Omissions From Gross Income and 'Numerators and Denominators'

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As expected after the questioning during oral arguments, the D.C. Circuit's recent *Intermountain* decision followed the Seventh Circuit's *Beard* decision in basing its holding on the special rule defining gross income as gross receipts for sales of goods or services in a trade or business for purposes of the 25 percent omission from gross income test for extending the statute of limitations for assessments of tax. The D.C. Circuit, like the Seventh Circuit, concluded that the presence of this special rule in the current statute, and its absence from the statute at issue in the Supreme Court's 1958 *Colony* decision, means that *Colony* is not controlling on whether an overstatement of basis resulting in an understatement of gross income is an omission under the 25 percent omission test.

Like the Seventh Circuit, the D.C. Circuit was mistaken in relying on this special gross receipts rule as the basis for concluding that *Colony* is no longer controlling, because the effects of *Colony* and the special gross receipts rule are similar only in the first step of the multi-step omission from gross income test — namely, in determining whether there has been an omission. In the later steps of the test, *Colony* and the special gross receipts rule are not at all similar, and these later steps cannot properly be dismissed, as by the Seventh Circuit, as mere "numerators and denominators."

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Background

In previous articles,[1] I have discussed several issues relating to the regulations[2] that overruled the Supreme Court's 1958 *Colony* decision.[3] *Colony* involved the statutory rule that extends the statute of limitations for assessments of additional tax when a taxpayer has omitted from gross income an amount that exceeds 25 percent of the gross income reported on the taxpayer's tax return. *Colony* held that an overstatement of basis that results in an understatement of gross income does not represent an omission from gross income for purposes of this 25 percent omission test. The validity of these regulations is the subject of litigation in multiple circuits. To date, four circuits have held for the government and two have held for the taxpayers.[4]

The cases relating to the overstated basis regulations are important for many reasons that extend

[1]*See* Patrick J. Smith, "Omissions From Gross Income and Retroactivity," *Tax Notes*, Apr. 4, 2011, p. 57, *Doc 2011-4748*, or *2011 TNT 65-7*; Smith, "Omissions From Gross Income and the *Chenery* Rule," *Tax Notes*, Aug. 16, 2010, p. 763, *Doc 2010-16074*, or *2010 TNT 158-3*; Smith, "*Brand X* and Omissions From Gross Income," *Tax Notes*, Feb. 1, 2010, p. 665, *Doc 2010-604*, or *2010 TNT 22-5*.

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

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

[4]*Compare Beard v. Commissioner*, 633 F.3d 616 (7th Cir. 2011), *Doc 2011-1764*, *2011 TNT 18-10* (holding that the interpretation adopted in the regulations is required under the clear language of the statute, taking into account the changes in the 25 percent omission test between the version at issue in *Colony* and the current version), and *Grapevine Imports Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011), *Doc 2011-5233*, *2011 TNT 49-14* (holding that *Colony* did not arrive at the only permissible interpretation of the version of the 25 percent omission test at issue there, and that the statutory changes to the 25 percent omission test also provide a basis for adopting a different interpretation), *with Home Concrete & Supply LLC v. United States*, 634 F.3d 249 (4th Cir. 2011), *Doc 2011-2674*, *2011 TNT 26-7* (holding that *Colony* remains applicable under the current version of the 25 percent omission test), and *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), *Doc 2011-2857*, *2011 TNT 28-12* (same). After this report was completed, the Tenth Circuit and the D.C. Circuit issued decisions in favor of the government. *See Salman Ranch Ltd. v. Commissioner*, No. 09-9015 (10th Cir. May 31, 2011), *Doc 2011-11714*, *2011 TNT 105-16*; *Intermountain Insurance Service of Vail LLC v. Commissioner*, No. 10-1204 (D.C. Cir. June 21, 2011), *Doc 2011-13510*, *2011 TNT 120-10*.

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well beyond the particular point of statutory interpretation at issue in the cases.[5] One reason for the importance of the cases was articulated in a concurring opinion in the Fourth Circuit's *Home Concrete* decision expressing the view held by many that the regulations represent extreme overreaching by the IRS and Treasury:

> It remains the case that agencies are not a law unto themselves. No less than any other organ of government, they operate in a system in which the last words in law belong to Congress and the Supreme Court. What the IRS seeks to do in extending the statutory limitations period goes against what I believe are the plain instructions of Congress, which have not been changed, and the plain words of the Court, which have not been retracted.
>
> This seems to me something of an inversion of the universe and to pass the point where the beneficial application of agency expertise gives way to a lack of accountability and a risk of arbitrariness.[6]

In light of the split in the circuits, it seems inevitable that the issue will be resolved by the Supreme Court. Another reason the cases are important is that a decision by the Supreme Court will provide an opportunity for the Court to clarify the meaning of its recent *Mayo* decision, which has been understood by some to grant the IRS and Treasury much broader authority in issuing regulations than would seem apparent from the text of the *Mayo* decision itself.[7]

In light of the importance of these cases, it is desirable that their ultimate resolution not be based on confusion or happenstance of argumentation. Based on specific developments in some of these cases, it seems there is a risk of this undesirable outcome.

