, despite criticizing the taxpayer's reliance on *Landgraf* because that case involved statutory retroactivity rather than retroactive regulations. The government's opening brief in *Grapevine Imports* even goes so far as to *quote* the three factors from *Princess Cruises* and *Rodriguez* but without citing *Landgraf* as the original source of the language setting forth those factors.[56] In its reply brief in *Grapevine Imports*, the government cites *Landgraf* (in response to the taxpayer's reliance on the case), *Princess Cruises*, and *Rodriguez*, but without acknowledging that there is any connection between *Landgraf* and the other two cases.[57]

Despite the government's failure to cite either *Princess Cruises* or *Landgraf* in its opening brief in *Intermountain*, and despite its failure to acknowledge the relationship between *Landgraf* and *Princess Cruises* in its *Grapevine Imports* briefs, the government's considerable reliance on *Rodriguez* must be taken as an implicit acknowledgement of the applicability of *Landgraf* (and of the three-factor test that the Federal Circuit derived from *Landgraf* in *Princess Cruises* and applied in *Rodriguez*) for purposes of evaluating whether the retroactivity of the omission from gross income regulations is impermissible. It would be difficult for the government to maintain that *Landgraf* has no application to the regulations after placing such great weight on the result in *Rodriguez*, which the Federal Circuit reached by applying a test that was indisputably based on *Landgraf*.

In particular, after placing such considerable reliance on *Rodriguez*, which not only applied *Landgraf* but also involved the retroactivity of regulations, it would be difficult for the government to claim that *Landgraf* has no relevance in evaluating the retroactivity of regulations because it involved statutory retroactivity rather than retroactive regulations. Yet, it is precisely that distinction between retroactive regulations and retroactive statutory provisions that the government attempts to rely on in response to taxpayers' citation of cases applying *Landgraf* to conclude that extensions of statutes of limitations that have the effect of reviving expired claims are impermissibly retroactive.[58]

Application of *Landgraf* Here

One of those cases applying *Landgraf* in the statute of limitations context is *Hughes Aircraft*,[59] in which the Supreme Court in dictum noted that ''extending a statute of limitations after the pre-existing statute of limitations has expired impermissibly revives a moribund cause of action.''[60] As support, the Court cited *Chenault*,[61] a Ninth Circuit decision it described as ''relying on *Landgraf* in concluding that 'a newly enacted statute that lengthens the applicable statute of limitations may not be applied retroactively to revive a plaintiff's claim that was otherwise barred under the old statutory scheme.'''[62] Taxpayers in the omission from gross income cases have also cited several other court of appeals decisions that reached the same result under *Landgraf* on statute of limitations extensions.[63]

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[53]*See*, *e.g.*, letter dated October 7, 2010, *Home Concrete & Supply LLC*, No. 09-2353 (4th Cir.); letter dated October 8, 2010, *M.I.T.A. Partners*, No. 09-60827 (5th Cir.); letter dated Oct. 8, 2010, *Burks*, No. 09-11061 (5th Cir.).

[54]*See* Brief for the Appellant at 65-68, *Intermountain*.

[55]*Id.*

[56]Brief for the Appellant at 56, *Grapevine Imports*.

[57]*See* Reply Brief for the Appellant at 9-12, 19-20, *Grapevine Imports*.

[58]*See*, *e.g.*, Reply Brief for the Appellant at 48, *M.I.T.A. Partners*; Reply Brief for the Appellant at 21-22, *Beard*.

[59]*Hughes Aircraft Co. v. United States ex rel. Schumer*, 520 U.S. 939 (1997).

[60]*Id.* at 950.

[61]*Chenault v. U.S. Postal Service*, 37 F.3d 535 (9th Cir. 1994).

[62]*Hughes Aircraft*, 520 U.S. at 950 (quoting *Chenault*, 37 F.3d at 539).

[63]*Lieberman v. Cambridge Partners LLC*, 432 F.3d 482 (3d Cir. 2005); *Margolies v. Deason*, 464 F.3d 547 (5th Cir. 2006); *In re Enterprise Mortgage Acceptance Co. Securities Litigation*, 391 F.3d 401 (2d Cir. 2004). *See*, *e.g.*, Brief for the Appellees at 38, *M.I.T.A. Partners*.

Those cases have reached the conclusion that extensions of statutes of limitations are impermissibly retroactive without going through the specific *Landgraf* factors. Still, those factors support the conclusion of impermissible retroactivity in the present case.

