No. 09-9015

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

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

Petitioners-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent-Appellant

On Appeal from the United States Tax Court, Docket No. 13677-08
Honorable James S. Halpern, Presiding

APPELLEES' ANSWER BRIEF

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ORAL ARGUMENT IS REQUESTED

CORPORATE DISCLOSURE STATEMENT

In accordance with Fed. R. App. P. 26.1, Appellees Salman Ranch, Ltd. and Frances S. Koenig state that Salman Ranch, Ltd. is a partnership, and that there is no parent corporation of Salman Ranch, Ltd. and no publicly held corporation that owns ten percent or more of the stock of Salman Ranch, Ltd.

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STATEMENT OF RELATED CASES

No other appeal in or from the same civil action or proceeding in the United States Tax Court was previously before this Court or any other appellate court. The issue in this case was previously decided in *Salman Ranch Ltd v. United States*, 573 F.3d 1362 (Fed. Cir. 2009).

JURISDICTIONAL STATEMENT

Appellees are satisfied with the jurisdictional statement provided in the Brief for the Appellant.

STATEMENT OF THE ISSUE

Is the Commissioner of Internal Revenue permitted to rely on the extended six-year period for assessing federal income tax under 26 U.S.C. § 6501(e)(1)(A), where the taxpayer allegedly overstated its basis in sold property and where the taxpayer previously obtained a judicial determination that the alleged overstatement of basis was not an omission from gross income giving rise to the extended period for assessing federal income tax under 26 U.S.C. § 6501(e)(1)(A)?

STATEMENT OF THE CASE

Under federal income tax law, the tax treatment of partnership items is determined at the partnership level. 26 U.S.C. § 6221. If, as a result of an audit, the Internal Revenue Service (the "IRS") determines that an adjustment should be

made in an income tax return filed by a partnership, it issues a notice of final partnership administrative adjustment. 26 U.S.C. § 6223(a)(2). Assessments of income tax against partners in the partnership, based on the adjustments proposed in the notice of final partnership administrative adjustment, are issued after the conclusion of administrative and judicial proceedings to review the notice of final partnership administrative adjustment. 26 U.S.C. § 6225(a).

The IRS reviewed the income tax returns of Appellee Salman Ranch, Ltd. ("Salman Ranch") for tax years 2001 and 2002. As a result of that review, the IRS issued separate notices of final partnership administrative adjustment (collectively, the "FPAAs," and individually, an "FPAA") for tax years 2001 and 2002, proposing to adjust certain partnership items reported in Salman Ranch's income tax returns for those tax years. *Exhibits A and B to Petition* dated 6/5/2008, Document 1.[1] The principal adjustment proposed in the FPAAs was a reduction in Salman Ranch's basis in certain land, improvements, and equipment comprising a ranch (the "Ranch"), a portion of which Salman Ranch sold during tax years 2001 and 2002. Salman Ranch correctly reported on its income tax returns the gross sales price from the sale of the Ranch, but, according to the IRS, overstated its basis in the Ranch. *Exhibits A and B to Petition* dated 6/5/2008, Document 1.

[1] As specified in 10th Cir. R. 28.1(B), references to the record will be through identification of the Tax Court document by title and date, followed by the Tax Court document number, and, where applicable, the page or paragraph number within that document.

As permitted by 26 U.S.C. § 6226(a)(1), Salman Ranch and its tax matters partner timely filed a petition with the United States Tax Court, seeking a readjustment of the partnership items adjusted in the FPAAs. *Petition* dated 6/5/2008, Document 1. Salman Ranch and its tax matters partner asserted that Salman Ranch did not overstate its basis in the Ranch, and that the FPAAs were invalid because any assessments of income tax resulting from the adjustments proposed in the FPAAs were barred by limitations. *Petition* dated 6/5/2008, Document 1, ¶¶ 12(p) and (q), 13.

Salman Ranch and its tax matters partner moved for summary judgment, based on the undisputed fact that the FPAAs were issued more than three years after the filing of the income tax returns of Salman Ranch and all of the direct and indirect partners of Salman Ranch (the "Taxpayers") for tax years 2001 and 2002. *Petitioners' Motion for Summary Judgment* dated 1/20/2009, Document 8; *Memorandum in Support of Petitioners' Motion for Summary Judgment* dated 1/20/2009, Document 9. *See* 26 U.S.C. § 6501(a) (providing that income tax for a tax year must generally be assessed within three years after the filing of the taxpayer's income tax return for the tax year); 26 U.S.C. § 6229(a) (providing that the period for assessing income tax attributable to partnership items generally does not expire before the date that is three years after the filing of the partnership's income tax return for the tax year).

The Commissioner of Internal Revenue (the "Commissioner") opposed the motion for summary judgment, arguing that the three-year period for assessing income tax was extended to six years. *Opposition to Petitioner's Motion for Summary Judgment* dated 2/23/2009, Document 12; *Memorandum of Points and Authorities in Support of Respondent's Opposition to Petitioner's Motion for Summary Judgment* dated 2/23/2009, Document 13. *See* 26 U.S.C. §§ 6501(e)(1)(A) and 6229(c)(2) (providing that the three-year period for assessing income tax is extended to six years if a partnership or a 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).[2]

On August 7, 2009, the United States Tax Court issued its Order and Decision granting the motion for summary judgment and finding that "the adjustments set forth in the [FPAAs] that are the basis of this case are barred by the 3-year period of limitations in Internal Revenue Code section 6501(a)." *Order and Decision* dated 8/7/2009, Document 19, p. 2. The Tax Court followed its prior decision in *Bakersfield Energy Partners, LP v. Commissioner*, 128 T.C. 207 (2007), *aff'd*, 568 F.3d 767 (9th Cir. 2009), and also noted that the Federal Circuit

[2] These provisions were recently amended by Section 513 of the Hiring Incentives to Restore Employment Act, Public Law 111-147. The recent amendments are not applicable to this case and did not change the relevant portions of the statutory provisions. All references to 26 U.S.C. §§ 6501(e)(1)(A) and 6229(c)(2) are to those statutory provisions as in effect prior to the Hiring Incentives to Restore Employment Act.

Court of Appeals reached the same result in *Salman Ranch*. *Order and Decision* dated 8/7/2009, Document 19, p. 2. The Commissioner then brought this appeal. *Notice of Appeal* dated 10/27/2009, Document 20.

STATEMENT OF THE FACTS

<u>The Ranch.</u> The Ranch is located in Mora County, New Mexico. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 4. From 1974 to 1986, the Ranch was owned and operated by William Salman Ranch, Inc., which was owned by members of the Salman family. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶¶ 3, 4. In 1986, William Salman Ranch, Inc. was dissolved and ownership of the Ranch was transferred to members of the Salman family. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶¶ 4, 5, 6.

In 1987, the members of the Salman family who owned the Ranch formed Salman Ranch as a New Mexico limited partnership and transferred their respective ownership interests in the Ranch to Salman Ranch. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 8. Since 1987, Salman Ranch has owned and operated the Ranch. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 10.

In December of 1999, Salman Ranch sold a portion of the Ranch to Hughes and Betsey Abell (the "Abells"). *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 11. At the same time, Salman Ranch also sold the Abells an

option on most of the remainder of the Ranch. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 12.

In 2000, the Abells gave Salman Ranch notice that they intended to exercise the option to purchase most of the remainder of the Ranch. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 13. The sale of this second portion of the Ranch closed on January 16, 2001, with payments received on such sale in 2001 and 2002. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶¶ 14, 15.

Salman Ranch reported on its 2001 income tax return the gross sales price that it received in 2001 from the sale of the second portion of the Ranch, its gross profits percentage, and its installment sale income. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 16. Salman Ranch's 2001 income tax was filed on or before April 15, 2002. *Answer to Petition* dated 10/28/2009, Document 5, ¶ 21(b).

In 2002, Salman Ranch received the final payment for the sale of the second portion of the Ranch. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 19. Salman Ranch reported on its 2002 income tax return the gross sales price that it received in 2002 from the sale of the second portion of the Ranch, its gross profits percentage, and its installment sale income. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 20. Salman Ranch's 2002 income tax return was filed on or before April 15, 2003. *Answer to Petition* dated 10/28/2009, Document 5, ¶ 22(b).

