No. 09-9015

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

SALMAN RANCH, LTD., FRANCIS S. KOENIG,
TAX MATTERS PARTNER,

Petitioners-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ORAL ARGUMENT REQUESTED

ON APPEAL FROM THE ORDER AND DECISION OF
THE UNITED STATES TAX COURT (JUDGE HALPERN)

BRIEF FOR THE APPELLANT

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TABLE OF CONTENTS

Page

Table of contents. i
Table of authorities. ii
Statement of related cases. vii
Statement of subject matter and appellate jurisdiction. 1
Statement of the issue.. 2
Statement of the case. 3
Statement of the facts. 3
Summary of argument. 13
Argument:

The underreporting of capital gain is an omission of gross income within the meaning of the extended assessment period regardless of whether the gross sales price is underreported or the basis of the property is overstated. 17

Standard of review. 17

A. An overview of TEFRA partnership proceedings and the statutory limitations on tax assessment.. 17

B. The development of basis-inflating tax shelters and the Secretary's promulgation of regulations. 22

C. The new regulations are entitled to *Chevron* deference. 28

D. The issuance of the regulations during the pendency of this litigation does not affect the deference to which they are entitled. 34

E. Application of the regulations requires reversal of the Tax Court's order and decision.. 38

F. The Federal Circuit's *Salman Ranch* decision has no res judicata or collateral estoppel effect on the proper resolution of this case. 44

Page(s)

Conclusion. 49
Statement regarding oral argument.. 50
Certificate of compliance.. 51
Certificate of service. 52
Statutory addendum. 53
Tax court order and decision

TABLE OF AUTHORITIES

Cases:

ABKCO Music, Inc. v. LaVere,
217 F.3d 684 (9th Cir. 2000). 39
AD Global Fund, LLC v. United States,
481 F.3d 1351 (Fed. Cir. 2007). 19
Adolph Coors Co. v. Commissioner,
519 F.2d 1280 (10th Cir. 1975). 44-45
Allen v. United States,
173 F.3d 533 (4th Cir. 1999). 29
Andantech L.L.C. v. Commissioner,
331 F.3d 972 (D.C. Cir. 2003). 19
Auer v. Robbins, 519 U.S. 452 (1997). 37
Bakersfield Energy Partners, LP v. Commissioner,
568 F.3d 767 (9th Cir. 2009). 13, 25-26, 30-31, 33
Barnhart v. Thomas, 540 U.S. 20 (2003). 29
Bingaman v. Department of Treasury,
127 F.3d 1431 (Fed. Cir. 1997). 45
Bowen v. Georgetown University Hospital,
488 U.S. 204 (1988). 39
Brandon Ridge Partners v. United States,
100 A.F.T.R.2d (RIA) 5347 (M.D. Fla. 2007). 25
Burks v. United States, 2009 WL 2600358 (N.D. Tex. 2008),
appeal docketed, No. 09-11061 (5th Cir. Oct 26, 2009). . . . 25
Chevron v. USA, Inc. v. Natural Res. Def. Council, Inc.,
467 U.S. 837 (1984). 14, 28-29
Colony v. Commissioner, 357 U.S. 28 (1958). 12, 14, 21, 30

Cases (cont'd): **Page(s)**

Commissioner v. Sunnen, 333 U.S. 591 (1948). 44
Cookeville Regional Medical Ctr. v. Leavitt,
531 F.3d 844 (D.C. Cir. 2008), *cert. denied*,
129 S. Ct. 1524 (2009). 39
E. Norman Peterson Marital Trust v. Commissioner,
78 F.3d 795 (2d Cir. 1996).. 29
Federal Labor Relations Authority v. U.S. Dept. of Treasury, Financial Management Service,
884 F.2d 1446 (D.C. Cir. 1989). 48
First Nat'l Bank of Chicago v. Standard Bank & Trust,
172 F.3d 472 (7th Cir. 1999). 39-41
Friends of Everglades v. South Florida Water Mgmt. Dist., 570
F.3d 1210 (11th Cir. 2009). 36
Grapevine Imports, Ltd. v. United States, 77 Fed. Cl. 505 (2007),
appeal docketed No. 2008-5090
(Fed. Cir. June 27, 2008).. 38
Hernandez-Carrera v. Carlson, 547 F.3d 1237 (2008),
cert. denied, 78 U.S.L.W. 3360 (Dec. 14, 2009). . . . 16, 33-34
Hoffman v. Commissioner, 119 T.C. 140 (2002). 31
Home Concrete & Supply, LLC v. United States,
599 F. Supp. 2d 678 (E.D.N.C. 2008), *appeal docketed*,
No. 09-2353 (4th Cir. Dec. 9, 2009).. 25
Jones v. Trapp, 186 F.2d 951 (10th Cir. 1950). 45
Kornman & Associates, Inc. v. United States,
527 F.3d 443 (5th Cir. 2008). 4, 24
Landreth v. Commissioner, 859 F.2d 643 (9th Cir. 1988). 48
Levy v. Sterling Holding Co., 544 F.3d 493 (3d Cir. 2008),
cert. denied, 129 S. Ct. 2827 (2009). 39-41, 43, 48
Liquilux Gas Corp. v. Martin Gas Sales,
979 F.3d 887 (1st Cir. 1992). 39-40
Long Island Care at Home, Ltd v. Coke,
551 U.S. 158 (2007). 36-37, 39
Luckey v. Miller, 929 F.2d 618 (11th Cir. 1991). 48
Mandel v. Commissioner, 229 F.2d 382 (7th Cir. 1956). 46-47
Marriott Internat'l Resorts v. United States,
586 F.3d 962 (Fed. Cir. 2009). 24

Cases (cont'd): **Page(s)**

Martinez v. Flowers, 164 F.3d 1257 (10th Cir. 1998). 29
McDonnell v. United States, 180 F.3d 721 (6th Cir. 1999). 29
Miller v. United States, 65 F.3d 687 (8th Cir. 1995). 29
Montana v. United States, 440 U.S. 147 (1979). 45
Motorola, Inc. v. United States,
436 F.3d 1357 (Fed. Cir. 2006). 34, 36
National Cable & Telecomms. Ass'n v. Brand X Internet Servs,
545 U.S. 967 (2005). 26, 32-33
Northern Ind. Pub. Serv. Co. & Subs. v. Commissioner,
101 T.C. 294 (1993). 32
Orr v. Hawk, 156 F.3d 651 (6th Cir. 1998). 39-40
Petro-Hunt, L.L.C. v. United States, 3
65 F.3d 385 (5th Cir. 2004). 47
Piamba Cortes v. American Airlines, Inc.,
177 F.3d 1272 (11th Cir. 1999). 39, 41
Princess Cruises, Inc. v. United States,
397 F.3d 1358 (Fed. Cir. 2005). 40
Randell v. United States, 64 F.3d 101 (2d Cir. 1995). 17
Red Lion Broadcasting Co. v. FCC, 395 U.S. 367 (1969). 40
Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner,
114 T.C. 533 (2000), *appeal dismissed and remanded*,
249 F.3d 175 (3d Cir. 2001).. 19
Salina Partnership, L.P. v. Commissioner,
80 T.C.M. (CCH) 686 (2000). 24
Salman Ranch Ltd v. United States,
573 F.3d 1362 (Fed. Cir. 2009). 3, 5, 8-9, 13, 23, 26, 30
Schneider v. Commissioner, 49 T.C.M. (CCH) 1032 (1985). 32
Smiley v. Citibank (South Dakota), N.A.,
517 U.S. 735 (1996). 34
United States v. Morton, 467 U.S. 822 (1984). 34
Zlotnick v. TIE Communications,
836 F.2d 818 (3d Cir. 1988) 5

Statutes:

Internal Revenue Code of 1939 (26 U.S.C. 1952 ed):
§275(c). 20-22

Statutes (cont'd): **Page(s)**

Internal Revenue Code of 1986 (26 U.S.C.):
§ 61.. . . . . 15, 30-31
§ 701.. 17
§ 702.. 17
§ 703.. 17
§ 704.. 17
§ 708(b)(1)(B). 5
§ 722.. . . . . 11, 23
§ 733(1). 11
§ 743(b). 6
§ 752.. 23
§ 752(a). 11, 23
§ 752(b). 11
§ 754.. 5-7
§ 1001(a). 31
§ 6031.. 17
§ 6223(a)(2). 17
§ 6223(d)(2). 17
§ 6225(a). 17
§ 6226.. 2
§ 6229.. . . . . 11, 18-19
§ 6229(a). 19
§ 6229(c)(2). 12, 20-21, 30, 33, 38, 50
§ 6229(d). 18
§ 6501.. 11
§ 6501(a). 13, 18
§ 6501(e)(1). 19
§ 6501(e)(1)(A). 11-16, 25-26
§ 6501(e)(1)(A)(i). 12, 16, 49
§ 6501(e)(1)(A)(ii).. . . . . 12, 16, 20, 49
§ 7482(a). 2
§ 7483.. 2
§ 7805(e).. 28

