No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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On both the jurisdictional and merits questions, respondent presents arguments that cannot be reconciled with the statutes Congress wrote. He first contends that, in a partnership-level proceeding under 26 U.S.C. 6226(f), a district court lacks jurisdiction to determine the applicability of any penalty whose imposition depends on a further "partner-level inquiry." Br. 27. But such an inquiry is virtually always required before any penalty can be imposed. Respondent's approach would therefore negate Congress's grant of authority to courts in partnership-level proceedings to determine the applicability of penalties. The only understanding of the jurisdictional provision that gives it practical significance is the one advanced by the government: that a district court must determine whether a partnership-level error, if carried over onto an individual partner's return, could trigger a penalty. Under that reading, the district court had jurisdiction to determine the applicability of the basis-overstatement penalty in this case.

On the merits, respondent principally argues that the penalty for overstating the "adjusted basis of any property," 26 U.S.C. 6662(e)(1)(A), is implicitly limited to "fact-based basis errors" (Br. 39), a concept that excludes misstatements produced through the unlawful manipulation of rules governing basis computation. None of the ten courts of appeals to address the issue has adopted that view; respondent did not urge that construction below; and nothing in the text, structure, or purposes of the relevant provisions supports respondent's position.

A. The District Court Had Jurisdiction Under Section 6226(f) Because The Basis-Overstatement Penalty "Relates To" The Court's Adjustments To Partnership Items

1. A district court in a partnership-level proceeding has jurisdiction to determine "the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Respondent does not dispute that any basis-overstatement penalty ultimately imposed on any of the partners here will be imposed as a consequence of the district court's "adjustment to a partnership item" (*i.e.*, the court's determination that the two partnerships and their transactions were legal shams). Respondent nevertheless maintains that the penalty would not "relate[] to" that adjustment. Respondent identifies no plausible understanding of the term "relates to" that would exclude a penalty imposed specifically because an ad-

justment to a partnership item rendered the taxpayer's individual return inaccurate.

Respondent emphasizes (Br. 25) that the imposition of a basis-overstatement penalty on any individual partner will require a determination that the partner's own return overstated his outside basis in partnership assets. Respondent argues that "[b]ecause 'outside basis is an affected item, not a partnership item,' the asserted penalty 'relates to an adjustment of an affected item, not a partnership item.'" *Ibid.* (quoting *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1380 (Fed. Cir. 2010)). The unstated premise of respondent's argument is that a particular penalty can "relate[] to" only one adjustment. Nothing in the Taxpayer Relief Act supports that proposition, which is contrary to the usual understanding that the term "relates to" encompasses a broad range of connections. See, *e.g.*, *Morales* v. *Trans World Airlines*, 504 U.S. 374, 383-384 (1992); Gov't Br. 31-32. Where, as here, a penalty relates to both an affected-item adjustment and a partnership-item adjustment, the plain text of Section 6226(f) gives a court jurisdiction to determine the applicability of the penalty in a partnership-level proceeding.

Respondent asserts that the government's approach would render the Taxpayer Relief Act's jurisdictional limitation "meaningless" because it would allow the district court in a partnership-level proceeding to consider all penalties that relate to adjustments to affected items. Br. 29. That argument reflects a misunderstanding of the government's position. The government does not contend that the courts below were authorized to determine the applicability of the basis-overstatement penalty *because* that penalty "relates to" an adjustment to an affected item. Rather, the government's view is that (a) a particular penalty may "relate[] to" more than one adjustment, and (b) so long as the necessary relationship to a partnership-item adjustment exists, the fact that the penalty *also* "relates to" an adjustment to an affected item does not prevent the court in a partnership-level proceeding from determining its applicability. [1]

Respondent acknowledges that, under his interpretation, Section 6226(f) would not provide jurisdiction to determine the applicability of any penalty requiring a further "partner-level inquiry," "whether or not the penalty has a connection to a partnership item." Br. 27. But the ultimate imposition of virtually every penalty (including all of the accuracy-related penalties that would naturally follow from adjustments to partnership items) requires a partner-level inquiry, if only to verify that errors on the partnership return were carried forward to the partner's individual return. The express statutory authorization for the court in a partnership-level proceeding to determine the "applicability" of penalties would be a practical nullity if the need for further partner-level inquires precluded the court from acting.

