No. 11-663

In the Supreme Court of the United States

INTERMOUNTAIN INSURANCE SERVICES OF VAIL, LLC, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA 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.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals as amended (Pet. App. 1a-43a) is reported at 650 F.3d 691. The opinions of the Tax Court (Pet. App. 44a-110a, 111a-118a) are reported at 134 T.C. 211 and 98 T.C.M. (CCH) 144.

JURISDICTION

The judgment of the court of appeals was entered on June 21, 2011. A petition for rehearing was denied on August 18, 2011 (Pet. App. 40a-43a). The petition for a writ of certiorari was filed on November 16, 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 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 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. 1001(a), 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.), 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.

b. In this case, petitioner Thomas Davies owned an insurance company, Intermountain Insurance Services of Vail, LLC (Intermountain), that he intended to sell.[2] In order to minimize his anticipated tax liability from the sale, petitioner executed short sales of United States Treasury notes for a combined total of approximately $1.7 million. Petitioner then transferred that amount to Intermountain, along with the obligation to close the short sales. Intermountain subsequently closed the sales by purchasing and delivering Treasury Notes in the requisite amounts. In calculating his outside basis in Intermountain, petitioner included the amount of the short-sale proceeds (approximately $1.7 million) that he had contributed to Intermountain, without reducing that

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[1] In August 2000, the IRS issued a notice informing taxpayers that Son-of-BOSS transactions were invalid under the tax laws. See I.R.S. 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 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.

[2] Intermountain is a petitioner in this case, but because petitioner Davies is the tax-matters partner for Intermountain, this brief refers to Davies as the petitioner solely for the sake of clarity. In addition, Intermountain is a limited liability corporation, which for present tax purposes is treated in the same manner as a partnership. See 26 U.S.C. 752; Treas. Reg. 301.7701-3(b)(1)(i). This brief therefore refers to Intermountain as a partnership and to ownership interests in Intermountain as partnership interests.

amount to reflect Intermountain's offsetting obligation to close the short positions. See Gov't C.A. Br. 5-6.

Petitioner then transferred partnership interests in Intermountain to two entities that he controlled. See C.A. App. 21. Those transfers triggered the termination of the existing Intermountain partnership and the formation of a new partnership. See *id.* at 22; see also 26 U.S.C. 708(b)(1)(B). The formation of that new partnership, in turn, permitted Intermountain to adjust, or "step up," its inside basis to equal petitioner's outside basis. See 26 U.S.C. 743(b)(1), 754. Because petitioner had inflated his outside basis (by including the short-sale proceeds contributed to Intermountain, without decreasing that amount by the offsetting obligation to close the short sales), Intermountain's new inside basis was similarly inflated. In August 1999, the assets of Intermountain were sold for approximately $1.9 million. See Gov't C.A. Br. 5-6.

On September 15, 2000, Intermountain filed its federal income-tax return for 1999. Because its inside basis had been artificially inflated, Intermountain reported a modest capital loss of $11,420 on the $1.9 million sale of its assets. See Pet. App. 4a. And because Intermountain's partners were required to report their respective shares of any gain or loss, petitioner reported a relatively small loss from the asset sale rather than the substantial gain that would have resulted if the Son-of-BOSS transaction had not been utilized.[3]

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[3] 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. On September 14, 2006, the IRS issued a Final Partnership Administrative Adjustment (FPAA), decreasing Intermountain's basis in its assets and thereby substantially increasing petitioner's taxable income for 1999. See Pet. App. 4a-5a. Petitioner challenged the FPAA in the Tax Court, 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."

a. On September 1, 2009, the Tax Court granted summary judgment to petitioner. Pet. App. 111a-118a. The court relied primarily 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 assessment period in Section 6501(e)(1)(A). Pet. App. 117a.

b. On September 24, 2009, 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)). 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 prop-

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

erty. At approximately the same time that it issued the temporary regulation, the Treasury Department issued a notice of proposed rulemaking 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. The government moved to vacate the Tax Court's decision and to reconsider that decision in light of the issuance of the temporary regulation. On May 6, 2010, the Tax Court, sitting en banc, denied reconsideration. Pet. App. 44a-110a. The seven-judge majority held that, under the terms of the regulation's applicability clause, the regulation does not apply to this case. See *id.* at 59a-60a. The majority held in the alternative that the regulation, even if applicable, was not entitled to deference because this Court's decision in *Colony, Inc.* v. *Commissioner*, 357 U.S. 28 (1958) (*Colony*), foreclosed Treasury's interpretation. See Pet. App. 68a-69a. Four judges of the Tax Court would have reached the same result "on narrower grounds relating to motions to vacate and reconsider or untimely motions to amend pleadings." *Id.* at 72a. Two judges would have reached the same result on the ground that the regulation was procedurally invalid. See *id.* at 93a-110a.

3. The court of appeals reversed. Pet. App. 1a-39a. The court held that "nothing in [S]ection 6501(e)(1)(A) unambiguously forecloses the Commissioner from interpreting 'omissions from gross income' as including basis overstatements." *Id.* at 29a. The court reached that holding "because the Court in *Colony* never purported to interpret section 6501(e)(1)(A); because section 6501(e)(1)(A)'s 'omits from gross income' text is at least

ambiguous, if not best read to include overstatements of basis; and because neither the section's structure nor its legislative history nor the context in which it was passed nor its reenactment history removes this ambiguity." *Id.* at 28a. The court concluded that the Treasury regulation, which had become final while the appeal in this case was pending, "[was] validly promulgated, appl[ies] to this case, qualif[ies] for *Chevron* deference, and pass[es] muster under the traditional *Chevron* two-step framework." *Id.* at 38a.

DISCUSSION

This case presents the question 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 (argued Jan. 17, 2012) (*Home Concrete*), which presents the same issue. 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 adjustment at issue in this case was 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.

CONCLUSION

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 (argued Jan. 17, 2012), and then disposed of as appropriate in light of that decision.

Respectfully submitted.

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