Revenue Act of 1934, ch. 277, 48 Stat. 680, § 275(c). 20

Statutes (cont'd): **Page(s)**

Tax Equity and Fiscal Responsibility Act of 1982,
Pub. L. No. 97-248, 96 Stat. 324. . . . . 3, 20

Miscellaneous:

CC-2010-001, 2009 WL 4753220.. 38

5 C.F.R. § 581.305(f). 35

Notice 2000-44, 2000-2 C.B. 255.. 23

Christopher Pietruszkiewicz, *Of Summonses, Required Records and Artificial Entities: Liberating the IRS from Itself*,
73 Miss. L.J. 921 (2004). 22

Matthew Roche, Comment, *Son of BOSS and the Troubling Legacy of* Colony, Inc. v. Commissioner, 58 Cath. U. L. Rev. 263,
263 (Fall 2008). 9

T.D. 9466, 74 Fed. Reg. 49321 (2009). 27-28, 37, 42-43

Temp. Treas. Reg. (26 C.F.R.):
§ 301.6229(c)(2)-1T(a).. . . . . 28, 30
§ 301.6229(c)(2)-1T(b).. . . . . 28, 38
§ 301.6501(e)-1T(a). 14, 27, 30-31, 38
§ 301.6501(e)-1T(b). 28

Treas. Reg. (26 C.F.R.):
§ 1.61-6(a). 31

STATEMENT OF RELATED CASES

Salman Ranch Ltd v. United States, 573 F.3d 1362 (Fed. Cir. 2009), was a related case. The following cases pending in other appellate courts raise the same issue as raised in this case: *Home Concrete & Supply, LLC v. United States*, 4th Cir., No. 09-2353; *Commissioner v. MITA*, 5th Cir., No. 09-60827; *Commissioner v. Equipment Holding Co.*, 5th Cir., No. 09-60866; *Burks v. United States*, 5th Cir., No. 09-11061; *Beard v. Commissioner*, 7th Cir., No. 09-3741; *Grapevine Imports, Ltd. v. United States*, Fed. Cir., No. 2008-5090. In addition, we understand that there are about 30 other cases pending in the district courts, the Tax Court, and the Court of Federal Claims that raise this issue.

IN THE UNITED STATES COURT OF APPEALS
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BRIEF FOR THE APPELLANT

STATEMENT OF SUBJECT MATTER AND APPELLATE JURISDICTION

On March 28, 2008, the Commissioner of Internal Revenue issued Notices of Final Partnership Administrative Adjustment ("FPAAs") to Salman Ranch, Ltd ("the Partnership" or "Salman Ranch") for the tax years ending December 31, 2001, and December 31, 2002. (*Petition* dated 6/4/08; Doc. 1, Exs. A-B.)[1] On June 5, 2008, Frances Koenig, the

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[1] "Doc." references are to the documents contained in the record
(continued...)

tax matters partner of the partnership, commenced an action for readjustment of partnership items on behalf of the partnership. Jurisdiction was conferred on the Tax Court by § 6226 of the Internal Revenue Code ("I.R.C.") of 1986 (26 U.S.C.)

On August 7, 2009, the Tax Court entered an order and decision in which it granted the petitioners' motion for summary judgment. (*Order* dated 8/7/09, Doc. 19 at 1-2.) The order and decision is final and disposes of all parties' claims. On October 27, 2009, the Commissioner filed a timely notice of appeal. (*Docket entries* at 3.) *See* I.R.C. § 7483. Jurisdiction is conferred on this Court by I.R.C. § 7482(a).

STATEMENT OF THE ISSUE

Whether an understatement of income resulting from an overstatement of the tax basis of sold property can qualify as an omission from gross income giving rise to the extended, six-year period for tax assessment.

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[1](...continued)
on appeal, as numbered by the Clerk of the Tax Court.

STATEMENT OF THE CASE

This TEFRA partnership proceeding[2] involves a challenge to the timeliness of two FPAAs, in which the Commissioner adjusted items reported on Salman Ranch's partnership returns for 2001 and 2002. (*Petition* dated 6/4/08, Doc. 1 at 10-11 & Exs. A-B.) The case was decided on the petitioners' motion for summary judgment. The Tax Court (Judge Halpern), in an unreported order and decision, determined that the FPAAs were untimely and granted the summary judgment motion. (*Order* dated 8/7/09, Doc. 19 at 1-2.)

STATEMENT OF THE FACTS

The Partnership, whose initial partners were members of the Salman and Koenig families, was formed on January 1, 1987, and it owned a ranch. (*Koenig Affidavit* dated 12/31/08, Doc. 10 at 1-2.) The sale of part of this ranch in 1999 and part in 2001 resulted in a tax controversy involving the 1999 tax year, *see Salman Ranch Ltd v. United States*, 573 F.3d 1362 (Fed. Cir. 2009), and this tax controversy involving the years 2001 and 2002. In both cases, petitioners challenged the timeliness of the FPAAs.

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[2] "TEFRA" is an acronym for the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

The transactions

The timeliness question in this case and in *Salman Ranch* arises in the context of a Son of BOSS tax shelter, in which, "reminiscent of an alchemist's attempt to transmute lead into gold" (*Kornman & Associates, Inc. v. United States*, 527 F.3d 443, 456 (5th Cir. 2008)), Salman Ranch and its partners attempted to use short sale transactions, which are economically a wash, to manufacture increased basis. This increased basis was used to decrease the Partnership's gain on the sale of its ranch.[4]

On October 8, 1999, the partners entered into short sales of U.S. Treasury Notes, which generated cash proceeds totaling approximately $10,982,373.[5] On October 13, 1999, the partners transferred these cash

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[4] In a Son of BOSS tax shelter, a taxpayer contributes to a partnership a high-value asset encumbered by a liability of approximately the same amount. The asset is included in the taxpayer's basis in his partnership interest, but the offsetting liability is not. The resulting artificially high basis is used to generate an equally high artificial tax loss, or to reduce the gain that would otherwise result from disposing of a partnership interest or property received upon withdrawal from the partnership. *See* Notice 2000-44, 2000-2 C.B. 255.

[5] A short sale is a sale of a security (often stock) that the investor does not own. Typically this is done by borrowing shares from a broker. The short seller is obligated, however, to buy an equivalent number of shares in order to return the borrowed shares, and he generally makes

(continued...)

proceeds and the corresponding obligation to close the short sales, *i.e.*, to replace the borrowed securities, to the Partnership. Before November 30, 1999, the Partnership purportedly closed the short sales at a cost of approximately $10,980,688. *Salman Ranch*, 573 F.3d at 1364.

On November 30, 1999, each partner contributed a portion of his interest in Salman Ranch to family limited partnerships. (*Koenig Affidavit* dated 12/31/08, Doc. 10 at 2; *Salman Ranch*, 573 F.3d at 1378.) As a result, each family limited partnership owned a partnership interest in Salman Ranch, which, in turn, owned the ranch. The Salman Ranch partners' transfer of their interests to their family limited partnerships caused a technical termination of Salman Ranch. *See* I.R.C. § 708(b)(1)(B). This technical termination allowed an adjustment in the basis of the ranch under I.R.C. §§ 754 and 743(b)(1). This adjustment purportedly increased the Partnership's basis in the ranch by a portion of the value of the short-sale cash proceeds contributed to the Partnership. *Salman Ranch*, 573 F.3d at 1364. The

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[5](...continued)
this covering purchase using the funds he received from selling the borrowed stock. *Zlotnick v. TIE Communications*, 836 F.2d 818, 820 (3d Cir. 1988).

Partnership did not, however, reduce this basis by the offsetting obligation to close the short sale, which the Partnership assumed and fulfilled.

On December 23, 1999, the new Salman Ranch partnership sold 17,754 acres of the ranch to Hughes and Betsey Abell. The 1999 sale was the subject of the earlier litigation. *See Salman Ranch, supra.* The terms of the sale also included an option to purchase most of the reminder of the ranch, which the Abells exercised on January 16, 2001, when they purchased about 12,038 acres of the ranch for $7,260,084. (*Koenig Affidavit* dated 12/31/08, Doc. 10 at 3.) In 2001 and 2002 the Partnership received payments of $1,990,656 and $5,269,429, respectively, from the Abells for the property they purchased in 2001. (*Id.* at 3-4.)

