Son of Boss and the Troubling Legacy of Colony, Inc. v. Commissioner

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"Income tax has made more liars out of the American people than golf."¹

The 1990s saw a surge in the tax shelter industry.² Because the Internal Revenue Service’s (IRS) initial review of a tax return is based on self-disclosure,³ and because of the complexity of many tax shelters, these schemes go largely undetected by IRS auditors until after the Internal Revenue Code’s (I.R.C.) statute of limitations expires.⁴ The I.R.C.’s limitations period has generated renewed attention in the tax-law community.⁵ This attention is due to recent litigation between promoters of tax shelters, taxpayers who used tax shelters to hide income, and the Treasury and Justice Departments, which have been aggressively campaigning against the use of partnerships in tax shelters.⁶

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² See Sheldon D. Pollack & Jay A. Soled, Tax Professionals Behaving Badly, TAX NOTES, Oct. 11, 2004, at 201, 202. A tax shelter can be understood to be an investment entered into solely to produce a “paper” loss that lowers the investor’s overall tax liability. Joe M. Chambers, New Developments in the Fight Against Tax Shelters: Unethical Behavior Under Fire, 30 J. LEGAL PROF. 117, 117 (2006) (citing Pollack & Soled, supra, at 201). These investments or similar transactions have “no economic purpose . . . except to create losses to offset taxable income.” Id. Tax shelters and other noncompliance schemes cost the government an estimated $290 billion each year. See Tom Herman, How to Fight the IRS: Audits Soar Among the Rich; Taking the Tax Man to Court, WALL ST. J., Feb. 18-19, 2006, at B1.


⁴ See id. ("[Catching non-compliant taxpayers] is a formidable task in the case of modern tax-avoidance schemes that involve submitting to the IRS numerous tax and information returns regarding multi-layer entities engaged in multi-party transactions in an attempt to obfuscate the true source, amount and/or owner of the income.").

⁵ See id. at 453.

These shelters usually involve a partnership's assumption of the partners' financial obligations in order to create non-economic tax losses.\(^7\)

This Comment focuses on the statute of limitations in the context of a notorious tax shelter, the Sales Option Bond Strategy, also known as the “Son of Boss” tax shelter.\(^8\) A number of factors contribute to the infamous reputation that Son of Boss shelters earned in the tax community, including the sheer audacity of these transactions and the billions of dollars that participants sought to hide.\(^9\) Justice Department investigations revealed that a high number of respected Americans bought into the shelters.\(^10\) Son of Boss shelters were also promoted by some of the most prestigious accounting and law firms in the country.\(^11\)

Under current law, a taxpayer may claim a loss as an income tax deduction only if it is a “bona fide” loss that “reflects actual economic consequences.”\(^12\) Under the economic-substance doctrine, a tax loss will not be allowed as an income tax deduction if it is deemed “fictitious,” or if the loss “lacks economic reality.”\(^13\) An artificial income tax deduction is precisely what the Son of Boss

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\(^7\) See Guidance on Partnership Abuses Press Release, supra note 6.

\(^8\) See Browning, Rare Look at Tax Shelter Clients, supra note 6 (“The tax shelter in question is known informally as Son of Boss, or sales option bond strategy.”).

\(^9\) See, e.g., id. (noting an example in which $2.4 billion was shielded).

\(^10\) See id. Browning describes one list of the investors as a “who’s who of rich Americans.” Id. Some of the investors identified include:

Edward S. Lampert, the hedge fund billionaire and chairman of Sears Holdings; Paul and Maurice Marciano, the founders and co-chairmen of the Guess clothing company; Gary C. Wendt, the former General Electric and Conseco executive; and Bill Simon Jr., who ran for governor of California in 2002.

Other big-name investors who bought the tax shelters through Presidio include Lodwrick Cook, a founder of Global Crossing; Joseph P. Nacchio, the former chief executive of Qwest Communications International; David Saperstein of Los Angeles, a prominent investor in the Westwood One radio network; and J. Paul Reddam, the founder of Ditech, a mortgage lender with billboards up and down the East Coast.

\(\text{Id.}\)

\(^11\) See Browning, Rare Look at Tax Shelter Clients, supra note 6 (identifying KPMG and Sidley Austin Brown & Wood as law firms providing legal “blessing” to Son of Boss shelters); Browning, A.I.G. Played Role in Tax Shelter, supra note 6 (identifying American International Group, BDO Seidman, and Sentinel Advisors as Son of Boss promoters); Browning, Inquiry Into Tax Shelters, supra note 6 (discussing how promoting Son of Boss led one partner at the law firm Jenkins & Gilchrist to bill “$93 million from 1999 through 2003,” but eventually destroyed the firm); Browning, Wider Look at Tax Shelters, supra note 6 (noting that “KPMG reached a $456 million deferred-prosecution agreement with prosecutors and admitted criminal wrongdoing over four types of shelters,” that were variations of Son of Boss).


\(^13\) See Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 45 (2007) (“Transactions are considered to have economic substance when ‘imbued with tax-independent considerations, and
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tax shelter is designed to produce.\textsuperscript{14} Son of Boss shelters involve the use of an inflated basis\textsuperscript{15} in partnership interests to create artificial losses in order to offset unrelated capital gains.\textsuperscript{16} The Federal Circuit recently reaffirmed the

\ldots not shaped solely by tax-avoidance features. \ldots” (quoting Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978)). The Federal Circuit explained the purpose of the economic substance doctrine as:

- A judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute. Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1353–54 (Fed. Cir. 2006); see also ACM P’ship v. Comm’r, 157 F.3d 231, 252 (3d Cir. 1998) (“In order to be deductible, a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax accounting rule to bifurcate a loss component of a transaction from its offsetting gain component to generate an artificial loss which, \ldots is ‘not economically inherent in’ the transaction.”); Scully v. United States, 840 F.2d 478, 485–86 (7th Cir. 1988) (“[Taxpayers] have not shown that they can establish any \ldots genuine economic loss.”); Shoenberg v. Comm’r, 77 F.2d 446, 448 (8th Cir. 1935) (“[The Revenue Act] \ldots requires such losses to be actual and real.”); 26 C.F.R. § 1.165-1(b) (2007) (“Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.”); Notice 99-59, supra note 12 (“An artificial loss lacking economic substance is not allowable.”).

14. See Browning, Rare Look at Tax Shelter Clients, supra note 6.

15. See BLACK’S LAW DICTIONARY 161 (8th ed. 2004) (defining basis as “[t]he value assigned to a taxpayer’s investment in property and used primarily for computing gain or loss from a transfer of the property”); see also I.R.C. § 1012 (2000) (defining basis of property not involving partnerships as “the cost of such property”). Other explanations of basis involving partnerships include the following:

Under the general rule, a partner’s basis in a partnership is determined by his contributions, distributive share of gains and losses, liabilities assumed and discharged, and distributions received. Under an alternative rule, the determination is made on the basis of the partner’s proportionate share of the adjusted basis of partnership property upon a termination of the partnership.


16. See Browning, Rare Look at Tax Shelter Clients, supra note 6 (“[Son of Boss] uses complex partnership structures to produce artificial losses to offset capital gains.”); see also Guidance on Partnership Abuses Press Release, supra note 6 (“In one variation of a ‘Son of Boss’ transaction, a taxpayer purchases and writes economically offsetting options and then purports to create substantial positive basis by transferring those option positions to a partnership. On the disposition [or sale] of the partnership interest, [or] the liquidation of the partnership \ldots the taxpayer claims a tax loss, even though the taxpayer has incurred no corresponding economic loss.”).

In a typical Son of Boss transaction, a taxpayer purchases and writes (that is, sells) stock options; the taxpayer then transfers the options to a partnership, thereby increasing his basis in the partnership interest. See I.R.S. Notice 2000-44, 2000-2 C.B. 255 [hereinafter Notice 2000-44]. For example,

- a taxpayer might purchase call options [that is, the option to buy stock at a set price before a specific date] for a cost of $1,000X and simultaneously write offsetting call options [selling the option], with a slightly higher strike price but the same expiration date, for a premium of slightly less than $1,000X.
validity of the economic substance doctrine, and courts are now using this doctrine to invalidate Son of Boss transactions.\textsuperscript{17}

The Son of Boss shelter and other similar tax shelters were declared abusive tax shelter transactions and shut down by the IRS in 2000.\textsuperscript{18} In 2004, The IRS issued a settlement offer to participants in the Son of Boss shelter, allowing them a window of time to disclose their participation in the scheme and pay all

\textit{Id.} Next, the taxpayer transfers the option positions to the partnership. \textit{Id.} The taxpayer then claims his basis in the partnership interest is \textit{increased} by the cost of the purchased call options \textit{without also reducing} the basis by the amount of the value of the taxpayer’s obligations from the written call options that were assumed by the partnership, and which is required under § 752(b) of the Tax Code. \textit{Id.; see also} I.R.C. § 752(b) (2000) (“Any decrease in a partner’s share of the liabilities of a partnership, or any decrease in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.”). In so doing, the taxpayer artificially inflates his basis in the partnership interest. \textit{See Notice 2000-44, supra}. Thus, the taxpayer claims to have “a basis in the partnership interest equal to the cost of the purchased call options . . . even though the taxpayer’s net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero.” \textit{Id.} With respect to the disposition of the partnership interest, the taxpayer claims a $1,000 loss, even though the taxpayer has not incurred an actual economic loss. \textit{Id.} The claimed loss thus reduces his unrelated capital gains tax liability.

\textit{17. See} Coltec, 454 F.3d at 1343 (disregarding for tax purposes a variant Son of Boss transaction as lacking in economic substance). In \textit{Coltec}, the Federal Circuit identified five principles included in the economic substance doctrine:

- First, . . . the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality . . .
- Second, when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance . . .
- Third, the economic substance of a transaction must be viewed objectively rather than subjectively . . .
- Fourth, the transaction to be analyzed is the one that gave rise to the alleged tax benefit . . .
- Finally, arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

\textit{Id.} at 1355–57. In the first case to litigate the merits of Son of Boss, the Court of Federal Claims used these five principles to hold that Son of Boss transactions lack economic substance. \textit{See Jade Trading,} 80 Fed. Cl. at 14 (“In sum, this transaction's fictional loss, inability to realize a profit, lack of investment character, meaningless inclusion in a partnership, and disproportionate tax advantage as compared to the amount invested and potential return, compel a conclusion that the spread transaction objectively lacked economic substance.”). The verdict in \textit{Jade Trading} was met with a largely positive response in the tax community. \textit{See} Lynnley Browning, \textit{Judge Hands I.R.S. Victory in Tax Shelter}, \textit{N.Y. Times}, Dec. 27, 2007, at Cl; Jesse Drucker, \textit{U.S. Prevails in Tax-Shelter Battle}, \textit{Wall St. J.}, Dec. 27, 2007, at A3; \textit{see also} Lee A. Sheppard, \textit{Erroneous Application of the Economic Substance Doctrine}, \textit{TAX NOTES}, Jan. 14, 2008, at 260 (favorably contrasting \textit{Jade Trading} with a recent Tax Court opinion that “knowingly misapplied” the economic substance doctrine).

\textit{18. See} Notice 2000-44, \textit{supra} note 16 (“These arrangements purport to give taxpayers artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those partnership interests.”).
of their claimed losses plus a small penalty.\textsuperscript{19} Taxpayers who did not comply with the settlement offer were issued deficiency notices and tax assessments disallowing all claimed losses plus maximum penalties.\textsuperscript{20} By 2005, the IRS had collected more than $3.7 billion from taxpayers participating in the settlement.\textsuperscript{21}

Taxpayers who did not participate in the settlement offer have sued the IRS.\textsuperscript{22} These taxpayers assert that deficiency notices issued to them are unenforceable because the government issued the notices after the I.R.C.'s statute of limitations expired.\textsuperscript{23} Generally, I.R.C. § 6501(a) provides that after a taxpayer has filed an income tax return, the IRS has three years from that date to review the return and issue a deficiency notice to the taxpayer.\textsuperscript{24} I.R.C. § 6501(e)(1)(A) extends the limitations period to six years for tax returns containing substantial omissions of income.\textsuperscript{25} An amount of income is

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\item \textsuperscript{19} 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 [hereinafter Son of Boss Settlement Heading for $4 Billion Press Release].
\item \textsuperscript{20} See Press Release, U.S. Treasury Dep't, IRS Collects $3.2 Billion from Son of Boss; Final Figure Should Top $3.5 Billion (March 24, 2005), available at http://www.irs.gov/newsroom/article/0,,id=137095,00.html.
\item \textsuperscript{21} See Son of Boss Settlement Heading for $4 Billion Press Release, supra note 19.
\item \textsuperscript{22} See, e.g., Brandon Ridge Partners v. United States, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at *1, 4 (M.D. Fla. July 30, 2007) (reviewing a challenge to the IRS notice that the partnership was liable for taxes as a result of Son of Boss shelters).
\item \textsuperscript{23} Id.
\item \textsuperscript{24} I.R.C. § 6501(a) provides:

\begin{quote}
Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed. . . . For purposes of this chapter, the term "return" means the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit).
\end{quote}

\item \textsuperscript{25} I.R.C. § 6501(e)(1)(A) provides:

If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—

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

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

Id. § 6501(e)(1)(A).
considered substantially omitted if it exceeds 25% of the return’s reported gross income. The issue for courts is whether the Son of Boss scheme constitutes an omission, and thus whether the six-year limitations period should apply.

