No. 11-582

In the Supreme Court of the United States

SALMAN RANCH, LTD., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTIONS PRESENTED

As a general matter, the Internal Revenue Service (IRS) has three years to assess additional tax if the agency believes that the taxpayer's return has understated the amount of tax owed. 26 U.S.C. 6501(a). That period is extended to six years, however, 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 [taxpayer's] return." 26 U.S.C. 6501(e)(1)(A). The questions presented are as follows:

1. Whether an understatement of gross income attributable to an overstatement of basis in sold property is an "omi[ssion] from gross income" that can trigger the extended six-year assessment period.

2. Whether a final regulation promulgated by the Department of the Treasury, which reflects the IRS's view that an understatement of gross income attributable to an overstatement of basis can trigger the extended six-year assessment period, is entitled to judicial deference.

3. Whether principles of collateral estoppel required the court of appeals to hold that the IRS's assessment of additional tax in this case was untimely.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-31a) is reported at 647 F.3d 929. The opinion of the Tax Court (Pet. App. 32a-34a) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on May 31, 2011. A petition for rehearing was denied on August 9, 2011 (Pet. App. 35a-36a). The petition for a writ of certiorari was filed on November 7, 2011. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. As a general matter, the Internal Revenue Service (IRS) has three years to assess additional tax if the agency believes that the taxpayer's return has under-

stated the amount of tax owed. 26 U.S.C. 6501(a). That period is extended to six years, however, 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 [taxpayer's] return." 26 U.S.C. 6501(e)(1)(A). The question presented in this case is whether that six-year assessment period applies to a tax-avoidance scheme that operated by overstating a taxpayer's basis in property.

a. When a taxpayer sells property, any "[g]ain[]" that he realizes from the sale contributes to his "gross income." 26 U.S.C. 61(a)(3). The taxpayer's gain, however, is not the sale price of his property. Rather, it is the sale price minus the taxpayer's capital stake in the sold asset, which is generally the amount paid to obtain the property, as adjusted by various other factors. 26 U.S.C. 1012. For tax purposes, that capital stake is commonly referred to as the taxpayer's "basis" in property. 26 U.S.C. 1011(a). Because the taxable income from a property sale is generally determined by subtracting the taxpayer's basis from the property's sale price, an overstatement of basis will typically decrease the amount of the taxpayer's gain (and thus the amount of federal income-tax liability) that is attributable to the sale.

This case involves a particular kind of tax shelter, known as a Son-of-BOSS (Bond and Option Sales Strategy) transaction. In a Son-of-BOSS transaction, a taxpayer uses some mechanism, often a short sale, to artificially increase his basis in an asset before the asset is sold. A short sale is a sale of a security that the seller does not own or has not contracted for at the time of the sale. To close the short sale, the seller is obligated to purchase and deliver the security at some point in the future, often by using the proceeds from the short sale itself. Typically in a Son-of-BOSS transaction, a taxpayer enters into a short sale and transfers the proceeds as a capital contribution to a partnership. The partnership then closes the short sale by purchasing and delivering the relevant security on the open market. See *Beard* v. *Commissioner*, 633 F.3d 616, 617-618 (7th Cir. 2011), petition for cert. pending, No. 10-1553 (filed June 23, 2011).

When the taxpayer and partnership file their tax returns for the year in which a transaction of the kind described above occurs, they are required under 26 U.S.C. 722, 723, and 752 to report their taxable bases in the partnership. The taxpayer's basis in the partnership is called an "outside basis," while the partnership's basis in its own assets is called an "inside basis." See *Kornman & Assocs., Inc.* v. *United States*, 527 F.3d 443, 456 n.12 (5th Cir. 2008). In a Son-of-BOSS transaction, when computing both "outside" and "inside" basis, the taxpayer and the partnership include the short-sale proceeds contributed to the partnership, without decreasing that amount by the corresponding obligation (*i.e.*, to close the short sale by purchasing and delivering the relevant security) that the partnership has assumed. As a result, the taxpayer either generates a large paper loss that can be used to offset capital gains on other unrelated investments, or turns what would otherwise have been a sizeable capital gain into a smaller taxable gain or even a capital loss.[1] See *Beard*, 633 F.3d at 618.