One of the principal issues raised by the regulations is whether the IRS and Treasury properly invoked the authority of the Supreme Court's 2005 *Brand X* decision, which, under some circumstances, authorizes agencies to overrule court decisions on issues of statutory interpretation relating to a statute administered by the agency. At the oral argument for the *Intermountain*[8] and *UTAM*[9] cases in the D.C. Circuit, two of the three judges on the panel seemed to be looking for a way to avoid having to address the *Brand X* issue of whether *Colony* was the type of statutory interpretation decision that could properly be overruled by a contrary agency interpretation. Those two judges seemed to want to find a way to avoid applying *Colony* without having to go through the *Brand X* analysis.[10]

The two judges were interested in an argument that was rejected in *Bakersfield*[11] and *Salman Ranch*[12] before the regulations were issued. This argument contends that a new statutory special rule relating to the 25 percent omission test that was not present in the version of the test at issue in *Colony* supposedly is equivalent to *Colony* and has made *Colony* inapplicable under the current version of the 25 percent omission test. Because this was also the

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[5]For example, these cases present (1) the issue of whether legislative history is properly considered under step one of the two-step test for evaluating the validity of regulations established in *Chevron U.S.A. Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837 (1984), both for purposes of direct application of the *Chevron* test and for purposes of applying the rule in *Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Serv.*, 545 U.S. 967 (2005), that judicial interpretations of statutory provisions cannot be overruled by agency regulations if the judicial interpretation represented an application of step one of *Chevron* rather than step two; (2) the issue of whether *Brand X* authorizes agencies to overrule decisions of the Supreme Court; (3) if so, whether that action by an agency must be accomplished through the issuance of regulations using notice and comment procedures rather than through ''interpretative rules'' that are exempt from notice and comment; (4) the issue of how to determine whether particular regulations are ''interpretative rules'' for purposes of the exemption from the Administrative Procedure Act (APA) notice and comment requirements; (5) the issue of whether IRS temporary regulations are subject to the notice and comment requirements of the APA, despite the references to temporary regulations in section 7805(e), which the government claims supersede the APA notice and comment requirements; (6) if temporary regulations are subject to the APA notice and comment requirements, whether the opportunity for post-promulgation notice and comment cures the failure to provide for pre-promulgation notice and comment; and (7) whether the regulations are impermissibly retroactive because the authority of the IRS to issue retroactive regulations relating to statutory provisions enacted before the 1996 amendment to section 7805(b) has necessarily been limited by the broadened discretion relating to the substantive content of regulations authorized by *Chevron*, *Brand X*, and *Mayo Found. for Med. Educ. and Research v. United States*, 131 S. Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*.

[6]*Home Concrete*, 634 F.3d at 259 (Wilkinson, J., concurring).

[7]*See*, *e.g.*, Smith, ''Life After *Mayo*: Silver Linings,'' *Tax Notes*, June 20, 2011, p. 1252, *Doc 2011-10520*, or *2011 TNT 119-2*.

[8]*Intermountain*, No. 10-1204 (D.C. Cir.).

[9]*UTAM Ltd. v. Commissioner*, No. 10-1262 (D.C. Cir. 2011), *Doc 2011-13514*, *2011 TNT 120-11*.

[10]These are my observations based on my attendance at the oral argument. My observations are consistent with the reporting on the oral argument. *See* Jeremiah Coder, ''D.C. Circuit Hears Oral Arguments in *Intermountain*,'' *Tax Notes*, Apr. 11, 2011, p. 135, *Doc 2011-7276*, or *2011 TNT 66-5*.

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

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

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approach taken by the Seventh Circuit in *Beard*,[13] it seems clear that this aspect of the controversy deserves more careful attention than it has received so far.[14]

Close attention to the argument that the addition of a new statutory special rule has made *Colony* inapplicable under the current version of the 25 percent omission test reveals that this argument is incorrect. This statutory addition is equivalent to *Colony* in its effect only in the very first step of the multi-step 25 percent omission from gross income test. Moreover, *Colony* is also different in scope from the new statutory special rule.