The tax returns

The old Salman Ranch's final partnership return (Form 1065) for the period ending November 30, 1999, contained a statement of Salman Ranch's election under I.R.C. § 754 to adjust its basis in its assets ("inside basis") under § 743(b),[7] but the statement did not explain the

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[7] Section 743(b) provides:

(continued...)

nature or amount of this adjustment. On the new Salman Ranch's partnership return for the one-month period of December, 1999, Salman Ranch reported gross proceeds of $7,188,588 from the ranch sale of 1999, a tax basis of $6,850,276, and a "net section 1231 gain" of $338,312. This tax return, like that of the old Salman Ranch partnership, contained a statement of Salman Ranch's election to adjust the basis of partnership property under § 754, but did not explain the nature or amount of the basis adjustment. Although not apparent from the return, the claimed basis of $6,850,276 included an

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[7](...continued)

> **Adjustment to basis of partnership property**.–In the case of a transfer of an interest in a partnership by sale or exchange . . . a partnership with respect to which the election provided in section 754 is in effect shall–
>
> (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or
>
> (2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

amount from the Treasury note transactions.[8] The individual partners' tax returns included their proportionate shares of the net § 1231 gain from the sale of the ranch. Neither the partnerships' returns nor the returns of any of the partners flagged the relationship between the Treasury Note transactions and the calculation of the Partnership's basis in the ranch. *Salman Ranch*, 573 F.3d at 1378 (dissent).

On or about April 15, 2002, and April 15, 2003, the Partnership filed its partnership returns for 2001 and 2002, respectively, in which it reported on Form 6252 (Installment Sale Income) the installment sale of the additional ranch land sold. (*Koenig Affidavit* dated 12/31/08, Doc. 10 at 3-4 & Exs. A-B.) On the return for 2001, it reported a total selling price of $7,260,084, a tax basis of $6,832,230, commissions and other expenses of $386,029, and a gross profit of $41,825. (*Id.*, Doc. 10 at 3.) As was the case for the year ending December 31, 1999, the high tax basis claimed was largely attributable to the Treasury note transactions. (*Petition* dated 6/5/08, Doc. 1, Ex. A, Explanation of Items at 2.) On its returns for 2001 and 2002, the Partnership reported

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[8] It was undisputed that the basis in the ranch, without the Treasury note transactions, was $1,917,978. *Salman Ranch*, 573 F.3d at 1378 n.3 (dissent).

installment sale income of $11,468 and $30,357, respectively, after applying a gross profits percentage of 0.5761% in each year. (*Koenig Affidavit* dated 12/31/08, Doc. 10 at 3-4.) Salman Ranch's partners reported their proportionate shares of this income on their returns. (*Id.* at 4-5.) Neither the partnerships' returns nor those of the partners explained the relationship between the Treasury Note transactions and the calculation of the Partnership's basis in the ranch. (*See Koenig Affidavit* dated 12/31/08, Doc. 10, Exs. A-F.)

Administrative and judicial proceedings

The IRS mailed FPAAs to the Partnership's tax matters partner on March 28, 2008, which was just under six years from the filing of the 2001 partnership return and five years from the filing of the 2002 partnership return.[9] In them, the IRS reduced the Partnership's basis in the sold property from $6,832,230, to $2,362,965. The IRS,

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[9] Similarly, the IRS had issued an FPAA for 1999, at issue in *Salman Ranch*, just before the expiration of six years from the filing of the partnership return for that year. *Salman Ranch*, 573 F.3d at 1378 (dissent). As a commentator recently observed, "[B]ecause 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.) [three-year] statute of limitations expires." Matthew Roche, Comment, *Son of BOSS and the Troubling Legacy of* Colony, Inc. v. Commissioner, 58 Cath. U. L. Rev. 263, 263 (Fall 2008).

therefore, determined that the Partnership's net taxable installment sale income for 2001 and 2002 was $1,342,749 and $3,554,367, respectively, rather than $11,468 and $30,357, as reported on the tax returns. (*Petition* dated 6/5/08, Doc. 1, Exs. A-B.)

The IRS reasoned, *inter alia*, "that Salman Ranch Ltd. was availed of for improper tax avoidance purposes by artificially overstating basis in the partnership interests of its partners and assets held by Salman Ranch Ltd. through a transaction engaged in during 1999 that was substantially similar to that described in Notice 2000-44, ..." The IRS explained that Salman Ranch had improperly adjusted the basis of the ranch pursuant to the § 754 election filed with its return for the tax year ending December 31, 1999, pursuant to which the partners' bases in their partnership interests ("outside basis") became the inside basis of the new Salman Ranch. The IRS asserted that the short sale proceeds and the obligation to close the short sale, which Salman Ranch assumed and fulfilled, were offsetting and that the partners, who increased their outside bases by the short sale proceeds, should also have decreased their bases when Salman

Ranch assumed their obligations to close the short sale.[10] (*See, e.g., Petition* dated 6/5/08, Doc. 1, Ex. A, Explanation of Items.)

Petitioners commenced this action and alleged, *inter alia*, that the adjustments in the FPAAs are barred by the three-year limitations period for tax assessments contained in I.R.C. §§ 6229 and 6501. (*Petition* dated 6/5/08, Doc. 1 at 10.) The IRS generally must assess income taxes within three years after the return is filed. I.R.C. § 6501. When, however, a taxpayer has omitted 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 assessment period is six years. I.R.C. § 6501(e)(1)(A).

The time periods in § 6229 are similar to those in § 6501. Under § 6229(a) the period for assessing income taxes attributable to any partnership item does not expire before three years from the later of

[10] Each partner's contribution of sale proceeds to the Partnership increased his outside basis by the amount of the proceeds. I.R.C. § 722. The Partnership's assumption of the obligation to close the short sale decreased each partner's outside basis by the amount of the liability assumed (I.R.C. §§ 733(1), 752(b)) and, at the same time, increased the partner's basis by his proportionate share of the assumed liability (I.R.C. §§ 722, 752(a)). When the Partnership satisfied the liability, each partner's outside basis was decreased by his proportionate share of this liability. I.R.C. § 752(b).

the date the partnership return was filed or the last day for filing it. This period is extended to six years in the case of a substantial omission of income from the partnership return. I.R.C. § 6229(c)(2). In this case, it is undisputed that, unless the assessment period was extended, assessment of taxes against Salman Ranch's partners is time-barred.

In their motion for summary judgment, petitioners urged that neither § 6501(e)(1)(A) nor § 6229(c) extended the three-year assessment period because a basis overstatement is not an omission of gross income within the meaning of either statute. They relied on *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which interpreted § 275(c) of the Internal Revenue Code of 1939. (*Petitioners' memorandum* dated 1/21/09, Doc. 9 at 19.) Petitioners also made two alternative arguments. First, they contended that Salman Ranch did not omit any gross income because the gross receipts provision (I.R.C. § 6501(e)(1)(A)(i)) applied.[11] Second, they urged that the safe harbor for adequate disclosure (I.R.C. § 6501(e)(1)(A)(ii)) protected Salman Ranch from the extended statute of limitations. (*Petitioners' memorandum*

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[11] Section 6501(e)(1)(A) defines "gross income" as gross receipts in the case of trade or business income from the sale of goods or services.

dated 1/21/09, Doc. 9 at 18 n.50.) The Commissioner opposed the summary judgment motion. (*Respondent's memorandum* dated 2/24/09, Doc. 13.)

The Tax Court granted the motion and upheld the applicability of the three-year assessment period contained in I.R.C. § 6501(a). It relied on two recent appellate decisions holding that an understatement of income resulting from an overstatement of the tax basis of sold property does not qualify as an omission from gross income for purposes of the extended, six-year period for tax assessment: *Salman Ranch*, *supra*; *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009). It therefore held that the FPAA was untimely. (*Order* dated 8/7/09, Doc. 19 at 1-2.)

SUM MARY OF ARGUMENT

The IRS generally has three years to assess taxes, but this period is extended to six years "[i]f 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." I.R.C. § 6501(e)(1)(A). In this partnership proceeding, the Commissioner contended that the six-year period applied because Salman Ranch had omitted substantial capital gain income from its partnership return by

overstating its tax basis in property it sold. The Tax Court rejected that contention because *Colony v. Commissioner*, 357 U.S. 28 (1958), and its progeny have held that an understatement of income resulting from an overstatement of basis is not an omission of gross income within the meaning of the applicable statutes.