Taxpayers cite to an almost fifty-year-old Supreme Court case, Colony, Inc. v. Commissioner, for the proposition that overstated basis that produces understated gain is not an omission of income, thus often barring the IRS from the extended limitations period. In Colony, the IRS issued a tax deficiency

The section of the Tax Code specifying the limitations period for partnership tax returns are in critical respects, identical. See I.R.C. § 6229(a), which provides:

- [The period for assessing any tax... with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is 3 years after the later of—
  (1) the date on which the partnership return for such taxable year was filed, or
  (2) the last day for filing such return for such year (determined without regard to extensions).

Id. § 6229(a).

When deciding a statute of limitations issue brought under § 6229, courts interpret it according to § 6501. See AD Global Fund, LLC v. United States, 481 F.3d 1351, 1354 (Fed. Cir. 2007). The rationale underlying this construction is the belief that § 6229(a) does not "create an independent statute of limitations" separate from § 6501. Id. Rather, § 6229(a) "unambiguously sets forth a minimum period for assessments of partnership items that may extend the regular statute of limitations in § 6501. Section 6501 explicitly provides that it applies to any tax imposed by the title, which would include tax imposed for partnership items." Id; see also Andantech, L.L.C. v. Comm’r, 331 F.3d 972, 976 (D.C. Cir. 2003) (holding § 6229 limitations period for assessing partnerships is controlled by § 6501); Grapevine Imps. Ltd. v. United States, 71 Fed. Cl. 324, 332 (2006); Rhone-Poulenc Surfactants and Specialties, L.P. v. Comm’r, 114 T.C. 533, 540–41 (2000) ("[S]ections 6229 and 6501 contain alternative periods within which to assess tax with respect to partnership items, with the later-expiring-period governing in a particular case.").

With respect to the substantial omission of income in partnership returns, I.R.C. § 6229(c)(2) provides: "[i]f any partnership omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in its return, subsection (a) shall be applied by substituting '6 years' for '3 years.'" I.R.C. § 6229(c)(2). Courts also interpret § 6229(c) according to § 6501(e)(1)(A)(ii). See Bakersfield Energy Partners, L.P. v. Comm’r, 128 T.C. 207, 212 (2007) ("Although section 6229 does not repeat all of the terms and provisions already set forth in section 6501, the precedents interpreting section 6501(e)(1)(A)(ii) have been held equally applicable to section 6229(c)(2), and that principle is not disputed here.").

26. See I.R.C. § 6501(e)(1). The I.R.C. also extends the statute of limitations to six years for tax returns involving omissions from, among other things, estate and gift taxes or excise taxes. Id. Taxpayers who file false or fraudulent returns or willfully attempt to evade a tax are exempt from the statute of limitations protection, and those returns may be audited at any time. Id.


claiming that the taxpayer had omitted income on its return by understating gross profits on the sale of land after the taxpayer overstated its basis. The issue before the Court was whether the tax assessments were barred by the three-year limitations period contained in § 275(a) of the 1939 tax code, or were made timely by the five-year limitations period provided by § 275(c), the predecessor to 26 U.S.C. § 6501(e). The Court agreed with the taxpayer that the five-year limitations period was inapplicable where gross receipts had been fully reported, even if gross income was substantially under-reported. The Court then stated in dicta that "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." 

Unsure as to the clarity of the interpretive mandate issued by the Supreme Court, lower courts searched for ways to distinguish or otherwise avoid applying Colony's holding. The judiciary is currently divided on whether the Court's holding in Colony remains applicable. With the recent surge in tax shelter litigation, including approximately 750 remaining Son of Boss cases, the unresolved issue of understated basis has gained renewed attention from courts.

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under section 6226(a) of the Code, requesting that the court either declare the FPAA invalid or, alternatively, order defendant to reverse the adjustments set forth therein."; Bakersfield Energy Partners, 128 T.C. at 210 ("Petitioners filed a motion for summary judgment on the ground that the FPAA was issued after the applicable period of limitations had expired. Petitioners contend that overstatement of basis is not an omission from gross income for purposes of the extended period of limitations under section 6501(e)(1)(A) ... .' 


30. Id. at 29.

31. Id. at 33 ("[T]he statute is limited to situations in which specific receipts or accruals of income items are left out of the computation of gross income.").

32. Id. at 37. I.R.C. § 6501(e)(1)(A) has not changed significantly since 1954. See I.R.C. § 6501(e)(1)(A) (2000).

33. See Grapevine, 77 Fed. Cl. at 509 ("In the wake of Colony, a judicial debate erupted ... [S]everal cases have questioned the continuing viability of Colony ... .' ).

34. Compare Grapevine, 77 Fed. Cl. at 510 ("[T]he Supreme Court's construction of the 1939 Code is precedential as to the 1954 version of section 6501(e)(1)(A), so as to bind this court[...].", and Bakersfield Energy Partners, L.P. v. Comm'r, 128 T.C. 207, 215 (2007) ("We are unpersuaded by respondent's attempt to distinguish and diminish the Supreme Court's holding in Colony'"), with Brandon Ridge, 2007 WL 2209129, at *6 (limiting Colony's holding to instances involving the sale of goods or services), and Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189, 200 (2007) (holding Colony applicable only where a taxpayer who "engaged in a trade or business selling goods or services ... 'omitted an income receipt ... .'").

35. See Son of Boss Settlement Heading for $4 Billion Press Release, supra note 19 ("About 750 taxpayers did not elect or did not qualify to participate in the Son of Boss settlement offer. The IRS will continue to pursue these cases through audits and the normal litigation process."). With respect to cases that were in active litigation, as of July 2005, the release stated, "more than 100 Son of Boss cases are in court and the IRS expects the first case to go to trial by early fall." Id.
As a result of the national attention given to Son of Boss and other similar tax shelters, Congress amended the I.R.C.'s existing tax shelter rules by passing the American Jobs Creation Act of 2004 (Act). Among other things, the Act codified Treasury Department regulations by categorizing tax shelters as "listed transaction[s]" and expanded the statute of limitations requirements for tax shelters by adding a new subsection to § 6501(c). The new § 6501(c)(10) provides that the limitations period for assessments of returns where the taxpayer fails to disclose a listed transaction will not expire before one year after the earlier of the date that either the taxpayer or his "material advisor" discloses information about the listed transaction. The Treasury Department has since identified the Son of Boss tax scheme and other similar transactions that use an artificially high basis to generate non-economic losses as impermissible "listed transaction[s]."

Two concerns have developed from the new regulations of listed transactions. First, the authority allocated to the Treasury Department to combat tax shelters seems to have shut the door on the continued use of Son of Boss transactions. However, the regulations do not address the potential problem of other situations involving inflated basis that may not qualify as a listed transaction. Second, the new § 6501(c)(10) "is effective [only] for taxable years with respect to which the limitations period on assessments did not expire prior to October 22, 2004." In other words, the new limitations period for listed transactions "does not revive" an expired limitations period. This is important because approximately 750 taxpayers either chose not to participate in the Son of Boss settlement offer, or they did not qualify to participate.

38. Id.
   If a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction (as defined in section 6707A(c)(2)) which is required under section 6011 to be included with such return or statement, the time for assessment of any tax imposed by this title with respect to such transaction shall not expire before the date which is 1 year after the earlier of—
   (A) the date on which the Secretary is furnished the information so required, or
   (B) the date that a material advisor meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to such transaction with respect to such taxpayer.
Id.
40. See Notice 2000-44, supra note 16 ("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.").
42. Id.
participate in the settlement offer.\textsuperscript{43} As of the fall of 2005, more than 100 of the 750 Son of Boss cases were in the beginning stages of litigation.\textsuperscript{44} Litigation also remains an option for the hundreds of other cases that the IRS has identified.\textsuperscript{45} All of these cases will be brought under the pre-2004 tax code amendments and are subject to the Supreme Court's holding in \textit{Colony}.\textsuperscript{46}

More importantly, in the first Son of Boss case to be fully litigated in December 2007, the Court of Federal Claims held that a Son of Boss transaction lacked economic substance.\textsuperscript{47} Consequently, because of the hundreds of millions of dollars at stake, whether \textit{Colony} may render the limitations period in § 6501(e)(1)(A) inapplicable is now a critical issue for many remaining cases.\textsuperscript{48} The IRS has indicated that "[t]he disparity in results among various courts . . . may lead to additional litigation on this issue."\textsuperscript{49} Both the government and taxpayers who lost statute of limitations claims have appealed to the Federal and Ninth Circuit Courts of Appeals.\textsuperscript{50} The outcomes of those cases will likely determine the outcome of the hundreds of pending cases.

This Comment will consider whether the Supreme Court's holding in \textit{Colony} precludes courts from treating overstated basis in a partnership's tax return as an omission of gross income when Son of Boss tax deficiencies were issued after the Tax Code's statute of limitations. First, this Comment will explore the facts and circumstances underlying the Supreme Court's holding in \textit{Colony}, paying particular attention to the Court's conclusion that its analysis of § 275(c) of the 1939 Tax Code was in harmony with § 6501(e)(1)(A) of the 1954 Code. Second, this Comment will examine and compare the various approaches lower courts have taken when applying \textit{Colony}'s holding. Third, this Comment will argue that lower courts should not be bound by \textit{Colony} because of recent amendments to the Tax Code. This Comment will then establish that § 6501(e)(1)(A)(ii)'s adequate disclosure standard will often permit the statute's longer limitations period. Next, this Comment will examine the new statute of limitations period for listed transactions passed under the American Jobs Creation Act. Finally, this Comment will conclude

\textsuperscript{43} See Son of Boss Settlement Heading for $4 Billion Press Release, supra note 19. More than 1200 taxpayers participated in the Son of Boss settlement offer. \textit{Id.}
\textsuperscript{44} \textit{Id.}
\textsuperscript{45} See \textit{id.}
\textsuperscript{46} See \textit{supra} notes 40–41 and accompanying text.
\textsuperscript{47} See Jade Trading, L.L.C. v United States, 80 Fed. Cl. 11, 14 (2007).
\textsuperscript{48} See \textit{supra} note 40 and accompanying text.
that Congress should amend § 6501(e)(1)(A) to include overstated basis as a method of omitting income.

I. COLONY AND ITS PROGENY

A. Understanding Colony

1. An Inauspicious Beginning: The Tax Court Decides that a Kentucky Real Estate Venture Omitted Income by Overstating Basis

The Supreme Court's decision that overstated basis is not an omission of gross income has its roots in a case that involved neither tax shelters nor allegations of deception or fraud. In Colony, Inc. v. Commissioner, the Tax Court upheld deficiency notices issued to Colony, Inc., a company that developed and sold real estate lots in the suburbs of Lexington, Kentucky. The dispute involved deficiency notices issued against Colony's 1946 and 1947 tax returns after the normal three-year statute of limitations period (under the 1939 Tax Code) had expired.

The Tax Court sustained the IRS's determination that Colony's return for 1946 and 1947 improperly included overstated development costs in its calculation of the basis for the lots. Applying § 275(c) of the 1939 Tax Code,

51. See Colony, Inc. v. Comm'r, 357 U.S. 28, 30 (1958) ("There was no claim that the taxpayer had inaccurately reported its gross receipts. . . . There was no claim that the returns were fraudulent.").