All of the income tax returns of Salman Ranch and the Taxpayers for the 2001 and 2002 tax years were filed in 2002 and 2003, respectively. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶¶ 24, 25. None of Salman Ranch, its partners, or the Taxpayers agreed to extend the periods for assessment of income tax for tax years 2001 or 2002. *Koenig Affidavit* dated 12/31/2008, Document 10, ¶ 32.

The FPAAs. On March 28, 2008, the IRS issued the FPAAs. *Exhibits A and B to Petition* dated 6/5/2008, Document 1. The FPAA for tax year 2001 was issued over five years after Salman Ranch and the Taxpayers filed their income tax returns for that tax year. *See Koenig Affidavit* dated 12/31/2008, Document 10, ¶¶ 18, 24, 36, 37; *Exhibit A to Petition* dated 6/5/2008, Document 1. The FPAA for tax year 2002 was issued over four years after Salman Ranch and the Taxpayers filed their income tax returns for that tax year. *See Koenig Affidavit* dated 12/31/2008, Document 10, ¶¶ 21, 25, 36, 37; *Exhibit B to Petition* dated 6/5/2008, Document 1.

In the FPAAs, the IRS did not challenge that a sale of the Ranch occurred or the amount of the gross sales price from the sale of the Ranch reported by Salman Ranch on its income tax returns for tax years 2001 and 2002. *See Exhibits A and B to Petition* dated 6/5/2008, Document 1. Rather, the IRS claimed that the basis of the Ranch reported by Salman Ranch was too high. *Exhibit A to Petition* dated

6/5/2008, Document 1 (Exhibit A, ¶ 6); *Exhibit B to Petition* dated 6/5/2008, Document 1 (Exhibit A, ¶ 6). The IRS, in the FPAAs, proposed to decrease the reported basis of the Ranch. *Exhibit A to Petition* dated 6/5/2008, Document 1 (Exhibit A, ¶ 6); *Exhibit B to Petition* dated 6/5/2008, Document 1 (Exhibit A, ¶ 6). This adjustment, if allowed, would result in an increase in the income tax liability for each Taxpayer for tax years 2001 and 2002.

As described in the Statement of the Case, above, Salman Ranch and its tax matters partner responded to the FPAAs by challenging the IRS' proposed decrease in the reported basis of the Ranch in Tax Court. *Petition* dated 6/5/2008, Document 1. The Tax Court issued summary judgment in favor of Salman Ranch and its tax matters partner. *Order and Decision* dated 8/7/2009, Document 19.

Prior Litigation. On April 10, 2006, the IRS issued to Salman Ranch (the same partnership that is the Appellee here) a notice of final partnership administrative adjustment for the 1999 tax year (the "1999 FPAA"). *Salman Ranch*, 573 F.3d at 1365. As was the case with the FPAAs issued with respect to tax years 2001 and 2002, the 1999 FPAA was issued more than three years, but less than six years, after Salman Ranch and the Taxpayers filed their income tax returns for tax year 1999. *Id.* at 1366.

As in the FPAAs issued with respect to tax years 2001 and 2002, the 1999 FPAA did not challenge the amount of the gross sales price from the sale of the

Ranch reported by Salman Ranch on its income tax return for tax year 1999. *Id.* at 1365. Rather, the IRS claimed that the basis of the Ranch reported by Salman Ranch was too high. *Id.* In the 1999 FPAA the IRS proposed to decrease the reported basis of the Ranch. *Id.* This adjustment, if allowed, would have resulted in an increase in the income tax liability for each Taxpayer for tax year 1999. *Id.* These assertions made by the IRS in the 1999 FPAA were essentially identical to the assertions made by the IRS in the FPAAs issued with respect to tax years 2001 and 2002. *Compare Salman Ranch*, 573 F.3d at 1365, *with Exhibit A to Petition* dated 6/5/2008, Document 1 (Exhibit A, ¶ 1) *and Exhibit B to Petition* dated 6/5/2008, Document 1 (Exhibit A, ¶ 1).

On July 30, 2009, the Federal Circuit Court of Appeals determined that the 1999 FPAA "was untimely and therefore invalid" because "the alleged overstatement of the basis of [the Ranch] by [Salman Ranch] did not constitute an omission from gross income under [26 U.S.C.] § 6501(e)(1)(A)." *Salman Ranch*, 573 F.3d at 1377. Therefore, the Federal Circuit concluded, "the IRS is not entitled to the benefit of the six-year statute of limitations set forth in § 6501(e)(1)(A)." *Id.*

SUMMARY OF ARGUMENT

It is undisputed that the three-year periods for assessing income tax for tax years 2001 and 2002 against the Taxpayers expired before the IRS issued the

FPAAs. Therefore, the FPAAs are invalid unless the three-year periods were extended.

The Commissioner contends that the three-year periods for assessing income tax against the Taxpayers for tax years 2001 and 2002 were extended to six years under 26 U.S.C. § 6501(e)(1)(A), which extends the period for assessing income tax if a 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 Commissioner argues that Salman Ranch omitted from gross income an amount properly includible therein because, according to the Commissioner, Salman Ranch overstated its basis in the Ranch. That is the same argument that the government made – and lost – in the Federal Circuit in *Salman Ranch*, where the Court held that the United States Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), was controlling. Because the parties, the facts and transaction, and the issue were the same in that case as in this case, the doctrine of collateral estoppel bars the Commissioner from relitigating in this case the legal issue of whether an alleged overstatement of basis constitutes an omission from gross income.

The Commissioner seeks to avoid the collateral estoppel effect of *Salman Ranch* and the precedential effect of *Colony* by pointing to certain Temporary Treasury Regulations that the IRS issued in September of 2009. The

Commissioner’s attempt to rely on the Temporary Regulations, and his position that the Temporary Regulations overcome the effect of collateral estoppel and overrule the Supreme Court’s *Colony* decision and the Federal Circuit’s *Salman Ranch* decision, are based on inconsistent and legally incorrect arguments.

Specifically, the Temporary Regulations do not constitute a significant change in controlling legal principles that is necessary to overcome equitable estoppel. The Temporary Regulations were not promulgated in accordance with the Administrative Procedure Act and they are therefore invalid. The Temporary Regulations by their terms do not apply to the tax years of the Taxpayers at issue in this case. The Commissioner’s attempt to apply the Temporary Regulations retroactively to reopen closed tax years, by arguing that the Temporary Regulations merely clarify, rather than change, the law, is directly to the Commissioner’s other arguments and must fail. The Commissioner’s attempt to apply the Temporary Regulations to tax years before their publication is an abuse of discretion. The Temporary Regulations are not entitled to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), because the Supreme Court in *Colony* determined the clear congressional intent of the statute, and that determination is controlling. The IRS cannot, by publishing its unsuccessful litigating position in the form of Temporary

regulations, overturn the Supreme Court's judicial determination of the congressional intent of the statute.

STANDARD OF REVIEW

Because the issue presented by the Commissioner's appeal is a question of law, the Appellees agree that the appropriate standard of review is *de novo*. *Hatch v. Commissioner*, 2010 WL 376629, at *3, 105 A.F.T.R.2d (RIA) 2010-860 (10th Cir. 2010).

ARGUMENT

An assessment of income tax for a tax year generally must be made within three years after the date on which the taxpayer files an income tax return for the tax year. 26 U.S.C. § 6501(a). In the case of income tax attributable to items passed through from a partnership to its partners, an assessment of income tax for a tax year generally may be made within three years after the date on which the partnership's income tax return for the tax year is filed, if that date is later than the date determined under 26 U.S.C. § 6501(a). *See* 26 U.S.C. § 6229(a).

It is undisputed that the IRS issued the FPAAs involved here more than three years after the date on which the Taxpayers filed their income tax returns for tax years 2001 and 2002 and more than three years after Salman Ranch filed its partnership income tax returns for those tax years. Therefore, as the Commissioner concedes (Brief for the Appellant, p. 12), unless the period for assessing income

tax against the Taxpayers was extended by some other statutory provision, the FPAAs were issued after the expiration of the time for assessing income tax against the Taxpayers for tax years 2001 and 2002 and, therefore, were not issued timely.

The Commissioner contends that the three-year period for assessing income tax against the Taxpayers for tax years 2001 and 2002 was extended to six years by 26 U.S.C. § 6501(e)(1)(A). Brief for the Appellant, pp. 13-14, 16. That section provides, in part:

> 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.