After entry of the Tax Court's order and decision, the Treasury Department issued temporary regulations clarifying that the Supreme Court's decision in *Colony* was not applicable outside of the trade-or-business context to tax years governed by the provisions of the Internal Revenue Code of 1986. These regulations provide that, in the case of disposition of property, the term "gross income" generally means the excess of the amount realized over the property's adjusted basis and that, consequently, an understated amount of gross income resulting from an overstated basis constitutes an omission of gross income for purposes of I.R.C. § 6501(e)(1)(A). *See* Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) (26 C.F.R.). These regulations are entitled to *Chevron* deference and require reversal of the Tax Court's decision.

Under *Chevron v. USA, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984), when, as here, a regulation interprets an ambiguous statute, that regulation receives controlling weight unless it

is "arbitrary, capricious, or manifestly contrary to the statute." The only question for the court is whether the agency's regulation is based on a permissible construction of the statute. Treasury's regulatory construction of "gross income" in § 6501(e)(1)(A) satisfies this standard. The definition of "gross income," contained in the temporary regulations, is consistent with the general definition of "gross income" in I.R.C. § 61, which broadly defines "gross income" as "all income from whatever source derived" and explicitly includes within the meaning of that term "[g]ains derived from dealings in property." Because gain is determined mathematically, by subtracting basis from the amount realized, the Treasury Department reasonably concluded that an understated amount of gross income resulting from an overstated basis constitutes an omission from gross income under § 6501(e)(1)(A).

Neither the Supreme Court's interpretation of "gross income" in *Colony* nor the issuance of the temporary regulations during the pendency of this action (and in response to litigation) affects the deference to which these regulations are entitled. This Court has recently confirmed that a reasonable agency interpretation of an ambiguous statute is entitled to deference, notwithstanding the Supreme Court's earlier contrary interpretation of a statute.

Hernandez-Carrera v. Carlson, 547 F.3d 1237, 1246 (2008), *cert. denied*, 78 U.S.L.W. 3360 (Dec. 14, 2009). Furthermore, the Supreme Court has repeatedly held that the issuance of regulations during litigation does not affect the deference to which they are entitled.

The temporary regulations apply to the Partnership's 2001 and 2002 tax years because the period for assessment under § 6501(e)(1)(A), as interpreted in the temporary regulations, remains open for those years. Under the regulations, the Partnership underreported its capital gain in 2001 and 2002 by over $1.3 million and $3.5 million, respectively, due to its overstatement of the basis of the ranch property. By virtue of this underreporting, the Partnership omitted gross income well in excess of 25% of the amount of gross income stated in its returns. Accordingly, the six-year assessment period applies, and the FPAAs were timely.

The Tax Court's order and decision is incorrect and should be reversed. The case should be remanded to the Tax Court for consideration of the remaining issues – the applicability of the gross receipts provision, I.R.C. § 6501(e)(1)(A)(i), and the safe harbor for adequate disclosure, I.R.C. § 6501(e)(1)(A)(ii).

ARGUMENT

The underreporting of capital gain is an omission of gross income within the meaning of the extended assessment period regardless of whether the gross sales price is underreported or the basis of the property is overstated

Standard of review

Construction of the Internal Revenue Code and the propriety of summary judgment are questions of law, reviewed *de novo*.

A. An overview of TEFRA partnership proceedings and the statutory limitations on tax assessment

When the IRS disagrees with a partnership's reporting of any partnership item, it must issue an FPAA before making any assessments against the partners attributable to this item.[12] I.R.C. §§ 6223(a)(2), (d)(2), 6225(a). The mailing of the FPAA suspends the running of the limitations period for assessing any income taxes that

[12] Although partnerships do not pay federal income tax, they are nevertheless required to file annual information returns reporting the partners' distributive shares of income, gain, deductions or credits. I.R.C. §§ 701, 6031; *Randell v. United States*, 64 F.3d 101, 103 (2d Cir. 1995). The individual partners report their respective distributive shares on their federal income tax returns. I.R.C. §§ 701-704. Unpaid taxes are assessed against the individual partners.

are attributable to any partnership item or affected item. I.R.C. § 6229(d).

The standard limitations period for assessing tax, both generally and in the specific context of a taxpayer who has an interest in a partnership, is three years. The Commissioner thus generally has three years after the later of the due date for filing a tax return or the date on which the taxpayer actually files its return to assess any additional tax due. I.R.C. § 6501(a). Additionally, § 6229 provides special rules that extend the period of limitations prescribed by § 6501 in the case of partnership items. The period of limitations for assessing income tax (against the partners) attributable to partnership items "shall not expire before" three years after the date on which the partnership return was filed, or the last day for filing such return

(determined without regard to extensions), whichever is later.[13] I.R.C. § 6229(a).

The Code doubles both the general limitations period and the special minimum period for assessing partnership items in cases involving substantial omission of income from the return. In cases of substantial omissions from individual returns, § 6501(e)(1) provides a six-year assessment period:

> **(e) Substantial Omission of Items**—Except as otherwise provided in subsection (c)—
>
> **(1) Income Taxes**.—In the case of any tax imposed by subtitle A—
>
> **(A) General Rule**.—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

[13] The period specified in § 6229 is not a separate and independent limitations period; rather, it operates as a minimum period of limitations that may, if necessary, extend the period of assessment as to partnership items so that it will never expire before three years from the filing of the partnership return. *AD Global Fund, LLC v. United States*, 481 F.3d 1351, 1354 (Fed. Cir. 2007); *Andantech L.L.C. v. Commissioner*, 331 F.3d 972, 976-77 (D.C. Cir. 2003); *Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner*, 114 T.C. 533, 540-42 (2000) (reviewed opinion), *appeal dismissed and remanded*, 249 F.3d 175 (3d Cir. 2001).

> 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.

Similarly, if a partnership omits from gross income an amount exceeding 25% of the gross income stated in the return, the special minimum limitations period for assessing partnership items is extended from three to six years.[14] I.R.C. § 6229(c)(2).

The extended statute of limitations in cases of substantial omissions of income originated in the Revenue Act of 1934, ch. 277, 48 Stat. 680, 745, § 275(c), and was incorporated in § 275(c) of the 1939

[14] Section 6229(c)(2), enacted in 1982 by TEFRA § 402(a), does not contain subsections analogous to §§ 6501(e)(1)(A)(i) & (ii).

Internal Revenue Code (26 U.S.C. 1952 ed.).[15] In *Colony v. Commissioner*, 357 U.S. 28, 29 (1958), the Supreme Court construed the statutory language "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," then contained in § 275(c) of the Internal Revenue Code of 1939 and now contained in I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A).

The Court considered this statutory language to be ambiguous. *See Colony,* 357 U.S. at 33 ("it cannot be said that the [statutory] language is unambiguous"). After examining the legislative history, the Court concluded that the ambiguous statutory language referred 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" (*id.* at 33). Accordingly, the Court ruled that a real estate company which had understated its business income from selling residential lots by

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[15] Section 275(c) of the 1939 Code provided a five-year statute of limitations for tax returns omitting substantial income and did not contain the special definition of "gross income" for trades and businesses or the adequate disclosure exception, which were added to the Code in 1954 (along with a provision lengthening the extended period from five to six years).

overstating the cost bases of these lots had not omitted gross income within the meaning of § 275(c). The extended period of assessment was, therefore, inapplicable.

B. The development of basis-inflating tax shelters and the Secretary's promulgation of regulations

For many years, *Colony*'s interpretation of the statutory language "omits from gross income" in the predecessor to §§ 6501 and 6229 outside of the trade-or-business context did not cause significant problems with tax enforcement. Understatement of income through overstatement of basis was relatively rare. The issue became problematic, however, with the spread of new tax shelters that sought to reduce income by artificially inflating a taxpayer's basis in an asset.

This case is one of about 250 cases currently in litigation in various federal courts involving the best-known basis-inflating tax shelter, the Son of BOSS transaction. In a Son of BOSS tax shelter,[16] a partner contributes encumbered property to the partnership which

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[16] BOSS is an acronym for Bond and Options Sales Strategy and refers to an abusive tax shelter with no economic outlay that purports to generate extraordinary tax savings. Christopher Pietruszkiewicz, *Of Summonses, Required Records and Artificial Entities: Liberating the IRS from Itself*, 73 Miss. L.J. 921 & n.2 (2004). For a description of a BOSS transaction, *see id.* at n.2.

expressly assumes the associated obligation. The partner increases his basis in his partnership by the value of the asset contributed to the partnership. *See* I.R.C. § 722. The partner, however, does not reduce his basis in his partnership interest under I.R.C. § 752(a) and (b) to reflect the partnership's assumption of the associated obligation, and that omission results in a vastly overstated basis, which, in turn, generates a large artificial tax loss on the sale of a partnership asset or the disposition of a partnership interest. In Notice 2000-44, 2000-2 C.B. 255, the IRS informed taxpayers that the purported losses arising from these transactions are not allowable for federal income tax purposes and that penalties may be imposed on the participants.