53. Id. at 41. Colony's tax return for the tax year ending October 31, 1946 was mailed on January 15, 1947. Id. Its return for the tax year ending October 31, 1947 was mailed on December 22, 1947. See id. The IRS mailed deficiency notices for Colony's 1946 and 1947 tax returns more than six years later, on March 29, 1954. Id. Normally this would have been well beyond the standard three-year limitations period contained in the 1939 Code. See I.R.C. § 275(a) (1939) ("General Rule. The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period."). However, pursuant to § 276(b) of the 1939 Code, on October 17, 1951, the taxpayers in Colony entered into the first of three agreements with the IRS that eventually extended the limitations period for assessing their 1946 return until June 30, 1954. Colony, 26 T.C. at 41. Similarly, for its 1947 return, on May 14, 1952, the limitations period was mutually extended twice until June 30, 1954. Id. Because both extensions occurred "more than 3 years and less than 5 years after the returns were filed," the Tax Court had to resolve "whether the 5-year statute of limitations contained in section 275(c) of the 1939 Tax Code [was] applicable." Id. at 48; see also I.R.C. § 275(c) ("Omission from gross income. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.").

54. Colony, 26 T.C. at 40. Specifically, the estimated development costs claimed by Colony, which the IRS disallowed, included funds to construct a water supply system, payments to utility companies, and the difference between Colony's estimated costs and amount actually spent. Id. at 44.
the court first held that the overstated basis resulted in understated gross income exceeding 25% of gross income stated in Colony's returns.55

Turning to the statute of limitations, the Tax Court rejected Colony's argument that § 275(c)’s longer limitations period was inapplicable "because the omission resulted from an overstatement of cost of goods sold, rather than from an omission of gross receipts."56 The court held that § 275(c)’s phrase "omits from gross income an amount properly includible therein" includes not only an omission of gross receipts or an item of income, but also understated gross income as a result of overstating cost or basis.57

On appeal, the Sixth Circuit affirmed the Tax Court's decision.58 In a brief opinion, the court noted that the alleged deficiency was "an erroneous overstatement of the basis of land sold, rather than from any omission of gross receipts."59 The court initially suggested it might agree with the taxpayer's argument that the § 275(c) five-year limitations period was inapplicable, especially because this argument was supported by "considerable persuasive force" from other circuits.60 However, the court ultimately chose to follow its previous holding in Reis v. Commissioner,61 "where it was held that the five-year limitation was applicable when the taxpayer's understatement of gross income of more than twenty-five per cent was the result of his overstatement of the cost basis of property sold."62 Upon the Sixth Circuit's affirmation, Colony was appealed to the Supreme Court.63

2. The Supreme Court Finds Zen-like Harmony with the 1954 Tax Code

When Colony reached the Supreme Court, it was reversed.64 Writing for the majority, Justice Harlan focused on § 275(c)’s use of the word "omit."65 Stating that the statute's words are "presumed to be used in their ordinary and

55. Id. at 40 ("[P]etitioner omitted from gross income an amount properly includible therein which was in excess of 25 per cent of the amount of gross income stated in its returns.").
56. Id. at 48–49.
57. Id. at 48 n.1. The court concluded, "[o]n the basis of the Gibbs and Goodenow cases, it is held that the 5-year statute of limitations in section 275(c) is applicable, and that the deficiencies determined . . . are not barred by the statute of limitations." Id. at 49 (citing Goodenow v. Comm'r, 25 T.C. 1 (1955); Estate of J.W. Gibbs, Sr. v. Comm'r, 21 T.C. 443 (1954)).
58. See Colony, Inc. v. Comm'r, 244 F.2d 75, 76 (6th Cir. 1957) (per curiam) ("[T]he decision of the Tax Court is affirmed.")., rev'd, 357 U.S. 28 (1958).
59. Id.
60. Id.
61. 142 F.2d 900, 903 (6th Cir. 1944).
62. Colony, 244 F.2d at 76 ("The facts in the Reis case are, of course, not identical with the facts in the present case, but the issue presented is the same.").
64. Id. at 31, 38.
65. See id. at 32 ("In determining the correct interpretation of § 275(c) we start with the critical statutory language, 'omits from gross income an amount properly includible therein.").
usual sense,"66 the Court explained that “omit” is commonly defined as, “[t]o leave out or unmentioned; not to insert, include or name.”67 The Court then agreed with the taxpayer's argument that § 275(c) is “limited to situations in which specific receipts or accruals of income items are left out of the computation of gross income.”68 In reaching this conclusion, Justice Harlan discussed textual ambiguities,69 such as Congress's use of the word “amount” rather than “item” in the context of an omission of gross income.70

The Court turned to the statute's legislative history to resolve the ambiguity.71 Justice Harlan concluded that the legislative history provided “persuasive evidence that Congress was addressing itself to the specific situation where a taxpayer actually omitted some income receipt or accrual in his computation of gross income, and not more generally to errors in that computation arising from other causes.”72 To support this interpretation, the Court quoted the House Report accompanying the statute's enactment.73 The House Report stated, “[i]t is not believed that taxpayers who are so negligent as to leave out of their returns items of such magnitude should be accorded the privilege of pleading the bar of the statute.”74 Justice Harlan also explained

66. Id. (citing DeGanay v. Lederer, 250 U.S. 376, 381 (1919)).
67. Id. at 32 (quoting WEBSTER'S NEW INTERNATIONAL DICTIONARY (2d ed. 1939)). Further, the Court noted, “the Court of Appeals for the Sixth Circuit has elsewhere similarly defined the word.” Id. at 33 (citing Ewald v. Comm'r, 141 F.2d 750, 753 (6th Cir. 1944)).
68. Id. at 33 (emphasis added) (“For reasons stated below we agree with the taxpayer's position.”).
69. Id. at 32-33 (“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 unambiguous.”).
70. See id. at 32. The Court noted the significance of the word “amount” in the tax code: The Commissioner states that the draftsman's use of the word “amount” (instead of, for example, ‘item’) suggests a concentration on the quantitative aspect of the error—that is, whether or not gross income was understated by as much as 25%. This view is somewhat reinforced if, in reading the above-quoted phrase, one touches lightly on the word “omits” and bears down hard on the words “gross income,” for where a cost item is overstated, as in the case before us, gross income is affected to the same degree as when a gross-receipt item of the same amount is completely omitted from a tax return.
71. Id. at 33-34.
72. Id. at 33.
73. Id. at 34.
74. H.R. REP. NO. 73-704, at 35 (1934). The Court explained the legislative history as follows:
Section 275(c) first appeared in the Revenue Act of 1934. 48 Stat. 680. As introduced in the House the bill simply added the gross-income provision to § 276 of the Revenue Act of 1932, 47 Stat. 169, relating to fraudulent returns and cases where no return had been filed, and carried with it no period of limitations. The intended coverage of the proposed provision was stated in a Report of a House Ways and Means Subcommittee as follows:
that when the Senate Finance Committee approved the House version of § 275, the Committee "believed the statute of limitations should not be kept open indefinitely in the case of an honest but negligent taxpayer." Because the only significant change to earlier provisions of the statute of limitations on tax assessments was the five-year limitations period, the Court reasoned that this "reflect[ed] no change in the original basic objective underlying its enactment."

The Court also rejected the Government's other two arguments, which would favor the IRS by extending the limitations period applicable to omissions resulting from understated gross income. First, the Government stressed Congress's use of the phrase "understates gross income" in § 275. However, the Court downplayed the force of this phrase, asserting that this

"Section 276 provides for the assessment of the tax without regard to the statute of limitations in case of a failure to file a return or in case of a false or fraudulent return with intent to evade tax."

"Your subcommittee is of the opinion that the limitation period on assessment should also not apply to certain cases where the taxpayer has understated his gross income on his return by a large amount, even though fraud with intent to evade tax cannot be established. It is, therefore, recommended that the statute of limitations shall not apply where the taxpayer has failed to disclose in his return an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return. The Government should not be penalized when a taxpayer is so negligent as to leave out items of such magnitude from his return."

This purpose of the proposal was related to the full Committee in the following colloquy between Congressman Cooper of Tennessee, speaking for the Subcommittee, and Mr. Roswell Magill, representing the Treasury:

"Mr. Cooper. What we really had in mind was just this kind of a 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 money on it, the tax on it.

"Mr. Magill. I will not argue against you on that score.

"Mr. Cooper. In other words, if a man is so negligent and so forgetful, or whatever the reason is, that he overlooks an item amounting to as much as 25 percent of his gross income, that we simply ought to have the opportunity of getting the tax on that amount of money."

Colony, 357 U.S. at 33-34 (citations omitted).

75. Colony, 357 U.S. at 35. Justice Harlan quoted from the relevant Senate Report:

Your committee is in general accord with the policy expressed in this section of the House bill. However, it is believed that in the case of a taxpayer who makes an honest mistake, it would be unfair to keep the statute open indefinitely. For instance, a case might arise where a taxpayer failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital or he might report as income for one year an item of income which properly belonged in another year. Accordingly, your committee has provided for a 5-year statute in such cases.

Id. at 35 (quoting S. REP. NO. 73-558, at 43-44 (1934)).
language is "diluted" where the term "understates gross income" is used in conjunction with the terms "failed to disclose" or "leaves out items of income." Next, the Government argued that the purpose of § 275(c) was to extend the limitations period "where returns contained relatively large errors adversely affecting the Treasury." The Court rejected the premise that the statute's primary concern was the "mere size of the error," given that the statute does not provide for errors in calculating total net taxable income. Instead, the Court held that the legislative history manifests Congress's intent that the extended limitations period applies only where an item of income was entirely omitted from a return. The Court concluded that:

We think that in enacting § 275(c) Congress manifested no broader purpose than to give the Commissioner an additional two years [now three 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. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting "gross income" or one, such as overstated deductions, affecting other parts of the return.

Finally, in a passing comment that would haunt lower courts attempting to interpret future versions of the Tax Code, the Court concluded that "the conclusion we reach is in harmony with the unambiguous language of [§] 6501(e)(1)(A) of the Internal Revenue Code of 1954." The Court thought it

80. See id. ("The force of [the government's] contention is much diluted, however, when it is observed that wherever this general language is found its intended meaning is immediately illuminated by the use of such phrases as 'failed to disclose' or 'to leave out' items of income." (citing Uptegrove Lumber Co. v. Comm'r, 204 F.2d 570, 572 (3d Cir. 1953))).
81. Id. at 36.
82. Id. ("If the mere size of the error had been the principal concern of Congress, one might have expected to find the statute cast in terms of errors in the total tax due or in total taxable net income. We have been unable to find any solid support for [this] theory . . . ").
83. Id. ("[T]his history shows to our satisfaction that the Congress intended an exception to the usual three-year statute of limitations only in the restricted type of situation already described.").
84. Id.
85. Id. at 37. When Congress replaced the 1939 Tax Code in 1954, the 1954 version changed several provisions in § 275(c). Specifically, the 1954 Tax Code stated:

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

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such
was doing no more than “noting the speculative debate between the parties as to whether Congress manifested an intention to clarify or to change the 1939 Code” when Congress enacted § 6501(e)(1)(A) of the 1954 Code.86

amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item. I.R.C. §§ 6501(e)(1)(A)(i)-(ii) (1954). The accompanying House and Senate reports shed light on the drafters’ reasoning. For instance, the House Report states:

Several changes from existing law have been made in subsection (e) of this section. In paragraph (1), which relates to income tax, the existing 5-year rule in the case of an omission of 25 percent of gross income has been extended to 6 years. The term gross income as used in this paragraph has been redefined to mean the total receipts from the sale of goods or services prior to diminution by the cost of such sales or services. A further change from existing law is the provision which states that any amount as to which adequate information is given on the return will not be taken into account in determining whether there has been an omission of 25 percent.


86. Colony, 357 U.S. at 37. The Court’s interpretation of § 275 was not without support among the circuits. As the Court noted in its conclusion:

[O]ur construction of § 275(c) accords with the interpretations in the more recent decisions of four different Courts of Appeals. The force of the reasoning in these opinions was recognized by the Court of Appeals in the present case, which indicated that it might have agreed with those courts had the matter been res nova in its circuit.