Substantially similar language is found in 26 U.S.C. § 6229(c)(2), relating to the period for assessing income tax attributable to items passed through from a partnership to its partners.

The Commissioner contends that, for tax years 2001 and 2002, Salman Ranch omitted from gross income an amount properly includible therein that exceeded the twenty-five percent threshold, in connection with Salman Ranch's sale of the Ranch. Brief for the Appellant, p. 16. It is undisputed that the sale of the Ranch was reported on Salman Ranch's income tax returns for tax years 2001

and 2002, and that the gross sales price from the sale of the Ranch was reported on those returns. Salman Ranch also reported on its income tax returns for tax years 2001 and 2002 its basis in the Ranch. Thus, the sale of the Ranch was reported on, not omitted from, Salman Ranch's income tax returns; the gross sales price was reported on, not omitted from, Salman Ranch's income tax returns; the basis of the Ranch as determined by Salman Ranch was reported on, not omitted from, Salman Ranch's income tax returns; and the gain from the sale of the Ranch was reported on, not omitted from, Salman Ranch's income tax returns.

Despite Salman Ranch's reporting of the sale of the Ranch, the gross sales price from the sale of the Ranch, its basis in the Ranch, and the gain from the sale of the Ranch, the Commissioner contends that Salman Ranch omitted from gross income an amount properly includible therein. Brief for the Appellant, p. 16. The Commissioner bases this contention on an assertion that Salman Ranch overstated its basis in the Ranch by including in its basis certain adjustments that the Commissioner contends were unallowable.[3] Brief for the Appellant, p. 10.

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[3] The Commissioner spends a substantial portion of the Brief for the Appellant describing the details regarding the transactions giving rise to the basis adjustments that the Commissioner contends were unallowable. Brief for the Appellant, pp. 4-9, 22-25. That entire discussion is irrelevant to the issue before this Court. The Commissioner acknowledges that the same parties, the same facts, and the same transaction involved here were also involved in the *Salman Ranch* case that the Federal Circuit decided in July of 2009. Brief for the Appellant, pp. 3, 44. The Commissioner recognizes that the Federal Circuit's decision in that case would have a collateral estoppel effect in this case, but for the publication of Temporary

The Commissioner contends that the phrase "omits from gross income an amount properly includible therein" in 26 U.S.C. § 6501(e)(1)(A) embraces not merely the omission of an item of income received by or accruing to a taxpayer, but also an understatement of gross income resulting from a taxpayer's miscalculation of profits through the erroneous inclusion of an excessive item of cost. That contention was rejected over fifty years ago by the United States Supreme Court in *Colony*, 357 U.S. at 31, 36-38. The Federal Circuit recently applied *Colony* as controlling precedent in rejecting the argument advanced by the Commissioner here, in a case involving the same parties, the same facts, and the same transaction that are involved here. *Salman Ranch*, 573 F.3d at 1372-1377 (holding that *Colony* controlled the disposition of the case and that, under *Colony*, "the alleged overstatement of the basis of [the Ranch] by [Salman Ranch] did not constitute an omission from gross income under § 6501(e)(1)(A)"). *Accord Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 2009).

Treasury Regulations §§ 301.6229(c)(2)-1T and 301.6501(e)-1T (the "Temporary Regulations"), described below. Brief for the Appellant, pp. 26 n.17, 44-45, 47. The Temporary Regulations make no distinctions that are based on the nature of the transactions giving rise to allegedly overstated basis, nor does the controlling statute, 26 U.S.C. § 6501(e)(1)(A), make any such distinctions. The statute and the Temporary Regulations apply without regard to the nature of the transactions giving rise to allegedly overstated basis. The specific facts and transaction leading to the allegedly overstated basis did not affect the legal determination in *Salman Ranch* and do not affect the legal determination here.

In *Salman Ranch*, the Federal Circuit noted that, in *Colony*, the Supreme Court examined the legislative history of the predecessor to 26 U.S.C. § 6501(e)(1)(A) and found in that legislative history "persuasive indications" that Congress intended the extended limitations period on assessments to apply only when particular income receipts and accruals were not reported, and did not intend the extended limitations period to apply whenever gross income was understated. *Salman Ranch*, 573 F.3d at 1367, 1374. *See Colony*, 357 U.S. at 35. The Federal Circuit noted that *Colony* applied the very same language that is now found in 26 U.S.C. § 6501(e)(1)(A), and that, in the more than fifty years since *Colony* was decided, "if Congress had so desired, it would have expressed its intention to change the meaning of the relevant language." *Salman Ranch*, 573 F.3d at 1374. The Federal Circuit found no basis for distinguishing the facts at issue in *Salman Ranch* (which are the same as the facts at issue here) from *Colony*, and rejected the argument that the holding of *Colony* was restricted to sales of goods or services by a trade or business. *Salman Ranch*, 573 F.3d at 1372-73. The Federal Circuit also rejected the argument that the recodification of the predecessor statute as 26 U.S.C. § 6501(e)(1)(A) in connection with the enactment of the Internal Revenue Code of 1954 somehow changed the meaning of the controlling language. *Salman Ranch*, 573 F.3d at 1373-74. The Federal Circuit gave the term "omits" in 26 U.S.C. § 6501(e)(1)(A) the same meaning ("to affirmatively 'leave

out'") that the Supreme Court gave that term, based on the Supreme Court's determination of congressional intent in enacting the predecessor statute. *Salman Ranch*, 573 F.3d at 1374; s*ee Colony*, 357 U.S. at 36; *see also Bakersfield Energy Partners*, 568 F.3d at 774-78.

Since *Salman Ranch* involved the same parties, the same facts and transaction, and the same issue as this case, the Commissioner's attempt to re-litigate in this case the issue resolved in *Salman Ranch* is barred by collateral estoppel. "A fundamental precept of common-law adjudication, embodied in the related doctrines of collateral estoppel and res judicata, is that 'a right, question or fact distinctly put in issue and directly determined by a court of competent jurisdiction . . . cannot be disputed in a subsequent suit between the same parties or their privies . . . .'" *Montana v. United States*, 440 U.S. 147, 153 (1979) (*quoting S. Pac. R.R. Co. v. United States*, 168 U.S. 1, 48-49 (1897)). "Under collateral estoppel, once an issue is actually and necessarily determined by a court of competent jurisdiction, that determination is conclusive in subsequent suits based on a different cause of action involving a party to the prior litigation." *Montana v. United States*, 440 U.S. at 153. The doctrine of collateral estoppel is central to the conclusive resolution of disputes within the jurisdiction of civil courts. *Id.* The doctrine protects parties "from the expense and vexation attending multiple lawsuits." *Id.* The doctrine also "conserves judicial resources, and fosters reliance

on judicial action by minimizing the possibility of inconsistent decisions." *Id.* (footnote omitted).

Collateral estoppel applies in federal income tax cases.[4] *Commissioner v. Sunnen*, 333 U.S. 591, 598-99 (1948); *Weiszmann v. Commissioner*, 483 F.2d 817, 819 (10th Cir. 1973); *Jones v. United States*, 466 F.2d 131, 133 (10th Cir. 1972). In such cases, collateral estoppel operates "to relieve the government and the taxpayer of 'redundant litigation of the identical question of the statute's application to the taxpayer's status.'" *Commissioner v. Sunnen,* 333 U.S. at 599 (*quoting Tait v. W. Md. Ry. Co.*, 289 U.S. 620, 624 (1933)). Collateral estoppel extends to issues of law as well as findings of fact. *Arizona v. California*, 530 U.S. 392, 414-15 (2000).

The elements of collateral estoppel exist here. *See Montana v. United States*, 440 U.S. at 155. As the Commissioner acknowledges, this case involves the same transaction and facts that were at issue in *Salman Ranch*. Brief for the Appellant, p. 44. The parties to this case are the same as the parties in *Salman Ranch*. The issue presented by the Commissioner in this case is precisely the same issue that was resolved against the government in *Salman Ranch*. Neither the relevant facts nor the controlling legal principles have changed in the several

[4] Because federal income taxes are levied on an annual basis, "[e]ach year is the origin of a new liability and of a separate cause of action." *Commissioner v. Sunnen*, 333 U.S. at 598. Therefore, collateral estoppel, rather than res judicata, is usually the claim preclusion doctrine applied in federal income tax cases.

months since the issuance of the Federal Circuit's decision in *Salman Ranch*. The Commissioner does not contend that other special circumstances warrant an exception to the normal rules of preclusion under the collateral estoppel doctrine.