Any conclusion that *Colony* is equivalent to this new statutory special rule gives undue weight to the first step in the 25 percent omission test and ignores the effect of the later steps. Although the Seventh Circuit in *Beard* seemingly concluded that the focus of the later steps on "numerators and denominators"[15] made these later steps unimportant, numerators and denominators are what the 25 percent omission test is all about.

This argument has not received more careful attention in the current round of cases because, unlike in *Bakersfield* and *Salman* (Fed. Cir.), the government has not presented this argument in a fully developed way, and the taxpayers have likewise not presented fully developed responses to the argument. In the current cases, the government has benefited from the confusion that has resulted from the lack of full development of and response to this argument. It would be unfortunate if confusion on this issue were to continue when these issues reach the Supreme Court.

This report was prompted by the oral argument in the D.C. Circuit in *Intermountain* and was completed before the D.C. Circuit issued its recent opinion in that case. However, the questions from the judges at the oral argument provided an accurate prediction of the reasoning in the opinion. I will make some comments on the opinion at the end of this report.

Colony Is Not Equivalent to the Special Rule

The statutory addition in the current 25 percent omission test that supposedly makes *Colony* inapplicable under this version of the test is the following special rule, which applies only for purposes of the current 25 percent omission test:

> In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.[16]

Under this special rule, gross income from the sale of goods or services in a trade or business is defined as gross receipts solely for purposes of the 25 percent omission test. To reach the conclusion that the addition of this special gross receipts rule makes *Colony* inapplicable under the current version of the 25 percent omission test, it would be necessary for the special gross receipts rule and *Colony* to be equivalent.

However, it is clear the special gross receipts rule produces results that are different from the results produced by *Colony*. Both the scope and the effect of the special rule are different from the scope and effect of *Colony*. Consequently, it is clear the addition of this special gross receipts rule does not make *Colony* inapplicable under the current version of the 25 percent omission test.

The following discussion distinguishes between the *effect* of applying each of the two rules — how each of the rules operates — and the *scope* of the two rules — the types of circumstances in which each applies. The two situations that will be contrasted are the application of the 25 percent omission test, taking into account the special gross receipts rule but not *Colony*, and the application of the 25 percent omission test, taking into account *Colony* but not the special gross receipts rule.

The Two Rules Differ in Effects

The core of the argument that the special gross receipts rule is equivalent to *Colony* is that the special rule has the same effect as *Colony* for purposes of the step in the 25 percent omission test that requires a determination of whether there has been an omission from gross income. Because, under the special gross receipts rule, basis does not play any role in the calculation of gross income on any

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[13]633 F.3d at 620 ("Therefore, it appears that subsection (i) addresses the situation faced by the Court in *Colony* where there is an omission of an actual receipt or accrual in a trade or business situation.").

[14]I discussed these issues in considerably less detail in "Omissions From Gross Income and the *Chenery* Rule," *supra* note 1, at 766-768. Moreover, the main focus of that article was the administrative law principle that an agency action can be upheld by a reviewing court only on the grounds explicitly relied on by the agency when it made its decision. The article also discussed whether the decisions in *Bakersfield* and *Salman* (Fed. Cir.) should be considered *Chevron* step-one decisions and therefore immune from agency overruling under *Brand X* despite the claim in the preamble to the temporary regulations that *Brand X* could be applied to overrule these decisions.

[15]633 F.3d at 623.

[16]Section 6501(e)(1)(B)(i).

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transaction, it necessarily follows that an overstatement of basis cannot be an omission of gross income under the special rule, the same result as under *Colony*. But this does not mean the special rule is equivalent to *Colony* or, by extension, that *Colony* is inapplicable under the current 25 percent omission test.

There are four steps to the 25 percent omission test, but it is only in the first of these that the effect of *Colony* and the effect of the special gross receipts rule are the same.[17] In contrast, the special gross receipts rule affects all four steps.

The first step in the 25 percent omission test is to determine whether there has been an omission of gross income. The second step is to determine the amount of the omitted gross income. The third step is to determine the amount of gross income reported on the return. The fourth and final step is to determine the percentage relationship between the amount of the omitted gross income and the amount of gross income reported on the return.

Even in that first step there are important differences between the two rules because the scope of *Colony* and the scope of the special gross receipts rule are different.

