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## One Case to Rule Them All: The Ninth Circuit in Bakersfield Applies Colony to Deny the IRS an Extended Statute of Limitations in Overstatement of Basis Cases

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2010]

## Notes

### ONE CASE TO RULE THEM ALL: THE NINTH CIRCUIT IN *BAKERSFIELD APPLIES COLONY TO DENY THE IRS AN EXTENDED STATUTE OF LIMITATIONS IN OVERSTATEMENT OF BASIS CASES*

Gandalf: There is some new devilry here, devised for our  
welcome, no doubt?

Legolas: Ai! Ai! A Balrog! A Balrog is come!

Gandalf: A Balrog, now I understand! . . . Fly! This is a foe beyond  
any of you.<sup>1</sup>

#### I. INTRODUCTION

In one episode of the *Lord of the Rings* trilogy, Frodo and his companions, while navigating the labyrinthine Mines of Moria, encountered the invincible Balrog, an ancient and terrible demon released long ago by the prideful actions of the mine's former occupants.<sup>2</sup>

Attorneys for the IRS (the Service) and the Department of Justice, in the course of litigating the latest round of seemingly impenetrable tax shelters dating back to the 1990s, have encountered an ancient Supreme Court precedent just as threatening to their litigation efforts as the Balrog was to the Fellowship of the Ring.<sup>3</sup> Unlike hapless Frodo and his friends, the Service, through its zealous and possibly excessive enforcement efforts in the most recent tax shelter cases, is squarely responsible for releasing this precedent back into the world.<sup>4</sup>

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1. J.R.R. TOLKIEN, *THE FELLOWSHIP OF THE RING* 320-21 (Houghton Mifflin 1994) (1954) (describing Fellowship's escape from Mines of Moria). The Balrog was an invincible beast made of flame that was released from the depths of the earth when dwarfish miners grew too prideful of their skills and dug their mine too deep. *See id.* at 309 ("The Dwarves tell no tale . . . they delved too greedily and too deep, and disturbed that from which they fled.").

2. *See id.* at 321-22 ("His enemy halted again, facing him, and the shadow about it reached out like two vast wings.").

3. *See generally* Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1635 (2009) ("At first glance, tax shelters resemble legitimate business deals that ought to receive the tax treatment claimed. . . . The close relationship between a real business deal and a tax shelter is what makes the Service's task of detecting abusive tax planning so difficult.").

4. *See* Lee A. Sheppard, *Scorched Earth in Son-of-BOSS Cases*, 120 TAX NOTES 9, 10 (2008) (chronicling unusually overzealous efforts of Service in prosecuting taxpayers and professionals associated with "Son of BOSS" tax shelter). The IRS, in a 2004 settlement offer, insisted on a penalty for abusers of the tax shelter before litigating a single case, denied taxpayers who declined the settlement access to the administrative appeals process, promulgated fighting regulations, and fought cases until it began to lose them. *See id.* (describing rationale behind settlement offer).

One tax shelter in particular, the “Son of BOSS,” or (Son of) Bond Option Sales Strategy, has spawned extensive litigation in recent years.<sup>5</sup> The Son of BOSS tax shelter involves a complicated series of partnership-level transactions designed to overstate partners’ basis in partnership assets, lower reportable gross income from the sale of those assets, and hide the nature of such transactions from the Service.<sup>6</sup> The Service discovered

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A tax shelter is defined as any transaction or investment designed solely to produce a loss on paper that lowers an individual’s overall tax liability. See Susan Nelson, *Taxes Paid by High-Income Taxpayers and the Growth of Partnerships*, STAT. INCOME BULL., Fall 1985, at 55, 56-57 (“For some years, many partnerships have been utilized as vehicles for tax shelters (defined . . . as activities producing net losses to offset net income from other activities), and frequently . . . they have incurred no real economic losses.”). For more on the history of the Service’s litigation of Son of BOSS tax shelter abusers, see *infra* notes 6, 9, and accompanying text.

5. See Sheppard, *supra* note 4, at 10 (noting that, at time of Sheppard’s article, 166 Son of BOSS cases were docketed in Tax Court, 55 cases docketed in federal district court, 33 cases docketed in Court of Federal Claims, and 460 cases remained undocketed).

6. See *Kligfield Holdings v. Comm’r*, 128 T.C. 192, 194 (2007) (describing Son of BOSS and related transactions). According to the United States Tax Court in *Kligfield*, the common thread of all Son of BOSS transactions is a “transfer of assets encumbered by” a liability to a partnership with the intent of “increasing basis in that partnership.” *Id.* The partnership can “treat the liabilities as uncertain” and ignore them in computing basis because “liabilities are usually obligations to buy securities, and typically are not fixed at the time of transfer.” *Id.* As a result, “partners will have a basis in the partnership” large enough to provide for huge paper losses on their individual tax returns. See *id.* (discussing impact of Son of BOSS transactions). Son of BOSS shelters might use offsetting currency options, premium loans, or short sales. See Sheppard, *supra* note 4, at 12 (noting variations of Son of BOSS transactions).

Tax basis in property refers to the taxpayer’s investment in that property and is primarily used to compute the taxpayer’s gain or loss from a property transfer. See 26 U.S.C. § 1012(a) (2006) (“The basis of property shall be the cost of such property . . .”); BLACK’S LAW DICTIONARY 161 (8th ed. 2004) (referring to value of taxpayer’s investment in property). The “amount realized” in a property disposition is the amount of money received and the fair market value of property received on the disposition. See 28 U.S.C. § 1001(b) (defining “amount realized”). Taxable gain from a property is calculated as the difference between the amount realized and the adjusted basis of the property; a higher adjusted basis leads to less taxable gain on a transaction. See *id.* (noting that loss is calculated as excess of adjusted basis over amount realized). Each partner’s basis in the partnership interest is “outside basis.” See *Kornman & Assocs. v. United States*, 527 F.3d 443, 456 n.12 (5th Cir. 2008) (noting that partners and partnerships do not recognize gain or loss from contributions of property to partnership, rather, partners receive partnership interest with outside basis equal to value of contribution). The partnership entity also calculates its investment in partnership items to determine its “inside basis.” See *Clearmeadow Invs., LLC v. United States*, 87 Fed. Cl. 509, 519 (2009) (“Under these provisions, this court is authorized to determine all the partnership items that enter into the calculation of Clearmeadow’s basis in its assets—a concept referred to as the ‘inside basis’ of the partnership.”).

A short sale involves selling securities that the seller does not own. See *Provost v. United States*, 269 U.S. 443, 450-51 (1926) (describing typical circumstances of short sale under rules of New York Stock Exchange). In a typical short sale, an investor borrows shares of a security from a broker at a stipulated fee or interest rate; the investor then sells the shares to a buyer for the broker’s purchase price.

these tax shelter transactions and in 2000 issued Notice 2000-44, effectively invalidating future Son of BOSS-type investments.<sup>7</sup> In accordance with

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*See Zlotnick v. Tie Commc'ns*, 836 F.2d 818, 820 (3d Cir. 1988) (describing typical short sale of stocks). The investor, however, remains obligated to buy an equivalent number of shares on the market and return the shares to the broker. *See id.* (noting that short sale investors expect price per share of their investment to decline). If the stock prices fall, the investor need not use the entire payment received from the buyer to make the covering purchase, and therefore the investor can make a profit on the transaction. *See id.* (cautioning that short sale investors face unlimited risk of rise in stock prices).

Under the statutory framework of the Internal Revenue Code, a partner's adjusted basis in the partnership is the partner's contribution to the partnership. *See* 26 U.S.C. § 752(a) ("Any increase in a partner's share of liabilities of a partnership . . . shall be considered as a contribution of money by such partner to the partnership."). Similarly, when a partnership assumes a partner's individual liabilities, the partner must decrease basis in the partnership. *See id.* § 752(b) ("Any decrease in a partner's share of the liabilities of a partnership . . . shall be considered as a distribution of money to the partner by the partnership."). Under the old rule, obligations created by selling an option (referred to as "contingent obligations") could not constitute liabilities under Section 752 because no actual obligation existed on the partnership's part until and unless the option was exercised. *See Helmer v. Comm'r*, 34 T.C.M. (CCH) 727, 731 (1975) (sustaining Government's argument that contingent liabilities could not allow partner to increase individual basis in partnership and therefore partner owed additional taxes when partnership made distribution). As late as 2000, the Service continued to assert the *Helmer* rule in cases of partner taxation. *See Sala v. United States*, 552 F. Supp. 2d 1167, 1197 (D. Colo. 2008) (citing *Salina P'ship v. Comm'r*, 80 T.C.M. (CCH) 686 (2000)) (requiring partner to increase basis where partnership received cash proceeds on sale of borrowed Treasury bills but partnership's gain or loss from transaction depended on cost of partnership to replace borrowed Treasury bills, and contrasting such cash proceeds with option payments in *Helmer* that represented fixed payments on sale of partnership asset and that did not depend on claim for repayment or demand for further services). For a further discussion of the impact of the *Helmer* rule in Son of BOSS litigation, see *infra* notes 142-64 and accompanying text.

Son of BOSS shelters came about because both the Service and taxpayers operated for decades without a working, comprehensive definition of a partnership liability. *See Sheppard*, *supra* note 4, at 13 ("During the years these shelters were being done, the partnership law had not yet adequately addressed . . . whether contingent obligations such as loan premiums, short sales, or options are 'liabilities' under [S]ection 752."). In the variant of a Son of BOSS transaction at issue in this Note, partners would create a new partnership into which they would transfer their interests in the old partnership. *See Jeremiah Coder*, *IRS Facing Unreceptive Courts in Overstated Basis Cases*, 124 TAX NOTES 758, 758-59 (2009) (describing Son of BOSS cases involving abuse of partnership rules). Under Section 708(b), the old partnership technically terminates if more than half of its partnership interests changes hands. *See id.* (describing statutory framework for Son of BOSS transaction similar to that at issue in this Note). Under Section 754, the old partnership can elect to adjust its basis in its assets to account for the sales price of its interests to new partners under Section 743(b). *See id.* (explaining how partnerships acquire enhanced basis). For an example of this type of transaction and the statutory framework that allowed it, see *infra* notes 64-71 and accompanying text.

7. *See* I.R.S. Notice 2000-44, 2000-2 C.B. 255 (disallowing artificial losses lacking economic substance as deductions for federal income tax purposes and specifically warning of penalties for engaging in use, promotion, or reporting of Son of BOSS basis overstatement transactions).

this Notice, courts have largely sided with the Service in cases where the validity of the underlying Son of BOSS tax shelter transactions was at issue, concluding that the transactions lacked economic substance and were therefore invalid.<sup>8</sup> Although the Service offered a settlement initiative in 2004 to more than 1200 qualifying taxpayers, roughly 750 taxpayers—many with large amounts of money at stake—chose not to participate or did not qualify.<sup>9</sup>

Catching Son of BOSS tax abusers in time to assess tax liability has become an issue of principal importance to the the Service.<sup>10</sup> Though the judiciary is mostly favorable to the Service's goal, quick detection remains a crucial goal for the Service because the tax abusers are using shelters that are complex, multilayered, and continuously evolving.<sup>11</sup> Tax shelters typically involve the use of several pass-through entities, including partnerships and trusts; while the pass-through entity itself is not taxable, it serves as a conduit through which its income, losses, and deductions pass to its owners.<sup>12</sup> If the Service cannot catch the tax abuse before the statute of

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8. See, e.g., *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11, 45-6 (2007) (finding partner taxpayers' adjusted basis artificially high where partners bought and sold Euro options through partnership for net premium of \$150,000, transferred spread to partnership, claimed basis of nearly \$15 million in partnership interests, and generated \$14.9 million tax loss), *reh'g denied*, 81 Fed. Cl. 173 (2008); see also *Cemco Investors v. United States*, 515 F.3d 749, 751 (7th Cir. 2008) ("A transaction with an out-of-pocket cost of \$6,000 and no risk beyond that expense, while generating a tax loss of \$3.6 million, is the sort of thing the Internal Revenue Service frowns upon."), *cert. denied*, 129 S. Ct. 131 (2008); *Kornman & Assocs.*, 527 F.3d at 456 ("The Trust . . . only suffered a \$200,000 economic loss . . . yet it claimed a \$102.6 [m]illion tax loss . . . . The Appellants' premeditated attempt to transform this wash transaction (for economic purposes) into a windfall (for tax purposes) is reminiscent of an alchemist's attempt to transmute lead into gold."). But see *Sala*, 552 F. Supp. 2d at 1175-76, 1186 (finding that series of transactions after taxpayer's investment of \$9 million, which resulted in tax loss of nearly \$60.3 million, did not lack economic substance); Sheppard, *supra* note 4, at 13 (arguing that most Son of BOSS cases now litigate fighting regulation issue, rather than validity of underlying transactions).

9. See Press Release, U.S. Treasury Dep't, Robust Response for Executive Stock Option Initiative; Son of BOSS Settlement Heading for \$4 Billion (July 11, 2005), available at <http://www.irs.gov/newsroom/article/0,,id=141014,00.html> ("About 750 taxpayers did not elect or did not qualify to participate in the Son of Boss settlement offer. The Service will continue to pursue these cases through audits and the normal litigation process.").

10. See Hale E. Sheppard, *Only Time Will Tell: The Growing Importance of the Statute of Limitations in an Era of Sophisticated International Tax Structuring*, 30 BROOK. J. INT'L L. 453, 462 (2005) (arguing that, when taxpayers utilize tax shelters, Service faces serious problems in assessing taxes on time).

11. See *id.* at 461-62 (explaining difficulties that Service faces when attempting to catch tax abusers in time to assess tax). For a discussion of court holdings regarding Son of BOSS cases, including victories and defeats for the Service in its enforcement efforts, see *infra* notes 142-64 and accompanying text.

12. See Sheppard, *supra* note 10, at 454 (citing *Publication 4310: Abusive Tax Schemes*, TAX FRAUD ALERT (IRS, Wash., D.C.), Apr. 2004, at 1) (noting that pass-through entities allow taxpayers to conceal true recipients of income and losses).

limitations runs, the taxpayer may experience a “total and complete victory” in any litigation, regardless of the merits of the the Service’s claim.<sup>13</sup>

The Service typically has three years after the date a tax return is filed to assess a tax or send a notice of deficiency to the taxpayer.<sup>14</sup> However, the Service may invoke a statute of limitations of up to six years when a taxpayer: (1) omits an amount of gross income greater than twenty-five percent of the gross income reported on the form, and (2) fails to disclose the amount in a manner adequate to inform the Service of the nature and amount of the omitted item.<sup>15</sup> In 2006, the Service began to assert the extended statute of limitations under Internal Revenue Code Section 6501(e)(1)(A) against abusers of the Son of BOSS tax shelter.<sup>16</sup>

The Service’s assertion of the extended statute of limitations raises the issue of whether an overstatement of basis can constitute an omission from gross income, and this issue has brought a fifty-year-old Supreme Court case to the forefront.<sup>17</sup> Since 1958, the decision in *Colony, Inc. v. Commissioner*<sup>18</sup> is the sole Supreme Court case to squarely address the issue of whether overstatements of basis constitute omissions from gross income

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13. *See id.* at 463 (citing EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE “NEW” IRS 1240 (Jerome Borrison ed., 3d ed. 2004)) (stressing importance of Section 6501’s statute of limitations in every tax case, and noting that it may be raised at any point before decision on merits).