Despite the existence of the elements of collateral estoppel, the Commissioner argues that collateral estoppel does not apply here because, according to the Commissioner, the "legal atmosphere" changed since the Federal Circuit issued its decision in *Salman Ranch* in July of 2009. Brief for the Appellant, pp. 47-48. The Commissioner does not identify any applicable intervening change in the controlling statute, and no such change has occurred. The Commissioner does not argue that the Supreme Court's decision in *Colony*, which the Federal Circuit determined to be controlling in *Salman Ranch*, has been overruled, and it has not been. The Commissioner does not identify any intervening judicial decision relevant to the issue decided by the Federal Circuit in *Salman Ranch*, and no such intervening judicial decision has been issued.

The Commissioner's argument is based solely on the contention that the September 2009 publication of his unsuccessful litigating position, in the form of the Temporary Regulations, warrants an exception to the normal application of the collateral estoppel doctrine. Brief for the Appellant, pp. 47-48. In fact, the publication of the Commissioner's unsuccessful litigating position in the form of the Temporary Regulations did not significantly change the controlling legal

principles upon which the Federal Circuit based its decision in *Salman Ranch*, and therefore the Commissioner cannot avoid the effect of collateral estoppel in this case.[5] *Montana v. United States*, 440 U.S. at 155, 161. In addition, the Temporary Regulations were not validly promulgated, do not and cannot apply to this case, are not entitled to deference, and cannot in any event overrule the Supreme Court's controlling precedent in *Colony*.

I. THE TEMPORARY REGULATIONS DO NOT CONSTITUTE A SIGNIFICANT CHANGE IN CONTROLLING LEGAL PRINCIPLES.

The IRS' publication of its unsuccessful litigating position as Temporary Regulations does not constitute a significant change in controlling legal principles.[6] Congress' intent over seventy-five years ago, in enacting the

[5] In *Salman Ranch,* the government filed a petition for panel rehearing after the IRS published the Temporary Regulations, based solely on the argument that the Temporary Regulations constituted "intervening legal authority" that warranted a rehearing. *Appellee's Petition for Panel Rehearing* dated 10/13/2009, Federal Circuit Case No. 2008-5053. The Federal Circuit denied the petition for panel rehearing without opinion. *Order* dated 11/19/2009, Federal Circuit Case No. 2008-5053. The government did not file a petition for a writ of certiorari in *Salman Ranch*, and on remand the Court of Federal Claims entered judgment for Salman Ranch and its tax matters partner. *Judgment* dated 1/20/2010, Court of Federal Claims Case No. 06-503T.

[6] In arguing that the Temporary Regulations are not impermissibly retroactive, the Commissioner describes the Temporary Regulations as "clarifications, rather than changes, of existing law." Brief for the Appellant, pp. 42-43. *See also* the preamble to the Temporary Regulations, T.D. 9466, 74 Fed. Reg. 49321-22 (2009) (describing the Temporary Regulations as a "clarification"). The Commissioner seeks to have it both ways, by arguing that he is not bound by collateral estoppel in this case because the Temporary Regulations significantly change controlling legal principles, while at the same time arguing that the Temporary Regulations are not

controlling statutory language now found in 26 U.S.C. § 6501(e)(1)(A), which was conclusively determined by the Supreme Court in *Colony*, did not change when the IRS published the Temporary Regulations.[7] The only change that occurred when the IRS published the Temporary Regulations was that the Commissioner's unsuccessful litigating position now appears in the Federal Register instead of only in the briefs filed by the government in various courts.

The Commissioner cites no case holding that the publication of an unsuccessful litigating position as a temporary regulation constitutes a significant change in controlling legal principles that warrants an exception to the collateral estoppel doctrine. While *Commissioner v. Sunnen*, cited at page 45 of the Brief for the Appellant, suggests in dicta that a regulation "can" make the use of collateral estoppel unwarranted, 333 U.S. at 601, the Court relied on "various intervening decisions" of the Supreme Court as the significant change in legal principles that warranted an exception to the collateral estoppel doctrine in that case. 333 U.S. at 602-03, 606-07. In *Bingaman v. Department of the Treasury*, 127 F.3d 1431 (Fed. Cir. 1997), also cited at page 45 of the Brief for the Appellant, the court did not say

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impermissibly retroactive because they are mere clarifications and not changes in existing law. This inconsistency is fatal to the Commissioner's case.

[7] In publishing the Temporary Regulations, the IRS made no attempt to discern Congress' intent in enacting the statutory language. Nor could it have done so, since the intent of Congress was determined by the Supreme Court in *Colony*, and an administrative agency such as the IRS has no authority to overturn the Supreme Court's determination of congressional intent. *Chevron*, 467 U.S. at 843 n.9.

that the publication of a regulation constituted a significant change in governing legal principles warranting an exception to the application of the collateral estoppel doctrine. Rather, the court relied on intervening quasi-judicial decisions of the Merit Systems Protection Board as constituting the significant change in governing principles of law warranting an exception to the collateral estoppel doctrine. 127 F.3d at 1437. The other cases cited by the Commissioner either apply collateral estoppel (*Montana v. United States*, 440 U.S. at 164; *Jones v. Trapp*, 186 F.2d 951, 954 (10th Cir. 1950)), conclude that collateral estoppel did not apply because the issue was not litigated and actually adjudged in the prior proceeding (*Adolph Coors Co. v. Commissioner*, 519 F.2d 1280, 1283 (10th Cir. 1975)), or rely on intervening judicial decisions as the basis for determining that collateral estoppel did not apply (*Petro-Hunt, L.L.C. v. United States*, 365 F.3d 385, 399 (5th Cir. 2004); *Fed. Labor Relations Auth. v. U.S. Dep't of the Treasury*, 884 F.2d 1446, 1456 (D.C. Cir. 1989); *Mandel v. Commissioner*, 229 F.2d 382, 390 (7th Cir. 1956)). The cases cited by the Commissioner do not support the argument that an administrative agency can avoid the collateral estoppel effect of a controlling prior judicial decision simply by publishing a temporary regulation disagreeing with that decision.

In addition, the rationale for the exception from the collateral estoppel doctrine in the case of a significant change in controlling legal principles does not

apply here. The exception is based on potential "undue disparity in the impact of income tax liability" that could result if a judicial determination is "perpetuated each succeeding year as to the taxpayer involved in the original litigation, [such that] he is accorded a tax treatment different from that given to other taxpayers of the same class." *Commissioner v. Sunnen*, 333 U.S. at 599; *see Montana v. United States*, 440 U.S. at 161. The potential discrimination in the income tax treatment of different taxpayers that motivated the Court in *Commissioner v. Sunnen* does not exist here. This case does not involve a question of the taxability or deductibility of a particular type of receipt or payment that may recur for a number of years into the future, such that a prior judicial determination might indefinitely allow a taxpayer to treat such receipt or payment differently from the treatment accorded other taxpayers. What is at issue here is nothing more than a determination of whether the period for assessing income tax for two particular tax years was three years or six years. A conclusion that the period for assessing income tax for a particular tax year has expired does not create the potential for on-going discrimination in the income tax treatment accorded particular receipts or payments.

The IRS does not have the authority to adopt a law prescribing the period in which income tax must be assessed against taxpayers. That is the exclusive prerogative of the legislative branch and the President. The IRS may, as it did

here, litigate the meaning of the law adopted by Congress, but once the courts have determined what Congress intended, the IRS cannot circumvent that intent by publishing its unsuccessful litigating position as a temporary regulation. Here, Salman Ranch and the government litigated the issue of whether Salman Ranch's alleged overstatement of its basis in the Ranch was an omission from gross income under 26 U.S.C. § 6501(e)(1)(A). The outcome of that litigation was a ruling by the Federal Circuit that it was not, and that ruling collaterally estops the IRS from re-litigating that issue here. "Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel." *Commissioner v. Sunnen*, 333 U.S. at 598.