As noted above, the first factor in the three-factor test based on *Landgraf* applied by the Federal Circuit is ''the nature and extent of the change in the law.'' It is hard to imagine how the nature and extent of the change in the law could be more substantial than when an agency attempts by regulation to overrule a Supreme Court decision. It is presumably largely because of that significant legal change that Tax Court judges James S. Halpern and Mark V. Holmes, concurring in *Intermountain*, concluded that overruling a Supreme Court decision was the type of agency action that could be implemented only using procedures that complied with the APA's notice and comment requirements.[64]

In that regard, the preamble to the final regulations leaves no room for doubt that the IRS and Treasury intended to overrule the Supreme Court:

> The interpretation adopted by the Supreme Court in *Colony* represented that court's interpretation of the phrase but not the only permissible interpretation of it. Under the authority of *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-83 (2005), the Treasury Department and the Internal Revenue Service are permitted to adopt another reasonable interpretation of ''omits from gross income,'' particularly as it is used in a new statutory setting. *See Hernandez-Carrera v. Carlson*, 547 F.3d 1237 (10th Cir. 2008) (agencies are free to promulgate a reasonable construction of an ambiguous statute that contradicts any court's interpretation, even the Supreme Court's).[65]

Thus, with the omission from gross income regulations, the extent of the change from prior law — which is always large when the change revives claims that would be considered barred by the statute of limitations under prior law — is made even more substantial by the fact that it is being accomplished by an agency's attempt to overrule a Supreme Court decision.[66]

The second factor in the three-factor test based on *Landgraf* is ''the degree of connection between the operation of the new rule and a relevant past event.'' In a case involving a change in a statute of limitations that has the effect of reviving claims that would be barred under prior law, the connection between the new rule and past events is extremely close. Thus, the first two *Landgraf* factors clearly support the conclusion that the retroactivity of the omission from gross income regulations is impermissible.

The third *Landgraf* factor — ''familiar considerations of fair notice, reasonable reliance, and settled expectations'' — raises the issue of the role properly played by reliance in the *Landgraf* analysis. The government contends that the taxpayers cannot successfully challenge retroactive application of the omission from gross income regulations because they cannot show that they relied on prior law.

According to the government, ''they cannot point to anything they would have done differently had they known of the effect of the Treasury regulations when the transactions in this case occurred.''[67] It is primarily in support of that argument that the government relies on *Rodriguez*. Individualized reliance was clearly a relevant consideration under the *Anderson, Clayton* factors, but, as discussed above, those factors must be viewed as obsolete. The role of reliance under *Landgraf* will be discussed in more detail below.

Government's 'Mere Clarification' Argument

As discussed above, the first *Landgraf* factor — ''the nature and extent of the change in the law'' — clearly points to the conclusion that the change in law resulting from the omission from gross income regulations is substantial enough that retroactivity exists because they attempt to overrule a Supreme Court decision and they revive claims that would be barred under that decision. In contrast, the principal theme of the government's argument for why the regulations are not impermissibly retroactive is that they represent a mere clarification of the law in an area that was uncertain.

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[64]*Intermountain*, 134 T.C. at 244 (Halpern and Holmes, J.J., concurring in the result only).

[65]75 *Fed. Reg.* at 78897. As noted earlier, the preamble to the temporary regulations did not include a corresponding statement.

[66]As noted above, the Fourth Circuit was to issue its opinion in *Home Concrete* after this report was completed. As an alternative rationale on the issue of whether the regulations could

(Footnote continued in next column.)

properly be applied retroactively, the Fourth Circuit concluded that retroactive application would be impermissible because the regulation would change the law by overruling the Supreme Court's holding in *Colony*. *Home Concrete*, slip op. at 14-15. As support, the Fourth Circuit cited its prior decision in *United States v. Capers*, 61 F.3d 1100 (4th Cir. 1995) (not cited in the taxpayer's briefs). That case held that an amendment to the federal sentencing guidelines could not be applied retroactively as a mere clarification, because the effect of the amendment was to change the law in the circuit. *Id.* at 1110. The court cited decisions from other circuits taking the same approach. *Id.* at 1110-1111.

[67]Brief for the Appellant at 65, *Intermountain*.