In this case, the appellees used the short-sale variant of the Son of BOSS scheme to create an enormous artificial tax loss to offset the Partnership's gain on the sale of the ranch. These short sale transactions were "economically meaningless." *See Salman Ranch*, 573 F.3d at 1381 (dissent). The courts have uniformly struck down the short-sale variant of the Son of BOSS tax shelter and have held that an obligation to close a short sale is a "liability" under I.R.C. § 752, and that a partner's outside basis must be reduced to account for the partnership's assumption of the obligation to close short sales. *See*

Marriott Internat'l Resorts v. United States, 586 F.3d 962 (Fed. Cir. 2009); *Kornman & Associates, Inc. v. United States*, 527 F.3d 443, 460-461 (5th Cir. 2008). *See also Salina Partnership, L.P. v. Commissioner*, 80 T.C.M. (CCH) 686 (2000).

The Fifth Circuit described the abusive nature of the short sale transactions utilized in a Son of BOSS tax shelter as follows:

> Before we begin our excursion into Subchapter K, we would be remiss if we did not comment on the elephant in the room. The Trust acknowledges that it only suffered a $200,000 economic loss in connection with these [Treasury note] transactions, yet it claimed a $102.6 Million tax loss on its return. The Trust used this fake loss in 1999 to offset over $2 Million in legitimate income and capital gains in 2000 and 2001. The Appellants' premeditated attempt to transform this wash transaction (for economic purposes) into a windfall (for tax purposes) is reminiscent of an alchemist's attempt to transmute lead into gold.

Kornman, 527 F.3d at 456. The Fifth Circuit "was reluctant to adopt any definition of liability that would . . . allow the Trust to continue its conspicuous raid on the Treasury through the use of this tax shelter." *Id.* at 455-456 (footnote omitted). Since the law uniformly supports the Commissioner's position on the merits of this shelter, the appellees

cannot prevail in this action unless their challenge to the timeliness of the FPAAs is successful.

In litigating cases involving the Son of BOSS transaction and similar shelters, the Government took the position that an understated amount of gross income opened the extended period of limitations in I.R.C. § 6501(e)(1)(A), regardless whether that understatement resulted from an overstatement of basis or from an understatement of the amount realized from the sale. A number of courts agreed with the Government's interpretation of § 6501(e)(1)(A). *See*, *e.g.*, *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678 (E.D.N.C. 2008), *appeal docketed*, No. 09-2353 (4th Cir. Dec. 9, 2009); *Burks v. United States*, 2009 WL 2600358 (N.D. Tex. 2008), *appeal docketed*, No. 09-11061 (5th Cir. Oct 26, 2009); *Brandon Ridge Partners v. United States*, 100 A.F.T.R.2d (RIA) 5347 (M.D. Fla. 2007).

However, in the first two appellate decisions on this issue, the Ninth Circuit and the Federal Circuit applied *Colony* to § 6501(e)(1)(A) outside the trade-or-business context, and held that an omission from gross income under § 6501(e)(a)(A) does not occur by reason of the overstatement of the basis of sold property. *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767, 768 (9th Cir. 2009);

Salman Ranch Ltd v. United States, 573 F.3d 1362, 1372-1377 (Fed. Cir. 2009).[17] In so holding, the Ninth Circuit acknowledged that the statutory language in issue was ambiguous. *Bakersfield*, 568 F.3d at 778. It also acknowledged that "[t]he IRS may have the authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code even if its interpretation runs contrary to the Supreme Court's 'opinion as to the best reading' of the provision." *Id.*, quoting *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-983 (2005).

Consistent with the Ninth Circuit's suggestion in *Bakersfield*, the Treasury Department issued temporary regulations on September 24, 2009, interpreting the phrase "omission from gross income" contained in I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2). The temporary regulations

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[17] The Government continues to maintain that its interpretation of § 6501(e)(1)(A) is fully supported by the statutory language, and reserves the right to argue that position in courts other than the Ninth and Federal Circuits. However, because the Federal Circuit's rejection of that specific argument occurred in prior litigation between precisely the same two parties that are currently before this Court, for purposes of this appeal only we acknowledge that the statute should be viewed as ambiguous. Consequently, we base our appeal here on the deference that must be given to the regulations that were adopted after the Federal Circuit issued its decision. *See* section F, *infra* (discussing collateral estoppel).

"clarify that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)." T.D. 9466, 74 Fed. Reg. 49321, 49321 (2009). Since, in the case of the sale of property, "gross income" under § 61 means the excess of the amount realized over the adjusted basis of the property, under the temporary regulations, "any basis overstatement that leads to an understatement of gross income under section 61(a) constitutes an omission from gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2)." *Id.*

Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) (26 C.F.R.) provides (74 Fed. Reg. at 49323 (emphasis in original)):

> For purposes of paragraph (a)(1)(i) of this section, the term *gross income*, as it relates to any income other than from the sale of goods or services in a trade or business, has the same meaning as provided under section 61(a), and includes the total of the amounts received or accrued, to the extent required to be shown on the return. In the case of amounts received or accrued that relate to the disposition of property, and except as provided in paragraph (a)(1)(ii) of this section, *gross income* means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property. Consequently, except as provided in paragraph (a)(1)(ii) of this section, an understated amount of gross income resulting from an overstatement of unrecovered cost or

> other basis constitutes an omission from gross income for purposes of section 6501(e)(1)(A).

Accord Temp. Treas. Reg. § 301.6229(c)(2)-1T(a)(1)(iii).[18] The temporary regulations "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b).

As we shall demonstrate, the new regulations, which are entitled to deference under *Chevron v. USA, Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), warrant reversal of the Tax Court's determination.

C. The new regulations are entitled to *Chevron* deference

In *Chevron*, the Supreme Court stated that "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Id.* at 843. If the agency's construction passes muster under this test, "a court may not substitute its own construction of a statutory provision for a reasonable interpretation

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[18] In accordance with I.R.C. § 7805(e), these temporary regulations were simultaneously issued as proposed regulations – Prop. Treas. Reg. §§ 301.6229(c)(2)-1, 301.6501(e)-1. 74 Fed. Reg. at 49354.

made by the administrator of an agency." *Id.* at 844 (footnote omitted). *Accord Barnhart v. Thomas*, 540 U.S. 20, 26 (2003); *Martinez v. Flowers*, 164 F.3d 1257, 1259 (10th Cir. 1998). Thus, "[i]f the statutory language is ambiguous or silent on the issue, the agency's regulation receives 'controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.'" *Martinez*, 164 F.3d at 1259, quoting *Chevron*, 467 U.S. at 844. This Court has applied *Chevron* deference to a Bureau of Prison regulation on a sentencing issue as to which the governing statute was silent (*id.* at 1259-1260):

> The statute is silent as to whether BOP may consider a prisoner's past convictions or only the most recent one in determining eligibility for a sentence reduction. Therefore, we must uphold the agency regulation unless it is arbitrary, capricious, or manifestly contrary to the statute. [Internal quotation marks omitted.]

Temporary regulations are entitled to the same weight as final regulations. *E. Norman Peterson Marital Trust v. Commissioner*, 78 F.3d 795, 798 (2d Cir. 1996). *See also McDonnell v. United States*, 180 F.3d 721, 722-23 (6th Cir. 1999) (upholding temporary Treasury regulation under *Chevron*); *Allen v. United States*, 173 F.3d 533, 537-38 (4th Cir. 1999) (same); *Miller v. United States*, 65 F.3d 687, 689-90 (8th Cir. 1995) (same). Since a final regulation interpreting the statutory

phrase "omission of gross income" would be entitled to *Chevron* deference, the temporary regulations interpreting that phrase are also entitled to *Chevron* deference.

The temporary regulations promulgated on September 24 easily pass muster under *Chevron*. The statutory language construed therein – "omits from gross income an amount properly includible therein" (I.R.C. §§ 6229(c)(2), 6501(e)(1)(A)) – was held by the Supreme Court to be ambiguous. *Colony*, 357 U.S. at 33. The Ninth and Federal Circuits agreed. *Bakersfield*, 568 F.3d at 778; *Salman Ranch*, 573 F.3d at 1367. The regulations resolve this ambiguity by providing that, in general, the term "gross income" "has the same meaning as provided in section 61(a)" of the Internal Revenue Code, and that, in the case of the disposition of property, "*gross income* means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property." Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii) (emphasis in original). *Accord* Temp. Treas. Reg. § 301.6229(c)(2)-1T(a)(1)(iii).