II. THE TEMPORARY REGULATIONS ARE INVALID BECAUSE THEY WERE ISSUED IN VIOLATION OF THE ADMINISTRATIVE PROCEDURE ACT.

The Administrative Procedure Act (the "APA") requires that agencies of the federal government, including the IRS and the Department of the Treasury, follow certain procedures when they engage in rule making. 5 U.S.C. §§ 551, 553. If the required procedures are not followed, the rule is invalid. *N. Am. Coal Corp. v. Dir. Office of Workers' Comp. Programs*, 854 F.2d 386, 388 (10th Cir. 1988) ("It is fundamental law that a rule promulgated by a federal agency is not valid unless adopted in substantial compliance with the requirements of the APA").

Rule making includes the agency process for formulating a rule. 5 U.S.C. § 551(5). A rule includes an agency statement of general applicability and future effect designed to implement, interpret, or prescribe law or policy. 5 U.S.C. § 551(4). Unless a rule is an interpretive rule or a general statement of policy, or the rule otherwise fits certain exceptions not relevant here, the promulgating agency must follow procedures generally known as "notice and comment," which include publication of the rule in the Federal Register and providing interested persons an opportunity to participate in the rule making. 5 U.S.C. § 553.

Because the Temporary Regulations were not issued after notice and comment, they are invalid, unless they are interpretive rules. In order to be an interpretive rule, a rule must not be substantive. *Rocky Mountain Helicopters, Inc. v. FAA*, 971 F.2d 544, 546-47 (10th Cir. 1992) ("A rule is interpretive if it is promulgated by an agency having authority to issue substantive rules and if it attempts to clarify an existing rule but does not change existing law, policy, or practice").

The Temporary Regulations do not clarify an existing rule. As described above, the existing rule is that an overstatement of basis does not constitute an omission from gross income. *Colony*, 357 U.S. at 33, 36; *Salman Ranch*, 573 F.3d at 1372-74, 1377; *Bakersfield Energy Partners*, 568 F.3d at 768, 778. The

Commissioner concedes that the Temporary Regulations are an attempt to change existing law when he argues that collateral estoppel does not apply in this case because the Temporary Regulations constitute a significant change in the controlling legal principles.[8] Brief for the Appellant, pp. 44-48. The preamble to the Temporary Regulations specifically notes that the regulations are contrary to existing judicial precedent. T.D. 9466, 74 Fed. Reg. at 49321-22 (2009).

In the Brief for the Appellant, the Commissioner carefully avoids characterizing the Temporary Regulations as either interpretive or substantive. The preamble to the Temporary Regulations also avoids any characterization of the Temporary Regulations as interpretive or substantive, although the preamble does refer to the Temporary Regulations as a "clarification." T.D. 9466, 74 Fed. Reg. 49321-22 (2009). In any event, the label used by a federal agency cannot transform a substantive legal change into a mere interpretation. *Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1024 (D.C. Cir. 2000); *Defenders of Wildlife v. EPA*, 415 F.3d 1121, 1127 (10th Cir. 2005). An attempt to overrule judicial precedent from the Supreme Court, the Federal Circuit, and the Ninth Circuit, as

[8] Again, the Commissioner seeks to have it both ways, by failing to follow the required procedures under the APA to promulgate the Temporary Regulations as substantive rules, while at the same time arguing that he is not bound by collateral estoppel because the Temporary Regulations significantly change controlling legal principles. *See* footnote 6, above. This recurring inconsistency is fatal to the Commissioner's case.

well as congressional intent, must be considered substantive, not merely interpretive.

The question of whether the Temporary Regulations are interpretive or substantive is conclusively answered by the Commissioner's argument that the Temporary Regulations are entitled to deference under *Chevron*. Brief for the Appellant, pp. 28-34. Interpretive rules are not entitled to *Chevron* deference.[9] *United States v. Mead Corp.*, 533 U.S. 218, 232 (2001) ("interpretive rules . . . enjoy no *Chevron* status as a class"). Since the Temporary Regulations are clearly intended to be substantive, not merely interpretive, the IRS' failure to follow the notice and comment requirements of the APA invalidates the Temporary Regulations.

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[9] If the Temporary Regulations are merely interpretive, they cannot constitute a significant change in controlling legal principles that allows the Commissioner to avoid equitable estoppel (*see* Part I, above), and they cannot overrule the prior judicial precedents of the Supreme Court, the Federal Circuit, and the Ninth Circuit (*see* Part IV, below). In addition, as interpretive rules, the Temporary Regulations would be tested under the standards set forth in *National Muffler Dealers Association v. United States*, 440 U.S. 472 (1979), or the standards set forth in *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944). Under either set of standards, the Temporary Regulations would not be given any deference, because they merely represent the IRS' unsuccessful litigating position, because they were recently issued over seventy-five years after the enactment of the underlying statute during which time no court has relied on them, because Congress has never devoted any time to them and the IRS has never issued published guidance similar to them previously, and because they are contrary to congressional intent. In any event, because the Temporary Regulations are contrary to congressional intent, the Court need not determine the degree of deference accorded the Temporary Regulations. *Gen. Dynamics Land Sys., Inc. v. Cline*, 540 U.S. 581, 600 (2004).

III. THE TEMPORARY REGULATIONS DO NOT AND CANNOT APPLY RETROACTIVELY TO THIS CASE.

A. The Temporary Regulations By Their Terms Do Not Apply To This Case.

The Temporary Regulations provide that they "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) and 301.6501(e)-1T(b). Neither the Temporary Regulations nor the preamble to them contain any statement indicating that the Temporary Regulations are intended to be applied retroactively. T.D. 9466, 74 Fed. Reg. 49321-23 (2009).

Under the law as in effect prior to the publication of the Temporary Regulations, the period for assessing income tax against the Taxpayers for tax years 2001 and 2002 expired long before September 24, 2009. *Colony*, 357 U.S. at 38; *Salman Ranch*, 573 F.3d at 1377 ("[W]e hold that the alleged overstatement of the basis of [the Ranch] by [Salman Ranch] did not constitute an omission from gross income under § 6501(e)(1)(A). Accordingly, the IRS is not entitled to the benefit of the six-year statute of limitations set forth in § 6501(e)(1)(A). The three-year limitations period of § 6501(e)(1)(A) controls, which means that the FPAA was untimely and therefore invalid."). The Commissioner is collaterally estopped from contending that the law prior to the publication of the Temporary Regulations was different from the law as determined by the Federal Circuit in *Salman Ranch*.

The Temporary Regulations do not and cannot change the law as it existed prior to the publication of the Temporary Regulations on September 24, 2009. *See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 983-84 (2005) ("*Brand X*") (an agency's subsequent interpretation of a statute does not reverse a judicial decision applying a different interpretation and does not say that the court's holding was legally wrong). Since the applicable period for assessing income tax with respect to the Taxpayers for tax years 2001 and 2002 expired before September 24, 2009, the Temporary Regulations by their own terms do not apply to this case.

The Commissioner seeks to avoid this clear application of the effective date provisions of the Temporary Regulations by adding to the effective date provisions language that does not exist in those provisions. Brief for the Appellant, p. 38 (adding the words "as interpreted in the temporary regulations" to the effective date provisions of the Temporary Regulations). This creates a circular analysis, in which the Commissioner applies the Temporary Regulations in order to determine whether the Temporary Regulations apply. The intended effect, of course, is to reopen tax years that were closed under the law in existence before the Temporary Regulations were published. As described below, such retroactive reopening of closed years is impermissible. More directly, the Temporary Regulations by their terms do not apply to tax years that were already closed as of September 24, 2009,

and the period for assessing income tax against the Taxpayers for tax years 2001 and 2002 expired before September 24, 2009.

B. The Temporary Regulations Cannot Reopen A Closed Tax Year.

The Temporary Regulations cannot apply retroactively to reopen a closed tax year. Not even Congress can enact a retroactive statute that revives a moribund cause of action. *Hughes Aircraft Co. v. United States*, 520 U.S. 939, 950 (1997). "[A] newly enacted statute that lengthens the applicable statute of limitations may not be applied retroactively to revive a plaintiff's claim that was otherwise barred under the old statutory scheme because to do so would alter the substantive rights of a party and increase a party's liability." *Id.* (quoting *Chenault v. U.S. Postal Serv.*, 37 F.3d 535, 539 (9th Cir. 1994)).