Respondent offers no response to this basic flaw in his position, even though the government's opening

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[1] Contrary to respondent's contention (Br. 28), a penalty can "relate to" an adjustment to an affected item without relating to an adjustment to a partnership item. For example, an adjustment to a partner's outside basis (an affected item) might stem from his misstatement of the price he had paid a prior partner for the partnership interest. 26 U.S.C. 742. In that case, the court in a partnership-level proceeding would lack jurisdiction to determine the applicability of the basis-overstatement penalty.

brief repeatedly highlights the problem. See Gov't Br. 22, 28, 35-37. Indeed, he embraces it, seeking relief under his newly minted jurisdictional theory from every penalty the district court found applicable. See Br. 31 n.4. That belated request confirms the extraordinary breadth of his argument.[2]

2. Respondent emphasizes what he views as an incongruity in the government's interpretation of Section 6226(f): that a district court has jurisdiction to determine the applicability of the basis-overstatement penalty for a taxpayer's misrepresentation of outside basis, but lacks jurisdiction to determine the taxpayer's outside basis itself. See Br. 21-24. Respondent contends that a court can determine the applicability of the penalty only if it has "jurisdiction to determine that the partners actually misrepresented their outside basis." Br. 21.

Respondent misunderstands the district court's task in determining "the applicability of any penalty" in a partnership-level proceeding. As discussed, every accuracy-related penalty that relates to a partnership-item adjustment—whether resting on a misrepresentation of outside basis, inside basis, income, or any other item—turns on a partner-level inquiry that a court in a partnership-level proceeding lacks jurisdic-

[2] Because respondent voluntarily dismissed his cross-appeal in the court of appeals, he cannot obtain relief in this Court from the district court's adverse rulings with respect to the applicability of other penalties (see Pet. App. 7a-13a). See *Greenlaw* v. *United States*, 554 U.S. 237, 244-245 (2008). Vacating those aspects of the district court's judgment would also "alter the Court of Appeals' judgment" affirming the district court, "which is impermissible in the absence of a cross-petition from respondent." *Genesis Healthcare Corp.* v. *Symczyk*, 133 S. Ct. 1523, 1529 (2013); Pet. App. 2a.

tion to conduct. For that reason, the statute requires "partner level defenses" to penalties to be raised only in subsequent partner-level proceedings. 26 U.S.C. 6230(c)(4).[3] Because of that bifurcated structure, the requirement that a district court determine the "applicability" of penalties in partnership-level proceedings can only mean that the court must determine whether any error at the partnership level, *if* carried over to an individual partner's return, could trigger a penalty.

Respondent's counterexample (Br. 27) of what he concedes to be a permissible partnership-level penalty determination—for a misrepresentation of a partnership's *inside* basis in a flea-market painting—simply illustrates that point. Because the partnership itself cannot be liable for any basis-overstatement penalty, the mere fact that the partnership misreported its basis in the painting does not mean that a penalty will ultimately be imposed. The determination whether any individual partner is subject to the penalty will turn on a number of subsidiary, partner-specific questions, such as whether the partner actually gave effect to the incorrect basis figure on her return and whether doing so led her to report less than her correct

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[3] Amici assert that it is "strained" to call individualized objections to the imposition of a penalty, such as a contention that the taxpayer does not meet the applicable dollar or percentage threshold for the penalty, partner-level "defenses." New Millennium Trading Amicus Br. 17. Under the statutory scheme, however, those objections arise as "defenses" because partners assert them in refund proceedings only after the IRS determines that the requirements for a penalty are met and assesses it. A Treasury regulation defines such objections as "defenses," see 26 C.F.R. 301.6221-1(d), and those regulations are entitled to *Chevron* deference.

income. Like a partner's outside basis, those determinations cannot be made at the partnership level and will be resolved only after the district court has determined "the applicability of any penalty which relates to an adjustment to a partnership item," 26 U.S.C. 6226(f).

Respondent's amici propose a somewhat different test, arguing that the court in a partnership-level proceeding has jurisdiction to determine the applicability of a penalty if its imposition on any individual partner would require the IRS to make only "purely mathematical" changes to individual returns. New Millennium Trading Amicus Br. 18. As an example of a situation in which the applicability of penalties could be determined in partnership-level proceedings, amici refer to "the common situation where the IRS adjusts the income or loss reported by a partnership." *Id.* at 19. Amici offer no principled basis for distinguishing that scenario from the situation presented here.

