A Fine Distinction: When A Temporary Regulation Is No Longer Temporary.

The IRS churns out regulations every year. When it does so it generally uses the notice and comment procedure prescribed by the Administrative Procedure Act. At times, however, it has to issue regulations immediately, as when new tax legislation is passed. In these cases, it resorts to temporary regulations. Sometimes these "temporary" regulations take up quasi-permanent status. In other instances, they may be incorporated into final regulations that are adopted through normal APA procedures.

Last Friday, the D.C. Circuit issued an opinion that turned on a very fine distinction: the difference between a temporary regulation standing on its own and a temporary regulation that had been incorporated into a final regulation. *Petaluma FX Partners, LLC v. Comm'r*, 2015 U.S. App. LEXIS 10847 (D.C. Cir. June 26, 2015). *Petaluma* was a Son of BOSS tax shelter case on its third trip to the Court of Appeals. The issue that remained was whether the Tax Court had jurisdiction to determine the applicability of an accuracy-related penalty to a partner in the course of a partnership level proceeding under TEFRA where the partnership was determined to be a sham. *Petaluma*, 2015 U.S. App. LEXIS 10847, slip op. at *10.

Although this question was seemingly answered by the Supreme Court in *United States v. Woods*, 134 S. Ct. 557 (2013), the court of appeals considered the issue because it had a different wrinkle: the taxpayers were challenging a temporary regulation that provided courts with jurisdiction to determine items that would be partnership items of an entity that was a sham partnership if it were not a sham. *Petaluma*, 2015 U.S. App. LEXIS 10847, slip op. at *11-*13 (citing Temp. Treas. Reg. § 301.6233-1T). Although the taxpayers had failed to raise this issue earlier, the government failed to raise a waiver argument, leaving the court to address the matter on the merits. *Id.*, slip op. at *13-*14.

After rejecting the government's argument that a challenge to the temporary regulation was barred by the law of the case doctrine, the D.C. Circuit turned to the merits. It commenced by questioning whether a valid regulation was necessary to confer jurisdiction on the Tax Court, particularly given the Supreme Court's decision in *Wood*. *Id.*, slip op. at *15-*16. It passed over that issue because it concluded that the taxpayer's jurisdictional argument had as little substance as the underlying partnership.

The problem, in the court's view, was that the taxpayers had focused on the wrong regulation. While the temporary regulation was issued in 1987, the IRS took steps to finalize that temporary regulation by issuing a notice of proposed rule-making in 1999 and finalizing a new regulation in 2001. *Id.*, slip op. at *17-*18.

As the Court explained, "[t]he Final Regulation applies to all tax years, but it adopts a bifurcated approach depending on the tax year in question. First, the Final Regulation's provisions control with regard to 'taxable years beginning on or after October 4, 2001,' the date of the Final Regulation's adoption." *Id.*, slip op. at *17-*18 (quoting Treas. Reg. § 301.6233-1(d)). Then for "taxable 'years beginning prior to October 4, 2001,' the Final Regulation says to 'see § 301.6233-1T.'" *Id.*, slip op. at *18 (quoting Treas. Reg. § 301.6233-1(d)).

At first blush, the cross-reference to the temporary regulation would seem to make a challenge to the temporary regulation viable, but the D.C. Circuit made clear that the cross-reference was simply a convenient way to state the now permanent regulatory standard that would apply to earlier tax years. Noting that the final regulation had elminated the relevant temporary regulation and directed that it be removed from the Code of Federal Regulations, the court of appeals concluded that "the Final Regulation controls for all tax years; but as to tax years commencing before October 4, 2001, the Final Regulation effectively incorporates the rules set forth in the no-longer-operative Temporary Regulation." *Id.*, slip op. at *18-*19.

The court concluded its analysis by commenting that there was no basis for the taxpayers to challenge the Final Regulation, which was promulgated in accordance with the required notice and comment procedure.

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