For example, in its opening brief in *Intermountain*, the government acknowledges ''the general prohibition on retroactive agency rulemaking'' but contends that it does not apply to rules that merely clarify existing law.[68] The government does not attempt to explain how a regulation that purports to overrule a Supreme Court decision can reasonably be described as representing a mere clarification of existing law, and it does not cite any cases holding that a regulation overruling a Supreme Court decision may properly be applied retroactively. The government's position is instead that the law was unclear on whether *Colony* remained good law under the 1954 code, even though the Ninth Circuit and the Federal Circuit had concluded it did.

In support, the government points to a 1968 Fifth Circuit decision[69] that purportedly reached a result at odds with that of the Ninth and Federal circuits.[70] However, in a recent opinion, the Fifth Circuit held that its prior decision does not in fact stand for the proposition the government contends.[71] Nevertheless, even if that earlier Fifth Circuit decision supported the government's position, the government ignores case law that calls into question its reliance on the proposition that any change in the law that might be characterized as a mere clarification may permissibly be made effective retroactively.

In support of that proposition, the government's opening brief in *Intermountain* cites opinions from the Third, Sixth, and Seventh circuits.[72] However, none of those cases involved a situation in which the ''clarified'' issue was whether a prior Supreme Court decision interpreting a statutory provision remained applicable after amendments affected related provisions of the statute.[73]

Moreover, even though *Intermountain* is in the D.C. Circuit, the government's opening brief in that case cites no D.C. Circuit cases in support of the ''mere clarification'' proposition. That omission might be explained by the fact that one D.C. Circuit decision is quite damaging to the government's position that the omission from gross income regulations do not have an impermissibly retroactive effect.

In *National Mining*,[74] the D.C. Circuit addressed whether regulations issued by the Department of Labor had a retroactive effect. The court described the applicable legal standard for determining whether a regulation is retroactive based on *Landgraf* and D.C. Circuit cases applying *Landgraf*: ''The critical question is whether a challenged rule establishes an interpretation that 'changes the legal landscape.'''[75]

The court applied the foregoing general principle as follows:

> The Secretary argues, and the District Court agreed, that none of the challenged rules changes the landscape, because the rules merely clarify the Secretary's position or conform to cases decided by the Courts of Appeals. In analyzing each new regulation, we first look to see whether it effects a substantive change from the agency's prior regulation or practice. If a new regulation is substantively consistent with prior regulations or prior agency practices, *and has been accepted by all Courts of Appeals to consider the issue*, then its application to pending cases has no retroactive effect. *If a new regulation is substantively inconsistent with* a prior regulation, prior agency practice, or *any Court of Appeals decision rejecting a prior regulation or agency practice, it is retroactive as applied to pending claims*.
>
> Some of the challenged rules here codify the results of a case in one circuit while effectively reversing a case in another circuit in which the court rejected the Secretary's practice or policy. Such rules change the legal landscape as applied to cases that were pending when the

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[68]*Id.* at 66.

[69]*Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968).

[70]*See, e.g.*, Brief for the Appellant at 64, *Intermountain*. The government also relies on the fact that a few trial courts have reached results at variance with the Ninth Circuit and the Federal Circuit.

[71]*Burks*.

[72]*Id.* at 66. The cases cited are *Levy v. Sterling Holding Co. LLC*, 544 F.3d 493, 506 (3d Cir. 2008); *First National Bank of Chicago v. Standard Bank & Trust*, 172 F.3d 472, 478 (7th Cir. 1999); and *Orr v. Hawk*, 156 F.3d 651, 654 (6th Cir. 1998).

[73]Of the three cases cited by the government, the Third Circuit's *Levy* decision arguably comes the closest to the present circumstances, because the regulation at issue there reversed the result reached by a prior Third Circuit decision under the authority of *Brand X*. *Levy*, 544 F.3d at 501-502. However, what was held to be a mere clarification in that case was the meaning of a prior regulation, not the meaning of a statutory provision, and the Third Circuit applied a four-factor test that by its terms is applicable only to clarifications of prior regulations. *Id.* at 506-508. The Seventh Circuit decision cited by the government dismisses *Landgraf* in a footnote as being inapplicable because it involved statutory retroactivity, not retroactive regulations. *First National Bank of Chicago*, 172 F.3d at 478 n.7. As discussed above, it is difficult for the government to rely on that basis for dismissing *Landgraf* in connection with the omission from gross income regulations after having given so much emphasis to the *Rodriguez* decision.

(Footnote continued in next column.)

[74]*National Mining Ass'n v. Department of Labor*, 292 F.3d 849 (D.C. Cir. 2002). This case is not cited by either the taxpayer or the amicus in their briefs in the D.C. Circuit in *Intermountain*, and it has not been cited by any of the taxpayers with cases on that issue in other circuits.