Far from being arbitrary or capricious, these regulations are reasonable because they are consistent with, and supported by, the general definition of "gross income" in I.R.C. § 61. Section 61 broadly

defines "gross income" as "all income from whatever source derived," and it explicitly includes within the meaning of that term "[g]ains derived from dealings in property." I.R.C. § 61(a) & 61(a)(3). *See also* Treas. Reg. § 1.61-6(a). Gains from the sale of property are defined as "the excess of the amount realized therefrom over the adjusted basis. . . ." I.R.C. § 1001(a). *See also* Treas. Reg. § 1.61-6(a). Because gain is determined mathematically, by subtracting basis from the amount realized, the Treasury Department reasonably concluded that "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6501(e)(1)(A)." Temp. Treas. Reg. § 301.6501(e)-1T(a)(1)(iii).

Indeed, the Ninth Circuit has characterized the Commissioner's interpretation of the statutory language, now incorporated in the temporary regulations, as both "reasonable" and "sensible." *Bakersfield*, 568 F.3d at 775, 778. Further, before the present controversy arose, the Tax Court held that the general definition of "gross income," contained in § 61, applies to § 6501(e)(1)(A). *See, e.g.*, *Hoffman v. Commissioner*, 119 T.C. 140, 148 (2002) ("Gross income is not defined in section 6501. We have held, however, that the general

definition of gross income found in the Code applies to section 6501(e), except for the modification provided in section 6501(e)(1)(A)(i)"); *Northern Ind. Pub. Serv. Co. & Subs. v. Commissioner*, 101 T.C. 294, 299 n.7 (1993) ("For nonbusiness items and those not covered under sec. 6501(e)(1)(A)(i), the general definition of gross income found in the Code applies"); *Schneider v. Commissioner*, 49 T.C.M. (CCH) 1032, 1034 (1985) (Tax Court "look[ed] to the general definition of gross income to determine the proper treatment of non-business gross income under section 6501"). Thus, there can be no doubt that the regulations are reasonable and are entitled to *Chevron* deference.

A prior judicial interpretation of an ambiguous statute, such as that contained in *Colony*, is no impediment to Treasury's subsequent issuance of a regulation containing a different interpretation. As the Supreme Court stated in *Brand X*, 545 U.S. at 982-983:

> [A]llowing a judicial precedent to foreclose an agency from interpreting an ambiguous statute . . . would allow a court's interpretation to override an agency's. *Chevron*'s premise is that it is for agencies, not courts, to fill statutory gaps. . . . . Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.

See also id. at 983 ("whether Congress has delegated to an agency the authority to interpret a statute does not depend on the order in which the judicial and administrative constructions occur"). *Accord Bakersfield*, 568 F.3d at 778.

This Court has recently confirmed that, under the principles elucidated in *Brand X*, "a subsequent, reasonable agency interpretation of an ambiguous statute . . . is due deference notwithstanding the Supreme Court's earlier contrary interpretation of the statute." *Hernandez-Carrera v. Carlson*, 547 F.3d 1237, 1242 (10th Cir. 2008), *cert. denied*, 78 U.S.L.W. 3360 (Dec. 14, 2009). This Court found "unpersuasive the argument that *Brand X* applies to lower courts, but not to the Supreme Court" because "*Chevron* deference is not a policy choice subject to balancing against other policy considerations; it is a means of giving effect to congressional intent." *Id.* at 1247. That Congressional "intent [is] to vest an agency with the power to fill in the gaps within its own statute." *Id.*

Thus, the Supreme Court's interpretation in *Colony* of what it held to be ambiguous statutory language – language now contained in I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A) – did not preclude the Treasury Department from subsequently issuing regulations containing a

different interpretation. That interpretation, which is reasonable, "is due deference notwithstanding the Supreme Court's earlier contrary interpretation of the statue." *See Hernandez-Carrera*, 547 F.3d at 1242.

D. The issuance of the regulations during the pendency of this litigation does not affect the deference to which they are entitled

That the regulations were issued in response to litigation is no impediment to giving them *Chevron* deference. *See, e.g., Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996); *United States v. Morton*, 467 U.S. 822 (1984); *Motorola, Inc. v. United States*, 436 F.3d 1357, 1366 (Fed. Cir. 2006). For example, in *Smiley*, the regulation in issue was allegedly prompted by that case and similar cases in which the Comptroller of the Currency had participated as *amicus curiae.* The challenged regulation was proposed after the California Superior Court's dismissal of the complaint and was adopted after the California Supreme Court's affirmance of that dismissal. 517 U.S. at 739-740.

Notwithstanding these undisputed facts, and the promulgation of the regulation over 100 years after the enactment of the relevant statute, the Supreme Court gave *Chevron* deference to the regulation. *Id.* at 744-745. The Court reasoned (*id.* at 740-741):

> The 100-year delay makes no difference. . . . We accord deference to agencies under *Chevron*, . . . because of a presumption that Congress, when it left ambiguity in a statute meant for implementation by an agency, understood that the ambiguity would be resolved, first and foremost, by the agency, and desired the agency (rather than the courts) to possess whatever degree of discretion the ambiguity allows. *See Chevron, supra*, at 843-844. . . . Nor does it matter that the regulation was prompted by litigation, including this very suit. . . . That it was litigation which disclosed the need for the regulation is irrelevant.

Likewise, in *Morton*, the Court ruled that OPM's promulgation of 5 C.F.R. § 581.305(f) after commencement of the action was "of no consequence" to the question whether the Court should defer to the regulation. 467 U.S. at 836 n.21. The Court explained (*id.*):

> Congress authorized the issuance of regulations so that problems arising in the administration of the statute could be addressed. Litigation often brings to light latent ambiguities or unanswered questions that might not otherwise be apparent. Thus, assuming the promulgation of § 581.305(f) was a response to this suit, that demonstrates only that the suit brought to light an additional administrative problem of the type that Congress thought should be addressed by regulation. When OPM responded to this problem by issuing regulations it was doing no more than the task which Congress had assigned it.

Accord Barnhart, 535 U.S. at 221 (declining to disregard regulations that were recently enacted, perhaps in response to that very litigation); *Friends of Everglades v. South Florida Water Mgmt. Dist.*, 570 F.3d 1210, 1219 (11the Cir. 2009) ("Under *Smiley* . . . it does not matter that the regulation was proposed and issued well after the beginning of this lawsuit. Neither does it matter that it was done in response to this and similar lawsuits"); *Motorola* 436 F.3d at 1366 (giving *Chevron* deference to regulatory interpretation of the word "treatment" and stating that "[i]t makes no difference to our analysis that the regulation was promulgated in 2002, after the controversy arose and after this litigation began").

In *Long Island Care at Home, Ltd v. Coke*, 551 U.S. 158 (2007), the Supreme Court even deferred to an agency's interpretation of an existing regulation that was made in an internal agency document drafted in response to the pending litigation. Noting that the Department of Labor may have interpreted its regulations differently at different times (551 U.S. at 171), the Court, nevertheless, upheld the Labor Department's most recent interpretation because it had no reason to suspect that this interpretation was "merely a ' "*post hoc* rationalizatio[n]"' of past agency action or that it 'does not reflect the

agency's fair and considered judgment on the matter in question'" *Id.*, quoting *Auer v. Robbins*, 519 U.S. 452, 462 (1997).

There is even more reason to defer to the temporary Treasury regulations at issue here than there was to defer to the agency interpretation in *Long Island Care*. Unlike the interpretation at issue there, which was set forth in an internal agency document, the temporary regulations at issue here were published in the Federal Register. Unlike the interpretation at issue in *Long Island Care*, the temporary regulations do not follow a history of fluctuating agency interpretations. To the contrary, the regulations are "consistent with the Secretary's application of those provisions both with respect to a trade or business (that is, gross income means gross receipts), as well as outside of the trade or business context (that is, section 61 definition of gross income applies). . . ." T.D. 9466, 74 Fed. Reg. at 49322. Since the regulations reflect Treasury's "fair and considered judgment on the matter in question" (*Long Island Care*, 551 U.S. at 171), they are entitled to *Chevron* deference.

Moreover, the Court's observation (*Morton*, 467 U.S. at 836 n.21) that litigation often discloses the necessity for a regulation applies with particular force here. For almost 50 years, no problems regarding

Colony's application of § 6501(e)(1)(A) outside of the trade-or-business context occurred until 2007, when the Tax Court in *Bakersfield* and a Court of Federal Claims judge in *Grapevine Imports, Ltd. v. United States*, 77 Fed. Cl. 505 (2007), *appeal docketed* No. 2008-5090 (Fed. Cir. June 27, 2008), applied *Colony* to block the application of the six-year statute of limitations to understated capital gain resulting from basis overstatements.