14. *See* 26 U.S.C. § 6501(a) (2006) (providing that statute of limitations tolls regardless of whether taxpayer filed return on or after prescribed filing date). Section 6501 also provides the applicable statute of limitations for the assessment of partnership items unless 26 U.S.C. § 6229(a) extends the period. *See* AD Global Fund, LLC *ex rel.* N. Hills Holding, Inc. v. United States, 481 F.3d 1351, 1352, 1354 (Fed. Cir. 2007) (finding no exception in Section 6501 for partnership items and applying Section 6501 to determine statute of limitations for final partnership administrative adjustment (FPAA)).

15. *See* 26 U.S.C. § 6501(e)(1)(A) (setting out extended statute of limitations for returns with substantial omissions from gross income); *id.* § 6501(e)(1)(A)(ii) (excluding amounts as “omissions” for Section 6501(e)(1)(A) purposes where taxpayer adequately discloses nature and amount on or attached to return). The United States Tax Court interpreted Section 6501(e)(1)(A)(ii) to require that the taxpayer furnish the Service with a “clue” more than “sufficient to intrigue a Sherlock Holmes,” but less than a “detailed revelation of each and every underlying fact.” *Quick Trust v. Comm’r*, 54 T.C. 1336, 1346-47 (1970) (finding that, because partnership return reported withdrawals by and distributions to estate far in excess of distributions of ordinary income to estate, Service had clear notice that estate received amounts from partnership far in excess of amount reported on estate’s return).

16. *See* Sheryl Stratton, *With Six-Year Statute, IRS Pulls Out All Assessment Stops for Shelters*, 111 TAX NOTES 536, 536 (2006) (noting that Service sent many practitioners representing Son of BOSS investors deficiency notices, FPAA notices, and notices of beginning of administrative proceedings, all relying on extended six-year statute of limitations).

17. *See* Coder, *supra* note 6, at 758 (“Two appellate courts in the past three months have both held that the IRS is limited to three years in issuing a deficiency . . . . The courts have primarily relied on the Supreme Court’s decision in *Colony, Inc. v. Commissioner* . . . .”) (citation omitted).

18. 357 U.S. 28 (1958).

under the Internal Revenue Code.<sup>19</sup> The Court in *Colony* held that an overstatement of basis leading to an understatement of gross income does not constitute an omission from gross income for the purposes of Section 6501(e)(1)(A) of the Internal Revenue Code.<sup>20</sup> The Court construed a provision under the 1939 Code that Congress carried over to the 1954 Code with substantially identical language.<sup>21</sup> Because the Court's holding in *Colony* precludes the extended statute of limitations, subsequent cases have distinguished the Supreme Court's holding in light of the 1954 Code changes by either limiting *Colony* to taxpayers in a trade or business, or finding that the taxpayer did not adequately disclose certain transactions on the return.<sup>22</sup>

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19. See Coder, *supra* note 6, at 758 ("The courts have primarily relied on the Supreme Court's decision in *Colony, Inc. v. Commissioner*, interpreting the tax code to allow extended assessment periods only for situations involving income items wholly missing from the return, rather than simply misreported.") (internal citation omitted).

20. See *Colony*, 357 U.S. at 36 ("[T]o impose a five-year limitation when such errors affect 'gross income,' but a three-year limitation when they do not, not only would be to read § 275(c) more broadly than is justified . . .").

21. For a discussion of the similarities between the extended statute of limitations provisions of the 1939 and 1954 Internal Revenue Codes, see *infra* note 52 and accompanying text.

22. See Coder, *supra* note 6, at 761 ("Most courts have felt constrained to follow *Colony* even if they alluded to a belief that it may have been wrongly decided fifty years ago."). For cases limiting *Colony* to taxpayers in a trade or business, see, for example, *N. Ind. Pub. Serv. Co. v. Comm'r*, 101 T.C. 294, 300 n.7 (1993) ("For non-business items and those not covered under [S]ec. 6501(e)(1)(A)(i), the general definition of gross income found in the Code applies."); *Insulglass Corp. v. Comm'r*, 84 T.C. 203, 210 (1985) ("In the case of a trade or business, 'gross income' is equated with gross receipts. Otherwise, 'gross income' means those items listed in [S]ection 61(a), which includes, among other things, gains derived from dealings in property."); *Benson v. Comm'r*, 91 T.C.M. (CCH) 925, 926 (2006) ("This Court has found that the [S]ection 61 definition of gross income generally applies to [S]ection 6501(e)(1)(A)."); *Schneider v. Comm'r*, T.C.M. (CCH) 1032, 1035 (1985) ("Thus, it is only for the purpose of calculating trade or business gross income under Section 6501(e) that the 'gross receipts' method is utilized in determining gross income."); *Carr v. Comm'r*, T.C.M. (CCH) 1695, 1703 (1978) ("For purposes of [S]ection 6501(e)(1)(A), gross income includes those items listed in [S]ection 61(a), except that [S]ection 6501(e)(1)(A)(i) provides that gross receipts from a trade or business are to be taken into account in lieu of gross income therefrom."). For cases distinguishing *Colony* on the ground that the taxpayer in the instant case did not adequately disclose certain transactions on the return, see, for example, *Salman Ranch Ltd. v. United States*, 573 F.3d 1362, 1382 (Fed. Cir. 2009) (Newman, J., dissenting) ("To summarize precedent, courts have generally applied the rationale of *Colony* . . . where taxpayers made errors in basis that were reasonably identifiable from the information in their tax returns."); *Taylor v. United States*, 417 F.2d 991, 993 (5th Cir. 1969) ("[T]he statute provides that an item of income is 'omitted' if the item is not shown in a manner sufficient to enable the Government, upon a reasonable inspection, to detect the error. . . . [T]he Government is not to be penalized by a taxpayer's failure to reveal the facts."); *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968) ("[T]he enactment of subsection (ii) . . . makes it apparent that the six year statute is intended to apply where there is . . . [a] misstating of the nature of an item of income which places the 'commissioner . . . at a special disadvantage in detecting errors.'");

Recently, however, courts have begun to apply *Colony* to all taxpayers generally, and accordingly refused to allow the extended limitations period in all cases where a taxpayer's overstatement of basis led to an understatement of gross income.<sup>23</sup> In 2009, following judicial setbacks in overstatement of basis cases such as *Bakersfield Energy Partners, LP v. Commissioner*<sup>24</sup> and *Salman Ranch Ltd. v. United States*,<sup>25</sup> the Service issued Treasury Decision 9466, a set of temporary regulations that limit *Colony* to cases involving a trade or a business.<sup>26</sup>

This Note discusses the evolution of lower courts' interpretations of the extended statute of limitations since *Colony* and concludes that *Bakersfield*, in which the Ninth Circuit held that a taxpayer's overstatement of basis in sold assets does not constitute an omission from gross income under Section 6501(e)(1)(A), correctly identified *Colony* as controlling precedent.<sup>27</sup> Additionally, this Note argues that, although the *Bakersfield* court correctly identified *Colony* as controlling judicial precedent, the *Colony* rule no longer adequately advances the policy concerns discussed in the Supreme Court's 1958 opinion in light of modern tax shelter schemes such as Son of BOSS.<sup>28</sup> Part II summarizes the jurisprudence—before, after, and including the *Colony* decision—surrounding the Service's assertion of an extended statute of limitations in overstatements of basis cases.<sup>29</sup> Part III focuses upon the Ninth Circuit's recent decision in *Bakersfield* that, under *Colony*, overstatement of basis does not constitute omission of gross income for the purpose of asserting the extended statute of

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*Brandon Ridge Partners v. United States*, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at \*7 (M.D. Fla. July 30, 2007) ("Furthermore, there are Fifth Circuit cases that are binding on this Court that state that an item of income is omitted if the item is not shown in a manner sufficient to enable the IRS, upon reasonable inspection, to detect the error.").

23. See *Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505, 509-10 (2007) (noting Tax Court's changing interpretation of *Colony* rationale from limitation to trade or business exception to more general application to all of Section 6501(e)(1)(A)); *Bakersfield Energy Partners v. Comm'r*, 128 T.C. 207, 215 (2007) ("We do not believe that either than language or the rationale of *Colony, Inc.* can be limited to the sale of goods or services by a trade or business."), *aff'd*, 568 F.3d 767 (9th Cir. 2009); see also *Salman Ranch*, 573 F.3d at 1373 ("[T]he Court did not say that its holding was limited to sales of goods or services by a trade or business.").

24. 128 T.C. 207, 215 (2007), *aff'd*, 568 F.3d 767 (9th Cir. 2009).

25. 573 F.3d 1362, 1382 (Fed. Cir. 2009).

26. See 26 C.F.R. § 301 (2009) ("Accordingly, outside the context of a trade or business, any basis overstatement that leads to an understatement of gross income under Section 61(a) constitutes an omission of gross income for purposes of [S]ections 6501(e)(1)(A) and 6229(c)(2).").

27. For a discussion of the holding in *Bakersfield*, see *infra* notes 77-96 and accompanying text.

28. For a discussion of the recent failures of the *Colony* rule in light of modern tax shelters and the need to revisit the rule, see *infra* notes 97-107 and accompanying text.

29. For a discussion of the development of jurisprudence concerning the extended statute of limitations, see *infra* notes 33-61 and accompanying text.



limitations under Section 6501(e)(1)(A).<sup>30</sup> Part IV analyzes whether, in light of decisions such as *Bakersfield*, the Supreme Court will overrule *Colony*, or lower courts will accord deference to Treasury Decision 9466 and limit *Colony* to only those cases involving a trade or a business.<sup>31</sup> Part V concludes with a discussion of the impact of *Bakersfield* and Treasury Decision 9466.<sup>32</sup>

## II. THERE AND BACK AGAIN: CONTROVERSY OVER BASIS CASES LEADS TO COLONY, COLONY LEADS TO CONTROVERSY OVER BASIS CASES

The extended statute of limitations for omissions from gross income has existed since the Revenue Act of 1934 was codified in the 1939 Internal Revenue Code under Section 275(c) and exists today as Section 6501(e)(1)(A).<sup>33</sup> From the outset, courts disagreed over whether an overstatement of cost items such as basis could constitute an “omission” from gross income that would trigger the extended statute of limitations.<sup>34</sup> The Supreme Court held in *Colony* that an overstatement of basis in a sold asset that leads to an understatement of gross income did not constitute an omission from gross income for the purposes of the extended statute of limitations.<sup>35</sup> Despite the Supreme Court’s holding in *Colony*, numerous lower courts have reached contrary results in subsequent cases.<sup>36</sup>

### A. Before Colony

From its inception, Section 275(c) of the Revenue Act of 1934 led to controversy regarding the meaning of the phrase “omits from gross income.”<sup>37</sup> As originally enacted, the statute provided an extended statute of limitations for tax assessment when the taxpayer non-fraudulently omits

30. For a discussion of the facts and procedure of *Bakersfield*, see *infra* notes 64-76 and accompanying text. For a discussion of the Ninth Circuit’s holding and rationale, see *infra* notes 77-96 and accompanying text.

31. For an analysis of the future of overstatement of basis cases after *Bakersfield*, see *infra* notes 97-168 and accompanying text.

32. For a discussion of the impact of Treasury Decision 9466, see *infra* notes 169-72 and accompanying text.

33. See *Colony, Inc. v. Comm’r*, 357 U.S. 28, 34 (1958) (addressing legislative history of extended statute of limitations under Section 275(c)).

34. For a discussion of the circuit split leading to the *Colony* decision, see *infra* notes 37-41 and accompanying text.

35. See *Colony*, 357 U.S. at 36 (“[T]o impose a five-year limitation when such errors affect ‘gross income,’ but a three-year limitation when they do not, not only would be to read § 275(c) more broadly than is justified . . .”).

36. See, e.g., *id.* at 31 (“We granted certiorari because this decision conflicted with rulings in other Courts of Appeals on the same issue . . .”); *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678, 684 (E.D.N.C. 2008) (“In the years since *Colony* was decided, a handful of courts have applied its holding regarding overstatement of basis to § 6501(e)(1)(A), with unharmonious results.”).

37. See *Colony*, 357 U.S. at 29, 33 (explaining developing circuit split over statute’s construction and outlining legislative history of statute).

more than twenty-five percent of gross income on a tax return.<sup>38</sup> Six circuit courts of appeals held that an overstatement of cost items, including basis, did not constitute an omission from gross income under Section 275(c) when the overstatement led to an understatement of gross income.<sup>39</sup> Standing in opposition, the United States Tax Court and the Sixth Circuit both held that, in some circumstances, understatements of gross income resulting from erroneous inclusion or overstatement of cost items could constitute an omission for the purposes of Section 275(c).<sup>40</sup> Specifically, these courts reasoned that an overstatement of basis in sold property, an improper listing of labor and supply items as a cost of goods sold, and improper inclusions that inflated the cost of a sold lease would

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38. *See* *Badaracco v. Comm'r*, 464 U.S. 386, 392 (1984) (instructing that both standard three-year and extended six-year statutes of limitations do not apply in cases of false or fraudulent returns with intent to evade tax).

39. *See, e.g.*, *Goodenow v. Comm'r*, 238 F.2d 20, 22 (8th Cir. 1956) (determining that overstatement of deductions for cost basis of assets sold, resulting in insufficient gross income on return, did not constitute "omission from gross income" for purposes of Section 275(c) extended statute of limitations), *rev'g* 25 T.C. 1 (1955); *Davis v. Hightower*, 230 F.2d 549, 553 (5th Cir. 1956) ("It cannot be thought that if a taxpayer . . . arrives at an incorrect computation of the tax only by reason of a difference between him and the Commissioner as to the legal construction . . . [of] a disclosed transaction, the use of a smaller figure than that ultimately found to be correct in one stage of the computation amounts to an omission from 'gross income' . . ."); *Slaff v. Comm'r*, 220 F.2d 65, 68 (9th Cir. 1955) (finding no omission from gross income for Section 275(c) purposes where taxpayer's return disclosed \$3,300 of overseas earnings, claimed earnings were exempt, and reported no gross income); *Deakman-Wells Co. v. Comm'r*, 213 F.2d 894 (3d Cir. 1954) (finding no omission of gross income for Section 275(c) purposes where taxpayer erroneously calculated carryback loss and understated gross income by roughly fifty percent and where taxpayer disclosed all income items on schedule attached to return but erroneously excluded some in final computation); *Uptegrove Lumber Co. v. Comm'r*, 204 F.2d 570, 572 (3d Cir. 1953) (finding no omission of gross income for Section 275(c) purposes where taxpayer included erroneous items in cost of goods sold calculation, resulting in understatement of final gross income calculation, and taxpayer revealed erroneous items on return); *Lazarus v. United States*, 142 F. Supp. 897, 898 (Fed. Cl. 1956) ("The plaintiffs could not have made any plainer disclosure of their gains of \$23,988.02 than they did make, without putting them directly in the income column and paying taxes on them.").