[75]*Id.* at 859 (citations omitted).

> regulations were promulgated. It goes without saying that such rules change the law for cases pending in the circuit that previously rejected the Secretary's approach. . . . Less obviously, the regulations preclude the courts in other circuits from adopting the view of their sister court rejecting the Secretary's position, a possibility that was still available when the cases were initially filed. Thus, to the extent that a new rule reflects a substantive change from the position taken by any of the Courts of Appeals and is likely to increase liability, that rule is impermissibly retroactive as applied to pending claims.[76]

The principle adopted by the D.C. Circuit in the passage quoted above is that an agency regulation will be considered retroactive if it is inconsistent with *any* prior decision by *any* court of appeals, even if there are *other* decisions by *other* courts of appeals that endorse the agency position. Under that principle, the omission from gross income regulations are unquestionably retroactive, because the interpretation reflected in the regulations was rejected by both the Federal and Ninth circuits.

Presumably the D.C. Circuit, in applying the foregoing test, would view an agency regulation that purports to overrule a Supreme Court decision as changing the legal landscape and therefore coming within that principle for categorizing a regulation as retroactive. Moreover, under D.C. Circuit authority, ''even where a rule merely narrows 'a range of possible interpretations' to a single 'precise interpretation,' it may change the legal landscape in a way that is impermissibly retroactive.''[77]

Similarly, the Federal Circuit in *Princess Cruises* rejected the government's position that the decision on whether agency action should be considered retroactive should be based on whether the action represented a change or a clarification:

> The government focuses its retroactivity arguments on a test it discerns from the Seventh Circuit, in which the court discussed ''whether a rule is a *clarification* or a *change* in the law.'' *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). Under this doctrine, changes, but not clarifications, have retroactive effect. The *Pope* court reasoned that ''[a] rule simply clarifying an unsettled or confusing area of the law . . . does not change the law, but restates what the law according to the agency is and has always been.'' 998 F.2d at 483. Further, under *Pope,* courts in the Seventh Circuit ''will defer to an agency's expressed intent that a regulation is clarifying unless the prior interpretation of the regulation or statute in question is patently inconsistent with the later one.'' *Id.*
>
> We find the binary analysis — change or clarification — advanced by the government largely unhelpful. Merely categorizing rules or applications of rules as ''clarifications'' or ''changes'' provides little insight into whether a retroactive effect would result in a particular case. As noted by the Court of Appeals for the D.C. Circuit, a clarification, in fact, ''changes the legal landscape,'' because ''a precise interpretation is not the same as a range of possible interpretations.'' *Health Ins. Ass'n of Am., Inc. v. Shalala*, 23 F.3d 412, 423-24 (D.C. Cir. 1994); *McCoy* [*v. Gilbert*], 270 F.3d [503] at 509 [(7th Cir. 2001)] (noting that the *Landgraf* factors must be applied because ''almost every new statute results in some perceptible effect or impact on countless past or pre-existing choices, decisions, and interests of the actors and subjects in the newly-regulated field'').
>
> Further, the bright-line, binary test espoused by the government conflicts with the court's obligation to weigh the various factors described in *Landgraf.* Indeed, *Landgraf* explicitly requires the court to consider ''the *nature and extent* of the change in the law,'' not merely whether a change has occurred. 511 U.S. at 270.[78] [Emphasis added.]

The test that was proposed by the government but rejected by the Federal Circuit in the foregoing passage is the same test the government is relying on for the omission from gross income regulations. The government contends that the regulations merely clarify an uncertainty in the law and that, for

[76] *Id.* at 860 (citations omitted; emphasis added). The reference in this passage to a ''substantive change'' clearly was not meant to draw a distinction between ''substantive'' rules and ''procedural'' rules, because in the paragraph in the opinion immediately preceding the quoted passage, the court noted, ''rather than rely on 'procedural' and 'substantive' labels, a court must 'ask whether the [regulation] operates retroactively.'' *Id.* at 859.

[77] *Arkema Inc. v. EPA*, 618 F.3d 1, 7 (D.C. Cir. 2010) (citations omitted).