[1] In 2000, the IRS issued a notice informing taxpayers that Son-of-BOSS transactions were invalid under the tax laws. See Notice 2000-44, 2000-36 I.R.B. 255 (describing arrangements that unlawfully "purport to give taxpayers artificially high basis in partnership interests"). In the wake of that notice, courts largely have invalidated Son-of-BOSS

b. In 1987, the owners of Salman Ranch in Mora County, New Mexico, formed a partnership, petitioner Salman Ranch Ltd., to which they contributed their ownership interests in the ranch in return for partnership shares. Pet. App. 46a-47a. In 1999, the partners decided to sell the ranch while attempting to minimize their taxable gains from the sales. On October 8, 1999, the partners engaged in various short sales of United States Treasury Notes, generating total cash proceeds of almost $11 million. *Id.* at 47a. Five days later, the partners transferred the proceeds of the short sales as capital contributions to petitioner. *Ibid.* Petitioner then closed the short sales by purchasing and delivering the requisite Treasury Notes. *Ibid.* In computing their outside bases, the Salman Ranch partners included the amount of the short-sale proceeds that they had contributed to petitioner, without reducing those amounts to reflect petitioner's offsetting obligations to close the short positions.

In November 1999, the Salman Ranch partners transferred portions of their interests in petitioner to three newly-formed partnerships. Pet. App. 48a. Those transfers triggered the termination of the existing Salman Ranch partnership and the formation of a new partnership. *Ibid.*; see 26 U.S.C. 708(b)(1)(B). The formation of that new Salman Ranch partnership, in turn, permitted petitioner to adjust, or "step up," its inside

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transactions as lacking in economic substance. See, *e.g.*, *Jade Trading, LLC* v. *United States*, 80 Fed. Cl. 11, 45-46 (2007), aff'd in relevant part, 598 F.3d 1372, 1376-1377 (Fed. Cir. 2010). In 2004, the IRS offered a settlement to approximately 1200 taxpayers. Many taxpayers who had engaged in Son-of-BOSS transactions, however, either did not qualify, chose not to participate in the settlement, or had not yet been identified. See *Beard*, 633 F.3d at 618.

basis to equal the partners' outside bases. See 26 U.S.C. 743(b)(1), 754. Because the partners had inflated their outside bases (by including the short-sale proceeds contributed to petitioner, without decreasing that amount by the offsetting obligations to close the short sales), petitioner's new inside basis was likewise inflated. Pet. App. 4a. In December 1999, petitioner sold part of the ranch for $7.19 million, along with an option to purchase most of the remainder of the ranch, which the buyers exercised in 2001 for an additional $7.26 million paid in installments during 2001 and 2002. *Ibid.*

In April 2000, petitioner filed its tax return for the one-month period in December 1999 during which it had completed the initial sale. Because petitioner had stepped up its inside basis to equal the partners' inflated outside bases, petitioner reported only a modest gain of $338,312 on the $7.19 million sale of its assets. Pet. App. 48a-49a. In April 2002 and April 2003, petitioner filed its respective tax returns for the 2001 and 2002 tax years. Again, because petitioner's inside basis had been artificially inflated, petitioner reported only a modest gain of $41,825 from the $7.26 million sale of its assets. *Id.* at 4a-5a. And because the Salman Ranch partners were required to report their respective shares of any gain, they reported income from the asset sales that was dramatically lower than it would have been if the Son-of-BOSS transaction had not been utilized.[2] *Id.* at 5a, 51a.

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[2] Partnerships do not pay federal income tax, but they are required to file annual information returns reporting the partners' distributive shares of income, gain, deductions, or credits. See 26 U.S.C. 701, 6031; *Randell* v. *United States*, 64 F.3d 101, 103 (2d Cir. 1995), cert. denied, 519 U.S. 815 (1996). The individual partners also report their respective distributive shares on their federal income tax returns. See

2. Specifically, the IRS determined that, as a result of petitioner's use of the Son-of-BOSS transaction, petitioner had omitted the following amounts from its gross income on its returns: $4.57 million in 1999, $1.33 million in 2001, and $3.52 million in 2002. Pet. App. 6a. The IRS therefore issued two Final Partnership Administrative Adjustments (FPAAs), one for the 1999 tax year and another for the 2001 and 2002 tax years, that decreased petitioner's basis in its ranch and thereby substantially increased the Salman Ranch partners' taxable income for the tax years at issue. *Id.* at 6a, 7a n.7. Those FPAAs were issued more than three years but less than six years after petitioner had filed its respective returns. *Id.* at 6a-7a.

a. Petitioner challenged the 1999 FPAA in the Court of Federal Claims, arguing that it was barred because it was issued after the expiration of the three-year assessment period provided by 26 U.S.C. 6501(a). The IRS contended that any assessments were governed instead by the extended six-year assessment period in 26 U.S.C. 6501(e)(1)(A), which applies when 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 Court of Federal Claims granted summary judgment to the government. See *Salman Ranch Ltd.* v. *United States*, 79 Fed. Cl. 189 (2007). It held that an understatement of gross income attributable to an overstatement of basis triggers the extended six-year assessment period in Section 6501(e)(1)(A), and that the 1999 FPAA therefore had been timely. See *id.* at 204.