40. *See, e.g.*, *Reis v. Comm'r*, 142 F.2d 900, 903-04 (6th Cir. 1944) (upholding extended statute of limitations under Section 275(c) where taxpayer adopted incorrect basis amount in property, sold it, and understated gross income by more than twenty-five percent); *Estate of Gibbs v. Comm'r*, 21 T.C. 443, 447-48 (1954) (applying extended statute of limitations under Section 275(c) where taxpayer improperly listed labor and supply items as costs of goods sold, accordingly understated gross income by more than twenty-five percent, and introduced no evidence to prove what erroneous labor and supply items actually were); *Am. Liberty Oil Co. v. Comm'r*, 1 T.C. 386, 388-89 (1942) (upholding extended statute of limitations under Section 275(c) where taxpayer included improper items in cost of lease it sold, resulting in understatement of gross income by more than twenty-five percent).

constitute an omission from gross income such that the extended statute of limitations would apply.<sup>41</sup>

### B. Colony

To resolve the circuit split, the United States Supreme Court granted certiorari to determine what constitutes an “omission from gross income” for the purposes of the extended statute of limitations.<sup>42</sup> In *Colony*, a corporation conducting real estate transactions allegedly filed a tax return containing understatements of gross income of more than twenty-five percent because of an overstatement of basis in land it sold.<sup>43</sup> The Court in *Colony* purported to provide definitive guidance on whether an overstatement of basis could constitute an omission from gross income under Section 275(c) of the 1939 Internal Revenue Code.<sup>44</sup>

Initially, the Court analyzed the language of Section 275(c) and determined that an omission from gross income should likely be limited to situations outside of overstatement of basis, in which “specific receipts or accruals of income items are *left out* of the computation of gross income.”<sup>45</sup> The Court concluded that Section 275(c) was ambiguous, and turning to the legislative history, found that Congress did not intend an overstatement of basis to be an omission from gross income.<sup>46</sup> The Court

41. For a discussion of pre-*Colony* cases and their specific factual situations, see *supra* notes 39-40 and accompanying text.

42. See *Colony*, 357 U.S. at 31-32 (“We granted certiorari because this decision conflicted with rulings in other Courts of Appeals on the same issue . . .”).

43. See *Colony, Inc. v. Comm’r*, 244 F.2d 75, 76 (6th Cir. 1957) (detailing case facts), *rev’d*, 357 U.S. 28. The Commissioner determined that the taxpayer understated gross profits on the sale of residential lots of land by erroneously including some unallowable items of development expense into its basis calculation. See *Colony*, 357 U.S. at 30 (outlining facts and procedure of case).

44. See *id.* at 31 (stating issue for decision).

45. See *id.* at 33 (agreeing with taxpayer’s plain language argument). The taxpayer argued that statutory words should be used according to their usual meaning. See *id.* at 32 (“[S]tatutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them.” (quoting *DeCanay v. Lederer*, 250 U.S. 376, 381 (1919))). Further, the Court noted that the dictionary definition of “omit” means “to leave out” or not mention. See *id.* (“[T]o leave out or unmentioned; not to insert, include, or name” (quoting WEBSTER’S NEW INTERNATIONAL DICTIONARY (2nd ed. 1939))). The Sixth Circuit had similarly defined “omit” in a case upholding the use of the six-year statute of limitations under Section 275(c). See *Éwald v. Comm’r*, 141 F.2d 750, 753 (6th Cir. 1944) (“Ordinarily, the word ‘omit’ means to disregard, to fail, forbear, neglect to mention, or fail to insert or include.”).

46. See *Colony*, 357 U.S. at 34 (chronicling legislative history of Section 276). The Court found that House Subcommittee debates emphasized that the taxpayer must leave out entire items from gross income, rather than overstate them. See *id.* (“What we really had in mind was just this kind of situation: Assume that a taxpayer left out, say, a million dollars; he just forgot it. We felt that whenever we found that he did that we ought to get the . . . tax on it.” (quoting *Hearings Before the H. Comm. on Ways and Means*, 73d Cong. 139, 149 (1934))). The full Committee appeared to take the same attitude to omissions. See *id.* (“It is not believed that taxpayers who are so negligent as to leave out of their returns items of such

noted that the underlying reason for the statute of limitations extension was to level the playing field between the Service and the taxpayer in cases where the Service is at a distinct disadvantage because the taxpayer omits information from the tax return and the return offers no clues that an omission has occurred.<sup>47</sup> Additionally, the Court rejected the Service's argument that where there is an error on the face of the return such that the Service is not at a disadvantage, the Service should be permitted the statute of limitations extension if the error "affect[ed] gross income."<sup>48</sup> While the Court expressly declined to construe amendments to the extended statute of limitations under the 1954 Code, it remarked that its construction of the predecessor statute, Section 275(c) under the 1939 Code, was consistent with the unambiguous language of its successor statute, Section 6501(e)(1)(A) under the 1959 Code.<sup>49</sup>

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magnitude should be accorded the privilege of pleading the bar of the statute." (quoting H.R. REP. NO. 73-704, at 35 (1934))). The Court then noted that Section 275(c) did not change the basic objectives underlying the enactment of Section 276 of the Revenue Act of 1934. *See id.* (applying Section 276 legislative history to Section 275(c)). *But see* *Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505, 510 n.5 (2007) ("Among other things, the Court in *Colony* seemingly downplayed the portions of the legislative history that suggested that the statute applies simply where a taxpayer 'understates gross income.'"); Robert J. Richards, Jr., *The Extended Statute of Limitations on Assessment*, 12 TAX L. REV. 297, 311 (1957) ("When the words of the statute are read in light of the Committee Reports taken as a whole, it is difficult to understand why such a limited meaning is placed on 'omits.'"). The Court of Federal Claims in *Grapevine* admitted that the legislative history included examples of situations in which the extended statute should apply, such as when a taxpayer completely left out a dividend from the return, but found the legislative history unclear as to when the extended statute *should not* apply. *See Grapevine*, 77 Fed. Cl. at 510 n.5 (quoting S. REP. NO. 73-558, at 44 (1934)) (questioning *Colony's* employment of legislative history in constructing Section 275(c)). *But see* *Pension Benefits Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 649 (1990) ("[T]he language of a statute . . . is not to be regarded as modified by examples set forth in the legislative history. An example, after all, is just that: an illustration of a statute's operation in practice.").

47. *See Colony*, 357 U.S. at 36 ("We think that in enacting § 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors.").

48. *See id.* at 36-37 ("To accept the Commissioner's interpretation and to impose a five-year limitation when such errors affect 'gross income,' but a three-year limitation when they do not, not only would be to read § 275(c) more broadly than is justified by the evident reason for its enactment, but also to create a patent incongruity in the tax law.").

49. *See id.* at 37 ("And without doing more than noting the speculative debate between the parties as to whether Congress manifested an intention to clarify or to change the 1939 Code, we observe that the conclusion we reach is in harmony with the unambiguous language of § 6501(e)(1)(A) of the Internal Revenue Code of 1954."). Courts have seized on this dictum in an effort to limit *Colony's* holding to only certain portions of Section 6501(e)(1)(A), the successor statute. For a discussion of judicial narrowing of the *Colony* decision, see *infra* notes 55-59 and accompanying text.

C. *The Aftermath of Colony*

*Colony* dealt with tax returns from tax years 1946 and 1947, which means that the Court interpreted the extended statute of limitations provision, Section 275(c), under the 1939 Code.<sup>50</sup> In 1954, Congress enacted a new Internal Revenue Code that purportedly resolved the issue, addressed in *Colony*, of whether an overstatement of basis constitutes an omission from gross income for the purposes of the extended statute of limitations.<sup>51</sup> The 1954 version of Section 275(c), Section 6501(e)(1)(A), enacted substantially identical text to Section 275(c) in subparagraph (A) and added two rules in Clauses (i) and (ii).<sup>52</sup>

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50. See *Colony*, 357 U.S. at 31-32 (“We granted certiorari because . . . the question as to the proper scope of § 275(c), although resolved for the future by § 6501(e)(1)(A) . . . remains one of substantial importance in the administration of income tax laws for earlier tax years.”).

51. See *id.* at 31 (noting that questions as to proper scope of Section 275(c) had been resolved by introduction of Section 6501(e)(1)(A) under 1954 Code). The 1954 Code added two new provisions to the extended statute of limitations for omissions from gross income that the *Colony* decision did not purport to construe. See *Salman Ranch Ltd. v. United States*, 573 F.3d 1362, 1371 (Fed. Cir. 2009) (“The [G]overnment contends that its limiting construction of *Colony* finds support in changes made to the 1939 Code by the 1954 Code. . . . In making this argument, the [G]overnment focuses first on subparagraphs (i) and (ii) of I.R.C. 6501(e)(1)(A), both of which were added . . . by the 1954 Code.”). Clause (i) specified that, in cases of sales of goods or services by a trade or business, gross income should be computed as “gross receipts,” without considering cost or basis in transactions. See 26 U.S.C. § 6501(e)(1)(A)(i) (2006) (“[T]he term ‘gross income’ means the total amounts received or accrued . . . prior to diminution by the cost of such sales or services.”). Clause (ii), the “safe harbor” provision, stipulates that if an amount is disclosed on the return in a manner adequate to inform the IRS of the nature and amount of the item, it cannot be considered in any calculation of an omission from gross income. See *id.* § 6501(e)(1)(A)(ii) (detailing adequate disclosure provision). For a discussion of the specific requirements of the adequate disclosure provision of Clause (ii), see *supra* note 15 and accompanying text.

52. See *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678, 684-85 (E.D.N.C. 2008) (discussing carryover of language from Section 275(c) to Section 6501(e)(1)(A) and impact of Congress’s addition of Clauses (i) and (ii)); see also *Salman Ranch*, 573 F.3d at 1373 (“Nevertheless, the fact remains that *Colony* represents an interpretation of the very same language that is now found in § 6501(e)(1)(A), and in the years since *Colony*, Congress has not indicated that the Court’s interpretation of the language of § 275(c) should not apply to § 6501(e)(1)(A).”); *Bakersfield Energy Partners, LP v. Comm’r*, 568 F.3d 767, 776 (9th Cir. 2009) (“Congress was presumably aware of the dispute over the interpretation of § 275(c), and it could have expressly added a definition of ‘omits’ if it wanted to overrule the cases that concluded . . . that ‘omits’ did not include an overstatement of basis.”); *Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505, 510 (2007) (noting that 1939 and 1954 statutes carry same meaning because Congress did not modify “omits” and Court in *Colony* determined its discussion of 1954 statute to be “in harmony” with its discussion of 1939 statute); NORMAN J. SINGER & J.D. SHAMBIE SINGER, *SUTHERLAND’S STATUTES AND STATUTORY CONSTRUCTION* § 22.33 (6th ed. 2002) (explaining that successor statutes constitute “a continuation of the original law”); cf. *United States v. O’Brien*, 542 F.3d 921, 926 (1st Cir. 2008) (finding that Congress’s act of breaking long sentences of predecessor statute up into subdivisions in successor statute reflected only current trend toward

Since the *Colony* decision and the enactment of the 1954 Code, courts have struggled with whether the extended statute of limitations in Section 6501(e)(1)(A) under the 1954 Code applies only when the taxpayer omits an item of gross income on the return, or whether it also applies in cases where a taxpayer overstates basis in an asset and understates gross income.<sup>53</sup> Under principles of stare decisis, lower courts may not overrule *Colony*.<sup>54</sup> Nevertheless, after *Colony*, some courts have attempted to limit the holding to situations involving the sale of goods or services by a trade

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ease of reading and did not render precedent construing predecessor statute inapplicable; *Strange v. Comm'r*, 114 T.C. 206, 210 n.4 (2000) (applying precedent that determined taxpayer could not deduct from gross income state income tax paid on share of net business income from certain partnerships where precedent construed sections of 1939 Internal Revenue Code that were “substantially the same” as provisions of 1954 Code); *Lilly v. Comm'r*, 45 T.C. 168, 175 (1965) (applying precedent that construed meaning of “life insurance” under 1939 Internal Revenue Code to after-death payments governed by 1954 Code where predecessor and successor provisions were “substantially the same”). Compare 26 U.S.C. § 257(c) (1939), repealed by American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101(b)(5)(A), 118 Stat. 1418, 1423 (2004) (“If the taxpayer omits from gross income an amount properly includable therein which is in excess of 25 per centum of the amount of gross income stated on the return, the tax may be increased . . . at any time within 5 years after the return was filed . . .”), with 26 U.S.C. 6501(e)(1)(A) (2006) (“If the taxpayer omits from gross income an amount properly includable therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed . . . at any time within 6 years after the return was filed.”).

53. See *Grapevine Imps.*, 77 Fed. Cl. at 509 (noting that since 1954 Code amendments, courts have begun to question relevance of *Colony*); see also *Home Concrete & Supply*, 599 F. Supp. 2d at 685 (“The two subsections Congress added to § 275(c) in drafting § 6501(e)(1)(A), acknowledged by the Court in *Colony*, make clear the limit of its holding.”).

54. See *Hohn v. United States*, 524 U.S. 236, 252-53 (1998) (“Our decisions remain binding precedent until we see fit to reconsider them, regardless of whether subsequent cases have raised doubts about their continuing vitality.”), vacated, 537 U.S. 801 (2002); *State Oil Co. v. Khan*, 522 U.S. 3, 20 (1997) (“Stare decisis reflects ‘a policy judgment that in most matters it is more important that the applicable rule of law be settled than it be settled right.’” (quoting *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting))); *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 484 (1989) (“If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions.”); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353 (Fed. Cir. 2006) (“There can be no question that the Court of Federal Claims is required to follow the precedent of the Supreme Court . . . even if the . . . decisions of the Supreme Court have been eroded, the Court of Federal Claims would still be required to follow them as binding precedent.”); *Stone Container Corp. v. United States*, 229 F.3d 1345, 1349-50 (Fed. Cir. 2000) (“Once the [Supreme] Court has spoken, it is the duty of other courts to respect that understanding of the governing rule of law.” (quoting *Rivers v. Roadway Express, Inc.*, 511 U.S. 298, 312 (1994))); cf. *Bakersfield*, 568 F.3d at 778 (noting that “IRS may have the authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code, even if its interpretation runs contrary to the Supreme Court” (citing *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-83 (2005))).

or business.<sup>55</sup> Until at least 1993, the Tax Court consistently limited *Colony* in this way.<sup>56</sup> The Fifth Circuit and other courts limit *Colony* in another manner, applying *Colony* only to situations where the taxpayer made errors on the return that the Commissioner could reasonably identify from information disclosed on the taxpayer's returns.<sup>57</sup> Under this interpretation, *Colony* is limited to cases where the taxpayer understated gross income but properly disclosed all relevant amounts and transactions on the return.<sup>58</sup> One explanation for such narrow application of *Colony* is that, as an unintended consequence of strict adherence to *Colony*, tax shelter promoters have relied on the 1958 decision to fend off the Service's enforcement efforts.<sup>59</sup>

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55. See, e.g., *Brandon Ridge Partners v. United States*, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at \*7 (M.D. Fla. July 30, 2007) ("The IRS argues that *Colony*'s gross receipts test only applies to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. To conclude otherwise would render § 6501(e)(1)(A)(i) superfluous.")

56. See, e.g., *N. Ind. Pub. Serv. Co. v. Comm'r*, 101 T.C. 294, 300 n.7 (1993) ("For nonbusiness items and those not covered under [S]ec. 6501(e)(1)(A)(i), the general definition of gross income found in the Code applies."); *Insulglass Corp. v. Comm'r*, 84 T.C. 203, 210 (1985) ("In the case of a trade or business, 'gross income' is equated with gross receipts. Otherwise, 'gross income' means those items listed in [S]ection 61(a), which includes, among other things, gains derived from dealings in property."); *Benson v. Comm'r*, 91 T.C.M. (CCH) 925, 926 (2006) ("This Court has found that the [S]ection 61 definition of gross income generally applies to [Section] 6501(e)(1)(A)."); *Schneider v. Comm'r*, 49 T.C.M. (CCH) 1032, 1035 (1985) ("Thus, it is only for the purpose of calculating trade or business gross income under Section 6501(e) that the 'gross receipts' method is used in determining gross income."); *Carr v. Comm'r*, 37 T.C.M. (CCH) 1695, 1703 (1978) ("For purposes of [S]ection 6501(e)(1)(A), gross income includes those items listed in Section 61(a), except that [S]ection 6501(e)(1)(A)(i) provides that gross receipts from a trade or business are to be taken into account in lieu of gross income therefrom.")