If a partnership return understated the partnership's net income, the ultimate imposition of the income-tax understatement penalty (26 U.S.C. 6662(b)(2)) on any individual partner would depend on, *inter alia*, whether the partner carried the error onto her individual return in calculating her tax liability, and whether any underpayment of tax resulted. In a particular case, either of those prerequisites to the imposition of penalties might be satisfied for "some, but not all, of the partners." New Millennium Trading Amicus Br. 20. If any individual partner asserted that he had "reasonable cause" for the error on his own return, it would also be necessary to make the (nonmathematical) determination whether such "reasonable cause" existed before the penalty could be imposed. See 26 U.S.C. 6664(c)(1). None of those determinations could be made in the partnership-level proceeding itself. Indeed, amici concede that the "applicability" of a penalty for partnership negligence may be determined at the partnership level "because no partner level determinations need be made to establish the factual support for that penalty," even though amici recognize that "partner level defenses" to the penalties may remain to be resolved in partner-level proceedings. New Millennium Trading Amicus Br. 19 & n.7.

Once that understanding of the term "applicability" is accepted, there is no sound reason to question the district court's jurisdiction to determine the "applicability" of the basis-overstatement penalty here. The court had jurisdiction to determine whether, *if* the partners computed their outside bases on the assumption that the COBRA partnerships and transactions had economic substance, the basis-overstatement penalty could apply. That this question is suitable for resolution in partnership-level proceedings is borne out by the fact that respondent has devoted approximately 25 pages of his brief to the issue (see Br. 31-55), without either relying on partner-specific information or suggesting that the unavailability of such information will hinder the Court's ability to decide the question on which it granted certiorari.

Contrary to respondent's contention, the government's approach does not reflect a "penalty first—verdict afterwards" scheme (Br. 23-24) (citation omitted), because no penalty is imposed as part of the partnership-level proceedings. After those proceedings have been completed, the IRS will adjust the partners' returns as warranted and determine the resulting deficiencies. 26 U.S.C. 6230(a)(2)(A)(i). It will then assess the additional tax and the corresponding penalties, and the individual partners will have the opportunity to raise any partner-level defenses to the penalties through refund proceedings. See 26 U.S.C. 6230(c)(1)(C) and (4).[4]

To relieve the burden on the IRS and the Tax Court, Congress made the potentially time-consuming deficiency procedures (which may include Tax Court review) inapplicable to "penalties * * * that relate to adjustments to partnership items." 26 U.S.C. 6230(a)(2)(A)(i); see Gov't Br. 37-38; H.R. Rep. No. 148, 105th Cong., 1st Sess. 594 (1997). As a prerequisite to that streamlined process, however, the IRS must first make a threshold finding in partnership-level proceedings, subject to judicial review, that a penalty is "applicable," *i.e.*, that a partnership-level error could trigger the penalty at the partner level. 26 U.S.C. 6221, 6226(f). Respondent never acknowledges this basic objective of the jurisdictional provision or explains how his reading of the statute comports with it.

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[4] Respondent suggests (Br. 15, 30) that the IRS FPAAs at issue in this case actually "imposed" the basis-overstatement penalty on the individual partners. That is incorrect. Rather, with regard to penalties, the FPAAs stated that use of the basis figures reflected on the partnership return would constitute a gross valuation misstatement, and that "a 40 percent penalty shall be imposed on the portion of any underpayment attributable to the gross valuation misstatement." J.A. 96, 150. The FPAAs did not analyze whether the partners' S corporations had actually used the inflated basis figures on their own returns, whether any underpayment of tax had resulted, or what the amounts of any applicable penalties might be.