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26 U.S.C. 701-704. Unpaid taxes are assessed against the individual partners.

b. A divided panel of the Federal Circuit reversed. See Pet. App. 44a-94a (*Salman Ranch Ltd.* v. *United States*, 573 F.3d 1362 (2009) (*Salman Ranch I*)). The court held that, under this Court's decision in *Colony, Inc.* v. *Commissioner*, 357 U.S. 28 (1958) (*Colony*), an overstatement of basis in property does not give rise to an omission from gross income for purposes of Section 6501(e)(1)(A). See Pet. App. 67a-68a. Judge Newman dissented. She would have held that the *Colony* Court's interpretation of the predecessor statute does not control the construction of current Section 6501(e)(1)(A), and that the current provision applies when an understatement of gross income is attributable to an overstated basis. See *id*. at 78a-94a.

3. a. Petitioner Salman Ranch Ltd. and its partner for tax matters, petitioner Frances Koenig, also challenged the timeliness of the 2001 and 2002 FPAAs. That challenge was filed in the Tax Court, which granted summary judgment to petitioners. See Pet. App. 32a-34a. The court relied on its earlier holding in *Bakersfield Energy Partners, LP* v. *Commissioner*, 128 T.C. 207 (2007), aff'd, 568 F.3d 767 (9th Cir. 2009), that an understatement of gross income attributable to an overstatement of basis does not trigger the extended six-year assessment period in Section 6501(e)(1)(A). See Pet. App. 32a-33a.

b. The government appealed that decision. In September 2009, while the appeal was pending, the Treasury Department issued a temporary regulation to address the application of Section 6501(e)(1)(A) to cases involving basis overstatements. See T.D. 9466, 2009-43 I.R.B. 551 (issuing Temp. Treas. Reg. 301.6501(e)-1T (2009)); see also Pet. App. 13a. In the temporary regulation, the Department construed the phrase "omits from gross income an amount properly includible therein" to encompass situations in which a taxpayer understates his income by overstating his basis in property. At the same time that it issued the temporary regulation, the Treasury Department issued a notice of proposed rule-making with a 90-day comment period for an identical final regulation. See 74 Fed. Reg. 49,354 (Sept. 28, 2009). In December 2010, the Department withdrew the temporary regulation and issued a substantially similar final regulation that is currently in effect. See T.D. 9511, 2011-6 I.R.B. 455.

c. In May 2011, the Tenth Circuit reversed. See Pet. App. 1a-31a (*Salman Ranch Ltd.* v. *Commissioner*, 647 F.3d 929 (*Salman Ranch II*)). Applying the two-step methodology set forth in *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842-843 (1984), the court held that "[Section] 6501(e)(1)(A) is ambiguous as to Congress's intent for the treatment of overstatements of basis outside the context of a trade or business." Pet. App. 21a. The court rejected petitioners' argument that this Court in *Colony* had found the predecessor statute, 26 U.S.C. 275(c) (1940), to be unambiguous. See Pet. App. 18a-19a. The court then held that the recent final regulation had reasonably resolved the statutory ambiguity. The court explained that "the IRS's interpretation of 'gross income' in [Section] 6501(e)(1)(A) is consistent with the definition of 'gross income' used elsewhere in the Tax Code" and "is consistent with legislative history" related to the 1954 amendments. *Id.* at 23a.

Finally, the court of appeals rejected petitioners' argument that principles of collateral estoppel required the court to adhere to the Federal Circuit's decision in *Salman Ranch I*. Pet. App. 25a-27a. The court explained that the issuance of the final regulation "'so change[d] the legal atmosphere as to render the rule of collateral estoppel inapplicable' in this appeal." *Id.* at 26a (quoting *Commissioner* v. *Sunnen*, 333 U.S. 591, 600 (1948)).

DISCUSSION

1. The first two questions presented involve (Pet. i, 7-8) whether an understatement of gross income attributable to an overstatement of basis in sold property is an "omi[ssion] from gross income" that can trigger the six-year assessment period in 26 U.S.C. 6501(e)(1)(A). On September 27, 2011, this Court granted the petition for a writ of certiorari in *United States* v. *Home Concrete & Supply, LLC*, No. 11-139 (oral argument scheduled for Jan. 17, 2012) (*Home Concrete*), which presents the same issues. If the Court concludes in *Home Concrete* that an overstatement of basis in sold property can trigger the extended six-year assessment period, then the administrative adjustments at issue in this case were timely, as the court of appeals correctly held. Accordingly, the Court should hold this petition pending its decision in *Home Concrete*, and then dispose of the petition as appropriate in light of that decision.

