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Tax Court Invalidates New Section 6501(e) Regulations

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Tax Court Invalidates New Section 6501(e) Regulations

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The title of an article of mine in the Fall 2009 issue of the NewsQuarterly asked "What's Next in the Section 6501(e) Overstated Basis Controversy?" The Tax Court answered that question on May 6, 2010, in its decision *Intermountain Insurance Service of Vail, LLC v. Commissioner*, 134 T.C. No. 11. In that decision, the court invalidated two temporary regulations that had been issued on September 24, 2009: sections 301.6229(c)(2)-IT and 301.6501(e)-IT.

The Tax Court was unanimous in its result, but seriously divided as to the reasons for the result. The *Intermountain* decision is important as to both the six-year statute of limitations on assessment and the validity of tax regulations generally. It is certain, however, that the decision will not be the last word on either of these topics.

Background

There are many exceptions to the usual three-year statute of limitations on assessments. One is section 6501(e)(1)

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(A)(i), which gives the Service six years to assess income tax liabilities "[i]f the taxpayer omits from gross income an amount properly includible therein [which] is in excess of 25% of the amount of gross income stated in the return." Section 6229(c)(2) provides a similar exception for cases governed by the TEFRA partnership audit and litigation rules.

These exceptions undoubtedly apply when the taxpayer omits enough taxable receipts, but it has been controversial whether they apply when the understatement arises instead from overstated basis of sold assets. As detailed in the Fall 2009 article, the case law on the section 6501(e) overstated basis issue is divided, but the Service suffered a string of defeats in 2009 cases.

To reverse its fortunes, Treasury issued the September 24 regulations in both temporary and proposed form. Aggressively, the temporary regulations were declared to apply to tax years still open to assessment on the date of issuance, with the intention that they apply to all pending cases, including those which taxpayers had won but in which the decisions had not yet become final. *See* T.D. 9466, 2009-43 I.R.B. 551. Both the new regulations and their effective date have been highly controversial from their inception.

Intermountain

Intermountain involves what the Service considers to be an abusive tax shelter involving overstated basis. Having failed to act within the normal three years, the Service relied on the six-year limitations period. Less than a month before issuance of the temporary regulations, the Tax Court had decided the statute of limitations issue in Intermountain's favor. T.C. Memo. 2009-195. Based on the new regulations, the Service filed motions to vacate and for reconsideration of that decision.

By 13 to 0, the Tax Court held against the Service, but the 13 judges fell into three camps. Seven judges, in an opinion written by Judge Wherry, explored the possibility that, as actually drafted, the effective date provision did not effectuate Treasury's intention to reach not-yet-final cases. Although advancing a questionable "plain meaning" analysis, the majority chose not to rest the decision on that ground.

Instead, the majority examined the substantive validity of the temporary regulations. Assuming arguendo that *Chevron* provides the governing standard, the majority concluded that the regulations did not pass muster under *Chevron* Step One or *Brand X. See National Cable & Telecomm. Ass'n v. Brand X Internet Services*, 545 U.S. 967, 982 (2005); *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.,* 467 U.S. 837 (1984). Specifically, the majority concluded that the Supreme Court's *Colony* decision a half century ago had held that what is now section 6501(e) unambiguously precludes the position taken in the temporary regulations. *Colony, Inc. v. Commissioner,* 357 U.S. 28 (1958). The majority also noted, but felt it unnecessary to rule on, the taxpayer's argument that the temporary regulations have impermissibly retroactive effect.

Four other judges concurred in an opinion penned by Judge Cohen. This concurrence would have resolved the case on narrower grounds. Motions such as the Service's typically are granted only in unusual circumstances. An intervening statutory change can be such a circumstance. *Alioto v. Commissioner,* T.C. Memo. 2008-185, *vacating* T.C. Memo. 2006-199. The concurrence would have held, however, that an intervening regulatory change does not rise to the same level, thus is insufficient to warrant vacating or reconsidering.