E. Application of the regulations requires reversal of the Tax Court's order and decision

The temporary regulations "apply to taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009." Temp. Treas. Reg. §§ 301.6229(c)(2)-1T(b), 301.6501(e)-1T(b). In other words, they apply to taxable years for which the period of limitations under §§ 6229(c)(2) and § 6501(e)(1)(A), as interpreted in the temporary regulations, did not expire with respect to the tax year at issue before September 24, 2009. *See* CC-2010-001, 2009 WL 4753220 (interpreting the temporary regulations as applying to cases "in which the period of limitations under sections 6229(c)(2) and 6501(e)(1)(A), as interpreted in the temporary regulations, did not

expire with respect to the tax year at issue, before September 24, 2009. . .").[19] They, therefore, apply to this case.

That the tax years in issue are 2001 and 2002 is no impediment to applying the regulations to this case. The general prohibition on retroactive agency rule-making in the absence of express statutory authority[20] does not apply to rules that merely clarify existing law. *Levy v. Sterling Holding Co.*, 544 F.3d 493, 506 (3d Cir. 2008), *cert. denied*, 129 S. Ct. 2827 (2009); *First Nat'l Bank of Chicago v. Standard Bank & Trust*, 172 F.3d 472, 478 (7th Cir. 1999); *Orr v. Hawk*, 156 F.3d 651, 654 (6th Cir. 1998). *See also Cookeville Reg'l Med. Ctr. v. Leavitt*, 531 F.3d 844, 849 (D.C. Cir. 2008), *cert. denied*, 129 S. Ct. 1524 (2009); *ABKCO Music, Inc. v. LaVere*, 217 F.3d 684, 689 (9th Cir. 2000); *Piamba Cortes v. American Airlines, Inc.*, 177 F.3d 1272, 1283 (11th Cir. 1999); *Liquilux Gas Corp. v. Martin Gas Sales*, 979 F.3d 887, 890

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[19] The interpretation of the applicability date of the temporary regulations contained in CC-2010-001, issued to coordinate the IRS's treatment of docketed Tax Court cases involving the six-year statute of limitations, is entitled to deference. *See Long Island Home Care*, 551 U.S. at 171 (deferring to agency interpretation of a regulation, even though interpretation was set forth in an internal agency document).

[20] *See Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208-209 (1988).

(1st Cir. 1992). *But see Princess Cruises, Inc. v. United States*, 397 F.3d 1358, 1363 (Fed. Cir. 2005). When a regulation merely clarifies existing law, that regulation can constitutionally be applied to pre-promulgation conduct. *Levy*, 544 F.3d at 506; *Orr*, 156 F.3d at 654. Indeed, "[c]larification, effective *ab initio*, is a well recognized principle." *Liquilux*, 979 F.2d at 890, citing *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367 (1969).

As the Third Circuit explained (*Levy*, 544 F.3d at 506):

> [W]e have held that a new rule should not be deemed to be 'retroactive' in its operation – and thus does not implicate the Supreme Court's concerns in *Bowen* – if it "d[oes] not alter existing rights or obligations [but] merely clarifie[s] what those rights and obligations ha[ve] always been." [Citation omitted.] Thus, where a new rule constitutes a clarification – rather than a substantive change – of the law as it existed beforehand, the application of that new rule to pre-promulgation conduct necessarily does *not* have an impermissible retroactive effect, regardless of whether Congress has delegated retroactive rulemaking power to the agency. [Emphasis in original.]

Accord First Nat'l Bank, 172 F.3d at 478 ("a clarification of an unsettled or confusing area of law does not change the law, but restates what the law according to the agency is and has always been; it is no more retroactive in its operation than is a judicial determination construing

and applying a statute to a case in hand") (internal quotation marks omitted). The temporary regulations do not apply in a manner that would have the effect of reopening any tax year that was otherwise closed as of September 24, 2009.

There is no bright-line test for determining whether a new regulation merely clarifies existing law. *Levy*, 544 F.3d at 506. In making this determination, the courts have considered, *inter alia*, whether the new regulation resolved or attempted to resolve an ambiguity and whether the new regulation's resolution of the ambiguity is consistent with the agency's prior treatment of the issue. *Id*. at 507; *First Nat'l Bank*, 172 F.3d at 479. *See also Piamba Cortes*, 177 F.3d at 1283-1284. Some courts have also relied on the declaration of the adopting body that the regulation (or statute) is intended to be a clarification of existing laws. *See First Nat'l Bank*, 172 F.3d at 478; *Piamba Cortes*, 177 F.3d at 1284. Indeed, the Seventh Circuit is of the view that "[i]f the agency expressly communicates that its intention in issuing the regulation was to clarify rather than change existing law, courts should defer to such announcements unless the revisions are in plain conflict with earlier interpretations." 172 F.3d at 478.

When these factors are applied to this case, it is apparent that the new regulations are clarifications, rather than changes, of existing law. The temporary regulations resolve what courts have held to be a statutory ambiguity. The Supreme Court and other courts have stated that the language "omission from gross income," now contained in §§ 6229(c)(2) and 6501(e)(1)(A), is ambiguous. *See* discussion *infra*, pp. 21, 26. In promulgating the regulations, the Treasury Department expressly referred to the acknowledgement of this ambiguity by the Ninth and Federal Circuits. T.D. 9466, 74 Fed. Reg. at 49322. Further, the temporary regulations are consistent with Treasury's prior application of the statutory provisions.[21] *Id.* (temporary regulations "are consistent with the secretary's application of those provisions both with respect to a trade or business . . . , as well as outside of the trade or business context. . .").

Moreover, in at least three places the Treasury Department described these regulations as clarifications of existing law. Treasury stated that the "temporary regulations are a clarification of the period of limitations provided in sections 6501(e)(1)A) and 6229(c)(2)" (T.D.

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[21] The wording of §§ 6501(e)(1)(A) and 6229(c)(2) has remained unchanged since their enactment in 1954 and 1982, respectively.

9466, 74 Fed. Reg. at 49322) and that they "clarify that, outside of the trade or business context, gross income for purposes of sections 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in section 61(a)" (*id.* at 49321). *See also id*. at 49322 ("regulations clarify what constitutes an 'omission from gross income' under sections 6501(e)(1)(A) and 6229(c)(2)"). That the regulation conflicts with some judicial interpretations of the pre-regulation law does not mean that the regulation is a substantive change, rather than a clarification. *Levy*, 544 F.3d at 507.

Since the regulations are an attempt to resolve statutory ambiguity, are consistent with Treasury's prior application of the statutory provisions, and are intended to be a clarification of existing law, the application of these regulations to the 2001 and 2002 tax years does not have an impermissible retroactive effect. *See Levy*, 544 F.3d at 506.

When these regulations are applied to this case, it is readily apparent that the Partnership has omitted gross income well in excess of 25% of the amount of gross income stated in its returns. The Partnership reported negative gross income of ($370,841) and ($305,595) on its returns for 2001 and 2002, respectively. (*See Koenig*

Affidavit dated 12/31/98, Doc. 10, Exs. A-B.) Under the regulations, the Partnership underreported its capital gain in 2001 and 2002 by over $1.3 million and $3.5 million, respectively, due to its overstatement of the basis of the ranch property. (*Petition*, dated 6/5/08, Doc. 1, Exs. A-B.) Accordingly, the six-year assessment period of § 6501(e)(1)(A) applies, and the FPAAs were timely.

F. The Federal Circuit's *Salman Ranch* decision has no res judicata or collateral estoppel effect on the proper resolution of this case

This case involves the same transaction that was at issue in the Federal Ciruict's *Salman Ranch* decision, but different tax years. It is well settled that, for res judicata purposes, each tax year "is the origin of a new liability and of a separate cause of action." *Commissioner v. Sunnen*, 333 U.S. 591, 598 (1948). Thus, the Government's loss as to 1999 does not bar its claims for 2001 and 2002.