57. See *Salman Ranch*, 573 F.3d at 1382 (Newman, J., dissenting) ("To summarize precedent, courts have generally applied the rationale of *Colony* . . . where taxpayers made errors in basis that were reasonably identifiable from the information on their tax returns"); see also *Taylor v. United States*, 417 F.2d 991, 993 (5th Cir. 1969) ("[T]he statute provides that an item of income is 'omitted' if the item is not shown in a manner sufficient to enable the Government, upon a reasonable inspection, to detect the error. . . . [T]he Government is not to be penalized by a taxpayer's failure to reveal the facts."); *Phinney v. Chambers*, 392 F.2d 680, 685 (5th Cir. 1968) ("[T]he enactment of subsection (ii) . . . makes it apparent that the six year statute is intended to apply where there is . . . [a] misstating of the nature of an item of income which places the 'commissioner . . . at a special disadvantage in detecting errors."); *Brandon Ridge Partners*, 2007 WL 2209129, at \*7 ("Furthermore, there are Fifth Circuit cases that are binding on this Court that state that an item of income is omitted if the item is not shown in a manner sufficient to enable the IRS, upon reasonable inspection, to detect the error.")

58. For a discussion of decisions that have limited *Colony* under the adequate disclosure rule, see *supra* note 57 and accompanying text.

59. See *Colony, Inc. v. Comm'r*, 357 U.S. 28, 36 (1958) ("We think that in enacting § 275(c), Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, *the Commissioner is at a special disadvantage in detecting errors.*") (emphasis added). Tax shelters are designed to

Recently, however, courts have applied *Colony's* construction of Section 275(c) to the entirety of Section 6501(e)(1)(A) and to all taxpayers generally.<sup>60</sup> Because such broad application of *Colony* precludes application of the extended statute of limitations, the trend toward broad application of *Colony* has led to increasingly unfavorable results for the the Service in its tax shelter litigation efforts.<sup>61</sup>

### III. BAKERSFIELD: THE NINTH CIRCUIT REAFFIRMS *COLONY*

The Ninth Circuit entered the *Colony* controversy in *Bakersfield Energy Partners, LP v. Commissioner*.<sup>62</sup> In this case, the Ninth Circuit adopted the Tax Court's trend of broadly applying the *Colony* rule to all taxpayers.<sup>63</sup>

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place the IRS at a "special disadvantage," so that the taxpayer can erroneously file a tax return without detection. See Sheppard, *supra* note 10, at 454 ("[I]nstead of simply not reporting income . . . a taxpayer may create numerous entities and then cause such entities to enter into a multiplicity of transactions with each other in order to obfuscate the fact that the taxpayer is the true recipient of the income and should be taxed as such."). Yet the *Colony* rule requires precisely this act of "not reporting" an item of income to trigger the extended statute of limitations. See *Colony*, 357 U.S. at 36 ("[B]ecause of a taxpayer's omission to report some taxable item . . ."). Most importantly, the *Colony* rule comes into play on motions for summary judgment; if the court finds no omission of gross income, the taxpayer automatically wins because the statute bars the Government's claim. See *Salman Ranch*, 573 F.3d at 1377 ("The three-year limitations period of § 6501(e)(1)(A) controls, which means that the FPAA was untimely and therefore invalid."); *Bakersfield*, 568 F.3d at 778 ("We therefore agree with the Tax Court's conclusion that the FPAA was untimely, and we AFFIRM the judgment of the Tax Court.").

60. See *Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505, 509-10 (2007) (noting Tax Court's changing interpretation of *Colony* rationale from limitation to trade or business exception to more general application to all of Section 6501(e)(1)(A)); see also *Salman Ranch*, 573 F.3d at 1373 ("[T]he Court did not say that its holding was limited to sales of goods or services by a trade or business."); *Bakersfield Energy Partners, LP v. Comm'r*, 128 T.C. 207, 215 (2007), *aff'd*, 568 F.3d 767 ("We do not believe that either the language or the rationale of *Colony, Inc.* can be limited to the sale of goods or services by a trade or business.").

61. See Sheppard, *supra* note 10, at 464 ("The magnitude of this matter has not escaped certain tax practitioners, who explain that the significance of the SOL [statute of limitations] as an issue cannot be overemphasized. It may provide a complete and total victory to the taxpayer if the IRS violates it.").

62. 568 F.3d 767 (9th Cir. 2009).

63. See *id.* at 778 (interpreting *Colony* to hold that taxpayers do not omit amounts properly includable from gross income by overstating their basis in assets on returns); see also Sheppard, *supra* note 4, at 12 (arguing that IRS's actions in combating Son of BOSS cases will increase number of taxpayers taking IRS to court). Sheppard explains that this rise is caused specifically by the IRS's insistence on massive penalties regardless of facts of individual cases, policy difficulties in settling cases against taxpayers with good facts, and the denial of access to appeals regardless of the Service's stated goals of encouraging compliance and stopping proliferation of Son of BOSS shelters. See Sheppard, *supra* note 4, at 12 (analyzing potential for litigation increases).



A. *Facts and Procedural Background*

In *Bakersfield*, the taxpayer, Bakersfield Energy Partners, LP (Bakersfield), owned an interest in an oil and gas property, which Seneca, a third party, offered to purchase for \$24 million.<sup>64</sup> Four of the seven Bakersfield partners—comprising a majority interest in Bakersfield—formed a new entity, Bakersfield Resources, LLC (Resources)—taxable as a partnership—and sold their interests in Bakersfield to Resources for \$20 million.<sup>65</sup> Because the four partners sold more than half of the total partnership interests in Bakersfield to Resources, the Bakersfield partnership technically terminated for tax purposes, and a new Bakersfield partnership was formed in which Resources held a majority interest.<sup>66</sup>

Following the transfer of partnership interest, the new Bakersfield partnership elected to increase its basis in partnership assets, including the oil and gas property.<sup>67</sup> Bakersfield adjusted its total basis in its assets by the \$20 million sale price of the partnership interests sold to Resources and allocated \$16.5 million of the new basis to the oil and gas property.<sup>68</sup> Bakersfield then closed the sale of the oil and gas property to Seneca for \$24 million.<sup>69</sup> On its partnership tax return for the tax year ending December 1998, Bakersfield reported a gain from the sale of roughly \$7.5 million (the sale price of \$24 million minus its basis of \$16.5 million) and attached a short statement to the return that explained its basis adjustment.<sup>70</sup> Shortly before the six-year statute of limitations expired, the Service claimed Bakersfield's basis adjustment was invalid because the transactions in partnership interests lacked economic substance.<sup>71</sup>

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64. See *Bakersfield*, 568 F.3d at 768-69 (stating facts of case).

65. See *id.* at 769 (stating facts of case).

66. See *id.* (stating facts of case); see also 26 U.S.C. § 708(b)(1)(B) (2006) (specifying technical termination of partnership when majority of partnership interests are sold or transferred within twelve month period).

67. See *Bakersfield*, 568 F.3d at 770 (stating facts of case); see also 26 U.S.C. § 754 (allowing election to adjust basis after transfer of partnership assets); *id.* § 743 (outlining procedure for election of basis adjustment).

68. See *Bakersfield*, 568 F.3d at 770 (stating facts of case).

69. See *id.* (stating facts of case).

70. See *id.* (stating facts of case). The attachment noted:

As reflected within the capital accounts, the partnership books were restated to reflect the value of assets as required in the regulations under I.R.C. [26 U.S.C. §] 704. As reflected within this return, in the event of a sale of these assets proper adjustments have been made to reflect the tax basis and the proper taxable gain.

*Id.* at 769-70.

71. See *id.* at 770 (setting forth IRS's claims that Bakersfield's basis adjustment lacked economic substance, had no business purpose or economic effect, and/or was meant to evade taxes and should not be honored for tax purposes). The IRS determined that Bakersfield's basis in the oil and gas property was zero and calculated the gain from the property sale to Seneca as \$22 million. See *id.* (describing IRS's determination of Bakersfield's tax deficiency). The IRS concluded that Bakersfield had underpaid its taxes and imposed a forty percent penalty on the underpayment. See *id.* (stating facts of case).

Bakersfield petitioned the United States Tax Court for readjustment of its deficiency, claiming the Service's adjustment was untimely under the three-year statute of limitations to assess a tax deficiency.<sup>72</sup> The Service argued that the adjustment was timely under the extended six-year statute of limitations, which it argued applied because Bakersfield omitted a properly includable amount from gross income that exceeded twenty-five percent of the gross income stated on the return.<sup>73</sup> The Tax Court applied *Colony* and determined that the three-year statute of limitations applied because the taxpayer did not omit any items from its gross income calculation.<sup>74</sup> Therefore, the Service's adjustment was untimely.<sup>75</sup> The Service appealed the Tax Court's decision and the Ninth Circuit affirmed, holding that the Supreme Court's decision in *Colony* foreclosed any argument that a taxpayer could omit an amount from gross income by overstating its basis and understating its gross income.<sup>76</sup>

### B. *The Ninth Circuit's Analysis*

In *Bakersfield*, the Ninth Circuit affirmed the Tax Court and held that an overstatement of basis does not constitute an omission from gross income for the purposes of the extended statute of limitations in Section 6501(e)(1)(A).<sup>77</sup> The court determined that *Colony* still controlled, the plain language of Section 6501(e)(1)(A) in the 1954 Code did not contradict *Colony*, the passage of Section 6501(e)(1)(A)(i) in 1954 did not materially alter the statutory language in the 1939 Code construed in *Colony*, and *Colony's* holding is not limited to cases concerning a trade or business.<sup>78</sup>

#### 1. *Colony Applies*

In reviewing the Service's statute of limitations claim, the Ninth Circuit first discussed whether the *Colony* decision was controlling in the pre-

72. See *id.* (laying out Bakersfield's argument in Tax Court).

73. See *id.* at 770-71 (describing IRS's argument before Tax Court); see also 26 U.S.C. § 6501(e)(1)(A) (allowing six-year statute of limitations when "taxpayer omits from gross income an amount properly includable therein which is in excess of 25 twenty-five percent of gross income stated in the return."); *id.* § 6229(c)(2) (applying Section 6501(e)(1)(A) extended statute of limitations to partnership taxpayers who similarly omit twenty-five percent or more of properly includable gross income).

74. See *Bakersfield*, 568 F.3d at 778 ("We therefore agree with the Tax Court's conclusion that the FPAA was untimely . . .").

75. See *id.* at 771 (summarizing Tax Court's holdings); *Bakersfield Energy Partners v. Comm'r*, 128 T.C. 207, 215-16 (2007) (ruling in favor of Bakersfield in motion for summary judgment).

76. See *Bakersfield*, 568 F.3d at 778 (stating holding of case).

77. See *id.* (presenting holding of case).

78. See *id.* (stating holding). For further discussion of each of these four grounds for the holding that an overstatement of basis does not constitute an omission from gross income for purposes of the extended statute of limitations, see *infra* notes 79-96 and accompanying text.

sent case.<sup>79</sup> Initially, the court explored the predecessor 1939 Code provision construed in *Colony*, and noted that because the predecessor Code provision was so similar to the current 1954 Code provision at issue, *Colony* must control.<sup>80</sup> The court acknowledged the disputes concerning whether the extended statute of limitations in the predecessor statute applied in overstatement of basis cases, but determined that Ninth Circuit precedent, like a majority of circuits, holds that it does not.<sup>81</sup>

The court then shifted its focus to the 1954 Internal Revenue Code, in which Congress reenacted Section 275(c) as Section 6501(e)(1)(A).<sup>82</sup> Importantly, the court noted the addition of Clause (i) to subparagraph 6501(e)(1)(A), which defines gross income in the case of a “trade or business” as gross receipts, or the total amount of money received in a transaction, regardless of cost or basis.<sup>83</sup> Because the *Colony* decision considered

79. See *Bakersfield*, 568 F.3d at 771 (outlining main issue of case).

80. See *id.* (comparing Section 275(c) of 1939 Internal Revenue Code with Section 6501(e)(1)(A) of 1954 Internal Revenue Code). The Ninth Circuit noted that the only changes between the two codes involved a change of the five-year extended period to a six-year period and the replacement of “per centum” with “percent;” otherwise, the language was identical. See *id.* (concluding that two provisions were generally identical); accord *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678, 684 (E.D.N.C. 2008) (“It is correct to say that the language of § 275(c) is virtually identical to a portion of § 6501(e)(1)(A).”). The Ninth Circuit also found that the 1939 Code, like the current one, defined gross income as including gains from property deals and would be calculated by the gross proceeds from the deal (gross proceeds) minus the adjusted basis in the property. See *Bakersfield*, 568 F.3d at 771 (comparing 26 U.S.C. § 22(a) (1934 & Supp. V), to 26 U.S.C. § 61(a) (2006) and 26 C.F.R. § 1.61-1(a) (2009)).

81. See *id.* at 772 (“Given this definition of ‘gross income,’ disputes arose as to whether the extended limitations period of § 275(c) applied if a taxpayer overstated its basis.”); see also *id.* (providing background on pre-*Colony* cases involving omissions from gross income under 1939 Internal Revenue Code). The Ninth Circuit adopted the majority position in a case where it determined that a taxpayer who reported overseas income on his return but erroneously excluded it from gross income was not subject to the extended statute of limitations. See *Slaff v. Comm’r*, 220 F.2d 65, 68 (9th Cir. 1955) (“From the day these returns were filed it was plainly revealed that this taxpayer had earned \$3,300 and said amount was claimed to be exempt. . . . How such a plain statement can be construed as an omission is difficult for us to understand under the circumstances.”); see also *Uptegrove Lumber Co. v. Comm’r*, 204 F.2d 570, 573 (3d Cir. 1953) (holding that corporate taxpayer did not omit from gross income when it erroneously inflated cost of goods sold due to general computational error). For the minority position on the issue, see *Reis v. Comm’r*, 142 F.2d 900, 903 (6th Cir. 1944) (allowing five-year extended statute of limitations where taxpayer adopted incorrect basis that resulted in understatement of more than twenty-five percent of properly stated gross income on return).

82. See *Bakersfield*, 568 F.3d at 772 (citing *Benson v. Comm’r*, 560 F.3d 1133, 1135-36 (9th Cir. 2009) (referring to § 275(c) as “the predecessor statute to § 6501(e)(1)(A)”).