In the first step of the 25 percent omission test (deciding whether there has been an omission from gross income) the special rule that says gross income equals gross receipts has the same result as the *Colony* holding that an overstatement of basis does not amount to an omission from gross income. Under both tests, there is an omission from gross income only if the gross receipts from the transaction are omitted. This follows directly from the terms of the special gross receipts rule and indirectly from the *Colony* holding that overstatements of basis do not count as omissions from gross income.

Regarding the second step in the 25 percent omission test (determining the amount of the omission established in the first step), the special gross receipts rule provides that the omission is the amount of gross receipts on the transaction. In contrast, under *Colony* the amount of the omission from gross income is determined under the normal rules: the amount of gross receipts on the transaction *less the basis of the property*. Unless the basis of the property is zero, the amount of the omission under *Colony* is different from the amount of the omission under the special gross receipts rule.

Because the special gross receipts rule applies only to the sale of goods (or services) in a trade or business, any sale of property that is not a sale of goods in a trade or business will give rise to a different omission amount under the *Colony* rule than would be the case if the special gross receipts rule applied.

The two rules likewise do not produce the same results regarding the third and fourth steps in the 25 percent omission test, which determine the amount of gross income reported on the return and whether the amount of the omission exceeds 25 percent of the amount of gross income reported on the return.[18] For example, assume that a taxpayer has only two transactions that produce gross income for a tax year. Both transactions are property sales and each transaction produces gross receipts of $100, but in one case the basis of the property is $90 and in the other the basis of the property is $40.

If the special gross receipts rule *does not apply to either transaction*, the gross income on the two transactions would be $10 and $60, respectively. An omission of the transaction with gross income of $10 would not represent an omission of more than 25 percent of the gross income reported on the tax return: $60 gross income was reported on the tax return, and 25 percent of $60 is $15, which is greater than the $10 in omitted gross income.

In contrast, if the special gross receipts rule *applies to both transactions*, the amount of omitted gross income on the transaction when the basis of the property was $90 would be $100, an omission of more than 25 percent of the amount of gross income reported on the tax return. The explanation for the variation in outcomes in this example is that the relationship between basis and gross receipts is likely to vary in different transactions, so that the relationship between gross receipts and gross income calculated without regard to the special rule also will vary. Additional variations in outcome would exist, for example, when the special gross receipts rule applies to transactions with the gross income reported on the tax return, but the special rule does not apply to a transaction with the gross income omitted from the tax return, or vice versa.

This example demonstrates that the effect of the special rule on the operation of the 25 percent omission test is not equivalent to the effect of *Colony*, when all the steps in the operation of the 25 percent omission test are taken into account.

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[17]Both the *Bakersfield* and *Salman* decisions cogently explained this reason for rejecting the equivalence argument. *See Bakersfield*, 568 F.3d at 776-777; *Salman*, 573 F.3d at 1375.

[18]The *Bakersfield* decision demonstrated a clear understanding of the importance of the definition of gross income for purposes of the third and fourth steps in the 25 percent omission test, even when there is no dispute about the existence and amount of an omission in the first and second steps. *See Bakersfield*, 568 F.3d at 777.

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The Two Rules Differ in Scope

As noted above, not only are the effects of the special gross receipts rule different from the effects of *Colony*, but the scope of the special gross receipts rule and the scope of *Colony* are also different. The special gross receipts rule applies to the sale of goods or services in a trade or business. *Colony* applies to any sales of property, without regard to whether those sales occur in the context of a trade or business, and without regard to whether the property sold is goods.

The special gross receipts rule does not apply to sales of property outside the context of a trade or business, or to sales of property in the context of a trade or business when the property being sold is not goods, but *Colony* applies in both categories of property sales.

The government has made various erroneous contentions regarding the scope of *Colony* and the scope of the special gross receipts rule to make it appear that the scope of the two rules is the same. For example, the government has contended that the factual situation in *Colony* was precisely the type of situation covered by the special gross receipts rule. The government's brief in the D.C. Circuit in *Intermountain* makes the claim that the situation covered by the special rule is ''the exact fact pattern of *Colony*,'' without providing any support for this claim.[19]

At the end of the oral argument in the D.C. Circuit in *Intermountain* and *UTAM*, in response to the clearly expressed desire on the part of two of the judges on the panel to rely on the argument that *Colony* should not apply under the current version of the 25 percent omission test, the government's attorney asserted that land can be inventory. If this assertion were correct, it would mean that the facts in *Colony* would have been the type covered by the special gross receipts rule. There is nothing in the government's briefs filed in the D.C. Circuit cases to support this assertion.[20] More significantly, this assertion that land can be inventory is clearly incorrect.