In defending the retroactivity of the Temporary Regulations, the Commissioner asserts that 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." Brief for the Appellant, p. 41. That assertion is simply not true. It is undisputed that the three-year periods for assessing income tax against the Taxpayers for tax years 2001 and 2002 expired before the FPAAs were issued in March of 2008. Brief for the Appellant, p. 12. Under *Colony*, and as *Colony* was applied to Salman Ranch in *Salman Ranch*, which the Commissioner acknowledges had a collateral estoppel effect before the Temporary Regulations

were published (Brief for the Appellant, pp. 26 n.17, 44-48), those three-year periods were not extended by 26 U.S.C. § 6501(e)(1)(A). Therefore, well before the publication of the Temporary Regulations in September of 2009, the period for assessing income tax against the Taxpayers for tax years 2001 and 2002 expired. But for the publication of the Temporary Regulations, no assessment of income tax against the Taxpayers for those tax years was allowed. Now, the Commissioner argues that because of the publication of the Temporary Regulations – and only because of the publication of the Temporary Regulations – the IRS is permitted to assess income tax against the Taxpayers for those previously closed tax years. It is difficult to conceive of a more obvious case of reopening tax years that were otherwise closed as of September 24, 2009.

The Commissioner also essentially acknowledges that the Temporary Regulations are retroactive, but argues that "the general prohibition on retroactive rule making" does not apply to the Temporary Regulations because they "merely clarify existing law." Brief for the Appellant, p. 39. This assertion is directly contrary to the Commissioner's argument that the Temporary Regulations constitute a significant change in controlling legal principles that allows the Commissioner to avoid the collateral estoppel effect of *Salman Ranch*. *See* Part I, above. This assertion is also directly contrary to the Commissioner's argument that the Temporary Regulations must be given deference under *Chevron* so that

they can overturn the prior judicial rulings in *Chevron* and *Salman Ranch*. *See* Part IV, below. Administrative action that seeks to change the result in prior litigation and that seeks to overrule Supreme Court and Federal Circuit precedents cannot be considered a mere "clarification." The attempted change in the law sought by the IRS in publishing the Temporary Regulations is substantive and is significant, and it cannot be applied retroactively.

The periods for assessing income tax against the Taxpayers for tax years 2001 and 2002 ended in 2005 and 2006, respectively. Congress could not have enacted a law in 2009 to revive claims against the Taxpayers for those tax years. The IRS, by publishing the Temporary Regulations, cannot do what Congress could not have done. The Temporary Regulations, as applied to Salman Ranch and the Taxpayers, are impermissibly retroactive.

C. Application Of The Temporary Regulations To Prior Tax Years Was An Abuse Of Discretion.

The IRS' decision to apply a regulation to tax years before the promulgation of the regulation is reviewed for abuse of discretion.[10] *See Auto. Club of Mich. v.*

[10] Notwithstanding the effective date provision of Section 1101(b) of Public Law 104-168, several courts have applied 26 U.S.C. § 7805(b), as enacted in 1996, to purportedly retroactive regulations, even after having determined that the regulations did not relate to a post-1996 statute. *Sala v. United States*, 552 F. Supp. 2d. 1167 (D. Colo. 2008); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008); *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516 (2009). If the current version of 26 U.S.C. § 7805(b) is applied here, the Temporary Regulations are clearly inapplicable to the tax years at issue.

Commissioner, 353 U.S. 180, 184 (1957); *Christian Echoes Nat'l Ministry v. United States*, 470 F.2d 849, 858 (10th Cir. 1973). The relevant considerations when reviewing the application of a regulation to prior tax years are: (1) whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the regulation alters that law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative re-enactment of the pertinent provisions of the Internal Revenue Code; (3) whether application of the regulation to prior tax years would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether applying the regulation to prior tax years would produce an inordinately harsh result. *Snap-Drape, Inc. v. Commissioner*, 98 F.3d 194, 202 (5th Cir. 1996), *cert. denied*, 552 U.S. 821 (1997).[11]

Consideration of the *Snap-Drape* factors leads to the conclusion that the Commissioner's attempt to apply the Temporary Regulations to the tax years at issue here is an abuse of discretion. The settled law for fifty years was the construction given to the statutory phrase "omits from gross income an amount properly includible therein" by the Supreme Court in *Colony*. The Taxpayers justifiably relied on that settled law. The Supreme Court's construction of the

[11] In *Klamath Strategic Investment Fund, LLC v. United States*, 440 F. Supp. 2d 608, 623-625 (E.D. Tex. 2006), the court applied the factors identified in *Snap-Drape* in rejecting another recent attempt by the IRS to apply a tax regulation in a similar factual context to tax years before the promulgation of the regulation.

statute was implicitly approved by Congress when it adopted 26 U.S.C. § 6229 in 1982 and on the many occasions when it amended 26 U.S.C. § 6501 over the last fifty years.

Application of the Temporary Regulations to prior tax years would not result in similarly situated taxpayers being treated equally. Any taxpayer that sold property in 2002 and timely filed an income tax return could only be affected by the Temporary Regulations if the taxpayer received a notice of final partnership administrative adjustment or a notice of deficiency before April of 2009 (the end of even the six-year period for timely filed tax returns for tax year 2002). Thus, taxpayers that did not receive such a notice five months before the publication of the Temporary Regulations are unaffected while taxpayers that did receive such a notice are required to seek judicial determinations (like that sought here by Salman Ranch) on the validity of the Temporary Regulations. The cost of seeking such determinations, or of paying the tax, interest, and penalties if the taxpayer chooses not to bear the cost of litigation, is an inordinately harsh result.

Based on the foregoing, consideration of the factors identified in *Snap-Drape* to the circumstances here establishes that the Commissioner abused his discretion in seeking to apply the Temporary Regulations to the tax years at issue in this case. Whatever the validity or effect of the Temporary Regulations with

respect to future tax years, they cannot apply to the Taxpayer's 2001 and 2002 tax years.

IV. THE TEMPORARY REGULATIONS ARE NOT ENTITLED TO *CHEVRON* DEFERENCE.

As explained in Parts I through III, above, the Temporary Regulations do not constitute a significant change in controlling legal principles that allows the Commissioner to avoid the collateral estoppel effect of *Salman Ranch*, were not validly issued under the APA, by their terms do not apply to the Taxpayers for the tax years at issue here, and cannot be applied retroactively to reopen closed tax years. In addition, the Commissioner's position in this case fails because that position depends on the Temporary Regulations being given deference under *Chevron*. Brief for the Appellant, p. 28 (relying exclusively on *Chevron* deference for the Temporary Regulations to support reversal of the Tax Court's judgment). Under the two-step analysis set out by the Supreme Court, the Temporary Regulations are not entitled to *Chevron* deference because: (A) Congress' intent is clear with respect to the issue addressed by the Temporary Regulations, leaving no room for IRS rule making; and (B) the Temporary Regulations are arbitrary, capricious, and manifestly contrary to the statute.

A. Congress' Intent Is Clear.

Under the first step of the *Chevron* analysis, the courts must determine whether the intent of Congress is clear with respect to the issue addressed by a

regulation. *Chevron*, 467 U.S. at 842-43 ("If the intent of Congress is clear, that is the end of the matter"); *United Keetoowah Band of Cherokee Indians v. U.S. Dep't of Housing and Urban Development*, 567 F.3d 1235, 1240 (10th Cir. 2009). In determining whether the intent of Congress is clear with respect to the issue addressed by a regulation, the courts employ "traditional tools of statutory construction." *Chevron,* 467 U.S. at 843 n.9. *See Gen. Dynamics Land Sys.*, 540 U.S. at 600 ("Even for an agency able to claim all the authority possible under *Chevron*, deference to its statutory interpretation is called for only when the devices of judicial construction have been tried and found to yield no clear sense of congressional intent"). If the courts determine that Congress had an intention on the issue addressed by the regulation, "that intention is the law and must be given effect." *Chevron*, 467 U.S. at 843 n.9.