83. See *id.* (noting additions to § 6501(e)(1)(A) in 1954 Code). As such, an overstatement of basis cannot constitute an omission from gross income where the taxpayer is a trade or business. See *id.* (explaining Clause (i)). Congress also added Clause (ii), the adequate disclosure provision, in the 1954 Code, but this addition is not at issue in *Bakersfield*. For a discussion of cases that interpret the

an identical issue in the context of a statute with substantially identical language, the court concluded that the *Colony* decision should control.<sup>84</sup>

## 2. *The Plain Language of Section 6501(e)(1)(A) Does Not Contradict Colony*

Notwithstanding *Colony*, the Service argued that the plain language of Section 6501(e)(1)(A) compels the court to hold that when a taxpayer overstates basis, the information reported on the taxpayer's tax return omits an "amount properly includable from gross income," thereby triggering the extended statute of limitations.<sup>85</sup> Other courts had sustained this plain language argument, but because the Supreme Court in *Colony* explicitly avoided construing the 1954 Code in its opinion, the Ninth Circuit rejected this argument in favor of deferring to *Colony's* interpretation of identical language under the predecessor statute.<sup>86</sup> Further, the Service contended that, because the addition of Clause (i) to Section 6501(e)(1)(A)(i) removes basis as a component of gross income in the case of a trade or business, the general rule of Section 6501(e)(1)(A) is that an overstatement of basis is an omission from gross income.<sup>87</sup> The court acknowledged that the Service's position was reasonable, but con-

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consequences of the addition of Clause (ii) to Section 6501(e)(1)(A), see *supra* note 57 and accompanying text.

84. See *Bakersfield*, 568 F.3d at 772 (quoting *Colony*, 357 U.S. at 33) (determining *Colony* to hold that extended statute of limitations applies to taxpayer who "actually omitted some income receipt or accrual in his calculation of gross income, and not more generally to errors in that computation arising from other causes"). The Ninth Circuit determined that, because the taxpayer in *Bakersfield* did not omit any income receipt or accrual in its gross income calculation, and reported the full amount of its receipts from the sale of the oil and gas property, its overstatement of basis alone could not trigger the extended statute of limitations. See *id.* (determining calculus for omission from gross income under Section 6501(e)(1)(A)).

85. See *id.* (describing IRS's plain language argument). The IRS argued that the Internal Revenue Code defines gross income as all income from any source and includes income from property deals. See *id.* at 774 ("Because gain is determined by subtracting basis from the amount realized, the IRS argues that, under a natural reading of § 6501(e)(1)(A), a taxpayer can 'omit from gross income an amount properly includable therein' by overstating its basis."); see also 26 U.S.C. § 61(a) (defining gross income as "all income from whatever source derived"); *id.* § 61(a)(3) (specifying that gross income includes "[g]ains derived from dealings in property").

86. Compare *Bakersfield*, 568 F.3d at 774 (citing cases in agreement with IRS position on plain language issue), with *Salman Ranch Ltd. v. United States*, 79 Fed. Cl. 189, 200 (2007) ("Instead, the court must import the meaning of 'gross income' in the Internal Revenue Code in order to ascertain what constitutes 'omits from gross income.'"), *rev'd*, 573 F.3d 1362 (Fed. Cir. 2009), and *Brandon Ridge Partners v. United States*, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at \*7 (M.D. Fla. July 30, 2007) ("In the case of a trade or business, 'gross income' is equated with gross receipts. Otherwise, 'gross income' means those items listed in Section 61(a) . . . ." (quoting *Insulglass Corp. v. Comm'r*, 84 T.C. 203, 210 (1985))).

87. See *Bakersfield*, 568 F.3d at 775 ("As noted above, subparagraph (i) removes basis as a component of the definition of 'gross income' in the case of a trade or business, and therefore taxpayers in a trade or business can never be sub-

cluded that it contradicted *Colony's* construction of identical language in Section 6501(e)(1)(A)'s predecessor statute.<sup>88</sup>

### 3. *Clause (i) Did Not Materially Alter Section 6501(e)(1)(A)*

Next, the Service argued that the addition of Clause (i) materially altered Section 6501(e)(1)(A), and that application of *Colony* to Section 6501(e)(1)(A) would render Clause (i) superfluous.<sup>89</sup> The court disagreed that the addition of Clause (i) materially altered the language of Section 6501(e)(1)(A), finding that Congress was presumably aware of the dispute over Section 275(c) when it enacted Section 6501(e)(1)(A).<sup>90</sup> The court concluded that Congress could have expressly defined the term "omits" if it wanted to overrule the line of cases that concluded, consistent with *Colony*, that "omits" does not include overstatements of basis.<sup>91</sup> The

ject to the six-year statute of limitations period merely because they overstated their basis.").

88. *See id.* (dismissing IRS's argument).

89. *See id.* ("The IRS points out that if we apply *Colony* to the main section of § 6501(e)(1)(A) . . . then no taxpayer that overstates its basis will be subject to the six-year limitations period."). Accordingly, the IRS argued, because subparagraph (i)'s special definition of "gross income" as gross receipts also prohibits an overstatement of basis from being an omission from gross income in the case of a trade or business, applying *Colony* to Section 6501(e)(1)(A) would render Clause (i) superfluous. *See id.* ("[I]t is a cardinal principle of statutory construction that a court must give effect, if possible, to every clause and word of a statute . . ." (quoting *In re Bonner Mall P'ship*, 2 F.3d 899, 908 (9th Cir. 1993))).

90. *See id.* at 776 ("In enacting the 1954 Code, Congress was presumably aware of the dispute over the interpretation of § 275(c), and it could have expressly added a definition of 'omits' if it wanted to overrule the cases that concluded . . . that 'omits' did not include an overstatement of basis.").

91. *See id.* (noting that Congress left language in Section 6501(e)(1)(A) identical to language of predecessor Section 275(c) that *Colony* construed). The court noted that, as a general rule, words in a new statute identical to words in a prior statute should be construed as having the same meaning. *See id.* (citing SINGER & SINGER, *supra* note 52, § 22.33) (explaining principle of statutory interpretation); *Benson v. Comm'r*, 560 F.3d 1133, 1135 (9th Cir. 2009) (applying *Colony* to Section 6501(e)(1)(A)); *cf.* *United States v. O'Brien*, 542 F.3d 921, 926 (1st Cir. 2008) ("There is no evidence that the breaking up of the sentence into the present subdivisions or recasting of language was anything more than the current trend."); *Strange v. Comm'r*, 114 T.C. 206, 210 n. 4 (2000) (noting decision of case that interpreted predecessor state income tax statute, which controlled interpretation of successor statute with substantially similar language); *Lilly v. Comm'r*, 45 T.C. 168, 175 (1965) ("While Section 101 is applicable in the instant case . . . petitioner's husband having died after the enactment of the 1954 Code, we think the same reasoning should apply here as was applied under Section 22(b)(1) of the 1939 Code for the two sections are substantially the same."). The Ninth Circuit determined that Congress intended to clarify, rather than rewrite, the language of Section 6501(e)(1)(A) by adding subparagraph (i). *See Bakersfield*, 568 F.3d at 776 (noting that redundancies in drafting are not unusual and that "presumption against redundancy applies more weakly in situations . . . in which the provision is potentially rendered superfluous by language contained in a separate, later statute"). The court concluded that Congress never intended to alter the general judicial construction of "omits" just because it clarified that an overstatement of basis is not an omission in the case of a trade or business. *See id.* (determining

court also disagreed with the Service's position that applying *Colony* to Section 6501(e)(1)(A) would render Clause (i) superfluous, reasoning that Clause (i) remained dispositive in cases where the amount omitted is not in dispute—whether or not the court accepted the Service's interpretation of *Colony*.<sup>92</sup>

#### 4. *Colony Applies to All Taxpayers*

Next, the Service argued that if *Colony* did apply to Section 6501(e)(1)(A), then *Colony's* interpretation should only apply in the case of a trade or business.<sup>93</sup> The Ninth Circuit rejected this argument because the Supreme Court in *Colony* expressly avoided construing the 1954 Internal Revenue Code, and in doing so, never implied that its holding was limited to taxpayers engaged in a trade or business.<sup>94</sup> According to the

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trade or business rule to be clarification, rather than exception, to main Section 6501(e)(1)(A) extended statute of limitations).

92. *See id.* (explaining that *Colony* applies only to amount omitted, not to total gross income stated on return, while Clause (i) affects both amounts). The court explained that Section 6501(e)(1)(A) requires a comparison of (1) the gross income omitted with (2) the gross income listed on the return; if the first value divided by the second value exceeds twenty-five percent, the six-year statute of limitations applies. *See id.* (explaining gross income omission calculation formula). The court provided that *Colony* only defines what constitutes an omission from gross income. *See id.* (limiting *Colony's* application to omissions, rather than total gross income reported). Accordingly, in cases where the amount of omitted gross income is not in dispute, only the second value—the gross income stated on the return—determines whether there has been an omission that meets the twenty-five percent threshold. *See id.* (finding that determination of whether taxpayer's omission meets requirements for extended statute of limitations will depend on whether taxpayer should be treated generally or as trade or business under Clause (i)). Because Clause (i) guides the computation of gross income stated on the return, it will prove dispositive in such cases. *See id.* (comparing operation of main rule to operation of trade or business exception); Hoffman v. Comm'r, 119 T.C. 140, 148, 150 (2002) (noting that issue hinges on whether taxpayer was considered trade or business under Clause (i) where taxpayer did not dispute omitted amount of gross income, and holding that because IRS did not meet burden of proving taxpayer's gross receipts, six-year limitations period did not apply); *Insulglass Corp. v. Comm'r*, 84 T.C. 203, 209-10 (1985) (“[T]he gross receipts test would necessarily not be applied in view of the broad sweep of [S]ection 6501(e)(1)(A).”); *cf. Connelly v. Comm'r*, 45 T.C.M. (CCH) 49 (1982) (“Whether or not a person is engaged in a trade or business . . . is a question of fact which requires an analysis of all the surrounding facts and circumstances.”).

93. *See Bakersfield*, 568 F.3d at 774-75 (detailing IRS's argument that *Colony* should only apply to trade or business exception). Specifically, the IRS argued that, because the main section of Section 275(c) that the Supreme Court interpreted in *Colony* was ambiguous, the main section of Section 6501(e)(1)(A) is also ambiguous; therefore the “unambiguous language” of Section 6501(e)(1)(A) must be Clause (i), and *Colony's* interpretation of Section 275(c) must apply only to taxpayers in a trade or business. *See id.* (explaining IRS's argument).

94. *See id.* (citing *Colony, Inc. v. Comm'r* 357 U.S. 28, 37 (1958)) (discussing taxpayers only in context of trade or business when quoting Section 6501(e)(1)(A)(i)). “Without doing more than noting the speculative debate between the parties as to whether Congress manifested an intention to clarify or to change the 1939 Code, we observe that the conclusion we reach is in harmony with

Ninth Circuit, under a fair reading of *Colony*, the Supreme Court issued a construction of Section 275(c) that was not limited to any specific type of taxpayer.<sup>95</sup> Therefore, because the Supreme Court in *Colony* had rejected similar arguments that the Service advanced in *Bakersfield*, the Ninth Circuit, despite acknowledging the reasonableness of the Service's position, refused to allow the extended statute of limitations under Section 6501(e)(1)(A).<sup>96</sup>

IV. IN THE AFTERMATH OF *BAKERSFIELD*, THE "TWO TOWERS" OF JUDICIAL AND ADMINISTRATIVE SOLUTIONS TO SON OF BOSS ABUSERS LED TO TREASURY DECISION 9466

Along with the Ninth Circuit's decision in *Bakersfield*, the Federal Circuit's recent decision in *Salman Ranch Ltd. v. United States* exemplified the need for clarification, modification, or overruling of *Colony* in the context of modern tax shelters.<sup>97</sup> In *Salman Ranch*, the Federal Circuit applied the *Colony* holding to all taxpayers generally, just as the Ninth Circuit did in *Bakersfield*.<sup>98</sup> Unlike the Ninth Circuit in *Bakersfield*, however, the Federal Circuit in *Salman Ranch* explicitly noted that the case involved a Son of

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the unambiguous language of § 6501(e)(1)(A) of the Internal Revenue Code of 1954." *Id.* at 774 (citing *Colony*, 357 U.S. at 37).

95. *See id.* (dismissing issue of trade or business exception).

96. *See id.* at 778 ("However sensible the IRS's argument may be that a taxpayer can 'omit . . . an amount' of gain by overstating its basis, this argument is foreclosed by *Colony*. The Court . . . rejected the same interpretation the IRS is proposing in this case."). The Ninth Circuit then noted that the IRS might promulgate a regulation that reinterprets an ambiguous Code provision, even if that regulation runs contrary to the "best reading" of the provision. *See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-83 (2005) ("Since [*Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984)] teaches that a court's opinion as to the best reading of an ambiguous statute an agency is charged with administering is not authoritative, the agency's decision to construe that statute differently from a court does not say that the court's holding was legally wrong."); *accord Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162, 170 (3d Cir. 2008) (citing *M.C.I. Telecomms. Corp. v. Bell Atlantic-Pa.*, 271 F.3d 491, 515-16 (3d Cir. 2001) ("If, however, the statutory provision is ambiguous, such ambiguity is viewed as an implicit congressional delegation of authority to an agency, allowing the agency to fill the gap with a reasonable regulation."); *see also* Jeremiah Coder, *IRS Strikes Back Against Judicial Losses in Overstated Basis Cases*, 125 TAX NOTES 19, 19 (2009) ("The temporary regulations are not all that surprising given the Ninth Circuit's hint that it believed the government's position was the right one, but that it was constrained by *Colony*.").

97. *See Salman Ranch Ltd. v. United States*, 573 F.3d 1362, 1377 (Fed. Cir. 2009) (granting summary judgment to taxpayers because IRS's assertion of tax deficiency was untimely under Section 6501(e)(1)(A)'s three-year statute of limitations); *see also id.* at 1382 (Newman, J., dissenting) ("However, it is highly relevant that the nature of the erroneous basis claim herein is markedly different from the more conventional basis error in *Colony*, and no 'clue' to this different nature was presented with the *Salman Ranch* returns.").

98. *See id.* at 1377 (majority opinion) ("Our holding today is consistent with the June 17, 2007 decision of the Ninth Circuit in *Bakersfield Energy Partners*.").

BOSS tax shelter, and explicitly applied the *Colony* holding to bar the use of the extended statute of limitations against a tax shelter abuser.<sup>99</sup>

In *Salman Ranch*, the Salman Ranch partners had engaged in a series of short sales, transferred the resulting obligations to the Salman Ranch partnership, improperly inflated the basis in partnership assets, then sold the assets, and understated their gross income as a result.<sup>100</sup> The Salman Ranch partnership tax schedule, issued to each partner for the taxable year in which the assets were sold, reported each partner's proportionate share of income from the ranch but did not disclose any information related to the transfer of the short sale proceeds or obligations to the Salman Ranch partnership.<sup>101</sup> Nearly six years later, the Service determined that the partners had understated their capital gains by a combined

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99. *See id.* at 1365 (“In other words, the FPAA asserted that a series of sham transactions . . . allegedly created an improper tax shelter.”); *see also id.* at 1378 (Newman, J., dissenting) (“The IRS stated that ‘Salman Ranch Ltd. was availed of for improper tax avoidance purposes . . . through a transaction that was substantially similar to . . . a procedure that the IRS calls ‘Son of BOSS.’”); *cf. id.* at 1381 (“In contrast with the *Salman Ranch* transactions, in *Bakersfield* as in *Colony* the items of basis were directly related to the product sold . . . . Transactions [in Treasury Notes] that are economically meaningless . . . are not . . . validated by simply designating the costs as ‘basis’ for unrelated property.”).

100. *See id.* at 1364 (majority opinion) (outlining steps of partnership's tax avoidance scheme). For a discussion of the mechanics of short sales and the statutory framework that made Son of BOSS tax shelters possible, *see supra* note 6 and accompanying text.