The contention by the government that the facts in *Colony* presented the type of situation covered by the special gross receipts rule is clearly not correct, because the property at issue in *Colony* was land, which is never classified as goods, even when, as in *Colony*, the taxpayer's business is land sales. In other cases, the IRS has consistently maintained that land and buildings are not merchandise or goods for purposes of the inventory provisions of the code (sections 471 and 472) and that accordingly land and buildings are not eligible for inventory treatment, including the last-in, first-out inventory method, and the lower-of-cost-or-market method; the courts have consistently agreed with that position.[21]

Moreover, in the context of the overstated basis cases, the government has shown it is well aware that land can never be goods, by pointing out in briefing that goods are defined as items of tangible, movable personal property, a definition that clearly excludes real property. This awareness was demonstrated in *Salman* in the Federal Circuit, where the taxpayer attempted to gain the benefit of the special gross receipts rule. The government countered that the transaction at issue in the case was not covered by the special gross receipts rule because the transaction involved a sale of land, and for that reason did not involve a sale of goods:

> Neither section 6501 nor regulations under that section defines ''goods or services.'' It is, however, well settled that ''words in a statute are deemed to have their ordinarily understood meaning.''
>
> Ordinarily, the term ''goods'' does not encompass a ranch. The term ''goods'' typically means ''tangible movable personal property having intrinsic value usually excluding money and other choses in action.'' *Webster's Third New Int'l Dictionary* 978 (1969). *See also*

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[19]''In section 6501(e)(1)(A)(i), [Congress] 'redefined' the term 'gross income' in the context of the sale of goods or services by a trade or business — the exact fact pattern of *Colony* — so that in that situation only, 'gross income' means gross receipts, undiminished by basis.'' Brief for the Appellant at 21, *Intermountain*, No. 10-1204 (D.C. Cir. Dec. 6, 2010). (The government's briefs in the other current cases include the same statement. *See, e.g.*, Brief for the Appellant at 25, *Wilmington Partners LP v. Commissioner*, No. 10-4183 (2d Cir. Mar. 9, 2011).) It might have been expected that this crucial claim would be developed in greater depth and detail later on in the brief, but later on, on p. 44, there is only a cross-reference back to this initial discussion, as though the proposition had already been established. It is notable that in the current round of cases, involving the effect of the regulations, the government has not articulated or developed this argument in any detail. The lack of detailed development could suggest an understanding on the government's part of the defects of the argument.

[20]Moreover, the government did not file a notice of supplemental authority on this point with the D.C. Circuit after the oral argument, as is commonly done when new points are raised at oral argument.

[21]*See, e.g., W.C. & A.N. Miller Dev. Co. v. Commissioner*, 81 T.C. 619, 630 (1983) (''In our view, real property should not be considered as 'merchandise' within the contemplation of the regulation. . . . In its commonly accepted usage, the term 'merchandise' is defined to encompass wares and goods, not realty''); *Homes by Ayres v. Commissioner*, 795 F.2d 832, 835 (9th Cir. 1986) (''The Commissioner has consistently maintained that real property cannot be inventoried for tax purposes''). This position was first given judicial approval in *Atl. Coast Realty Co. v. Commissioner*, 11 B.T.A. 416 (1928).

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> *Black's Law Dictionary* at 701 (7th ed. 1999) (defining "goods" as "tangible or movable personal property other than money; especially articles of trade or items of merchandise," as in "goods and services").
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> Plaintiffs' reliance (Br. 34) on the definition of "goods or services" in the unrelated context of charitable contributions in Treas. Reg. section 1.170A-13(f)(5) is misplaced. . . . In that context, section 1.170A-13(f)(5) defines "goods or services" as "cash, property, services, benefits, and privileges." Significantly, real estate is not included; thus, even if the regulation somehow applied here, it would not make the ranch a "good or service."
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> . . .
>
> In their effort to fit Salman Ranch's ranch sale within the gross receipts provision, plaintiffs seek to nullify the requirement that the income in question must be "amounts received or accrued from the sale of goods or services." I.R.C. section 6501(e)(1)(A)(i). Plaintiffs argue (Br. 32) that the "goods and services" provision does not mean what it says because Congress did not use the term "inventory." Plaintiffs conclude (Br. 33) that "the only limitation provided by Congress is that the gross receipts provision applies 'in the case of a trade or business.'" Thus, according to plaintiffs, section 6501(e)(1)(A)(i) applies to any sale by a trade or business, regardless of whether it is a sale of goods or services, or the sale of an asset used in the trade or business.
>
> Plaintiffs are wrong. To begin with, the term "inventory" typically refers to goods, not services. *See Webster's Third New Int'l Dictionary* at 1189 (defining "inventory" as "the quantity of goods or materials on hand: STOCK, SUPPLY," as in "adequate *inventories of* washing machines to meet local demand") (emphasis in original). When Congress limited the gross receipts provision to a trade or business's sale of goods or services, it meant exactly what it said.[22]