Id. (citations omitted); see also Goodenow v. Comm’r, 238 F.2d 20, 21–22 (8th Cir. 1956) (holding that overstatement of inventory resulting in understatement of gross profits does not constitute an “omission” of gross income under § 275(c)); Davis v. Hightower, 230 F.2d 549, 553 (5th Cir. 1956) (holding that there is no § 275(c) omission of income where understatement of reported income results from a “difference between [the taxpayer] and the Commissioner as to the legal construction to be applied to a disclosed transaction”); Slaff v. Comm’r, 220 F.2d 65, 68 (9th Cir. 1955) (holding that a taxpayer did not omit income when his tax return disclosed the full amount of income earned overseas, but erroneously claimed a tax exemption for income earned overseas); Deakman-Wells Co. v. Comm’r, 213 F.2d 894, 897 (3d Cir. 1954) (“[Section 275(c)] applies only where the taxpayer has failed to make a return of some taxable gain, where he has altogether omitted an item from the income reported, and not to a case . . . where he merely understates the final figure in his gross income computation, the item in question having been disclosed in the return but eliminated in the computation of the final figure.”); Uptegrove Lumber Co. v. Comm’r, 204 F.2d 570, 572 (3d Cir. 1953) (holding that because § 275(c)’s extended limitations period applies “only to situations where the taxpayer . . . failed to make a return of some taxable gain,” the normal limitations period for assessments is applicable where a tax return accurately disclosed gross sales but understated gross income because of erroneous deduction); Lazarus v. Comm’r, 142 F. Supp. 897, 898 (Ct. Cl. 1956) (“The courts have, we think rightly, refused to give the Government the benefit of the exception if in fact the income in question is shown on the return, though it is omitted in arriving at the amount shown on the return as gross income.”).
B. Colony's Wake: Courts Adopt Three Approaches to Colony

1. Avoiding Colony: § 6501(e)(1)(A)(ii)’s Adequate-Disclosure Test and Sherlock Holmes’s Search for a Clue

The application of § 6501(e)(1)(A)(ii) in light of Colony was considered by the Fifth Circuit in Phinney v. Chambers. In Phinney, the court was asked to consider the timeliness of an assessment made to a widow’s tax return that had been prepared and filed by a local bank in its role as executor to the widow’s deceased husband’s estate. The controversy involved Ruth Chambers’s 50% ownership of a $795,957.73 note for stock that she and her husband had previously sold under an installment plan. Shortly after the note was paid in full, Mrs. Chambers’s tax return was prepared and filed by the bank along with the return for her husband’s estate. For the estate’s return, the bank reported the $375,736.07 in cash proceeds from the note along with $318,904.79 listed as the reported gain from the sale. However, with respect to Mrs. Chambers’s Tax Form 1040, the bank listed the stock’s sales price as $375,736.06, and it also listed its basis as $375,736.06, with a reported gain or loss of zero.

When the IRS issued its assessment of Mrs. Chambers’s return after the normal three-year limitations period expired but within the six-year period, she argued that the extended period was inapplicable under § 6501(e)(1)(A)(ii) because the statute’s adequate disclosure test was met. Further, the bank maintained that Colony rendered any inquiry into the adequacy of the return’s disclosure unnecessary because “so long as the gross amount reported was not in error, there was no omission of ‘an amount’ from the return at all.”

Applying the Supreme Court’s holding in Colony, in light of § 6501(e)(1)(A)(ii) of the 1954 Code, the court held that when Congress enacted subsection (ii), it intended the longer limitations period to apply either when an item of income is totally omitted from a return, or when a return “misstat[es] the nature of an item of income” which places the ‘commissioner . . . at a special

87. 392 F.2d 680, 685 (5th Cir. 1968).
88. Id. at 682.
89. Id. at 681 (indicating that the widow’s half-interest in the note was $397,978.87).
90. Id. at 681–82.
91. Id. at 682.
92. Id.
93. Id. at 683. Mrs. Chambers maintained the disclosure of income was adequate because: (1) the return listed the amount of gross income received from the stock’s sale; (2) the amount was reported as a “sale of stock,” acquired on the day Mrs. Chambers’ husband died; and (3) the stock’s basis equal to the sales price meant that, “even if there was [an omission], there was . . . disclosure ‘in a manner adequate to apprise the secretary or his delegate of the nature and amount of such item.’” Id.
94. Id. at 685.
disadvantage in detecting errors."

Focusing on the drafter's choice of the word "amount," the court reasoned that if a return facially discloses an item of income "that is not shown in a manner sufficient to enable [an IRS agent] by reasonable inspection of the return to detect the errors" then that item will constitute an "omission of 'an amount' properly includable in the return." Applying its construction of § 6501(e)(1)(A)(ii) to Mrs. Chambers's return, the court concluded that the disclosures in the return were insufficient to meet this test, and therefore the six-year limitations period should apply.

In *CC & F Western Operations Ltd. Partnership v. Commissioner*, the First Circuit construed § 6501(e)(1)(A)(ii)'s adequate disclosure standard to apply "where the taxpayer omitted a particular income item from its calculations but disclosed it in substance." There, the taxpayer used inflated basis and a massive debt payment from the sale of partnership interests to create an artificial loss in "a complicated two-step transaction."

CC & F Western Operations Limited Partnership (Western) was formed in 1990. The two principal partners involved were CC & F Investment Company (CC & F Investment) and CC & F Investors Inc. (CC & F Investors). They incorporated Western in order to aid the sale of partnership interests owned by CC & F Investment to Trammell Crow Equity Partners II, Ltd. (Trammell Crow). The interests included an 84% general partnership interest in seven real estate partnerships (the other 16% were retained by separate partnerships comprised of CC & F employees) and complete ownership interests in five tracts of land. Before the sale, CC & F Investment sold Western its interest in seven real estate partnerships. It also conveyed the five land parcels to five new partnerships, giving Western a 99% ownership interest in the five new partnerships. In the spring of 1990,
Western, along with CC & F Investors and its other employee partnerships, sold all of their interests in all twelve partnerships to Trammell Crow. As a condition of the sale, the partnerships were to be conveyed debt free; accordingly, $52,928,095 of the proceeds from the sale went directly to pay the balance of Western's debt.

In its tax return for the 1990 tax year, Western did not disclose this payment. Rather, Western's return disclosed only that it sold "various partnership interests" in March 1990 for a total price of $27,965,551. Without providing any explanation, the return also listed its basis as $31,161,890, with a resulting net loss of $3,196,339. In addition, Western attached to its return the Schedule K-1s taken from the twelve partnership returns it sold to Trammell Crow. The IRS determined that the debt payment constituted undisclosed income, and that the basis had been incorrectly calculated; therefore, the reported net loss really should have been a net gain of $9,182,216. The IRS eventually issued Western an adjustment to its taxable income "a day less than six years after Western's return was filed."

In deciding whether § 6501(e)(1)(A)(ii) made the deficiency notice timely, the court rejected Western's argument that the "aggregate of Western's indebtedness, reflected in the twelve subsidiary partnerships' Schedule K-1s that were attached to Western's own partnership return," disclosed enough information for the IRS to determine whether an omission of income occurred during the normal three-year limitations period. The court reasoned that,

107. Id.
108. Id.
109. Id.
110. Id.
111. Id.
112. Id.
113. Id.
114. Id.
115. Id.
116. Id.
117. Id. at 407. The court summarized Western's argument that its adequate disclosure burden was met as follows:

Western's argument as to adequate disclosure is that the Schedule K-1s of the twelve partnerships specified figures representing Western's indebtedness immediately before the sale in amounts that, if aggregated, approached $70 million. This, says Western, should have alerted the IRS to a large amount of missing gross income because Western had reported only $27 million as the "gross sales price" on its own return. If the $70 million were treated as attributed income, the reported figure should have been much higher.

Id. at 408. Before this argument was made however, the court determined that Trammell Crow's "huge payment . . . discharging Western's indebtedness to banks is properly treated as a gross receipt and gross income attributable to Western." Id. at 406 (citing I.R.C. §§ 752(d), 1001(b)
assuming the IRS was aware of the pre-sale debt, the government could not reasonably infer that the balance of the debt was "paid off by Trammell Crow incident to its purchase" of the partnerships. The court pointed to the fact that Western's return did not disclose or otherwise indicate the terms of the sale or any debt allocation. The court concluded that the "chain of inferences relied upon by Western is simply too thin and doubtful" to satisfy § 6501(e)'s adequate disclosure test.

The court refused to construe Justice Harlan's reference to returns that provide the IRS with "no clue" as a "description of a condition for implementing section 275." Instead, the court reasoned that Colony's reference to a "clue" was to illustrate the distinction between an omitted receipt and overstated basis: an omitted receipt implicitly shows no indication of error, thereby putting the IRS at a disadvantage when reviewing a return. By contrast, an overstated basis is still disclosed in the return, which "provides something the IRS can check." More importantly, the court argued that the critical phrase, "adequate to apprise the Secretary of the nature and amount," contained in § 6501(e)(1)(A)(ii), "establishes a much stiffer test than a mere clue, and quite properly the cases tend to interpret it as requiring far more than a mere clue that might intrigue Sherlock Holmes."
More recently, the United States District Court for the Middle District of Florida, in Brandon Ridge Partners v. United States, applied Colony in light of § 6501(e)(1)(A)(ii). In Brandon Ridge Partners, the court applied § 6501(e)(1)(A)(ii)'s adequate disclosure standard to a Son of Boss tax scheme. The case arose when, in 1998, Nelson Jefferson wanted to sell his shares in Florida Electronic Supply, Inc. (FES). At the time, Jefferson was the majority shareholder in FES, and his stock had a low basis. On November 18, 1998, Jefferson formed two partnerships: NJ Investments, LLC, with Jefferson having 100% partnership interest; and Brandon Ridge Partners, with Jefferson owning a 99% partnership interest, and his wife Carolyn Jefferson having a 1% interest. The next day, November 19, 1998, Jefferson incorporated Brandon Ridge, Inc., an S-corporation that Jefferson owned outright.

On November 24, 1998, NJ Investments (meaning Jefferson, with the partnership acting as the submissive “pass-through” entity) entered into a short sale of United States Treasury Notes (T-Notes), whereby the partnership “borrowed” the T-Notes, then sold them to a third party at a higher price. The court explained, “[w]hen one engages in a short sale, there is a corresponding obligation following the sale to replace the borrowed security. Typically, this is done by purchasing the security on the open market at some later date and transferring it to the lending party.” The partnership eventually sold the T-Notes for $3,258,458.33.

On November 25, 2008, NJ Investments transferred to Brandon Ridge Partners both the $3,258,458.33 in cash from the sale and the corresponding obligation to cover the short sale. Brandon Ridge Partners covered the sale two days later, on November 27, 1998. A few days later, on December 2, 1998, Jefferson conveyed his ownership of the FES stock to Brandon Ridge Partners. On December 3, 1998, Mr. and Mrs. Jefferson conveyed 99% of

125. Brandon Ridge Partners v. United States, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at *10-11 (M.D. Fla. July 30, 2007). The court held that the “gain on the sale of the... stock was not shown in a manner sufficient to enable the IRS, upon reasonable inspection, to detect that it had been calculated incorrectly due to an overstatement in the basis... which led to an understatement of gross income by over $3 million.” Id. at *7.

126. See id. at *4 (“The transactions described above are termed by the IRS as a ‘Son of Boss’ tax shelter.”).

127. Id. at *1.

128. Id.

129. Id. at *2.

130. Id.

131. Id.

132. Id.

133. Id.

134. Id.

135. Id.

136. Id.
their partnership interests in Brandon Ridge Partners to Brandon Ridge, Inc.137 Jefferson kept a 1% interest in Brandon Ridge Partners. The court summarized the transactions: "by December 3, 1998, Brandon Ridge, Inc. held a 99% interest in Brandon Ridge Partners, which in turn held the FES stock. Both Brandon Ridge Partners and Brandon Ridge, Inc. were controlled by the Jeffersons."139

On December 3, 1998, Brandon Ridge Partners made a § 754 election to adjust the basis of the FES stock, increasing it to $3,258,458.33.140 On December 4, 1998, Brandon Ridge Partners sold the stock for $3,315,000.141 The reported gain on the sale of the stock was $31,042.142 Brandon Ridge Partners filed its 1998 tax return on September 13, 1999, which the IRS received on October 5, 1999.143 After the three-year statute of limitations period expired, the IRS then issued a Final Partnership Administrative Adjustment (FPAA) to Brandon Ridge.144

In considering whether there was adequate disclosure in the Brandon Ridge Partners' tax return, the court applied the reasonableness standard as explained by the Fifth Circuit in Phinney: "[i]f an item of income is not shown on the face of the return or an attached statement 'in a manner sufficient to enable the [IRS] by reasonable inspection of the return to detect the errors,' then the item is not adequately disclosed."145 In considering what was disclosed on the returns, the court honed in on what was undisclosed: while the returns reported the FES stock and the stock's basis, the returns did not disclose (1) that the

137. Id. Under § 708 of the Tax Code, Brandon Ridge Partners underwent a "technical termination" when the Jeffereisons transferred their 99% partnership interest in that partnership to Brandon Ridge Inc. Id. at *2 & n.4 ("Section 708(b)(1)(B) provides that if there is a sale or exchange of 50% or more of the total interest in partnership capital and profits within a twelve month period, the partnership is considered terminated.").
138. Id. at *2 n.3.
139. Id. at *2.
140. Id. I.R.C. § 754 provides:
If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.
142. Id.
143. Id.
144. Id.
145. Id. at *10 (emphasis added) (alteration in original) (quoting Phinney v. Chambers, 392 F.2d 680, 685 (5th Cir. 1968)).
cash and obligation to cover the short sale was conveyed to the partnership; (2)
that the plaintiffs' basis in the partnership was not reduced by the dollar
amount of the obligation to cover the sale; and (3) that the basis of the FES
stock increased by $3,258,458.33. The court concluded:

In order to adequately disclose the gain on the sale of the FES stock,
information regarding the contribution of the obligation to cover the
short sale and its effect on the basis of the Jeffersons' interest in the
Partnership (which was later transferred to Brandon Ridge, Inc.) was
necessary so that the IRS could detect the error in the calculation of
the net long-term capital gain on the sale of the FES stock.