[78] *Princess Cruises*, 397 F.3d at 1363. As noted earlier, after this report was completed, the Federal Circuit issued its opinion in *Grapevine Imports*. That opinion rejected the taxpayer's retroactivity challenge in a fairly brief discussion upholding retroactive application of the regulations under the abuse of discretion standard. Slip op. at 23-25. This discussion does not refer to *Princess Cruises* or *Rodriguez* and holds *Landgraf* satisfied because the applicable version of section 7805(b) clearly authorizes retroactive regulations. Slip op. at 25.

that reason, they are either not retroactive or not impermissibly retroactive.

In the quoted passage from *Princess Cruises*, the Federal Circuit clearly rejected that possible standard for evaluating retroactivity.[79] As discussed above, in light of the government's considerable emphasis on *Rodriguez*, and in light of the fact that *Rodriguez* merely applied the retroactivity test developed in *Princess Cruises*, it is difficult for the government to ignore or dismiss the conclusion reached by the Federal Circuit in the foregoing passage.

Thus, it is clear that in both the D.C. and Federal circuits, the government's ''mere clarification'' argument should fail because it conflicts with circuit precedent. Also, the argument should fail in all circuits because it disregards that the regulations purport to overrule a Supreme Court decision and thus cannot be a mere clarification.

The Role of Reliance

As noted above, the third *Landgraf* factor raises the question of the proper role to be played by reliance in retroactivity analysis. The principal reason the government places so much weight on *Rodriguez* is that it believes that decision makes reliance a relevant consideration.[80] However, by relying so heavily on that single decision as support for requiring individualized reliance as part of the retroactivity analysis, the government significantly oversimplifies the state of the law on that point.

Several courts of appeals have addressed the role to be played by reliance in applying the *Landgraf* retroactivity analysis, but their answers have not been uniform. The question is whether, to prevail in a *Landgraf* retroactivity dispute, the challenging party must demonstrate that he relied on the prior state of the law in some identifiable way, and whether, as part of that showing, he must demonstrate that he could or would have behaved differently with knowledge of the new legal rule.[81]

Based on an extended analysis, the Fourth Circuit concluded in *Olatunji* that ''neither *Landgraf*'s holding nor subsequent Supreme Court authority supports a subjective reliance requirement.''[82] In *Atkinson*, the Third Circuit concluded that ''impermissible retroactivity, as defined in *Landgraf*, does not require that those affected by the change in law have relied on the prior state of the law.''[83] In *Lovan*, the Eighth Circuit followed the Third Circuit's decision in *Atkinson* in concluding that ''requiring actual reliance in each case 'runs contrary' to the Supreme Court's retroactivity analysis in *Landgraf*.''[84] In *Hem*, the Tenth Circuit concluded that ''the Supreme Court has never insisted upon actual reliance as a prerequisite to sustain a retroactivity challenge.''[85] In *Hernandez de Anderson*, the Ninth Circuit followed the approach taken by the Tenth Circuit.[86]

In contrast, for example, the Second Circuit in *Wilson* held that at least in one specific statutory context, ''our choice between a categorical approach to reliance or an individualized approach to reliance depends upon the general likelihood that aliens of a particular class altered their conduct in reasonable reliance on'' prior law.[87] Dealing with the same immigration statute, the Fifth Circuit in *Carranza-De Salinas* similarly required an individualized showing of reliance for a *Landgraf* retroactivity challenge to prevail.[88] Also in the same context, the Seventh Circuit in one case described its approach as being an ''actual reliance requirement,''[89] but in a more recent decision it described its approach on the retroactivity issue as ''categorical.''[90] Again addressing the immigration statute, the Eleventh Circuit in *Ferguson* held that ''reliance is a component of the

[79]In addition to the points made by the Federal Circuit in the quoted passage, it should be noted that the Seventh Circuit case discussed in this passage predated *Landgraf*.

[80]However, in *Rodriguez*, as in the cases relied on by the government in support of the proposition that a mere clarification of the law is not impermissibly retroactive, the issue that was clarified did not involve the question whether a prior Supreme Court decision interpreting a statutory provision remained applicable after statutory changes affecting related provisions of the statute. Another significant difference between the situation in *Rodriguez* and the context of the omission from gross income regulations is that, while the government asserts that the IRS has ''consistently'' interpreted the omission from gross income test in the manner set forth in the new regulations, the government has not identified any official public announcement of that position before the promulgation of the temporary regulations in late September 2009. In contrast, in *Rodriguez*, the agency relied on the fact that ''the General Counsel for the Department officially announced [its] interpretation in 1990,'' six years before the claims at issue in the case were filed. *Rodriguez*, 511 F.3d at 1153.