Although the government also argued that the land at issue in *Salman* did not qualify for the special gross receipts rule because it was property used in a trade or business, rather than property held for sale to customers, the government's brief leaves no doubt that an important part of the government's argument against the applicability of the special gross receipts rule was that the land at issue did not qualify as goods, regardless of whether the land is held for sale to customers or is used in the taxpayer's trade or business. This well-established argument that the government asserts in *Salman* is clearly at odds with the government's argument in *Intermountain*.

In addition to its erroneous argument that the property at issue in *Colony* was the type of property that would be subject to the special gross receipts rule, the government has also argued that *Colony* should be *limited* to sales of goods in a trade or business. But, because *Colony* did not involve a sale of goods, it would be nonsensical to conclude that *Colony* should somehow *be limited* to sales of goods.

As the *Bakersfield* and *Salman* decisions recognized, there is nothing in the *Colony* opinion to support the contention that *Colony* is limited to sales of goods in a trade or business.[23] Even if the government were correct that the facts in *Colony* are covered by the special gross receipts rule, this would not support the conclusion that *Colony* should be *limited* to the type of property that would be subject to the special gross receipts rule.

The government has suggested that Congress intended the special gross receipts rule to address the *Colony* issue, even though the special gross receipts rule was enacted four years before the *Colony* decision. The significant differences in the scope and effect of the special gross receipts rule and of *Colony* powerfully refute that contention.

Moreover, if Congress had really wanted to address the *Colony* issue, it could have done so easily and directly by adding language to the code saying explicitly that an understatement of gross income resulting from an overstated basis is not considered an omission for purposes of the 25 percent omission test.[24] If Congress had intended to address the

[22]Brief for the Appellee at 45-49, *Salman*, No. 2008-5053.

[23]*Salman*, 573 F.3d at 1372-1373: "We do not discern any basis for limiting *Colony*'s holding concerning the 'omits from gross income' language of I.R.C. section 275(c) to sales of goods or services by a trade or business. Neither the language nor rationale of *Colony* indicates such an intent on the part of the Court. The Court interpreted the language of section 275(c) based upon what it viewed as congressional intent and purpose, without ever mentioning the taxpayer's trade or business." *Bakersfield* at 778:

> The Court . . . did not even hint that its interpretation of section 275(c) was limited to cases in which the taxpayer was engaged in a "trade or business." There is no ground for suggesting that the Court intended the same language in section 275(c) to apply differently to taxpayers in a trade or business than to other taxpayers. . . . Under a fair reading of *Colony*, the Court provides a general construction of section 275(c) that is not limited to any particular type of taxpayer.

[24]*Bakersfield*, 568 F.3d at 776: "In enacting the 1954 Code, Congress was presumably aware of the dispute over the interpretation of section 275(c), and it could have expressly added a

(Footnote continued on next page.)

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Colony issue in the special rule defining gross income from trade or business sales of goods or services as gross receipts, this provision would likely have been made more broadly applicable to all property sales.

Moreover, that the special gross receipts rule encompasses sales of services as well as sales of goods strongly suggests the special gross receipts rule was not directed at the *Colony* issue. The terms, effect, and scope of the special gross receipts rule all suggest it was enacted in response to the issue the special gross receipts rule actually addresses — namely, whether specific costs do or do not reduce gross income for purposes of the entire sequence of steps in the 25 percent omission test.[25]

Colony Defined Omits, Not Gross Income

If it is, as I contend, clear that *Colony* and the special gross receipts rule are not equivalent (except in the first step of the multi-step 25 percent omission from gross income test), why are appellate judges attracted to the argument that the supposed equivalence of the two rules means *Colony* must be inapplicable under the current 25 percent omission test, especially after the *Bakersfield* and *Salman* decisions cogently explained why this argument is wrong? It is easy to understand why judges might want to find a way to avoid the difficult issues relating to the application of *Brand X* in these cases, such as whether *Brand X* allows an agency to overrule a Supreme Court decision, whether a decision to that effect can properly be reached by any court other than the Supreme Court, and whether *Colony*'s use of legislative history means *Colony* is not a *Chevron* step-one decision, with the consequence that it may potentially be subject to agency overruling.