Here, the Supreme Court, employing the traditional statutory construction tool of legislative history, determined that, when Congress used the phrase "omitted from gross income an amount properly includible therein," it 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." *Colony*, 357 U.S. at 33. The Court rejected the Commissioner's argument that an overstatement of basis constituted an omission from gross income, finding no "solid support" for

the Commissioner's theory in the legislative history. *Id.* at 36. Instead, the Court concluded that the legislative history showed, to the Court's satisfaction, that "Congress intended an exception to the usual three-year statute of limitations ***only*** in the restricted type of situation" described in the Court's opinion, which did not include an overstatement of basis. *Id.* (emphasis added). In fact, the Court stated that acceptance of the Commissioner's interpretation of the statutory language "omits from gross income an amount properly includible therein" would not only read that language "more broadly than is justified by the evident reason for its enactment, but also to create a patent incongruity in the tax law." *Id.* at 36-37.[12]

The statutory language at issue in *Colony* was carried over into the current Internal Revenue Code and is the precise language that the Temporary Regulations purport to construe, in a manner that is directly contrary to the Supreme Court's determination of Congress' intent in using that language. The Commissioner argues that the Temporary Regulations should be given *Chevron* deference (and therefore, according to the Commissioner, overrule the Supreme Court's decision in *Colony*) based on the Supreme Court's comment in *Colony* that the statutory language at issue there "cannot be said [to be] unambiguous." *Colony*, 357 U.S. at 33. The Commissioner bootstraps this comment into an assumption that the first

[12] By contrast, in *Chevron*, the Supreme Court, after extensive review, found the relevant legislative history to be "unilluminating." *Chevron*, 467 U.S. at 862 ("We find that the legislative history as a whole is silent on the precise issue before us").

step in the *Chevron* analysis is satisfied here. The Commissioner ignores the clear statement in *Chevron*, 467 U.S. at 843 n.9, that, when a court ascertains that Congress had an intention on an issue, that intention is the law and must be given effect, and the clear determination in *Colony*, 357 U.S. at 33, that Congress intended that the extended period for assessing taxes would apply only when a taxpayer left out an income receipt or accrual, and not more generally to errors in computation of gross income arising from other causes.[13] The Commissioner also ignores the Supreme Court's statement in *Colony*, 357 U.S. at 37, that its conclusion was "in harmony with the ***unambiguous*** language of § 6501(e)(1)(A)" (emphasis added), which is the specific provision that the Temporary Regulations purport to construe.

The Supreme Court in *Colony* did not choose from among alternative reasonable interpretations of the statutory language. 357 U.S. at 36-37 ("To accept the Commissioner's interpretation . . . would be to read [the statute] more broadly than is justified by the evident reason for its enactment, [and] to create a patent incongruity in the tax law"). Rather, the Supreme Court ascertained the intent of

[13] *See Cuomo v. Clearing House Ass'n, L.L.C.*, 129 S.Ct. 2710, 2715 (2009) (finding, after looking to "[e]vidence from the time of the statute's enactment, a long line of [Supreme Court] cases, and application of normal principles of construction," that a regulation was too broad even though the underlying statute was ambiguous, and noting that "the presence of some uncertainty does not expand *Chevron* deference to cover virtually any interpretation" of a statute).

Congress in enacting the statutory language and applied that intent. In doing so, the Court rejected the precise interpretation that the IRS has incorporated into the Temporary Regulations, because that interpretation was not consistent with the intent of Congress.[14] The IRS has no authority to redefine a statutory term when the Supreme Court has ascertained the intent of Congress with respect to the meaning of that term. *Chevron*, 467 U.S. at 843 n.9 ("The judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent"). *See Gen. Dynamics Land Sys.*, 540 U.S. at 600, where the Court gave no deference to the administrative agency's construction of a statute with "textual ambiguity," because congressional intent was clear. Since Congress' intent on the issue in this case is clear, under the first step of the *Chevron* analysis, "that is the end of the matter." *Chevron*, 467 U.S. at 842. The Temporary Regulations, being directly contrary to the intent of Congress as ascertained by the Supreme Court, are invalid.

[14] Contrary to the suggestion in the Brief for the Appellant, at pages 26 and 30, and in the preamble to the Temporary Regulations, T.D. 9466, 74 Fed. Reg. at 49322, neither the Ninth Circuit in *Bakersfield Energy Partners* nor the Federal Circuit in *Salman Ranch* found any ambiguity in the congressional intent underlying the relevant statute. Both Circuit Courts noted the Supreme Court's statement in *Colony* that the statute cannot be said to be unambiguous, but both Circuit Courts acknowledged that the Supreme Court in *Colony* eliminated that ambiguity by determining congressional intent through legislative history, and both Circuit Courts found that determination to be controlling on the applicability of the statute in circumstances substantially similar (and, in the case of *Salman Ranch*, identical) to the circumstances here.

B. THE TEMPORARY REGULATIONS ARE ARBITRARY, CAPRICIOUS, AND MANIFESTLY CONTRARY TO THE STATUTE.

Even if one moved beyond the first step of the *Chevron* analysis, the Temporary Regulations are not entitled to deference. Under the second step of the *Chevron* analysis, a regulation is upheld unless it is arbitrary, capricious, or manifestly contrary to the statute. *Chevron*, 467 U.S. at 844. Here, the Temporary Regulations are arbitrary, capricious, and manifestly contrary to the statute. As noted in Part IV.A, above, the Supreme Court concluded in *Colony* that the Commissioner's position there, which is the same position that is reflected in the Temporary Regulations, was not consistent with the congressional intent underlying the statutory language. *Colony*, 357 U.S. at 36. Since the Temporary Regulations adopt a construction of the statute that was rejected by the Supreme Court as being inconsistent with the congressional intent of the statute, that construction is arbitrary, capricious, and manifestly contrary to the statute. *Cf. Ala. Power Co. v. U.S. Dept of Energy*, 307 F.3d 1300, 1312-13 (11th Cir. 2002) (concluding that, even if *Chevron* deference applied to a particular agency interpretation of its governing statute, the agency's interpretation was invalid because it conflicted with the applicable statute, as interpreted by the Court using "traditional tools of statutory construction").

V. THE TEMPORARY REGULATIONS CANNOT OVERTURN THE CONTROLLING SUPREME COURT PRECEDENT OF *COLONY*.

The Commissioner contends that the decision of the Supreme Court in *Colony*, as well as the decisions of the Federal Circuit in *Salman Ranch* and of the Ninth Circuit in *Bakersfield Energy Partners*, can be overturned by the Temporary Regulations under the authority of *Brand X*.[15] Brief for the Appellant, p. 32-34. This contention fails because the Temporary Regulations are not entitled to *Chevron* deference, the interpretation of the statute given by *Colony* was the only interpretation warranted by congressional intent, and the determination of congressional intent by the Supreme Court (as the ultimate arbiter of that intent) cannot be overturned by regulation.

The preamble to the Temporary Regulations clearly indicates that the Temporary Regulations are intended to overturn the result in *Salman Ranch* and in *Bakersfield Energy Partners*. T.D. 9466, 74 Fed. Reg. at 49321-22 (2009). In

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[15] The Commissioner states that the Temporary Regulations are consistent with the "suggestion" of the Ninth Circuit in its opinion in *Bakersfield Energy Partners*. Brief for the Appellant, p. 26. The Ninth Circuit simply observed that it did not have the authority to overturn a decision of the Supreme Court, but that the IRS "may" have authority to promulgate a reasonable reinterpretation of an ambiguous provision of the tax code. *Bakersfield Energy Partners*, 568 F.3d at 778. This observation by the Ninth Circuit cannot be read as a "suggestion" that the IRS can overturn the Supreme Court's fifty-year-old determination of congressional intent underlying a statute by publishing its unsuccessful litigating position in the form of Temporary Regulations without undergoing notice and comment rule making, and then apply those Temporary Regulations retroactively to reopen tax years that were closed under prior law.

those cases, the Federal Circuit and the Ninth Circuit determined that *Colony* was controlling authority with respect to whether overstatement of basis constitutes an omission from gross income. *Salman Ranch*, 573 F.3d at 1372 ("We conclude that *Colony* controls the disposition of this case"); *Bakersfield Energy Partners*, 568 F.3d at 768 ("We conclude, like the Tax Court below, that we are bound by [*Colony*], which held that a taxpayer's overstatement of basis does not 'omit[] from gross income an amount properly includible therein'"). Therefore, the Temporary Regulations cannot overturn *Salman Ranch* and *Bakersfield Energy Partners* unless they also overturn the decision of the Supreme Court in *Colony* and the Supreme Court's determination of Congress' intent in that case.