Consequently, because the Jeffersons' disclosures were inadequate, the court
applied the longer limitations period.

2. Limiting Colony to Its Holding: The Trade or Business Exception

Salman Ranch v. United States is a recent case by the Court of Federal
Claims addressing Son of Boss transactions under § 6501(e)'s statute of
limitations. The facts in Salman Ranch reflect a classic Son of Boss
transaction. Salman Ranch has its genesis in a series of partnership
transactions beginning with the formation of Salman Ranch, Ltd. in 1987.
Salman Ranch Ltd. was formed by the owners of Salman Ranch, operating in
New Mexico. The partners included William J. Salman, David M. Salman,
Frances S. Koenig, the Frances D. Salman Testamentary Trust, and other
Salman and Koenig family members. The ranch owners transferred their
interests in Salman Ranch in exchange for partnership interests in Salman
Ranch Ltd.

On December 30, 1998, the Salman Ranch partners laid the foundation for a
Son of Boss tax shelter by forming three limited partnerships, the William J.
Salman Family Limited Partnership, the David M. Salman Family Limited
On October 8, 1999, the Salman Ranch partners “entered into short sales of U.S.
Treasury Notes” yielding $10,982,373. One week later the partners
transferred the proceeds from the Treasury Notes, along with their obligation

146. Id.
147. Id. at *11; see also Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189, 204 (2007)
(“The partnership returns and the partners' individual returns do not disclose the nature and
amount of the omitted gross income in a manner adequate to apprise the IRS.”).
149. Salman Ranch, 79 Fed. Cl. at 190.
150. See id. at 190-91.
151. Id. at 190.
152. Id.
153. Id.
154. Id.
155. Id.
to close on the short sale, to Salman Ranch Ltd. Salman Ranch Ltd. then closed the short positions for $10,980,866.

About six weeks later, on November 30, 1999, the Salman Ranch partners contributed, according to family membership, their partnership interests in the ranch to the three new partnerships. Consequently, "[e]ach family partnership, with each of the respective family members as partners, now held a partnership interest in Salman Ranch, which, in turn, held the ranch." Under Tax Code partnership provisions, the transaction caused a "technical termination" of Salman Ranch Ltd. In the final partnership tax return for the taxable period ending November 30, 1999, the partners elected to raise their basis in Salman Ranch Ltd. to $6,850,276. Less than a month later, on December 23, 1999, the partnership sold a part of the ranch for $7,088,588. Salman Ranch Ltd. filed its final tax return on April 16, 2000, reporting $7,188,588 from the sale of the ranch, $6,850,276 in basis, and $338,312 in taxable gain.

On April 10, 2006, the IRS issued a FPAA to the partnership, reducing the partnership’s basis in the ranch. The reduced basis increased the partnership’s capital gains from the ranch’s sale by $4,567,949. The Salman Ranch partners sued the Government, claiming the treatment of overstated basis by the Supreme Court in Colony and the governing statute of limitations in § 6501(e)(1)(A) rendered the FPAA untimely.

The Salman Ranch court adopted a new interpretation of Colony. Judge Miller observed that although Justice Harlan described the Supreme Court’s holding in Colony as "in harmony with the unambiguous language of § 6501(e)(1)(A)," the opinion also asserted that the language, "omits from gross income an amount properly includible therein," in § 275(c) of the 1939 tax code "cannot be said [to be] unambiguous.

156. Id.
157. Id. The court explained that a short position is "the obligation following the short sale to replace the borrowed securities." Id.
158. Id. at 191.
159. Id.
160. Id.
161. Id. ("The election to adjust the basis of partnership property purported to increase the partners’ basis in the ranch to a reported amount of $6,850,276.00, a step-up in basis reflecting the original basis in the ranch, plus the value of the short-sale cash proceeds contributed to the partnership."); see also I.R.C. §§ 743(b)(1), 754 (2000) (providing tax treatment for optional adjustment to partnership property).
163. Id. at 191.
164. Id.
165. Id.
166. See id. at 190, 194.
167. See id. at 199.
168. Id. (quoting Colony, Inc. v. Comm'r, 357 U.S. 28, 33, 37 (1958)).
textually, both I.R.C. § 275(c) (1939) and I.R.C. § 6501(e)(1)(A) (2000) contain the same language, "omits from gross income an amount properly includible therein." Judge Miller argued that, "as a matter of logical consistency," the two versions "must differ in some respect" from each other. The only significant difference between the two versions was the "inclusion of the gross receipts and adequate disclosure provisions" in § 6501(e)(1)(A). Consequently, Judge Miller concluded that Justice Harlan's statement that Colony's holding "is in harmony with the unambiguous language of § 6501(e)(1)(A)," can only mean that its holding is "in harmony with the addition of those two provisions."

Reviewing § 6501(e), the court concluded that the term "omit" must be defined by referencing the term "gross income." This construction requires a court to review the nature of the taxpayer's business and the transaction being litigated. A critical fact to the Salman Ranch court's analysis of Colony was that the taxpayer in Colony was "engaged in the trade and business of developing and selling real estate lots." Under the Tax Code, unless otherwise provided for, trade or business gross income that is derived from the sale of goods or services is calculated by "subtracting the 'Cost of Goods Sold'... from the gross receipts of the sales." The court went on to contrast the normal method of calculating trade or business income with the method provided for in § 6501(e)(1)(A)(i). Judge Miller concluded that the later provision "provides an exception to the customary definition of gross income in the event of sales of goods or services by a trade or business," because under § 6501(e)(1)(A)(i), "gross income" is "defined as the 'gross receipts' alone of those sales." Thus, under that provision, in order for a court to conclude that a trade or business omitted income, an actual receipt from the sale of goods or services must be omitted from the return. When viewed under this light, Judge Miller found Colony's requirement that "specific receipts or accruals of

169. Id.
170. Id.
173. Id. at 200.
174. Id. at 199–200.
175. Id.
176. Id. at 199 (citing In re Lilly, 76 F.3d 568, 572 (4th Cir. 1996); Lawson v. Comm'r, 67 T.C.M. (CCH) 3121, 3121–23 (1994)). This interpretation is also supported by other Tax Court cases. See, e.g., Schneider v. Comm'r, 49 T.C.M. (CCH) 1032, 1034 (1985) (determining that the calculation of gross income is unaffected by capital loss). In determining that "gross income" in § 6501(e)(1)(A)(i) did not include the sale of a capital asset, the court stated: "Therefore, we must look to the general definition of gross income to determine the proper treatment of non-business gross income under [I.R.C. § 61 (1954)]." Id. The court concluded that § 61 precluded treating a capital loss as gross income. Id.
177. Salman Ranch, 79 Fed. Cl. at 199.
178. Id.
income items [should be] left out of the computation of gross income'" in order for an omission to occur under § 275(c) "makes eminent sense because The Colony, Inc. was a trade or business selling goods or services." 179

The court declined to interpret Colony's holding as standing for the proposition that overstated basis cannot lead to an omission of gross income as an "impermissibly broad rendering of the Colony holding." 180 Such an interpretation of Colony's holding renders "the gross receipts provision of I.R.C. § 6501(e)(1)(A)(i) superfluous." 181 Accordingly, Judge Miller concluded that "[t]he term 'omit,' as used in section 275(c) and again in I.R.C. § 6501(e)(1)(A), cannot be defined and understood without reference to the qualifying term 'gross income' and, consequently, to the nature of the taxpayer's business." 182

The U.S. District Court for the Middle District of Florida reached a similar conclusion in Brandon Ridge Partners v. United States. 183 In Brandon Ridge Partners, Judge Bucklew also limited Colony's gross receipts test to circumstances involving the sale of actual goods or services, as set forth in § 6501(e)(1)(A)(i). 184 The court agreed with the Tax Court's holding that the text of § 6501(e)(1)(A)(ii) requires limiting Colony to trade or business sales of goods or services. 185 The court argued that "[t]o conclude otherwise would

179. Id. at 199–200 ("[Colony's] conclusion that The Colony, Inc. had not omitted any gross income and thus was not liable under section 275(c) is 'in harmony with the unambiguous language of [§] 6501(e)(1)(A),' in that the resolution would be the same under either provision.").

180. Id. at 200 ("[T]he Supreme Court did not set forth a general prescription for every instance in which an omission of income may be contested.").

181. Id.

182. Id.


184. Id. at *6–7 ("[T]he phrase 'omits from gross income an amount properly includible therein' encompasses not only situations where an item of income is completely left out, but also situations where the amount of gross income is understated due to an error in the calculation . . . .").

185. See id. at *6; see also Schneider v. Comm'r, 49 T.C.M. (CCH) 1032, 1035 (1985) ("[W]e are convinced that Congress was simply changing for section 6501(e) purposes the definition of trade or business gross income from the generally accepted definition that 'gross income' means the total sales, less the cost of the goods sold . . . ."); Insulglass Corp. v. Comm'r, 84 T.C. 203, 209–10 (1985) (holding that § 6501(e)(1)(A)(i)'s definition of income is exclusive to income derived from a "trade or business," and "provides an exception . . . to the general meaning of 'gross income' as stated in section 6501(e). In the case of a trade or business, 'gross income' is equated with gross receipts."). In Lawson v. Commissioner, the Tax Court explained that Congress limited Colony's gross receipts test to sales of goods or services when it revised the Tax Code in 1954:

However, with respect to taxable years beginning after August 17, 1954, Congress had already resolved the problem addressed in Colony, Inc. v. Comm'r by enacting section 6501(e)(1)(A) of the 1954 Code. In that section Congress broadened the definition of "gross income" to mean "total receipts from the sale of goods or services prior to diminution by the cost of such sales or services" and provided that "any amount as to which adequate information is given on the return will not be taken into account in
render § 6501(e)(1)(A)(i) superfluous."186 The court also noted that § 6501(e)(2),187 which concerns estate and gift taxes, also extends the limitations period to six years "when a "taxpayer omits . . . items includible in [the] gross estate or [the] total gifts."188 However the language of both sections, which are otherwise very similar, differ on key points. Section 6501(e)(2) states "item[s]" in the context of an omission, whereas § 6501(e)(1) states "amount."189 In discussing Congress's use of the two terms, the court argued that the distinction showed the drafter's intent that § 6501(e)(2)'s limitations period is applicable only "when an item is completely left out."190 By comparison, the limitations period found in § 6501(e)(1) is applicable not only when an item is left out, but also when "the amount of gross income reported is understated."191

3. Complete Fidelity: Worshipping at the Altar of Colony

This question was taken up again by the Tax Court in Bakersfield Energy Partners v. Commissioner.192 In Bakersfield, the IRS issued an FPAA after concluding that the partners in Bakersfield Energy Partnership omitted income determined whether there has been an omission of 25 percent." This special definition of "gross income" was limited to interpretations of section 6501(e) and was not intended to be applied outside of that section unless the Code otherwise provided. Lawson v. Comm'r, 67 T.C.M. 3121, 3121–24 (1994) (citations omitted).


187. I.R.C. § 6501(e)(2) addresses estate and gift taxes:

In the case of a return of estate tax under chapter 11 or a return of gift tax under chapter 12, if the taxpayer omits from the gross estate or from the total amount of the gifts made during the period for which the return was filed items includible in such gross estate or such total gifts, as the case may be, as exceed in amount 25 percent of the gross estate stated in the return or the total amount of gifts stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. In determining the items omitted from the gross estate or the total gifts, there shall not be taken into account any item which is omitted from the gross estate or from the total gifts stated in the return if such item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.