First, the *Salman Ranch* partners entered into a short sale transaction involving United States Treasury Notes which gave rise to an obligation to replace the borrow security known as a “short position.” *See id.* (citing *Zlotnick v. TIE Commc'ns*, 836 F.2d 818, 820 (3d Cir. 1988)) (describing typical short sale). The short sales generated \$10.9 million in cash proceeds, which the tax matters partner transferred, along with the accompanying short position, to the Salman Ranch partnership. *See id.* (outlining tax shelter transactions). The partnership then closed the short position on the Treasury Notes for \$10.9 million and used that money to pay back the party from which the partners had borrowed the Notes. *See id.* (same). The partners then transferred a majority of their Salman Ranch interests to three newly formed family partnerships, which caused a technical termination of Salman Ranch. *See id.* (describing Section 708(b)(1)(B) technical termination). Next, the partners made an election under Sections 754 and 743(b)(1) to adjust Salman Ranch's basis in a ranch property it owned to \$6,850,276—a value that reflected the original basis in the ranch plus a portion of the value of the short-sale cash proceeds contributed to Salman Ranch. *See id.* (describing adjustment of basis in ranch property). The partners then sold the ranch for a gross sales price of \$7,188,858, while reporting a basis of \$6,850,276, for a net taxable gain of only \$338,312. *See id.* (describing sale of Salman Ranch partnership property).

101. *See Salman Ranch Ltd. v. United States*, 79 Fed. Cl. 189, 191 (2007) (“There is no indication in the partners' individual Form 1040 returns . . . that the partnership had assumed liability to cover the short position in Treasury Notes.”), *rev'd*, 573 F.3d 1362. The Federal Circuit in *Salman Ranch* adopted the Court of Federal Claims's statement of the facts of the case. *See Salman Ranch*, 573 F.3d at 1363 (“The pertinent facts are set forth in the decision of the Court of Federal Claims.”).



\$4,567,949 on the sale of the ranch property.<sup>102</sup> The Federal Circuit, strictly adhering to the *Colony* rule, overruled the Court of Federal Claims and held that the six-year extended statute of limitations did not apply, making the Service's assessment of tax on the partnership untimely.<sup>103</sup>

Since the *Bakersfield* and *Salman Ranch* decisions, the Tax Court has adopted the *Colony* rule as applicable to all taxpayers.<sup>104</sup> Perhaps more importantly, the Federal Circuit's strict adoption of *Colony* in *Salman Ranch* made taxpayers who overstated their basis in assets through Son of BOSS transactions more likely to file their claims in the Court of Federal Claims in order to escape the six-year extended statute of limitations.<sup>105</sup> The Federal Circuit's strict adherence to the *Colony* rule allowed tax shelter abusers to escape tax liability by disclosing the amounts of their transactions but concealing the substance, nature, origin, and destination of those

102. *See id.* at 1365 (detailing IRS's recalculation of partners' tax liabilities after sale of ranch).

103. *See id.* at 1377 (“[W]e conclude that the Supreme Court’s interpretation of the language ‘omits from gross income’ . . . controls the interpretation of the identical language in [Section 6501(e)(1)(A)]. . . . For this reason, we hold that the alleged overstatement of the basis of *Salman Ranch* by the Partnership did not constitute an omission from gross income . . .”).

104. *See, e.g., Intermountain Ins. Serv. v. Comm’r*, 98 T.C.M. (CCH) 144 (2009) (“[The parties] disagree whether a basis overstatement by Intermountain could have extended the period of limitations for assessing tax . . . Our opinion in [*Bakersfield*] is directly on point.”); *Wilmington Partners, LP v. Comm’r*, 98 T.C.M. (CCH) 138 (2009) (“The Court previously decided . . . that respondent may not assess as to 1999-2 any income tax . . . because the applicable limitations period had expired. The Court stated that [*Bakersfield*] controlled our decision, and the Court rejected the Commissioner’s invitation to overrule *Bakersfield*.”); *Beard v. Comm’r*, No. 13372-06, 2009 WL 2460768, at \*4 (T.C. Aug. 11, 2009) (“We assume that petitioners overstated the bases of their S corporations . . . . Under *Colony* and *Bakersfield*, petitioners did not omit income from their return such as would subject them to the extended period of limitations.”); *see also Coder, supra* note 6, at 760 (“The Tax Court is unlikely to change its position, especially given that its ruling in *Bakersfield* was released as a division opinion. Just this month in a memorandum opinion, the court invoked *Bakersfield* and the Supreme Court in *Colony*.”). The Tax Court will adopt the rule of the circuit in which the case is appealable if the circuit has ruled on the issue. *See Coder, supra* note 6, at 759 (“In the Fifth Circuit, the IRS clings to *Phinney v. Chambers* . . . as precedent for applying a six-year statute of limitations period in overstated basis cases.”).

105. *See id.* (“[Phillip A.] Pillar [of Greenberg Traurig LLP] agreed that the Federal Circuit decision will provide a significant barrier for further government efforts to recapture momentum on the issue.”). For refund suits, the United States Court of Federal Claims serves as an alternative forum to any district court in which the taxpayer may bring suit. *See* 28 U.S.C. § 1346(a)(1) (2006) (“The district courts shall have original jurisdiction, concurrent with the United States Court of Federal Claims, of . . . [a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected . . .”). The Federal Circuit’s holdings serve as binding precedent on the Court of Federal Claims. *See Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353 (Fed. Cir. 2006) (citing *First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1290 n.3 (Fed. Cir. 1999)) (“There can be no question that the Court of Federal Claims is required to follow the precedent of the Supreme Court, our court, and our predecessor court, the Court of Claims.”).

amounts in ways that put the Service at a disadvantage in detecting non-compliance.<sup>106</sup> While Congress has closed the statutory loopholes that initially allowed the Son of BOSS tax shelter, the legislative solutions are not retroactive and thus will not apply to many already existing cases.<sup>107</sup>

A. *The Judicial Solution: Will the Supreme Court Overrule Colony and Cast It into the Fires of Mount Doom?*

A change in judicial construction of Section 6501(e)(1)(A) would allow courts to apply the extended statute of limitations against tax shelter abusers that would otherwise meet the superficial requirements of the *Colony* decision.<sup>108</sup> The Ninth Circuit in *Bakersfield* reaffirmed *Colony* as the starting point for determining the meaning of the term “omits” in Section

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106. See *Salman Ranch*, 573 F.3d at 1383 (Newman, J., dissenting) (“The taxpayers herein omitted over 25 percent of their gross income, but did not provide sufficient information to apprise the Commissioner of the nature and amount of the omission.”).

107. See generally Matthew Roche, Comment, *Son of Boss and the Troubling Legacy of Colony, Inc. v. Commissioner*, 58 CATH. U. L. REV. 263, 270 (2008) (describing congressional efforts to combat Son of BOSS tax shelter abusers). In 2004, Congress passed the American Jobs Creation Act, which amended the existing tax shelter provisions of the Internal Revenue Code. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended at 26 U.S.C. § 6501 (2006)). The Act created a separate statute of limitations for certain “listed transactions” that tolled from the date of disclosure of the transactions, rather than from the date that the taxpayer filed the return. See 26 U.S.C. § 6501(c)(10) (“[T]he time for assessment of any tax imposed by this title with respect to such transaction shall not expire before . . . the date on which the Secretary is furnished the information so required . . . .”); Roche, *supra*, at 292 (“Transactions that are the same as or substantially similar to the transactions described in this Notice 2000-44 are identified as ‘listed transactions’ for the purposes of § 1.6011-4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the Temporary Procedure and Administration Regulations.” (citing I.R.S. Notice 2000-44, 2000-2 C.B. 255)). The Act made no changes to the general extended statute of limitations under Section 6501(e)(1)(A). See Roche, *supra*, at 292 (discussing changes to Internal Revenue Code under American Jobs Creation Act). Compare 26 U.S.C. § 6501(e)(1)(A) (“If the taxpayer omits from gross income an amount properly includable therein . . . .”), with *Phinney v. Chambers*, 392 F.2d 680, 683 (5th Cir. 1968) (“If the taxpayer omits from gross income an amount properly includible therein . . . .” (quoting Internal Revenue Code of 1954, § 6501(e)(1)(A))). The Treasury Department specifically identified the Son of BOSS tax shelter and related transactions that use overstated bases to generate losses lacking in economic substance as impermissible “listed transactions.” See Roche, *supra*, at 292 (describing nature of listed transactions). The Act, however, did not specifically address *Colony*’s construction of the word “omits” in the general context of Section 6501(e)(1)(A) and only imposed the disclosure-based statute of limitations on listed transactions. See *id.* at 299-300 (“Therefore, Congress should amend § 6501(e)(1)(A) to ensure uniform treatment of what constitutes an ‘omission of gross income.’”).

108. Cf. *Bakersfield Energy Partners v. Comm’r*, 568 F.3d 767, 778 (9th Cir. 2009) (noting Ninth Circuit lacks authority to overrule Supreme Court precedent).

6501(e)(1)(A), so any judicial change in the law must address *Colony*.<sup>109</sup> Even though colorable arguments exist that *Colony* was wrongly decided, in light of stare decisis principles in decisions involving statutory interpretation, the Court is unlikely to revisit *Colony*.<sup>110</sup>

Even if *Colony* were wrongly decided, the Court has evinced a particular reluctance to overrule its prior statutory interpretation decisions.<sup>111</sup>

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109. See *id.* (“However sensible the IRS’s argument may be that a taxpayer can ‘omit . . . an amount’ of gain by overstating its basis, this argument is foreclosed by *Colony*.”).

110. See *Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505, 510 (2007) (“[A] few questions linger as to the correctness of the Supreme Court’s ruling.”). The Supreme Court’s preference for construction of statutory words according to their plain meaning may have led the Court to wrongly decide the *Colony* case by disregarding the context and policy concerns behind Section 275(c)’s language. See *Old Colony R.R. Co. v. Comm’r*, 284 U.S. 552, 560 (1932) (“[T]he plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.” (quoting *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364, 370 (1925))). In *Colony*, the Supreme Court first addressed the definition of the word “omits” by looking to contemporary dictionary definitions, despite the fact that dictionary definitions have sometimes led to controversy. See, e.g., *Pioneer Inv. Servs. v. Brunswick Assocs. LP*, 507 U.S. 380, 396 n.14 (1993) (“Faced with a choice between our own precedent and Black’s Law Dictionary, we adhere to the former.”); *County of Wash. v. Gunther*, 452 U.S. 161, 198 n.10 (1981) (Rehnquist, J., dissenting) (“Rather than ‘make a fortress out of the dictionary,’ the Court should instead attempt to implement the legislative intent of Congress.”); *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 247 (1979) (Brennan, J., dissenting) (noting that Congress comprised “neither insurance experts nor dictionary editors”). The Court in *Colony* noted that the word “omits” was ambiguous and that dictionary definitions that the taxpayer advanced could not resolve the ambiguity. See *Colony, Inc. v. Comm’r*, 357 U.S. 28, 33 (1958) (“Although we are inclined to think that the statute on its face lends itself more plausibly to the taxpayer’s interpretation, it cannot be said that the language is ambiguous.”). The Court looked to the legislative history to resolve the ambiguity, and determined that Congress intended the extended statute of limitations to apply only where taxpayers omitted entire items from their returns. See *id.* at 36 (“We think that in enacting [S]ection 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer’s omission to report some taxable item . . .”) (emphasis added). The Court, however, ignored legislative history that suggested the statute should apply in cases of understatements of gross income. See *Richards, supra* note 46, at 311 (“However, both the House and Senate reports refer to a situation where the taxpayer ‘understates gross income’ and thereby falls within the terms of Section 275(c).”); see also S. REP. NO. 558, at 43 (1934) (providing example of gross income understatement that would trigger extended statute of limitations). Notwithstanding certain legislative history provisions, the Court employed a definition of “omits” that failed to consider the entirety of the context and policy concerns behind the enactment of Section 275(c). Cf. Samuel A. Thumma & Jeffrey L. Kirchmeier, *The Lexicon Has Become a Fortress: The United States Supreme Court’s Use of Dictionaries*, 47 BUFF. L. REV. 227, 293 (1999) (“Accordingly, although a descriptive dictionary may set forth possible alternative definitions for a term, it cannot provide the definitive definition for what that term actually means in a specific context.”).

111. See *Ill. Brick Co. v. Illinois*, 431 U.S. 720, 736 (1977) (“In considering whether to cut back or abandon the *Hanover Shoe* rule, we must bear in mind that

For instance, in *John R. Sand & Gravel Co. v. United States*,<sup>112</sup> the Supreme Court declined to overrule its earlier decisions holding that a statute of limitations period on claims against the Government was an absolute jurisdictional requirement that a court should address *sua sponte* if not raised by the parties.<sup>113</sup> The petitioner in *John R.* argued that the Court should overturn the existing rule in light of changes in law that required courts to place greater weight on the equitable importance of treating the Government like other litigants, coupled with a decreased congressional emphasis in protecting public funds.<sup>114</sup> The Court upheld the existing rule and determined that, even if the Government could not show that it relied on earlier case law, principles of *stare decisis* dictated that the Court value legal stability over pursuit of the correct rule.<sup>115</sup> Conversely, in *State Oil Co. v. Khan*,<sup>116</sup> the Supreme Court overruled its prior holding that vertical maximum price fixing was *per se* unlawful under the Sherman Antitrust Act.<sup>117</sup> The Court determined that *stare decisis* was not an “inexorable

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considerations of *stare decisis* weigh heavily in the area of statutory construction, where Congress is free to change this Court’s interpretation of its legislation.”), *superseded by state statutes as recognized in California v. ARC Am. Corp.*, 490 U.S. 93, 97-98 (1989); *cf. Edelman v. Jordan*, 415 U.S. 651, 671 (1974) (“Since we deal with a constitutional question, we are less constrained by the principle of *stare decisis* than we are in other areas of the law.”), *overruled on other grounds by Will v. Mich. Dep’t of State Police*, 491 U.S. 58 (1989). *But see Payne v. Tennessee*, 501 U.S. 808, 828 (1991) (“Considerations in favor of *stare decisis* are at their acme in cases involving property and contract rights, where reliance interests are involved; the opposite is true in cases such as the present one involving procedural and evidentiary rules.”) (internal citations omitted).

112. 552 U.S. 130 (2008).

113. *See id.* at 139 (declining to overrule previous decisions interpreting statute where Congress has “acquiesced” to Court’s interpretation over many years). The Court’s previous decisions determined that courts had a duty to raise statute of limitations issues whether the parties pled the issues or not. *See, e.g., Soriano v. United States*, 352 U.S. 270, 273 (1957) (“It has been settled . . . that the Congress in creating the Court of Claims restricted that court’s jurisdiction . . . only in certain classes of claims and that no others may be asserted against it, including ‘claims which are declared barred if not asserted within the time limited by statute.’”); *Finn v. United States*, 123 U.S. 227, 232 (1887) (“The duty of the court, under such circumstances, whether limitation was pleaded or not, was to dismiss the petition . . . .”); *Kendall v. United States*, 107 U.S. 123, 125 (1883) (“For instance, where it appears in the case that the claim is not one for which . . . a judgment can be given against the United States, it is the duty of the court to raise the question whether it is done by plea or not. To that class may be referred claims which are declared barred if not asserted within the time limited by statute.”).

114. *See John R.*, 552 U.S. at 136-39 (presenting arguments of petitioner).

115. *See id.* at 139 (“To overturn a decision settling one such matter simply because we might believe that decision is no longer ‘right’ would inevitably reflect a willingness to reconsider others. . . . [T]hat willingness could itself threaten to substitute disruption . . . for necessary legal stability. *We have not found here any factors that might overcome these considerations.*”) (emphasis added).