2. Petitioners further contend (Pet. 9-12) that, even if the Court rules in the government's favor in *Home Concrete*, the court of appeals' judgment in this case should still be reversed because principles of collateral estoppel required that court to treat the IRS's assessment of additional tax here as untimely. In a previous case between these parties (*Salman Ranch I*), the Federal Circuit held that application of the extended six-year assessment period could not be premised on an understatement of gross income resulting from an overstatement of basis. In petitioners' view (Pet. 9-11), the

court of appeals in this case (*Salman Ranch II*) was therefore foreclosed from reaching a different result in this subsequent case, which pertains to different tax years but involves the same parties as in *Salman Ranch I*.

The court of appeals correctly rejected that contention (Pet. App. 25a-27a), and its decision does not conflict with any decision of this Court or of any other court of appeals. The doctrine of collateral estoppel is "confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged." *Commissioner* v. *Sunnen*, 333 U.S. 591, 599-600 (1948). "It naturally follows," this Court has observed, "that an interposed alteration in the pertinent statutory provisions or *Treasury regulations* can make the use of that rule unwarranted." *Id.* at 601 (emphasis added); see *id.* at 599 (explaining that the doctrine of collateral estoppel "is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers"); *Montana* v. *United States*, 440 U.S. 147, 161 (1979) (noting that "a change in controlling legal principles" renders the doctrine of collateral estoppel inapplicable in the tax context). Applying those principles here, the court of appeals correctly held that the Treasury Department's issuance of a final regulation changed the "applicable legal rules," thereby "'render[ing] the rule of collateral estoppel inapplicable' in this appeal." Pet. App. 26a (quoting *Sunnen*, 333 U.S. at 600).

In *National Cable & Telecommunications Ass'n* v. *Brand X Internet Services*, 545 U.S. 967, 982 (2005), this Court held that "[a] court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute." The Court explained that a judicial decision identifying "the *best* reading of" a particular statutory provision does not logically imply that the preferred interpretation is "the *only permissible* reading of the statute." *Id.* at 984. The same distinction bears directly on the collateral-estoppel analysis here because collateral estoppel applies only when "the matter raised in the second suit is identical in all respects with that decided in the first proceeding." *Sunnen*, 333 U.S. at 599-600. The question that the Tenth Circuit was called upon to decide (*i.e.*, whether the Treasury Department's final rule reflected a permissible interpretation of Section 6501(e)(1)(A)) was one that the Federal Circuit in *Salman Ranch I* had no occasion to address, since the Federal Circuit ruled before the regulation was promulgated. And the Tenth Circuit's determination that the final rule is *reasonable* is not logically inconsistent with the Federal Circuit's previously expressed view as to the *better* interpretation of Section 6501(e)(1)(A).

Indeed, in determining the stare decisis effect of its decision in *Salman Ranch I*, the Federal Circuit itself has recognized that the decision contained "no separate holding that the statute was unambiguous for purposes of *Chevron* step one." *Grapevine Imports, Ltd.* v. *United States*, 636 F.3d 1368, 1378 (2011) (*Grapevine*), petition for cert. pending, No. 11-163 (filed Aug. 5, 2011). In *Grapevine*, the Federal Circuit treated the final Treasury regulation as "new intervening authority" that required the court "to depart from *Salman Ranch* [*I*]." *Id.* at 1376. The Tenth Circuit's treatment of *Salman*

Ranch I in this case is therefore consistent with the Federal Circuit's own treatment of that decision.

For those reasons, the Tenth Circuit correctly declined to give collateral-estoppel effect to the Federal Circuit's prior decision in *Salman Ranch I*. In any event, the court of appeals' application of established collateral-estoppel principles to the unusual circumstances of this case raises no issue of widespread importance warranting this Court's review. Thus, if the Court holds in *Home Concrete* that an understatement of basis can trigger the application of Section 6501(e)(1)(A)'s six-year assessment period, the petition for a writ of certiorari in this case should be denied.

CONCLUSION

With respect to the first and second questions presented, the petition for a writ of certiorari should be held pending the Court's decision in *United States* v. *Home Concrete & Supply, LLC*, cert. granted, No. 11-139 (oral argument scheduled for Jan. 17, 2012), and then disposed of as appropriate in light of that decision. In all other respects, the petition should be denied.

Respectfully submitted.

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JANUARY 2012