Judges Halpern and Holmes concurred in another opinion. These judges rejected the majority's effective date and *Chevron* analyses but saw the temporary regulations as invalid on procedural grounds. The Administrative Procedure Act ("APA") applies to rulemaking by federal agencies, including the Treasury Department. *See* 5 U.S.C. § 551(1). Unless a stated exception applies, regulations are validly promulgated only if they go through the notice-and-comment process prescribed by 5 U.S.C. § 553. The temporary regulations were not promulgated through this process. Nonetheless, the Service defended their validity on two grounds: that the regulations fall within the APA exception for merely interpretive rules and that Congress implicitly excepted temporary tax regulations from the notice-and-comment requirement. The Halpern/Holmes concurrence rejected both contentions, and thus would hold the regulations to be procedurally invalid under the APA.

Evaluation

All three opinions in *Intermountain* reflected distaste for what the judges viewed as overly zealous use of the regulations process. The Service saw the *Intermountain* tax shelter as abusive. It is worth remembering that not just taxpayers, but the Service, too, can commit tax abuse.

Although motivated by a common impulse, the Tax Court judges differed greatly as to the doctrine by which to make that impulse legally operative. In my view, Judges Halpern and Holmes had the best view of the case. The omission of notice-and-comment is not justified by either of the grounds asserted by the Service.

The Service's "merely interpretive" argument is hopeless. The temporary regulations at issue were promulgated under the general authority of section 7805(a), not specific authority within sections 6501 or 6229. The Service and tax lawyers as a whole have long called general-authority regulations "interpretive" and specific-authority regulations "legislative." It is high time that we broke ourselves of that bad habit. "Interpretive" and "legislative" regulations have well understood meanings in administrative law—meanings which have nothing to do with the general-authority versus specific-authority distinction. Instead, legislative regulations have "force of law" character—they make binding law or change the law—while interpretive regulations merely explain the agency's view of the statute. *E.g., Chrysler Corp. v. Brown*, 441 U.S. 281, 301-02 (1979). Tax regulations that make binding law are legislative whether they are promulgated under specific authority or general authority. The temporary regulations at issue clearly are legislative; their point was not to explain the Service's view of section 6501 but to change the law by administratively reversing the law as articulated by the adverse cases.

The Service's argument that Congress excepted temporary tax regulations from APA notice-and-comment is better but probably not good enough. The argument is based on inference, not explicit text. Yet Congress has provided that other statutes may modify APA requirements only expressly, not impliedly. 5 U.S.C. § 559.

The arguments advanced in the other *Intermountain* opinions do not strike me as persuasive. First, as pointed out by Judges Halpern and Holmes, the regulations' effective date provision is ambiguous, not plain. The provision might be read to mean "open under the normal three-year period," as the *Intermountain* majority read it, or it might mean "open under the six-year period, as that period is extended by this regulation," as Treasury and the Service intended. An agency's construction of its own ambiguous regulation is entitled to deference. *E.g., Auer v. Robbins*, 519 U.S. 452, 461 (1997); *Stinson v. United States,* 508 U.S. 36, 44-46 (1993).

Second, the majority likely is wrong as to its *Chevron* Step One analysis. *Colony* itself did not say that its result was unambiguously commanded by the statute. Moreover, *Colony* construed a predecessor of current section 6501(e), and the current statute arguably is somewhat more congenial to the Service's position. Finally, as noted in the Fall 2009 article, the Service won a number of the cases after *Colony* but before 2009. There are two possibilities. Either the courts holding for the Service failed to notice that *Colony* had settled the issue, or the *Intermountain* majority overplayed its hand in characterizing *Colony*'s holding. I think that the second of these alternatives better states the matter.

Third, the narrow ground offered by Judge Cohen and the judges joining her is dubious. Yes, a statute outranks a regulation. But a validly promulgated legislative regulation has force of law status. Thus, the distinction offered by Judge Cohen's concurrence is not a meaningful difference.

Predictions

The Tax Court's *Intermountain* decision surely is not the last shot that will be fired in the overstated basis statute of limitations battle. The Government may appeal *Intermountain*, and the validity and applicability of the new regulations will surely be tested in other cases in the future.

Based on the above analysis, the temporary regulations should continue to be invalidated. However, when they have been finalized after completion of notice-and-comment, the regulations should be upheld, particularly if applied only prospectively. Taxpayers who already have won their cases should be safe, but taxpayers whose cases have not yet been decided will be in jeopardy. ■