116. 522 U.S. 3 (1997).

117. *See id.* at 22 (considering importance of *stare decisis* in statutory interpretation decisions but nonetheless overruling prior precedent interpreting Sherman

command,” at least in the area of antitrust law.<sup>118</sup> In reaching its holding, the Court balanced *stare decisis* concerns with competing interests evident in the Court’s prior antitrust decisions, such as recognizing changed circumstances and adopting the Court’s own experiences to such changes.<sup>119</sup> In consideration of the general practice of using common law to shape the broad mandate of the Sherman Act, the Court overruled its prior decision and held that vertical maximum price fixing was no longer *per se* unreasonable, and instead should be evaluated under a reasonableness inquiry.<sup>120</sup>

The *Colony* decision is more similar to prior decisions upheld in *John R.*, rather than the decision overruled in *State Oil*.<sup>121</sup> Therefore, the Supreme Court will probably not overrule *Colony*.<sup>122</sup> First, like the prior decisions in *John R.*, *Colony* represents a longstanding interpretation of a relatively unchanged statute that Congress has, arguably, implicitly accepted by leaving the statutory language unchanged.<sup>123</sup> Second, unlike the Sherman Antitrust Act in *State Oil*, no authority exists to support the

Act). Previously, the Court had determined that a supplier’s vertical maximum price controls on distributors were *per se* illegal because the supplier might set the prices too low for the distributor to offer necessary or desired services. *See Albrecht v. Herald Co.*, 390 U.S. 145, 152 (1968) (“But schemes to fix maximum prices, by substituting the perhaps erroneous judgment of a seller for the forces of the competitive market, may severely intrude upon the ability of buyers to compete and survive in that market.”), *overruled by State Oil*, 522 U.S. at 3.

118. *See Payne v. Tennessee*, 501 U.S. 808, 828 (1991) (noting *stare decisis* “is a principle of policy and not a mechanical formula of adherence to the latest decision”) (citation omitted).

119. *See Khan*, 522 U.S. at 22 (noting that developments in case law, economics, and academic thought have greatly diminished force of Court’s prior holding).

120. *See id.* at 21 (“*Albrecht* has been widely criticized since its inception.”).

121. *Compare John R. Sand & Gravel Co. v. United States*, 552 U.S. 130, 135, 139 (2008) (“The statute’s language has changed slightly since *Kendall* was decided in 1883, but we do not see how any changes in language make a difference here. . . . To overturn a decision settling one such matter simply because we might believe that decision is no longer ‘right’ would inevitably reflect a willingness to reconsider others.”), *with Bakersfield Energy Partners, LP v. Comm’r*, 568 F.3d 767, 775 (9th Cir. 2009) (“Unfortunately for the IRS, however, it is also directly contrary to *Colony*’s construction of the same language in the predecessor statute, § 275(c).”).

122. *See Coder*, *supra* note 6, at 760-61 (discussing extent to which *Colony* should control interpretation of 1954 rather than 1939 Code, and quoting professor arguing against holding *Colony* inapplicable to 1954 Code, stating, “[t]he real weakness of the government’s position . . . is the lack of a strong tax policy argument for its rationale that *Colony* has to be understood in terms of its facts.”).

123. *Compare John R.*, 552 U.S. at 136 (“This Court does not ‘presume’ that the 1948 revision ‘worked a change in the underlying substantive law unless an intent to make such a change is clearly expressed.’ . . . We can find no such expression of intent here. . . . Thus, it is not surprising that nearly a decade *after* the revision, the Court [cited the prior decision] . . .”), *with Bakersfield*, 568 F.3d at 775 (“Congress did not change the language in the body of § 6501(e)(1)(A), which is identical to the language of § 275(c) that the Supreme Court construed in *Colony*. As a general rule, we construe words in a new statute that are identical to words in a prior statute as having the same meaning.”).

proposition that Congress intended that courts use the common law to continuously shape the Internal Revenue Code to adapt to changing circumstances in tax administration.<sup>124</sup> Third, unlike the prior holding in *State Oil*, which courts and commentators almost universally criticized and diminished, the *Colony* holding has not been as vigorously questioned.<sup>125</sup> Accordingly, the Supreme Court is likely to find that stare decisis concerns outweigh any other factors, and is unlikely to overrule its prior decision in *Colony*.<sup>126</sup>

B. *The Administrative Solution: Did the Service Cast Colony into the Depths of Khazad-Dun with Treasury Decision 9466?*

On August 24, 2009, the Service issued Treasury Decision 9466: a set of temporary regulations that limit the *Colony* gross receipts test to cases involving the trade or business exception.<sup>127</sup> Some procedural irregularities in the regulations' promulgation, however, may lead courts to refuse to grant the new rules deference as legislative regulations.<sup>128</sup>

The regulations clarified that an overstatement of basis, leading to an understatement of gross income, is an omission from gross income for the purposes of the extended statute of limitations for both partnerships and

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124. Compare Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 688 (1978) (interpreting Sherman Antitrust Act and determining that Congress "expected the courts to give shape to the statute's broad mandate by drawing on common-law tradition"), with Swallows Holding, Ltd. v. Comm'r, 515 F.3d 162, 172 (3d Cir. 2008) ("*Chevron* recognizes the notion that *the IRS is in a superior position to make judgments concerning the administration of the ambiguities in its enabling statute.*") (emphasis added).

125. Compare *Khan*, 522 U.S. at 21 ("Just as *Schwinn* was 'the subject of continuing controversy and confusion' under the 'great weight' of scholarly criticism, *Albrecht* has been widely criticized since its inception. With the views underlying *Albrecht* eroded by this Court's precedent, there is not much of that decision to salvage.") (citations omitted), with *Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505, 509-10 (2007) ("As this court noted in its prior opinion . . . several cases have questioned the continuing viability of *Colony* in light of the 1954 amendments to Section 6501(e)(1)(A)."). None of those decisions, however, came from the Supreme Court. See *CC&F W. Operations LP v. Comm'r*, 273 F.3d 402, 406 n.2 (1st Cir. 2001) (doubting whether *Colony* applies to income outside of trade or business exception).

126. For a discussion regarding the relative importance the Supreme Court attaches to stare decisis concerns in statutory interpretation cases, see *supra* note 111 and accompanying text.

127. See T.D. 9466, 2009-43 I.R.B. 552 (to be codified at 26 C.F.R. pt. 301) ("Accordingly, outside the context of a trade or business, any basis overstatement that leads to any understatement of gross income under [S]ection 61(a) constitutes an omission of gross income for purposes of [S]ections 6501(e)(1)(A) and 6229(c)(2).").

128. See *Coder*, *supra* note 96, at 20 ("The added wrinkle to the ongoing debate over Section 6501(e) is a procedural one: Will courts allow the IRS to avoid *Colony* through the issuance of new regulations?").

individual taxpayers.<sup>129</sup> The regulations also expressly stated the Treasury Department's explicit disagreement with the recent decisions in *Bakersfield* and *Salman Ranch*.<sup>130</sup> The regulations justified the new rule on a theory that Congress, by adding the trade or business special definition for gross income under Clause (i) of Section 6501(e)(1)(A), intended to limit what became the *Colony* gross receipts test only to cases involving Section 275(c) of the 1939 Internal Revenue Code, and bar it from the current Section 6501(e)(1)(A).<sup>131</sup> The new regulations codified the Treasury Department's agreement with the holdings in prior cases that applied the broad Section 61(a) definition of gross income to Section 6501(e)(1)(A) generally.<sup>132</sup> Most importantly, the temporary regulations are retroactive, and would apply to all taxable years for which the period for assessing a tax had not expired before September 24, 2009.<sup>133</sup> In the wake of the temporary regulations, the Service will likely file motions for reconsideration in some cases, while appealing other recent cases where courts have applied *Colony* in favor of the taxpayer.<sup>134</sup> The question is whether, in these cases, courts will defer to Treasury Decision 9466 as a legislative regulation, and whether they will find that retroactive application of the temporary regulations is valid.<sup>135</sup>

In its fight against Son of BOSS tax shelters, the Service issued a prior "fighting regulation" that proves instructive in evaluating the fate of Treasury Decision 9466.<sup>136</sup> The Service promulgated Regulation Section

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129. *See id.* ("Further, in light of the different interpretations given by courts to the meaning of Section 6501(e)(1)(A), the temporary regulations clarify the meaning of this section.")

130. *See id.* ("The Treasury Department and the Internal Revenue Service disagree with these courts that the Supreme Court's reading of the predecessor to Section 6501(e) in *Colony* applies to Sections 6501(e)(1)(A) and 6229(c)(2).")

131. *See id.* (describing Congress's intent in drafting Section 6501(e)(1)(A) of 1954 Code).

132. *See id.* (agreeing with cases limiting *Colony* to trade or business exception); *see also* Home Concrete & Supply, LLC v. United States, 599 F. Supp. 2d 678, 690 (E.D.N.C. 2008) ("The question whether an overstatement of basis can constitute an omission is, therefore, answered in the affirmative."); Brandon Ridge Partners v. United States, 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at \*8 (M.D. Fla. July 30, 2007) (finding omission from gross income where basis was erroneously inflated by \$3.3 million).

133. *See* T.D. 9466, *supra* note 127, at 551, 553 (outlining effective and expiration dates for temporary regulations).

134. *See* Coder, *supra* note 96, at 19 (noting IRS's argument that temporary regulations merely codify longstanding IRS litigating position regarding *Colony* and should receive deference from courts).

135. For a discussion of whether courts will accord deference to Treasury Decision 9466 as a legislative regulation that applies retroactively, *see infra* notes 136-68, and accompanying text.

136. *See* Coder, *supra* note 6, at 761 ("The Supreme Court has suggested that it might be within the Service's power to promulgate guidance . . . taking a position contrary to the Court's own interpretation. That move would be controversial.") (internal citation omitted). A fighting regulation is one that retroactively issues a rule to bootstrap the Service's litigating position on a particular issue. *See*

1.752-6 to address a variant of the Son of BOSS scheme that abused partnership contingent obligation rules to inflate bases of partnership assets.<sup>137</sup> The regulation stipulated that any obligation, including a contingent obligation, that creates or increases the basis of the obligor's assets or gives rise to an immediate deduction, or that results in a nondeductible expense not charged to capital, is a liability for Section 752 purposes.<sup>138</sup> This new regulation addressed the contingent obligation rule that allowed the Son of BOSS tax shelter transactions to artificially inflate basis.<sup>139</sup>

Courts grant two different degrees of deference to Treasury Regulations, depending on whether the regulations are interpretive or legislative.<sup>140</sup> In addition, to determine whether a regulation can be applied

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Coder, *supra* note 96, at 19 (“This is the most outrageous example of bootstrapping by the IRS that I have seen in the past 20 years,” said Christopher Rizek of Caplin & Drysdale.”); Sheppard, *supra* note 4, at 13 (“Reg. [S]ection 1.752-6 . . . was retroactive to October 1999, the effective date of [S]ection 358(h), which was enacted to prohibit artificial basis inflation in the corporate analogue of son-of-BOSS. . . . [T]he regulation . . . was controversial within the government when it was promulgated.”).

137. *See, e.g.*, *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1343 (Fed. Cir. 2006) (outlining steps of transactions to inflate basis in assets). First, the parent company reorganized a subsidiary into a special purpose entity. *See id.* (detailing transactions). Second, the parent transferred property and contingent liabilities to the subsidiary in exchange for stock in the subsidiary. *See id.* (same). Third, the parent would sell the stock to a third party for a nominal fee. *See id.* (same). The parent would treat its basis in the stock as equal to the value of the property it transferred to the subsidiary but not reduced by the value of the contingent liabilities. *See id.* (same). As a result, the parent would claim a loss from the sale because the sale price of the stock was lower than the parent's basis in it. *See id.* (calculating taxpayer's taxable gross income).

138. *See* 26 C.F.R. § 1.752-6 (2009) (“[T]he partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of exchange) of the liability.”); Sheppard, *supra* note 4, at 13 (describing impact of “fighting regulation”). For a discussion of the rules under the Internal Revenue Code for liabilities and their relation to the rules for basis, *see supra* note 6.

139. *See* 26 C.F.R. § 1.752-6 (tying definition of “liability” for partnerships to definition of “liability” for corporations under 26 U.S.C. § 358(h)(3), in which liabilities include contingent obligations); Sheppard, *supra* note 4, at 13 (“[A] partner's basis in the partnership would generally be reduced by the value of the contingent liability.”). To summarize, prior to the issuance of Regulation Section 1.752-6, a partner's basis in partnership interests was not reduced when the partner transferred contingent obligations to the partnership, but after the regulation was promulgated, basis was thereafter reduced accordingly. *See Cemco Investors, LLC v. United States*, 515 F.3d 749, 751 (7th Cir. 2008) (noting that Regulation Section 1.752-6 “scupper[s] the entire class of offsetting-option tax shelters . . . by subtracting, from the partnership's basis in an asset, the value of any corresponding liability”) (emphasis added).

140. *See generally* *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608, 621 (E.D. Tex. 2006) (discussing judicial formulations of standards of review for Treasury Regulations). An “interpretive regulation” is promulgated under the Treasury Department's general authority under Section 7805 of the Internal Revenue Code to prescribe regulations. *See Snap-Drape, Inc. v. Comm'r*, 98



retroactively, several factors are considered, including: (1) whether the taxpayer justifiably relied on settled prior law and to what extent the regulation altered that law, (2) the extent that Congress implicitly approved the prior law by enacting pertinent Internal Revenue Code provisions, (3) whether retroactivity would advance the interest in equal treatment of similarly situated taxpayers, and (4) whether granting retroactivity would produce unduly harsh results.<sup>141</sup>

In *Klamath Strategic Investment Fund, LLC v. United States*,<sup>142</sup> the District Court for the Eastern District of Texas found that Regulation Section 1.752-6 could not be applied retroactively to taxpayers.<sup>143</sup> The taxpayers in *Klamath* borrowed money at a large premium, contributed the loan proceeds to a partnership that also assumed the debt, sold their partnership interests for an artificial loss, and claimed that the loss amount equaled the loan premium amount.<sup>144</sup> The Service argued that the premiums fell under the new definition of “liabilities” provided in Regulation Section 1.752-6 and should therefore have reduced the taxpayers’ basis in the partnership.<sup>145</sup> The court disagreed and found that the regulation was not retroactive to the *Klamath* taxpayers because they engaged in prohibited conduct before the regulation was issued and could justifiably rely on prior settled law.<sup>146</sup>

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F.3d 194, 198 (5th Cir. 1996) (contrasting interpretive and legislative regulations). A “legislative regulation” is issued under a specific grant of authority in a statutory provision to prescribe a method of executing that statute, and it receives a higher degree of deference than an interpretive regulation. *See id.* (contrasting interpretive and legislative regulations). Legislative regulations receive deference such that they have controlling weight, unless they are arbitrary, capricious, or contrary to the underlying statute. *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984) (setting forth standard for force of law deference, known as “*Chevron* deference”).

141. *See, e.g., Snap-Drape*, 98 F.3d at 202 (citing *Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 981 (5th Cir. 1977)) (noting that these factors should serve as “flexible guidance” and not “rigid requirements”). The court also noted that that list of factors is not conjunctive. *See id.* (rejecting Commissioner’s argument that unless all four factors are present, regulation applies prospectively only).

142. 440 F. Supp. 2d 608 (E.D. Tex. 2006).