188. Brandon Ridge Partners, 2007 WL 2209129, at *7 (quoting I.R.C. § 6501(e)(2) (alterations in original)).

189. See id.; see also I.R.C. § 6501(e)(1)(A) ("If the taxpayer omits . . . an amount . . .") (emphasis added); I.R.C. § 6501(e)(2) ("[I]f the taxpayer omits . . . items . . . ") (emphasis added).


191. Id.

from the sale of oil and gas property by overstating its basis by more than $16.5 million. The taxpayer challenged the timeliness of the adjustment, arguing that Colony precluded treating overstated basis as an omission of gross income under § 6501(e). The Government argued that the application of gross income under § 6501(e)(1)(A)(i) to a case not involving the sale of goods or services would be a misapplication of Colony.

In a stark departure from its previous holdings, the Tax Court flatly rejected the Government’s position. The court held that “[w]e are unpersuaded by [the Government’s] attempt to distinguish and diminish the Supreme Court’s holding in Colony, Inc., . . . . We do not believe that either the language or the rationale of Colony, Inc. can be limited to the sales of goods or services by a trade or business.”

The court then issued this brief explanation for its holding, “[a]s petitioners point out, the Supreme Court held that ‘omits’ means something ‘left out’ and not something put in and overstated.”

More recently, this issue was taken up in the United States Court of Federal Claims in Grapevine Imports, Ltd. v. United States. Grapevine involved Joseph and Virginia Tigue’s formation of Grapevine Imports Ltd. in March, 1996. Its 1999 Partnership return showed a net short term loss of $21,884. The Tigues’ individual tax return for 1999 showed a larger loss of $973,087. The IRS issued the FPAA to T-Tech, Grapevine’s tax matters

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193. Id. at 208–10.
194. Id. at 210.
195. See id. at 214. The Government argued that “gross income” should instead be defined according to its general definition in § 61 of the Tax Code. Id. The Government maintained that “Colony[,] does not provide any authority for treating gross receipt as gross income for the sale of land or other property; rather, under the current [Tax Code], that treatment depends on whether the property sold is a good or service.” Id. at 215. The Government sought to distinguish Colony from the facts of this case:

[1] In Colony, Inc., the Supreme Court had before it a case of a sale of goods or services, as the taxpayer’s principal business was the development and sale of lots in a subdivision. In cases not concerning a sale of goods or services, Colony, Inc.’s approach would conflict with I.R.C. sec. 6501(e)(1)(A). See CC & F Western Operations L.P., 273 F.3d at 406, in which the First Circuit questions whether Colony’s main holding carries over from the 1939 Internal Revenue Code for land sales in general (“Gross income on land sales is normally computed as net gain after subtracting basis. I.R.C. secs. 61(a)(3), 1001(a); 26 C.F.R. sec. 1.61-6 (2001.”).

Id. (citations omitted).
196. Id. at 215.
197. Id.
198. Id.
199. 77 Fed. Cl. 505, 510 (2007) (“The question here, of course, is whether the Supreme Court’s construction of the 1939 Code is precedential as to the 1954 version of section 6501(e)(1)(A), so as to bind this court’s construction of the latter.”).
200. Id. at 507.
201. Id.
202. Id.
partner, on December 17, 2004, after expiration of the three-year limitations period. The issue before the court was whether section 6501(e)'s extended limitations period was applicable.

After a careful discussion of the Supreme Court's holding in Colony, Judge Allegra concluded that § 6501(e)(1)(A)'s extended limitations period was inapplicable, and thus the 1999 assessment was barred by the normal three-year statute of limitations. Judge Allegra discussed three reasons for concluding that Colony was applicable to the post-1954 Tax Code.

First, the meaning of “omits” applies to the 1954 Tax Code with as much force as it did the 1939 Code, “for, in both, that word is pivotal.” The court observed that the “plain meaning” of “omits,” which the Supreme Court understood to mean an entire income item was missing, did not change between 1939 and 1954.

Second, Judge Allegra challenged the conclusion reached by other courts that Congress intended a different construction of § 275(c) when it passed the 1954 Code. The court noted, “any notion that Congress altered the meaning of the statute in 1954 is belied . . . by its failure to modify the word ‘omits

203. Id. Judge Allegra explained the term of tax matters partner:
Under section 6231(a)(7) of the Code, the “tax matters partner,” or TMP, generally is either “the general partner designated as the tax matters partner as provided in the regulations” or if no such partner has been designated, “the general partner having the largest profits interest in the partnership at the close of the taxable year involved.” For a fuller discussion of the partnership audit provisions of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (TEFRA), see Keener v. United States, 76 Fed. Cl. 455, 458-59 (2007).

204. Id. at 507 n.1.

205. Id. at 507. The court further noted that the following spring Joseph Tigue, “as the sole owner of T-Tech, . . . remitted deposits of $1,594,205 and $221,170 for tax years 1999 and 2000, respectively, in accordance with section 6226 of the Code.” Id.

206. Id. at 506, 510-12.

207. See id. at 510-11. The court explained:
As the Federal Circuit recently reminded, “[t]here 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,” adding that this rule applies even if the decisions of the Supreme Court have been eroded.” Id. at 510 (citing Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1353 (Fed. Cir. 2006)). The court referred to its 1998 decision in Hohn v. United States, “[o]ur decisions remain binding precedent until we see fit to reconsider them, regardless of whether subsequent cases have raised doubts about their continuing vitality.” Id. (citing Hohn v. United States, 524 U.S. 236, 252-53 (1998)).

208. Id. at 510.

209. Id. In a footnote, Judge Allegra noted that the meaning of omit has not changed since 1934. Id. at 510 n.6.

210. Id. at 510-11.
Furthermore, Judge Allegra argued that the Supreme Court’s now infamous passing statement that the 1954 Tax Code is “in harmony” with the unambiguous language of the 1939 Tax Code has not been overturned or modified, and thus is still binding precedent.\(^{212}\)

Third, Judge Allegra explained his disagreement with those courts that have limited *Colony:*\(^{213}\) “this court sees no basis for limiting the Supreme Court’s decision to cases involving the sale of goods or services by a trade or business.”\(^{214}\) Judge Allegra then explained his disagreement with a narrow application of *Colony,* because “neither the Supreme Court’s construction of the word ‘omits,’ its examination of the legislative history, nor the remainder of its ratio decendi reasonably can be confined to that setting.”\(^{215}\)

C. Congress Weighs In: The American Jobs Creation Act

In 2004 Congress amended the I.R.C.’s existing anti-tax shelter provisions when it passed the American Jobs Creation Act.\(^{216}\) The amendments tightened the rules relating to tax shelters by replacing the existing tax shelter registration regime with a disclosure regime that is supported by stiff penalties for tax shelter participants.\(^{217}\) The amendments codified prior Treasury regulations\(^{218}\) for tax shelters and other tax avoidance transactions deemed by regulators to be “reportable [or] listed transactions.”\(^{219}\) Generally, the Code

\(^{211}\) Id. at 510. Interestingly, Judge Allegra used this opportunity to hint that he disagreed with the Supreme Court’s statutory construction in *Colony.* He wrote, “one might disagree with the latter observation [of Justice Harlan’s “in harmony” statement], but ultimately it leaves little room for this court to conclude that the modifications made in 1954, by adding sections 6501(e)(1)(A)(i) and (ii), somehow altered the meaning of the preexisting base provision.” Id. at 510–11.

\(^{212}\) Id. at 510.

\(^{213}\) See id. at 511.

\(^{214}\) Id.

\(^{215}\) Id.


\(^{217}\) See I.R.C. § 6011 (2000) (establishing disclosure requirements); id. § 6662A (Supp. V 2005) (“imposition of accuracy related-penalty on understatements with respect to reportable transactions”); id. § 6707 (imposing penalties on material advisors for nondisclosure of reportable transactions); id. § 6707A (imposing penalties on participants of reportable transactions for nondisclosure); id. § 6708 (“Failure to maintain lists of advisees with respect to reportable transactions”).

\(^{218}\) Notice 2000-44, supra note 16.

\(^{219}\) See I.R.C. § 6707A. The amendments authorize the Treasury Department to regulate reportable and listed transactions under § 6011. See id. The Code defines reportable and listed transactions as follows:

(1) Reportable transaction—The term “reportable transaction” means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.
recognizes both listed and reportable transactions as transactions entered into by taxpayers that the Treasury Department regard as being "substantially similar" to a tax avoidance transaction, or, more broadly, has a "potential for tax avoidance or evasion."  

The Act also changed the statute of limitations requirements for listed transactions.  

The Act added a new paragraph to § 6501(c), the section regarding fraudulent returns.  

The new § 6501(c)(10) provides that the limitations period for assessments of returns where the taxpayer fails to disclose a listed transaction will not expire before one year after the earlier of the date that either the taxpayer or his "material advisor" discloses information about the listed transaction.  

There were no changes to the statute of limitations provisions in § 6501(e)(1)(A).  

The Treasury Department has identified the Son of Boss tax scheme and other similar transactions that use an artificially high basis to generate non-economic losses as impermissible "listed transaction[s]."
II. THE TROUBLING LEGACY OF *COLONY*

The *Colony* decision presents trial courts with a dilemma when they are confronted with a § 6501(e)(1) limitations issue. Because of the nature of complex tax avoidance schemes, IRS agents may take years before they realize a taxpayer’s participation in one. As such, if a taxpayer reports at least some income received from a non-listed transaction, under *Colony’s* holding the taxpayer could still use inflated basis to avoid disclosing his true capital gains from the transaction. Indeed, not long after *Colony*, courts expressed their concern and disagreement with the seemingly obvious loophole that the Supreme Court fashioned. Unsure as to the clarity of the interpretive mandate the Supreme Court handed down, courts began to look for ways to narrow *Colony’s* holding. Judge Allegra articulated the problem in *Grapevine Imports*: “[i]n the wake of *Colony*, a judicial debate erupted over whether the 1954 version of section 6501(e)(1)(A) is triggered only where an item of income is entirely omitted from a return.” With the recent surge in Son of Boss cases, this problem has gained renewed attention.

After *Colony*, federal courts declined to expressly adopt the approach to § 6501(e) that some courts used before *Colony*, in which overstated basis was regarded as an omission of income. Instead, federal courts tried to distinguish *Colony* and, when appropriate, gave the IRS the extended limitations period through § 6501(e)(1)’s other two provisions, the gross receipts and adequate disclosure tests.

A. Extending the Limitations Period Because of a Return’s Failure to Adequately Disclose the Nature of the Transaction

Generally, courts have construed § 6501(e)(1)(A)(ii)’s “adequate disclosure standard” as providing a tougher requirement for the taxpayer to overcome

226. See Sheppard, supra note 3, at 462.
228. See, e.g., CC & F W. Operations Ltd. P’ship v. Comm’r, 273 F.3d 402, 406 & n.2 (1st Cir. 2001) (“Whether *Colony’s* main holding carries over to section 6501(e)(1) is at least doubtful.”).
229. See, e.g., id. at 407–08 (“On its face, the ‘adequate to apprise the secretary of the nature and amount’ language establishes a much stiffer test than a mere clue, and quite properly the cases tend to interpret it as requiring far more than a mere clue that might intrigue Sherlock Holmes.”).
231. See supra Part I.B.1.
232. See, e.g., CC & F W. Operations Ltd. P’ship, 273 F.3d at 406 (distinguishing *Colony’s* substantial omission test).
233. See I.R.C. § 6501(e)(1)(A)(ii) (2000) (“In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.”).
than is otherwise suggested by Colony's facial clue test. Courts have developed several interpretive standards when applying Colony to § 6501(e)'s adequate disclosure test. First, courts hold that Justice Harlan's reference to a "clue" establishes a minimum requirement that sufficient information be provided in the return; adequate disclosure does not require a "glaring[ red] flag." Rather, the extent of disclosure only has to be "merely one which would tip off a careful examining agent as to the existence of error." Other courts have described the standard as establishing a "much stiffer test than a mere clue," requiring more than a "clue . . . sufficient to intrigue a Sherlock Holmes." At the same, the taxpayer need not provide a "detailed revelation of each and every underlying fact."