The doctrine of collateral estoppel is also inapplicable. This doctrine, strictly applied in tax cases, "is applicable only when an issue identical to that presented in the second case has been raised and fully adjudicated under identical and inseparable relevant facts in a prior action between the same parties involving a different tax year." *Adolph*

Coors Co. v. Commissioner, 519 F.2d 1280, 1283 (10th Cir. 1975). In income tax cases involving different tax years, the doctrine of collateral estoppel "must be confined to situations where . . . the applicable legal rules remain unchanged." *Sunnen*, 333 U.S. at 599-600. Collateral estoppel "is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers." *Id.* at 599. Thus, the doctrine of collateral estoppel is inapplicable when "a subsequent . . . change or development in the controlling legal principles . . . make[s] that [first] determination obsolete or erroneous, at least for future purposes." *Id. See Montana v. United States*, 440 U.S. 147, 161 (1979); *Jones v. Trapp*, 186 F.2d 951, 953 (10th Cir. 1950).

The new legal developments that make the use of collateral estoppel "unwarranted" include an "alternation [sic] in the pertinent statutory provisions or Treasury regulations. . . ." *Sunnen*, 333 U.S. at 601. *Accord Bingaman v. Department of Treasury*, 127 F.3d 1431, 1438 (Fed. Cir. 1997) (noting that "this court and others have held that a significant change in the 'legal atmosphere'– whether in the form of new legislation, a new court decision, or even a new administrative

ruling – can justify a later court's refusal to give collateral estoppel effect to an earlier decision").

The application of these principles is illustrated in *Sunnen* and *Mandel v. Commissioner*, 229 F.2d 382 (7th Cir. 1956). *Sunnen* involved the income tax consequences of royalties a corporation paid to an inventor-patentee pursuant to a 1928 license agreement that the inventor assigned to his wife. In a previous proceeding, the Board of Tax Appeals had held that the inventor was not taxable on the royalties paid to his wife from 1929 through 1931 pursuant to the 1928 agreement. *Sunnen* presented the same question with respect to royalties paid in 1937. Although the facts of the two cases were identical, the Supreme Court agreed with the Commissioner that the doctrine of collateral estoppel was inapplicable because "legal principles developed in various intervening decisions of this [Supreme] Court have made plain the error of the Board's conclusion in the earlier proceeding. . . ." 333 U.S. at 620.

Similarly, in *Mandel*, the Seventh Circuit rejected claims of collateral estoppel although the facts and issue were identical to those in a prior proceeding. Both proceedings involving the deductibility of life insurance premiums that a divorced husband was required to pay

pursuant to the terms of a separation agreement. In the first proceeding, the Tax Court upheld the deductibility of premiums paid in 1942 and 1943. *Mandel* presented the same question with respect to premiums paid in 1948 and 1949. The Seventh Circuit, however, rejected the ex-husband's reliance on the doctrine of collateral estoppel because the applicable legal principles had changed. The court explained (229 F.2d at 390):

> While the controlling facts here are the same as those before the Tax Court, upon which it predicated its previous decision, we do not think it can be said that there has been no change in the legal principle applicable to such facts. Its previous decision was predicated on the principle that petitioner was entitled to deduct because Edna was required to include. That principle, however, was rejected by this court in Seligmann. . . .

In the present case, there has been a change in the applicable "legal atmosphere" (333 U.S. at 600) by virtue of the Treasury Department's promulgation of new regulations clarifying what some earlier cases had held to be an ambiguity in the statute. Accordingly, the doctrine of collateral estoppel is inapplicable. *See Petro-Hunt, L.L.C. v. United States*, 365 F.3d 385, 399 (5th Cir. 2004) ("changes in the controlling legal principles prevent the United States from being

precluded from litigating the issue in this case"; footnote omitted); *Federal Labor Relations Authority v. U.S. Dept. of Treasury, Financial Management Service*, 884 F.2d 1446, 1456 (D.C. Cir. 1989) (same).

The Federal Circuit's denial without opinion of the Government's petition for panel rehearing in *Salman Ranch* does not alter this conclusion, notwithstanding the Government's reliance on the temporary regulations in its petition. Denial of a petition for rehearing without opinion or comment is not a precedential determination as to the matters raised therein. *Levy v. Sterling Holding Co., LLC*, 544 F.3d 493, 499 n.5 (3d Cir. 2008), *cert. denied*, 129 S. Ct. 2827 (2009) ("[t]he failure of a petition to achieve the necessary votes for rehearing does not . . . imply any judgment on the merits and has no jurisprudential significance") (internal quotation marks omitted); *Luckey v. Miller*, 929 F.2d 618, 622 (11th Cir. 1991) (denial of rehearing en banc is not precedential); *Landreth v. Commissioner*, 859 F.2d 643, 648 (9th Cir. 1988) (a panel may disagree with a prior panel based on intervening changes in the law, and "an authority is 'intervening' if it post-dates the filing of the original opinion and is not discussed by the court in its order denying the petition for rehearing").

CONCLUSION

For the foregoing reasons, the Tax Court's order and decision is incorrect and should be reversed and remanded to the Tax Court for consideration of the remaining issues – the applicability of the gross receipts provision, I.R.C. § 6501(e)(1)(A)(i), and the safe harbor for adequate disclosure provisions, I.R.C. § 6501(e)(1)(A)(ii).

STATEMENT REGARDING ORAL ARGUMENT

Oral argument should be heard in this case because the question of the effect of the temporary regulations on the question whether an understatement of income resulting from an overstatement of the tax basis of sold property can qualify as an omission from gross income under I.R.C. §§ 6229(c)(2) and 6501(e)(1)(A) is one of first impression in the appellate courts.

Respectfully submitted,

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FEBRUARY 2010

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It is hereby certified that, on this 16th day of February, 2010, this brief was filed with the Clerk of the United States Court of Appeals for the Tenth Circuit by using the CM/ECF system and seven paper copies were sent to the Clerk by FedEx for next business day delivery. Counsel for the appellees were served electronically by the Notice of Docket Activity transmitted by the CM/ECF system.

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/s/ Joan I. Oppenheimer
JOAN I. OPPENHEIMER
Attorney

STATUTORY ADDENDUM

Internal Revenue Code of 1986 (26 U.S.C.):

Sec. 6501. **Limitations on Assessment and Collection**.

(a) **General Rule**.–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 (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period. 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).

. . . . .

(e) **Substantial Omission of Items.–Except as otherwise provided in subsection (c)--**

(1) **Income Taxes.**–In the case of any tax imposed by subtitle A–

(A) General Rule.–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.

. . . . .

P/A J.R. J. Halpern

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UNITED STATES TAX COURT

WASHINGTON, DC 20217

Appl Pen: 11/5/09
File To Appls: 11/16/09

SALMAN RANCH, LTD., FRANCES S. KOENIG, TAX MATTERS PARTNER,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 13677-08.

ORDER AND DECISION

This case is before the Court on petitioner's motion for summary judgment (the motion). Respondent objects. The issue for decision is whether the Notices of Final Partnership Administrative Adjustment (FPAA) challenged in the petition were untimely because they were sent more than 3 years after the due date of the returns for the years in issue or were timely because they were sent within the 6-year extended period of limitations provided by Internal Revenue Code section 6501(e)(1)(A). The issue is presented in terms of whether this Court, in Bakersfield Energy Partners v. Commissioner, 128 T.C. 207 (2007), affd. 568 F.3d 767 (9th Cir. 2009), correctly followed the United States Supreme Court opinion in Colony, Inc. v. Commissioner, 357 U.S. 28 (1958).[1]

There is no dispute that the issue is one of law that may properly be disposed of by summary judgment pursuant to Rule 121, Tax Court Rules of Practice and Procedure.

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[1] In his answer, respondent also claimed the period of limitations remained open because of secs. 6229(b)(1)(A), and 6501(c)(10). Petitioner addressed those claims in his memorandum in support of the motion. Respondent has failed to address those claims, so we assume he has abandoned them. See Mendes v. Commissioner, 121 T.C. 308, 312-313 (2003) ("If an argument is not pursued on brief, we may conclude that it has been abandoned.").

SERVED AUG - 7 2009

Respondent does not argue that this case is distinguishable from Bakersfield, supra, but argues that Bakersfield was wrongly decided.

Bakersfield has now been affirmed by the Court of Appeals for the Ninth Circuit, and we decline to reconsider our conclusion in that case. Moreover, the same result has been reached in factual circumstances involving this taxpayer and facts similar, if not identical, to those in this case. Salman Ranch, Ltd. v. United States, ___ F.3d ___ (Fed. Cir. 2009).

Much has now been written on the issue, and we see no reason to repeat or elaborate by a formal opinion in this case. On the premises stated, it is hereby

ORDERED that the motion is granted. It is further

ORDERED AND DECIDED that the adjustments set forth in the notices that are the basis of this case are barred by the 3-year period of limitations in Internal Revenue Code section 6501(a).

(Signed) James S. Halpern
Judge

ENTERED: AUG - 7 2009