Nevertheless, judges cannot properly avoid these difficult issues based on a rationale that is not correct. One explanation for the appellate judges' being persuaded by a flawed rationale based on the supposed equivalence of *Colony* and the special gross receipts rule might be that the government is no longer making this argument as directly in its briefs and taxpayers in the current round of cases are likewise not presenting fully developed responses to the argument. Because of the lack of a full development of the issue in briefing, and the resulting lack of clarity on this issue, some judges are giving undue weight to the first-step determination of whether there has been an omission from gross income and insufficient weight to the more mundane and seemingly mechanical later steps of determining the amount of any omission, the amount of gross income reported on the tax return, and the percentage relationship between the two amounts.

Although these later steps in the 25 percent omission test might seem less interesting than the first step issue of whether there has been an omission from gross income, the later steps are actually the essence of the 25 percent omission test.

In both *Bakersfield* and *Salman*, the government argued that *Colony* held that gross income equals gross receipts.[26] That argument is clearly incorrect. *Colony* did not hold that gross income means gross receipts. *Colony* held that an overstatement of basis that results in an understatement of gross income does not represent an omission.

Colony was about the meaning of omits, not the meaning of gross income.[27] *Colony* held that omit does not mean understate, and that gross income is omitted only if the gross receipts component of gross income is omitted. This is not the same as holding that gross income means gross receipts.

The Seventh Circuit opinion in *Beard* asserts that although retaining *Colony* under the current version of the 25 percent omission test might not make the

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definition of 'omits' if it wanted to overrule the cases that concluded, as the Supreme Court later did in *Colony*, that 'omits' did not include an overstatement of basis.''

[25]For example, in *Woodside Acres Inc. v. Commissioner*, 134 F.2d 793 (2d Cir. 1943), the Second Circuit accepted the IRS's position that for purposes of the personal holding company provisions, the costs of farming operations represented a reduction in gross income from farming even though this was not the result prescribed by regulations. The same rule was applied by the Tax Court in *Garrett Holding Corp. v. Commissioner*, 9 T.C. 1029 (1947). Although these cases dealt with the determination of the amount of gross income for purposes of the personal holding company provisions rather than the 25 percent omission test, subsequent cases addressed the issue of whether the same result should be applied for purposes of the 25 percent omission test. *See*, *e.g.*, *McCulley v. Kelm*, 112 F. Supp. 832 (D. Minn. 1953) (refusing to apply *Woodside* to farming gross income for purposes of the 25 percent omission test); *Washington Farms Inc. v. United States*, 122 F. Supp. 31 (D. Ga. 1954) (same); *Webber v. Commissioner*, 21 T.C. 742, 746 (1954) (refusing to apply the *Woodside* approach to a service business for purposes of the 25 percent omission test).

[26]''Properly construed, *Colony* simply held that 'gross income' meant gross receipts in the context of trade or business income from the sale of goods or services.'' Brief for the Appellant at 34, *Bakersfield*, No. 07-74275; Brief for the Appellee at 38, *Salman*, No. 2008-5053. ''If *Colony* is broadly construed to hold that 'gross income' in the extended statute of limitations means gross receipts in all circumstances, that holding has been superseded by statutory changes.'' Brief for the Appellant at 38, *Bakersfield*; Brief for the Appellee at 41, *Salman*.

[27]The taxpayer in *Bakersfield* made this point forcefully and repeatedly throughout its brief. *See* Brief for the Appellees, *Bakersfield*, No. 07-74275.

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special gross receipts rule entirely superfluous, retaining *Colony* would leave the special gross receipts rule ''certainly diminished.''[28] This assertion is illustrative of the undue weight given to the first-step determination of whether there has been an omission from gross income.

The Seventh Circuit also criticized the *Bakersfield* opinion for ''wad[ing] through a convoluted discussion of numerators and denominators.''[29] However, the 25 percent omission test *by its very nature* requires a consideration of numerators and denominators. To focus entirely, as the Seventh Circuit seems to have done, on whether there has been an omission from gross income gives clearly undue weight to only one part of the multi-step 25 percent omission test and results in a distortion of the statutory inquiry, which, whether the Seventh Circuit likes it or not, clearly requires a comparison of numerators and denominators.