The Commissioner's contention that the IRS can overturn a prior judicial interpretation of a statute, including a prior judicial interpretation of a statute by the Supreme Court, is based entirely on *Brand X*. Brief for the Appellant, pp. 32-34. As a preliminary matter, *Brand X* applies only if the regulation at issue is entitled to *Chevron* deference. *Brand X*, 545 U.S. at 982. As explained in Part IV, above, the Temporary Regulations are not entitled to *Chevron* deference, so *Brand X* does not provide authority for the Commissioner's argument that the Temporary Regulations can overturn the prior judicial determinations of the Supreme Court in *Colony*, the Federal Circuit in *Salman Ranch*, and the Ninth Circuit in *Bakersfield Energy Partners*.

In addition, unlike *Brand X*, this is not a case in which a court applied the best of multiple possible and reasonable interpretations of a statute, followed by an administrative agency's adoption of a different, but still reasonable, interpretation of the statute. Here, the Supreme Court in *Colony*, applying traditional methods of construction, ascertained ***the*** congressional intent underlying the statutory language at issue. *Colony*, 357 U.S. at 33, 36-37. Once the underlying congressional intent has been determined, an administrative agency has no authority to issue a regulation in contravention of that congressional intent, which is what the IRS has done here. *Chevron*, 467 U.S. at 842-43; *Timex V.I., Inc. v. United States*, 157 F.3d 879, 882 (Fed. Cir. 1998) (stating that no deference is allowed where the court has construed the meaning of a statute using traditional construction methods, as was done in *Colony*); *Ala. Power*, 307 F.3d at 1312-13. It is well settled that "[j]udgments within the powers vested in courts by the Judiciary Article of the Constitution may not lawfully be revised, overturned or refused faith and credit by another Department of Government." *Chicago & S. Air Lines v. Waterman S.S. Corp.*, 333 U.S. 103, 113 (1948); *see Brand X*, 545 U.S. at 1017 (Scalia, J., dissenting) ("Article III courts do not sit to render decisions that can be reversed or ignored by executive officers").

The circumstances involved in *Brand X* were significantly different from the circumstances involved here. Unlike *Brand X*, the prior judicial determinations

involved here were made in cases in which the government was a party, and the courts specifically rejected the position now advanced in the Temporary Regulations. The Temporary Regulations were adopted specifically to bolster the government's litigating position in pending cases, including this one. When the government manipulates the administrative rule making process to obtain a desired outcome in litigation, the result is an improper "abuse of the interaction between administrative agencies and the courts." *Tallahassee Mem'l Reg'l Med. Ctr. v. Bowen*, 815 F.2d 1435, 1452 (11th Cir. 1987), *cert. denied*, 485 U.S. 1020 (1988). In *Tallahassee*, the Eleventh Circuit rejected the government's use of regulations to moot an issue in a pending appeal in which the agency was a party, in part because "the potential for abuse is real if agencies are allowed to moot claims by hurried rule making." *Id.* at 1452 n.33. The "potential for abuse" is even more real here, where the Commissioner seeks to avoid the constraints of collateral estoppel by "hurried rule making" undertaken after issuance of the adverse decision. *See Chock Full O' Nuts Corp. v. United States*, 453 F.2d 300, 303 (2nd Cir. 1971) ("the Commissioner may not take advantage of his power to promulgate retroactive regulations during the course of a litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations").

Finally, *Brand X* involved a prior decision issued by a court of appeals, not the Supreme Court. As Justice Stevens noted in his concurrence in *Brand X*, the Court's explanation of "why a court of appeals' interpretation of an ambiguous provision in a regulatory statute does not foreclose a contrary reading by the agency . . . would not necessarily be applicable to a decision by [the Supreme] Court that would presumably remove any pre-existing ambiguity." 545 U.S. at 1003 (Stevens, J., concurring); *see Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990) ("Once we have determined a statute's clear meaning, we adhere to that determination under the doctrine of *stare decisis*, and we judge an agency's later interpretation of the statute against our prior determination of the statute's meaning"); *see also Lechmere, Inc. v. Nat'l Labor Relations Bd.*, 502 U.S. 527, 536-39 (1992) (rejecting an agency's interpretation of a statute because it conflicted with the Supreme Court's prior interpretation of the statute); *Neal v. United States*, 516 U.S. 284, 296 (1996) ("Were we to alter our statutory interpretations from case to case, Congress would have less reason to exercise its responsibility to correct statutes that are thought to be unwise or unfair").[16]

[16] *Maislin Industries*, *Lechmere*, and *Neal* were all cited with approval in *Brand X*. 545 U.S. at 984. While this Court has apparently determined that *Brand X* applies whether the judicial precedent at issue is that of a lower court or the Supreme Court, *Hernandez-Carrera v. Carlson*, 547 F.3d 1237, 1248 (10th Cir. 2008), it did so in the context of Supreme Court rulings applying the constitutional avoidance canon (which is a canon that "comes into play only when, after the application of ordinary textual analysis, the statute is found to be susceptible of more than one

The Commissioner's reliance on *Brand X* to support his effort to overturn the controlling Supreme Court precedent defining the congressional intent in using the term "omits from gross income" and to avoid the collateral estoppel effect of *Salman Ranch*, by issuing Temporary Regulations without notice and comment rule making, and then applying those Temporary Regulations retroactively to reopen statutes of limitations closed under prior law, stretches the *Brand X* ruling beyond all recognition.

CONCLUSION

Colony and *Salman Ranch* control the disposition of this case. The Commissioner's attempt to overturn those judicial decisions by publishing his unsuccessful litigating position as Temporary Regulations fails, because:

- The Temporary Regulations are not a significant change in controlling legal principles that allows the Commissioner to overcome the acknowledged collateral estoppel effect of *Salman Ranch*;

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construction"), rather than in a situation, such as this case, where the Supreme Court found congressional intent based on legislative history and removed any pre-existing ambiguity from the statute. *Id*. at 1245. *Hernandez-Carrera* involved a prior judicial ruling that construed a statute to avoid constitutional doubts, and held that the agency can interpret the same statute in a different manner so long as its subsequent interpretation is reasonable and avoids serious constitutional questions. *Id.* at 1251. Where, as here, the Supreme Court found a clear congressional intent based on legislative history, the agency cannot promulgate a rule that interprets the same statute in a manner that contrary to the judicially determined congressional intent.

- The Temporary Regulations were not validly promulgated under the APA;
- The Temporary Regulations, by their terms, do not apply to the Taxpayers for the tax years at issue here;
- The Temporary Regulations cannot reopen closed tax years;
- Application of the Temporary Regulations to tax years prior to their publication is an abuse of discretion;
- The Temporary Regulations are not entitled to deference under *Chevron*;
- The Temporary Regulations are manifestly contrary to congressional intent; and
- The Temporary Regulations cannot overturn the Supreme Court's determination of the congressional intent underlying the controlling statute.

For all of the foregoing reasons, the Appellees request that this Court affirm the judgment of the United States Tax Court.

STATEMENT CONCERNING ORAL ARGUMENT

Counsel for Salman Ranch believes that oral argument should be allowed in order to address the significant issues raised by the Commissioner's attempt to rely on the Temporary Regulations to avoid collateral estoppel and by the Commissioner's attempt to apply the Temporary Regulations retroactively to reopen closed tax years and to overturn Supreme Court precedent on the congressional intent underlying the relevant statute.

CERTIFICATE OF COMPLIANCE WITH FED. R. APP. P. 32(a)(7)(B)

In accordance with Fed. R. App. P. 32(a)(7)(C), undersigned counsel certifies that this brief complies with the type-volume limitation set forth in Fed. R. App. P. 32(a)(7)(B), and that this brief, including the included items listed in Fed. R. App. P. 32(a)(7)(B)(iii), but excluding the excluded items listed in Fed. R. App. P. 32(a)(7)(B)(iii), contains 11,757 words.

Dated: April 21, 2010.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on April 21, 2010, using the Court's ECF system, I submitted/served a copy of the foregoing Appellee's Answer Brief to:

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I hereby certify that: (1) all required privacy redactions have been made to said document, and, with the exception of those redactions, every document submitted in digital form or scanned PDF format is an exact copy of the written document filed with the Clerk; and (2) the digital submission has been scanned for viruses with the most recent version of a commercial virus scanning program (Trend Micro OfficeScan Client – Version 10.0) and, according to the program, is free of viruses.

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