In tax shelter cases involving inflated basis, courts look to similar factors in determining whether returns provide sufficient information to meet the disclosure requirements. For example, in Western Limited Partnership, the court concluded that the provision required Trammell Crow to disclose the debt payment. In Brandon Ridge Partners, the court held that in order to satisfy the disclosure standard, the returns should disclose the partnership's assumption of "the obligation to cover the short sale[s]," and that the partners'

234. 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. In such instances the return on its face provides no clue to the existence of the omitted item." (emphasis added)); see also Brandon Ridge Partners v. United States, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at *7 (M.D. Fla. July 30, 2007) ("[T]he court finds that the gain on the sale of the FES stock was not shown in a manner sufficient to enable the IRS, upon reasonable inspection, to detect that it had been calculated incorrectly due to an overstatement in the basis, which led to an understatement of gross income by over $3 million.").

235. See, e.g., CC & F W. Operations Ltd. P'ship, 273 F.3d at 408 ("In the end, the safe harbor provision of section 6501 has to be read in light of its purpose, namely, to give the taxpayer the shorter limitations period where the taxpayer omitted a particular income item from its calculation but disclosed it in substance."); Taylor v. United States, 417 F.2d 991, 993 (5th Cir. 1969) ("As Congress recognized, the Government cannot be required to act promptly on information that is not known to it."); Phinney v. Chambers, 392 F.2d 680, 685 (5th Cir. 1968) ("It seems here that there can be no substantial argument that the disclosure made by the bank's return was 'adequate to apprise the Secretary or his delegate of the nature and amount of such item.'").

236. See Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 393 (N.D. Tex.), rev'd, 425 F.2d 1328 (5th Cir. 1970); see also Benderoff v. United States, 398 F.2d 132, 136 (8th Cir. 1968) ("The proper test thus appears to be whether the return provides a clue as to the omitted item.").


239. Quick's Trust, 54 T.C. at 1347.

240. Id.

241. CC & F W. Operations Ltd. P'ship, 273 F.3d at 408.
"took the position that the assumption did not reduce their basis in their interests in the partnership." 242

Courts have also developed different approaches to the scope of § 6501(e)'s adequate disclosure test. Some courts regard the disclosure provision as providing a "safe harbor" for taxpayers who otherwise were found to have omitted income. 243 However, other courts have interpreted the adequate disclosure provision as providing an independent test for determining whether an omission of income occurred. 244

In the Fifth Circuit's construction of § 6501(e)(1)(A)(i) in Phinney, the court reasoned by negative implication that a return's failure to adequately disclose an amount of income will constitute an omission of income. 245 That is, an item of income will be held to be omitted from the return if it is disclosed in the return or an attached statement, but it is "not shown in a manner sufficient to enable the secretary by reasonable inspection of the return to detect the errors." 246 Thus, independent of Colony's requirement that an item of income be completely left out of a return, under the Fifth Circuit's rationale, an omission will also occur when a return "misstat[es] . . . the nature of an item of income which places the 'commissioner . . . at a special disadvantage in detecting errors.'" 247 The six-year limitations period provided by § 6501(e)(1)(A)(ii) is justified because the government ought not be "penalized by a taxpayer's failure to reveal the facts." 248

Under the court's construction of § 6501(e)(1)(A)(ii) in Phinney, the adequate disclosure provision can be seen as far more than simply a "safe harbor" for taxpayers who have omitted income. Instead, the disclosure provision provides another tool for courts to use against tax evaders in the ongoing "substance versus form" debate. 249

To the extent that this approach is used to give effect to the taxpayer's self-reporting responsibilities, the purpose behind the adequate disclosure provision complements the economic substance doctrine. For example, according to the

242. Brandon Ridge Partners v. United States, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at *10, 12 (M.D. Fla. July 30, 2007); see also Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189, 203 (2007) (rejecting plaintiffs' contention that the income was sufficiently reported where plaintiff reported the gross receipts of the sale).
243. See, e.g., Salman Ranch, 79 Fed. Cl. at 204 ("Plaintiffs therefore may not take advantage of the safe harbor afforded by the adequate disclosure provision of I.R.C. § 6501(e)(1)(A)(ii).")
244. See, e.g., Brandon Ridge Partners, 2007 WL 2209129, at *7 (explaining that under the Fifth Circuit, "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") (citing Taylor v. United States, 417 F.2d 991, 993 (5th Cir. 1969)).
245. Phinney v. Chambers, 392 F.2d 680, 685 (5th Cir. 1968).
246. Id.
247. Id. (quoting Colony, Inc. v. Comm'r, 357 U.S. 28, 36 (1958)).
249. See supra note 13 for a discussion of the different views of substance versus form.
economic substance doctrine, even though a taxpayer complied with the formalities of the tax code, a tax loss will be disallowed where the sole purpose behind the loss-generating transaction is tax avoidance.\textsuperscript{250} By contrast, the adequate disclosure provision provides courts with a mechanism to grant the Commissioner the extended limitations period where the taxpayer fails to comply with the code’s formalities.\textsuperscript{251} Both require courts to consider the nature or substance of the transaction itself.\textsuperscript{252}

**B. Limiting Colony to Sales of Goods from Trade or Businesses**

Courts have also applied the first prong of § 6501(e)(1)(A), the “gross receipts test,” so as to specifically limit Colony’s holding to omissions of income derived only from the sale of goods or services by trades or businesses.\textsuperscript{253} In general, courts applying this approach see the definition of gross income from the sale of goods or services by a trade or business in § 6501(e)(1)(A)(i) as the “gross receipts alone from those sales,” however, § 6501(e)(1)(A)(i) does not take basis into account.\textsuperscript{254} As such, it is an exception to § 6501(e)(1)(A), to which courts apply § 61’s general definition of gross income.\textsuperscript{255} These courts emphasize that in Colony the Supreme Court was only determining what constituted an omission under § 275(c) of the 1939 Tax Code, which did not contain the definition of gross income found in § 6501(e)(1)(A)(i) of the 1954 Code.\textsuperscript{256} They maintain that Congress reconciled

\begin{itemize}
\item \textsuperscript{250} See I.R.C. § 6707A(1) (2000) (requiring a reporting statement for any transaction the Secretary determines could be used for tax evasion).
\item \textsuperscript{251} \textit{Phinney}, 392 F.2d at 685.
\item \textsuperscript{252} See supra notes 17, 236. Under the adequate disclosure provision, courts look to see if the taxpayer disclosed sufficient information about the nature of the transaction so as to alert the Commissioner to the fact of the transaction’s existence. See \textit{Brandon Ridge Partners v. United States}, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at *10 (M.D. Fla. July 30, 2007). Whereas the economic substance doctrine provides courts with an opportunity to evaluate the legitimacy of the transaction itself. See supra note 17.
\item The decisions in \textit{Bakersfield} and \textit{Grapevine} are disappointing to the extent that the courts did not discuss whether the deficiency notices could be made timely by applying the adequate disclosure standard. Even if the courts correctly concluded that Colony should not be limited to the trade or business exception, a different result might still have been reached if the courts had analyzed the returns under the Fifth Circuit’s interpretation of the adequate disclosure standard. See \textit{Grapevine Imps. Ltd. v. United States}, 77 Fed. Cl. 505, 512 n.10 (2007) (finding that because the extended limitations period is inapplicable under Colony’s treatment of overstated basis, “this court need not consider whether plaintiffs’ various returns adequately disclosed features of the various transactions so as to trigger the safety-valve provision of section 6501(e)(1)(A)(ii)’’); \textit{Bakersfield Energy Partners, L.P. v. Comm’r}, 128 T.C. 207, 215 (2007).
\item \textsuperscript{253} See discussion supra Part I.B.2.
\item \textsuperscript{254} \textit{Salman Ranch Ltd. v. United States}, 79 Fed. Cl. 189, 199 (2007).
\item \textsuperscript{255} See discussion supra Part I.B.2.
\item \textsuperscript{256} See, e.g., \textit{Schneider v. Comm’r}, 49 T.C.M. (CCH) 1032, 1035 (1985) (“In applying section 275(e), a conflict arose over what was meant by the term gross income when dealing with trade or business gross income. The courts had to choose between using ‘gross receipts’ or ‘gross profits.’”).
\end{itemize}
the matter in the passage of the new Tax Code in 1954, and point to the new Code’s legislative history to buttress these arguments.\textsuperscript{257}

Courts provide additional support for limiting the rationale in \textit{Colony} to § 6501(e)(1)(A)(i) by highlighting Congress’s specific use of “items” when describing an omission for estate and gift tax purposes.\textsuperscript{258} This suggests that the extended limitations period in § 6501(e)(2) is specifically applicable only where an item of reportable income is totally left out.\textsuperscript{259} By contrast, the broader reference to “an amount” in § 6501(e)(1)(A) is applicable both where an item of income is left out and where there is an error in reporting gross income because of an understatement of capital gains.\textsuperscript{260}

The more persuasive argument is that \textit{Colony}’s gross receipts test should only apply to § 6501(e)(1)(A)(i)’s trade or business income derived from sales of goods or services and not to the Tax Code’s general definition of income in § 61 because such an expansion of \textit{Colony}’s holding renders § 6501(e)(1)(A)(i) surplusage.\textsuperscript{261} In other words, there is simply no point to § 6501(e)(1)(A)(i) if the phrase “omits from gross income,” as used in § 6501(e)(1)(A), encompasses § 61’s general definition of gross income as well as gross income from the sale of goods in a trade or business.

\begin{footnotes}
\item[257] See supra note 184.
\item[258] See \textit{Brandon Ridge Partners} v. United States, No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129, at *7 (M.D. Fla. July 30, 2007) (distinguishing Congress’s differing uses of “amount” and “item”); see also \textit{Grapevine Imps. Ltd.} v. United States, 77 Fed. Cl. 505, 510 n.7 (2007) (“[S]ection 6501(e)(2) . . . provides a rule covering estate and gift taxes, corresponding to the income tax rule. That paragraph, however, unlike section 6501(e)(1)(A), specifically refers to the omission of ‘items’ includible in the gross estate or total gifts, apparently to make clear that the six-year period was not to apply because of differences as to the valuation of property. . . . [T]he presence of the words ‘items’ in paragraph (2) suggests that word ought not be implied into section 6501(e)(1)(A), as the latter refers only generally to omissions of ‘an amount’ from ‘gross income.’”). However, the court in \textit{Grapevine} concluded that neither the additions of §§ 6501(e)(1)(A)(i) or (ii) altered \textit{Colony}’s construction of § 6501(e)(1)(A). See id.
\item[259] See \textit{Grapevine Imps.}, 77 Fed. Cl. at 510 n.7.
\item[261] See \textit{Grapevine Imps.}, 77 Fed. Cl. at 510 n.7. Judge Allegra indicates his support of the surplusage reasoning in a footnote in \textit{Grapevine}:

To conclude, as plaintiffs do, that the \textit{Colony} gross receipts test applies, under section 6501(e)(1), to every sort of sale is to render surplusage Congress’[s] reference to that same test as applying “[i]n the case of a trade or business.” That result, however, would violate the canon that “a legislature is presumed to have used no superfluous words.”

\textit{Id.}; see also \textit{CC & F W. Operations Ltd. P’ship} v. \textit{Comm’r}, 273 F.3d 402, 406 n.2 (1st Cir. 2001) (“Whether \textit{Colony}’s main holding carries over to section 6501(e)(1) is at least doubtful. That section’s first ‘special rule’ adopts Justice Harlan’s gross receipts test but only for sales of goods or services. The arguable implication is that it does not apply under section 6501 to other types of income.” (citations omitted)); \textit{Lawson} v. \textit{Comm’r}, 67 T.C.M (CCH) 3121, 3121–24 (1994) (“This special definition of ‘gross income’ was limited to interpretations of section 6501(e) and was not intended to be applied outside of that section unless the Code otherwise provided.”).
\end{footnotes}
III. Section 6501(c)(10)’s New Limitations Period Fails to Resolve the Question of Overstated Basis Created by Colony

As part of its response to the use of partnerships in tax shelters in the American Jobs Creation Act of 2004, Congress added § 6501(c)(10) to the Tax Code. This addition prevents a taxpayer who has not disclosed his participation in an impermissible tax transaction from pleading the statute of limitations bar under § 6501(a). However, this new limitations period applies only to taxpayers who fail to disclose their participation in a transaction specifically identified by the Treasury Department as a listed transaction. Thus, a problem presented by § 6501(c)(10)’s narrow focus is its inapplicability to litigation involving tax transactions that are not otherwise identified as listed transactions. If a taxpayer in such a suit challenged the enforceability of a deficiency notice based on the I.R.C.’s statute of limitations, the outcome would likely turn on the applicability of § 6501(e)(1)(A), which Congress left unchanged. Unfortunately, Congress has also left unresolved the lingering judicial debate over whether the Supreme Court’s holding in Colony precludes treating overstated basis that produces understated gain as an omission of income under § 6501(e)(1)(A). This question is especially pertinent to litigation involving tax shelters or other tax avoidance schemes, where the tax returns are just short of being deemed evasive or fraudulent by the IRS.