The government begins all of its recent briefs with a presentation of the proposition that apart from the special gross receipts rule, the term ''gross income'' in the 25 percent omission test has the same meaning that the term has elsewhere in the code.[30] This proposition is neither controversial nor in dispute. What is highly disputable is how the government purports to claim this proposition leads to the conclusion that *Colony* no longer applies.

What is in dispute is the meaning of omits, not the meaning of gross income. That gross income for purposes of the 25 percent omission test has the same meaning as elsewhere in the code (gross receipts less basis) does not help determine whether there has been an omission when basis has been overstated. Gross income had the same meaning when *Colony* was decided that it has today, and the meaning of gross income did not decide the case then any more than it does today. The *Colony* Court was surely aware that gross income means gross receipts less basis, because that equation factored into whether an overstatement of basis results in an omission of gross income.

The issue today, as it was in *Colony*, is whether an understatement of gross income that results from an overstated basis is an omission. There is no dispute that an overstatement of basis produces an understatement of gross income. The only dispute is whether that understatement represents an omission. *Colony* decided that issue.

In the current round of cases, in contrast to *Bakersfield* and *Salman*, the government does not overtly argue that *Colony* held that gross income equals gross receipts or that *Colony* and the special gross receipts rule are equivalent. Instead, the government argues that if gross income were interpreted as meaning gross receipts in all cases, the special gross receipts rule would be rendered superfluous.[31] However, this argument would lead to the conclusion that *Colony* is inapplicable under the current version of the 25 percent omission test only if *Colony* were equivalent to the special gross receipts rule. As discussed at length above, that is not the case.

Moreover, contrary to the government's argument, none of the taxpayers is arguing that the meaning of *Colony* is that gross income means gross receipts. It is only the government that claims *Colony* has that meaning.

The difference between the current round of cases and *Bakersfield* and *Salman* is that the government is no longer *explicitly* claiming that *Colony* is equivalent to the special gross receipts rule, and therefore taxpayers have not responded to this argument directly. The government has had a greater success rate in the appellate courts by following the less direct approach. It remains to be seen whether the government will pursue this indirect approach when these issues reach the Supreme Court and, if so, what type of reception the approach will receive.

The current cases demonstrate that the special gross receipts rule is not equivalent to *Colony*. In these cases, if *Colony* applies, the taxpayers win. If the special gross receipts rule is deemed to have supplanted *Colony*, the government wins, because the special gross receipts rule is not applicable to the factual situations in these cases. If the special gross receipts rule were in fact equivalent to *Colony*, these cases would not be in court.

If the special gross receipts rule makes *Colony* irrelevant when the special rule applies, it makes little sense to say that the special rule also makes *Colony* inapplicable when the special gross receipts rule does *not* apply.

As noted earlier, this report was prompted by the oral argument in the D.C. Circuit in *Intermountain* and was completed before the D.C. Circuit's recent decision in that case. However, the questions at oral argument accurately predicted the reasoning in the decision. The decision repeatedly claims that the purpose of the special gross receipts rule was to address the overstated basis issue later decided in

[28]633 F.3d at 622.
[29]*Id.* at 623.
[30]The government began its briefs in *Bakersfield* and *Salman* in the same way, but these briefs also included a more explicit and prominent statement of the other claims.

[31]*See* Brief for the Appellant at 18-19, *Intermountain*, No. 10-1204.

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Colony. As discussed in this report, while the special gross receipts rule has the same effect as *Colony* in the first step of the 25 percent omission test, it has significantly different effects on the remaining steps as well as a different scope.

In light of these significant divergences, the D.C. Circuit's conclusion that the purpose of the special gross receipts rule was to address the *Colony* issue is ill-founded. As the Federal Circuit recently noted in another context, ''had Congress wanted to adopt [that] interpretation, it could have drafted language to effectuate that result.''[32]

[32]*Energy East Corp. v. United States*, No. 2010-5132, slip op. at 7 (Fed. Cir. 2011), *Doc 2011-13476, 2011 TNT 119-7*.

Conclusion

The apparent inclination of two of the judges on the D.C. Circuit panel hearing the *Intermountain* and *UTAM* cases to accept the argument that the special gross receipts rule and *Colony* are equivalent, together with the Seventh Circuit's reliance in *Beard* on this same argument, make it necessary to give renewed attention to this argument, which was decisively rejected in *Bakersfield* and *Salman* and has not been fully developed in the current round of cases. When subjected to careful analysis, the argument is revealed as wrong and an inappropriate basis for upholding the validity of the regulations.

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