[81]The taxpayer's brief, Brief for Appellees, in *UTAM Ltd. v. Commissioner*, No. 10-1262 (D.C. Cir. 2011), which was filed after this report was completed, argues that reliance exists because the taxpayer relied on *Colony* in filing suit. *Id.* at 30-31.

[82]*Olatunji v. Ashcroft*, F.3d 383, 391 (4th Cir. 2004).

[83]*Atkinson v. Attorney General*, 479 F.3d 222, 229 (3d Cir. 2007).

[84]*Lovan v. Holder*, 574 F.3d 990, 993 (8th Cir. 2009).

[85]*Hem v. Maurer*, 458 F.3d 1185, 1195 (10th Cir. 2006).

[86]*Hernandez de Anderson v. Gonzales*, 497 F.3d 927, 940-941 (9th Cir. 2007).

[87]*Wilson v. Gonzales*, 471 F.3d 111, 122 (2d Cir. 2006).

[88]*Carranza-De Salinas v. Gonzales*, 477 F.3d 200, 210 (5th Cir. 2007).

[89]*United States v. De Horta Garcia*, 519 F.3d 658, 661 (7th Cir. 2008).

[90]*Canto v. Holder*, 593 F.3d 638, 644 (7th Cir. 2010).

retroactivity analysis.''[91] In *Kellermann*, the Sixth Circuit seems to have followed the Eleventh Circuit's *Ferguson* decision in the same context.[92]

As the foregoing discussion suggests, the government has drastically oversimplified the analysis of reliance by relying on a single decision — *Rodriguez* — to support the conclusion that individualized reliance is necessary to support a retroactivity challenge under the *Landgraf* analysis. Moreover, even *Rodriguez* does not hold that individualized reliance is always necessary for a successful retroactivity challenge.

The passage in *Landgraf* from which the three factors are taken suggests that the third factor — ''familiar considerations of fair notice, reasonable reliance, and settled expectations'' — comes into play only in hard cases, when the first two factors do not provide a clear answer to the retroactivity analysis. In *Princess Cruises*, the Federal Circuit noted that the D.C. Circuit ''appears to view the 'familiar considerations' [that is, the third *Landgraf* factor] as akin to a tiebreaker in close cases.''[93]

The Federal Circuit in *Princess Cruises* went on to note that, ''in this case, however, we need not resolve the relative weight to be given to the third *Landgraf* factor because it points in the same direction as the first and second factors.''[94] Likewise, in *Rodriguez*, after noting the foregoing points from *Princess Cruises*, the Federal Circuit stated, ''similarly, here, because we find that all three factors favor the same position, we need not decide how much weight to afford the third prong of the test.''[95]

Thus, *Rodriguez* clearly does not support the government's position that individualized reliance is always necessary for a party making a retroactivity challenge to prevail. The better answer is that when the first two *Landgraf* factors clearly support a retroactivity challenge, as they do with the omission from gross income regulations, a showing of individualized reliance is not required for a retroactivity challenge to prevail. Moreover, the cases noted earlier that hold that it is impermissibly retroactive to extend a statute of limitations in a way that revives claims that would be barred under the prior law do not engage in any inquiry whether the party challenging the extension can demonstrate specific and individualized reliance.

Conclusion

Because of the substantial expansion of the scope of agency discretion resulting from the Supreme Court's decisions in *Chevron* and *Brand X* many years after the enactment of the original version of section 7805(b), that provision cannot reasonably be interpreted as authorizing retroactive regulations that exercise the broad authority granted by those decisions. Because of that same expansion, and because of the change in judicial attitude toward retroactivity reflected in the Supreme Court's decisions in *Bowen* and *Landgraf*, the abuse of discretion standard for evaluating the retroactivity of regulations under the 1954 version of section 7805(b) as set forth in the Fifth Circuit's 1977 *Anderson, Clayton* decision is obsolete. Under the *Landgraf* three-factor test for evaluating retroactivity, the omission from gross income regulations are impermissibly retroactive.

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[91]*Ferguson v. Attorney General*, 563 F.3d 1254, 1271 (11th Cir. 2009).

[92]*Kellermann v. Holder*, 592 F.3d 700, 706-707 (6th Cir. 2010).

[93]*Princess Cruises*, 397 F.3d at 1366 (citing *Marrie v. SEC*, 374 F.3d 1196, 1207 (D.C. Cir. 2004)).

[94]*Princess Cruises*, 397 F.3d at 1366.

[95]*Rodriguez*, 511 F.3d at 1155.