The facts in Phinney v. Chambers provide a good illustration of this problem. In Phinney, the taxpayer’s return accurately reported gross

263. See id.
264. See id. (providing that the statute of limitations period is extended, “[i]f a taxpayer fails to include on any return or statement any information with respect to a listed transaction”). In one sense, the new limitations period is more generous than its counterpart in § 6501(a). If a taxpayer meets the rigorous disclosure requirements of § 6501(c)(10), then the IRS has only a year to issue a deficiency notice to the taxpayer. See id. (“[T]he time for assessment of any tax imposed by this title with respect to such transaction shall not expire before the date which is 1 year after the earlier of” two occurrences.). On the contrary, § 6501(a) provides the IRS a minimum of three years to issue a deficiency notice. See I.R.C. § 6501(a) (“[T]he amount of any tax imposed by this title shall be assessed within 3 years after the return was filed . . . .”).
267. See Memorandum in Support of Defendant’s Cross Motion for Summary Judgment and in Response to Plaintiff’s Motion for Summary Judgment at 9, Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189 (2007) (No. 06-503 T) (“Although their use of the Son of Boss tax shelter resulted in the omission of $4,567,946 of income, the partners’ returns give no indication that any shelter transaction was involved at all. At best, their reporting was sloppy, incomplete, and misleading. At worst, it was designed to deceive. Either way, the partners failed to honor their self-reporting responsibility.”).
receipts from the sale of stock. However, the stock’s reported basis was an erroneously inflated amount that resulted in a reported gain of zero. Today, hypothetically, if the taxpayer in Phinney were to file a summary judgment motion before a court asserting that the IRS’s deficiency notice is unenforceable because it was not timely issued, which statute of limitations period should the court apply: § 6501(c)(10)’s or § 6501(a)’s?

Because the taxpayer in Phinney was not alleged to have participated in a listed transaction or even a tax shelter, § 6501(c)(10) would not apply. Thus, the timeliness of the deficiency notice’s issuance must be resolved by the Tax Code’s standard statute of limitations period contained in § 6501(a) unless the extended limitations period is applicable under § 6501(e). To qualify for § 6501(e)’s extended statute of limitations the IRS must show that the taxpayer omitted more than 25% of gross income stated in the return. To do so, the IRS and (until recently) the Tax Court would have trial courts treat gain or other income that is understated as a result of overstated basis as a substantial omission of income under § 6501(e)(1)(A), whereas the Supreme Court in Colony clearly suggests that overstated basis may not be considered in calculating substantially omitted income. Which version should a reviewing court accept? In spite of Congress’s recent efforts, the possibility remains that courts must continue their attempts to square § 6501(e) with Colony’s treatment of overstated basis. If Dr. Watson had drafted § 6501(c)(10), Sherlock Holmes would undoubtedly tell him to dig deeper.

A. Congress Should Amend § 6501(e)(1)(A)

Unless the Supreme Court revisits Colony to determine its viability in an era of complex tax shelters, courts will continue to struggle with this uncertainty. Therefore, Congress should amend § 6501(e)(1)(A) to ensure uniform

269. See id. at 682–83.
270. See id. at 682.
271. See id. at 683.
273. See id. § 6501(e)(1)(A) (“If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.”).
274. See, e.g., Estate of Fry v. Comm’r, 88 T.C. 1020, 1022 (1987) (finding the taxpayer’s disclosure insufficient); Insulglass Corp. v. Comm’r, 84 T.C. 203, 210 (1985) (holding that the six-year limitations applied where taxpayer failed to disclose more than 25% of gross income); Schneider v. Comm’r, 49 T.C.M. (CCH) 1032, 1035 (1985) (applying the six-year statute of limitations).
275. See Colony, Inc. v. Comm’r, 357 U.S. 28, 33 (1958) (construing the predecessor to § 6501(e)(1)(A) as applicable only to “the specific situation where a taxpayer actually omitted some income receipt or accrual in his computation of gross income, and not more generally to errors in that computation arising from other causes”).
treatment of what constitutes an "omission of gross income." Congress has several effective options from which to choose.

First, Congress can clarify the meaning of "omits from gross income" as stated in § 6501(e)(1)(A). This can be done by clearly stating that an omission can occur either where an item of income is left out of a return, or when errors occur due to overstated basis. This could also be done by stating that "gross income" is to be defined according to § 61. Under either method, a return that reports understated gain because of overstated basis would result in an "omission from gross income."  

Of the three possible Congressional remedies, this is the most preferable. It would go a long way toward further strengthening the Tax Code’s anti-abuse provisions by eliminating the ability of taxpayers who enter into non-listed transactions that use inflated basis to offset gains to plead the limitations bar. This option also has the added benefit of resolving the current inconsistency among courts over the proper application of Colony to the 1954 Code.

Second, Congress could narrowly define "sale of goods and services" as stated in § 6501(e)(1)(A)(i) to mean income from inventory or gross receipts income, and not § 61 income. This has the benefit of curing courts’ surplusage concerns by clarifying that § 6501(e)(1)(A)(i) is exclusively an exception to the general rule of § 6501(e)(1)(A). This would also finally settle the discussion about the scope of Colony’s holding, limiting it to taxpayers who are "engaged in a trade or business selling good or services where the taxpayer 'omitted some income receipt or accrual in his computation of gross income.'"  

Third, Congress could alternatively adopt the narrow construction of Colony, advocated by many Son of Boss plaintiffs, that an "omission from gross income" can only occur under § 6501(e)(1)(A) when an item of income is completely left out of a return. This is the least preferable course of action

277. This is assuming the deficiency notice is mailed within § 6501(e)(1)’s six-year period. But see Grapevine Imps. Ltd. v. United States, 77 Fed. Cl. 505, 512 (2007) (noting that "it is far from evident that every sort of significant understatement of gross income ought to trigger a six-year statute of limitations").
278. See supra note 34.
279. Salman Ranch, 79 Fed. Cl. at 200 (quoting Colony, 357 U.S. at 33).
280. See Colony, 357 U.S. at 32 (contemplating that the term omit may mean completely left out). That more than fifty years have passed since the Colony decision would seem to suggest Congress concurred with Justice Harlan’s statement that Colony is in “harmony” with the 1954 Code. That Congress chose to ignore the limitations provisions in § 6501(e) and instead focused on § 6501(c) when it enacted tax shelter reforms in the American Jobs Creation Act also supports this view. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 811, 118 Stat. 1418, 1575–77, 1581 (codified as amended in I.R.C. §§ 6707A, 6501 (2004)). However, these arguments are offset by the corresponding congressional inaction while courts narrowed Colony’s applicability to its facts. Such a broad construction of Colony’s holding has been squarely rejected by courts that have addressed this question. See supra Part I.B.2. for a discussion of court decisions limiting Colony to its holding.
for Congress to take. It would codify a construction of § 6501(e)(1)(A) that has been disputed by courts ever since the Colony decision. It would render § 6501(e)(1)(A)(i) surplusage by making that provision’s special definition of “gross income” indistinguishable from “gross income” as used in § 6501(e)(1)(A). More importantly, it would codify a gaping hole in the code’s limitations provisions, allowing taxpayers to enter into transactions that “put the Commissioner at a special disadvantage in detecting errors in the return.”

Moreover, this would run contrary to Congress’s recent efforts to strengthen the code’s anti-tax shelter provisions.

B. A Rational Approach to Colony

Congress did not amend the Tax Code retrospectively to affect the outcome of the remaining 750 cases that the IRS has identified as Son of Boss transactions where the taxpayers did not participate in the voluntary disclosure settlement offer. These cases are currently being litigated and courts must apply the 1986 Tax Code prior to its amendment under the American Jobs Creation Act. The problem is that lower courts are split on whether Colony’s holding bars enforcing deficiency notices sent to Son of Boss participants after § 6501(a)’s statute of limitations expired.

For those courts litigating § 6501(e)(1) under Colony, the Fifth Circuit’s construction of § 6501(e)(1)(A)(ii)’s adequate disclosure standard provides an independent method for determining whether an omission of income has occurred when a return “misstate[es] . . . the nature of an item of income.” Courts citing § 6501(e)(1)(A)(ii) correctly note that Congress’s concern was whether the taxpayer’s return provided the IRS with sufficient information about the “substance” of the transaction, notwithstanding errors in calculation or other mistakes in the return.

When faced with Son of Boss transactions, recent courts have looked to whether a tax return discloses any pertinent obligations by partners or partnerships to cover the liabilities from the underlying transaction. For

281. Colony, 357 U.S. at 36.
282. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 814(b), 118 Stat. 1418, 1581 (“Effective Date.—The amendment made by this section shall apply to taxable years with respect to which the period for assessing a deficiency did not expire before the date of the enactment of this Act.”). See also supra note 33–34 and accompanying text.
example, in a federal district case reviewing Son of Boss transactions involving a partner's transfer of recently purchased call options to the partnership, critical factors include whether the return disclosed the transfer of the options to the partnership, any obligations or liabilities from the transfer of the option, and the transfer's effect on the basis of the partnership.288 A return that withholds such information fails to adequately disclose the substance of the transaction, and would constitute an omission of income under the Fifth Circuit's construction of § 6501(e)(1)(A)(ii).289 Assuming the omission exceeds 25% of the amount of gross income stated in the return, "an extended limitations period is warranted in order for the IRS 'not to be penalized by a taxpayer's failure to reveal the facts,' because the IRS 'cannot be required to act promptly on information that is not known to it.'"290

The facts of Colony tend to support this construction. At the outset of his opinion in Colony, Justice Harlan noted that there was no allegation of fraud or deception made against the taxpayer.291 There, the taxpayer inflated the basis of real estate lots by erroneously including legitimate development costs that the IRS later determined to be impermissible for calculating basis.292 This activity is far different from the modern tax shelter practice of intentionally inflating basis in order to generate artificial losses. Indeed, given that Colony was decided in 1958, well before courts took notice of the development of the tax shelter industry, it is hard to imagine that Justice Harlan would approve of his construction of the 1939 Tax Code being used to justify imposing the shorter limitations period to such schemes.

This suggests that Colony's holding, properly construed, should be viewed as applicable to situations where a transaction is honestly reported as an alternative approach. Therefore, applying the rationale of the economic substance doctrine to the adequate disclosure provision, understated gain should be treated as omitted income when there is evidence of a deliberate misstatement of basis. This is buttressed by Congress's effort to prevent participants in tax shelters from pleading the limitations bar provided in recent tax shelter reforms.293

In the absence of congressional action, for courts litigating § 6501(e)(1) under Colony, the Fifth Circuit's robust interpretation of the adequate disclosure standard provides another "judicial tool for effectuating the underlying Congressional purpose" behind the statute of limitations.294 That

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289. See id.
290. Id. at *10 (quoting Taylor v. United States, 417 F.2d 991, 993 (5th Cir. 1969)).
291. See Colony, Inc. v. Comm'r, 357 U.S. 28, 30 (1958) ("There was no claim that the taxpayer had inaccurately reported its gross receipts. . . . There was no claim that the returns were fraudulent.").
292. Id.
294. Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1354 (Fed. Cir. 2006).
purpose is "to give the taxpayer the shorter limitations period where the taxpayer omitted a particular income item from its calculations but disclosed it in substance."295

IV. CONCLUSION

The courts and the IRS have largely succeeded in their efforts to end the Son of Boss tax shelter and other variant tax avoidance schemes on grounds that these transactions lack economic substance. However, in an effort to continue benefiting from their participation in these transactions, many taxpayers are hoping that courts will find that the Tax Code’s statute of limitations bars enforcement of their deficiency notices. These taxpayers maintain that the Supreme Court’s holding in Colony, Inc. v. Commissioner stands for the proposition that overstated basis that produces understated gain may never constitute an omission of gross income under § 6501(e)(1)(A). The judiciary is currently divided on the applicability of Colony to the modern Tax Code. The American Jobs Creation Act leaves unanswered the question of whether overstated basis may result in omitted income. Consequently, courts must litigate the remaining Son of Boss cases and other similar cases not resolved by the new regulations regime subject to the Supreme Court’s holding in Colony. The best solution to this problem is for Congress to amend § 6501(e)(1)(A) to state that overstated basis that results in understated gain qualifies as an omission of gross income.