143. *See id.* at 626 (“However, taxpayers—like the [p]laintiffs in this case—that engaged in conduct before issuance of any notice could justifiably rely on *Helmer* and its progeny. Thus, the retroactivity of the Regulation is ineffective as to these [p]laintiffs.”).

144. *See id.* at 611-14 (providing details of taxpayers’ loan transactions with partnership); Sheppard, *supra* note 4, at 14 (describing underlying circumstances of *Klamath* case).

145. *See Klamath*, 440 F. Supp. 2d at 619-20 (considering regulation’s effect on taxpayers’ partnership liabilities).

146. *See id.* at 626 (considering factors of Fifth Circuit’s *Anderson* retroactivity test and determining that totality of circumstances dictated that regulation should not be retroactive to taxpayers at issue). First, the court determined that twenty-five years of consistent Service positions regarding the definition of “liability,” from the *Helmer* case onward, entitled the taxpayers to rely on that settled law; further, the regulation’s significant departure from that law militated against retroactivity. *See id.* at 623 (considering “justifiable reliance” factor of *Anderson* test). Second,

In contrast, in *Cemco Investors, LLC v. United States*,<sup>147</sup> the Seventh Circuit upheld the retroactivity of the fighting regulation and ruled for the Government in a Son of BOSS shelter case.<sup>148</sup> In *Cemco*, the taxpayer purchased long and short options in Euros with net premiums that canceled each other out.<sup>149</sup> The Cemco partners, however, transferred long and short options to Cemco Investors, a limited liability corporation, increasing their basis by the amount of the long options but ignoring the offsetting contingent obligation of the short options in calculating their increased basis.<sup>150</sup> The Seventh Circuit held that the transactions lacked economic substance and affirmed the validity of the fighting regulation because the Service had authority to issue the regulation retroactively.<sup>151</sup> The court in *Cemco* found that the retroactivity of Regulation Section 1.752-6 traced back to Section 309 of the Community Renewal Tax Relief Act of 2000 because the Act authorized the Service to adopt regulations setting out basis-reduction rules for partnerships.<sup>152</sup>

Similarly, in *Clearmeadow Investments, LLC v. United States*,<sup>153</sup> the Court of Federal Claims applied Regulation Section 1.752-6 retroactively in a case where the taxpayer inflated a partnership's basis in Canadian cur-

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the court noted that Congress failed to amend Section 752, which defines liabilities, in the wake of the *Helmer* decision, which would support denying retroactivity to the regulation. *See id.* (considering "congressional approval" factor of *Anderson* test). Third, the court found nothing in the regulation to lead to unequal treatment of taxpayers. *See id.* at 624 (considering "unequal results" factor of *Anderson* test). Fourth, the court determined that the Service had made no mention of any intent to change the definition of "liability" under the Code before the year 2000, so a grant of retroactivity would weigh harshly against the taxpayer. *See id.* (considering "harsh result" factor of *Anderson* test).

147. 515 F.3d 749 (7th Cir. 2008).

148. *See id.* at 752 ("So Treas. Reg. § 1.752-6 applies to this deal and prevents Cemco's investors from claiming a loss. . . . [T]his tax shelter was constructed after the warning in Notice 2000-44 . . . all the regulation does is instantiate the pre-existing norm that transactions with no economic substance don't reduce people's taxes.").

149. *See id.* at 750 ("One would think from this description that the Trust . . . suffered a loss of \$6,000 . . . while Cemco had neither profit nor loss.").

150. *See id.* (describing partners' transactions leading to inflation of basis).

151. *See id.* at 751 ("The Commissioner has a statutory power to disregard transactions that lack economic substance. And the IRS has considerable latitude in issuing regulations that specify sorts of transactions that may be looked through."); *see also* Sheppard, *supra* note 4, at 15 ("The regulation could be retroactive all the way back to the effective date of Section 358(h), [Judge Easterbrook] ruled [in *Cemco*], because it was also an economic substance rule."). In *Cemco*, Judge Easterbrook noted that such regulations avoid the need to litigate tax shelters one at a time to determine whether any actually has economic substance. *See Cemco*, 515 F.3d at 751 (rationalizing and justifying fighting regulation).

152. *See id.* at 752 (discussing statutory grant of power for Service to issue regulations to combat partnership basis overstatement abuse).

153. 87 Fed. Cl. 509 (2009).

rency.<sup>154</sup> The taxpayer in *Clearmeadow* engaged in a Son of BOSS tax shelter by engaging in a complex series of market-linked deposit transactions, which essentially transferred short and long contingent obligations to a partnership, increased the partnership's basis by the long obligations but did not reduce the basis by the short obligations, and subsequently liquidated the partnership.<sup>155</sup> Before liquidating, the partnership distributed \$1,000 in Canadian currency, with a basis of \$2,501,000, to the taxpayer's S-corporation, which passed through to the taxpayer, who later claimed a portfolio loss of \$1,004,040 that offset taxable gain of \$921,885.<sup>156</sup> The Service later disallowed the basis increases in the Canadian currency and determined that the taxpayer owed \$175,870 in income tax.<sup>157</sup> While the Service argued that Regulation Section 1.752-6 retroactively applied to the case, the taxpayer in *Clearmeadow* did not challenge the validity of the regulation but rather challenged its applicability to the given facts.<sup>158</sup> The court implicitly affirmed the validity and retroactivity of the regulation when it applied the regulation to invalidate the taxpayer's basis inflation transactions.<sup>159</sup>

Alternatively, *Sala v. United States*<sup>160</sup> represented a setback to the Service's use of fighting regulations to combat tax shelters.<sup>161</sup> In *Sala*, the taxpayer engaged in a sophisticated series of international currency option transactions that resulted in a tax loss of over \$60 million on an investment of roughly \$9 million.<sup>162</sup> The United States District Court for the

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154. *See id.* at 527 ("Based on the foregoing, the court finds that Treas. Reg. § 1.752-6 applies with full force here, having the effect of eliminating the increased basis claimed by the partnership in the Canadian currency.").

155. *See id.* at 514-16 (chronicling series of transactions giving rise to increased basis of Canadian currency assets in partnership).

156. *See id.* at 516 (discussing consequences of transactions on taxpayer's tax returns).

157. *See id.* at 517 (discussing Service's adjustments to taxpayer's returns).

158. *See id.* at 524 ("Faced with similar arguments, other taxpayers have challenged the validity of the regulation itself, particularly in terms of retroactivity. But, plaintiffs have not chosen to do so. Nonetheless, they mount a vigorous challenge to the application of the regulation to their transaction on several grounds.").

159. *See id.* at 527 (applying Regulation Section 1.752-6 "with full force," though leaving extent of application to be determined in further proceedings).

160. 552 F. Supp. 2d 1167 (D. Colo. 2008).

161. *See Sheppard, supra* note 4, at 16 ("[*Cemco*] has so little analysis that the *Sala* court felt comfortable rejecting it.").

162. *See Sala*, 552 F. Supp. 2d at 1175 (detailing taxpayer's transactions). First, the taxpayer sold stock options for over \$60 million. *See id.* (same). Second, the taxpayer invested approximately \$9 million of this money in the "Deerhurst Program," a foreign currency investment program. *See id.* (same). As part of the program, the taxpayer deposited \$500,000 into a personal account at Refco Capital Markets that Deerhurst Management Company, Inc. managed. *See id.* (same). Next, the taxpayer deposited an additional \$8,425,000 into his Refco account. *See id.* at 1176 (same). Deerhurst Management then acquired for the taxpayer twenty-four foreign currency options, consisting of long and short options, in several foreign currencies, with a net cost to the taxpayer of \$728,297.85. *See id.* (explaining

District of Colorado determined that the taxpayer's investment vehicle was not a sham transaction because it held a reasonable opportunity for profits.<sup>163</sup> The court then considered the fighting regulation and found that the regulation was overbroad, exceeded the Service's statutory authority to regulate partner-partnership transactions, and, therefore, could not be applied retroactively.<sup>164</sup>

As the above discussion illustrates, litigation involving the previous fighting regulation, Section 1.752-6, has not produced a definitive rule regarding retroactivity of Treasury regulations that would aid in determining whether the courts will likely grant deference to Treasury Decision 9466.<sup>165</sup> Treasury Decision 9466 is more controversial than the previous Son of BOSS fighting regulations because it allows the Service to circumvent the Supreme Court's *Colony* decision.<sup>166</sup> Further, Treasury Decision 9466 carries with it possible procedural problems under the Administra-

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foreign currency option transactions). The taxpayer then formed Solid Currencies, Inc., a Delaware S corporation in which he was the sole shareholder, and transferred the twenty-four currency options and \$8 million in cash to Solid Currencies, Inc. *See id.* (explaining taxpayer's transactions). The taxpayer transferred the cash and options from Solid Currencies, Inc. to Deerhurst Investors, GP, a partnership, in exchange for partnership interests. *See id.* (explaining Solid Currency transactions). Deerhurst Investors, GP, was then liquidated, and Solid Currencies, Inc. received a share of the proceeds. *See id.* (detailing taxpayer's transactions). For that tax year, the taxpayer reported wages of \$51,748,681 but adjusted gross income of only \$23,681. *See id.* (explaining statements on taxpayer's return). The taxpayer achieved a \$60 million loss by exploiting the *Helmer* rule—that contingent liabilities did not affect a partner's basis in the partnership—to increase basis by the value of the long options but not offset them by the value of the short options. *See id.* (explaining discrepancy between wages and adjusted gross income). For a further discussion of the *Helmer* rule and its effect on partnership taxation, see *supra* note 6.

163. *See Sala*, 552 F. Supp. 2d at 1186 (“In light of the potential and actual profits arising from the Deerhurst Program, I find and conclude the program offered a reasonable opportunity for profits exclusive of tax benefits and therefore possessed economic substance.”).

164. *See id.* at 1201 (“The overbreadth of § 1.752-6 is especially evident . . . . Had congress decided to make a sea change in the law with respect to transactions between partners and their partnerships, it would have done so directly.”).

165. *See, e.g., Cemco Investors v. United States*, 515 F.3d 749, 751 (7th Cir. 2008) (tracing regulation's retroactivity to statute codifying economic substance doctrine); *Sala*, 552 F. Supp. 2d at 1201 (finding regulation to be overbroad and completely invalid); *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608, 625 (E.D. Tex. 2006) (concluding regulation was not retroactive under *Snap-Drape* retroactivity test); *Clearmeadow Invs., LLC v. United States*, 87 Fed. Cl. 509, 527 (2009) (applying regulation retroactively where taxpayer did not challenge its validity).

166. *See Coder, supra* note 96, at 20 (“The added wrinkle to the ongoing debate over section 6501(e) is a procedural one: Will courts allow the IRS to avoid *Colony* through the issuance of new regulations?”). In one case, however, the Supreme Court suggested that a regulation takes precedence over a prior adverse judicial holding, so long as the judicial holding determines the statute it construes to be ambiguous. *See Nat'l Cable & Telecomms. Assoc. v. Brand X Internet Svcs.*, 545 U.S. 967, 982 (2005) (“*Chevron's* premise is that it is for agencies, not courts, to fill statutory gaps.”).

tive Procedure Act because it did not pass through the normal notice and comment process generally required for legislative regulations.<sup>167</sup> On the other hand, considerations particular to the administration of revenue laws and unique obstacles facing litigants seeking to challenge Treasury regulations on procedural grounds make it probable that the regulations will survive procedural challenges in court.<sup>168</sup>

## V. CONCLUSION

Like the earlier regulations that clarified the Service's treatment of contingent obligations vis-à-vis basis calculations, the promulgation of Treasury Decision 9466 will move the fight over the statute of limitations issue from a debate over the applicability of *Colony* to a debate over the

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167. See 5 U.S.C. §§ 553 (c)-(d) (2006) (outlining notice and comment requirements, and providing exception to such requirements for interpretive regulations); Coder, *supra* note 96, at 21 (explaining that for Treasury Decision 9466 to receive deference as legislative regulation, some exception to Administrative Procedure Act must apply). Treasury Decision 9466 did not follow the normal notice and comment rulemaking process. See Coder, *supra* note 96, at 21 (noting that little case law exists that could shed light on how courts will treat regulations' lack of compliance with notice and comment requirements). The temporary regulations explicitly state that Section 553 of the Administrative Procedure Act does not apply to the regulations because they are not a "significant regulatory action" for the purposes of the Act. See T.D. 9466, *supra* note 127, at 543 ("It has been determined that these temporary regulations are not a significant regulatory action as define in Executive Order 12866. . . . It has also been determined that [S]ection 553(b) of the Administrative Procedure Act . . . does not apply to these regulations."). While the Treasury Department nearly always denies the applicability of Section 553(b) of the Act to its regulations, under the modern distinction between legislative and interpretive regulations, that position has become untenable. See Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1158-60 (2008) [hereinafter Hickman, *A Problem of Remedy*] (noting Treasury's frequent practice of issuing binding temporary regulations open to notice and comment only after promulgation). Further, a recent empirical study of Treasury regulation projects showed that 40.9% of projects surveyed failed to meet the requirements of Section 553 of the Act. See Kristen E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1759 (2007) ("Treasury offers little or no explanation for its exemption claims, however."). The modern trend of increasing judicial application of constitutional due process standards to administrative agencies has largely ignored the area of tax law administration. See Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 HOUS. L. REV. 1145, 1159 (2004) ("Perhaps because taxing powers, unlike other agency practices, are so essential to our government, administrative and constitutional law scholarship has had little impact on IRS adjudication practices."). Such considerations are, unfortunately, beyond the scope of this Note.

168. See Hickman, *A Problem of Remedy*, *supra* note 167, at 1164-65 (noting that 26 U.S.C. § 7421, often labeled Anti-Injunction Act, and corresponding language in Declaratory Judgment Act, limit timing of challenges to tax laws). *But see* Cohen v. United States, 578 F.3d 1, 38 (D.C. Cir. 2009) (remanding taxpayers' procedural challenge to excise tax refund procedure to district court to determine if procedure was "inadequate and unlawful" under Administrative Procedure Act).

validity of the regulations.<sup>169</sup> If courts strike down the regulations as invalid, then *Colony* will resume its prior place as the controlling precedent in overstatement of basis cases, and a multitude of Son of BOSS abusers will likely evade potential tax liability.<sup>170</sup> If courts uphold the regulations, they will effectively encourage more “bootstrapping” and “gamesmanship” by the Government in future litigation.<sup>171</sup> Perhaps the only sure lesson to be learned from the saga of *Bakersfield* and Treasury Decision 9466 is that, when one party unnecessarily pursues litigation, the result is needless uncertainty for both parties.<sup>172</sup>

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169. See Sheppard, *supra* note 4, at 13 (“Because the government . . . moved the fight from where it should be to a place that has put the government in a defensive posture . . . the government moved the legal dispute from a sensible discussion of the concept of liability to a fight about the validity of a harsh, retroactive administrative rule.”).

170. For a discussion of how *Colony*’s status as controlling precedent permits tax abuse through Son of BOSS tax shelters, see *supra* notes 105-07 and accompanying text.

171. See Coder, *supra* note 96, at 21 (“There is no bar against the IRS issuing regulations during litigation to influence the outcome . . . . ‘Claims of bootstrapping is an emotional reaction; as a legal doctrine, it’s not likely one taxpayers will succeed with.’”).

172. See Sheppard, *supra* note 4, at 9-10 (“The government should be banking its victories and settling son-of-BOSS cases, not waiting for a conflict among the circuits to develop on a question that has been resolved prospectively by regulations defining liability for purposes of subchapter K.”).