B. When A Taxpayer Overstates His Basis In Property By Giving Legal Effect To Sham Transactions, The Overstatement Penalty Can Apply

1. A taxpayer who uses sham transactions to illegally claim a high basis in assets overstates "the adjusted basis of any property"

Respondent urges for the first time an interpretation of Section 6662(e)(1)(A) that none of the ten courts of appeals to consider the issue has adopted: that the basis-overstatement penalty applies only to "fact-based basis errors," not to "legal errors" arising from misapplication of the rules governing the computation of basis. Br. 31-46. That argument lacks merit.

a. i. Respondent contends that the overstatement penalty applies only where the basis overstatement rests on an error of "valuation," *i.e.*, "a fact-based assessment of the monetary worth (or value) of something." Br. 33-34, 37. That is not what Section 6662 says. The statute imposes a penalty where "the value of any property (*or* the adjusted basis of any property) claimed on any [income tax] return * * * is 200 percent or more of the amount determined to be the correct amount of such valuation *or* adjusted basis (*as the case may be*)." 26 U.S.C. 6662(e)(1)(A) (emphases added). Congress's use of the disjunctive "or," and its inclusion of the phrase "as the case may be," indicate beyond serious doubt that the penalty can be imposed when the taxpayer's return overstates *either* the "value" of property *or* the "adjusted basis" of property, and an underpayment of tax results.

Respondent's interpretation of Section 6662(e)(1)(A) relies substantially on the presence of parentheses around the phrase "or the adjusted basis of any property." He argues that the "parenthetical construction signals that the item inside the parenthesis is meant to illustrate or explain what is outside the parentheses." Br. 38. But while that is true in many contexts, it is surely not true here, where the parenthetical clause begins with the word "or." That disjunctive does not introduce a clarification or illustration; it points to an alternative way to trigger the penalty. Cf. *Chickasaw Nation* v. *United States*, 534 U.S. 84, 89 (2001) (parenthetical clause introduced by "including"). As this Court has explained, "[c]anons of construction ordinarily suggest that terms connected by a disjunctive be given separate meanings, unless the context dictates otherwise." *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 339 (1979).[5]

Here, no special contextual factor supports an atypical reading of "or." The term "basis" could not be read as an example or synonym of "value," because "basis" is generally defined as "the cost of * * * property" to the taxpayer. 26 U.S.C. 1012(a). A taxpayer's basis in her house does not increase because the housing market picks up. And in the immediately following subparagraph of Section 6662(e), which identifies another set of circumstances in which the overstatement penalty is triggered, two disjunctive parenthetical phrases appear, neither of which is illustrative. See 26 U.S.C. 6662(e)(1)(B)(i) ("the price for any property or services (or for the use of proper-

[5] As respondent acknowledges (Br. 38), moreover, the predecessor to the current Section 6662(e)(1)(A) did not include parentheses. The legislative history of the current provision stated that the new penalty was "generally the same as the valuation overstatement penalty provided under present law with five [irrelevant] modifications." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 653 (1989).

ty) claimed on any such return * * * is 200 percent or more (or 50 percent or less) of the amount determined * * * to be the correct amount of such price"). Moreover, any conceivable ambiguity raised by the parentheses would be resolved by the repetition of the term "adjusted basis" outside of the parentheses at the end of the sentence and, most clearly, by the phrase "as the case may be." That phrase indicates that the penalty targets two categories of "case[s]": overstatements of value and overstatements of adjusted basis.

The only actual language in the operative text that respondent cites for support is the term "correct amount." Br. 34. Both "value" and "adjusted basis," however, are numerical "amounts," and there is nothing anomalous about using the term "amount" to refer to a sum whose calculation depends in part on the application of legal rules. See, *e.g.*, 26 U.S.C. 6662(d)(2)(A) (referring to "the amount of the tax required to be shown on the return for the taxable year"). Respondent also observes that the defined term is "valuation misstatement." Br. 34. But while ambiguities in a statutory definition may be resolved by reference to usual understandings of the defined term, Section 6662(e)(1)(A) *unambiguously* defines "valuation misstatement" to include specified overstatements of adjusted basis. That unambiguous definition controls. See *Burgess* v. *United States*, 553 U.S. 124, 129-130 (2008).

ii. Contrary to respondent's apparent assumption, the terms "basis," "value," and "valuation" do not connote purely "fact-based" concepts. The Internal Revenue Code's definition of "basis" makes clear that the formula for calculating it, even before making adjustments, depends on the application of legal rules, including specialized rules for "partners and partnerships." See, *e.g.*, 26 U.S.C. 1012(a). In enacting Section 6662(e)(1)(A), Congress thus legislated against a well-settled understanding that basis is the product of both legal and factual determinations.

The same is true of "value" or "valuation." As any student of accounting knows, valuation depends in part on the application of methodological rules and principles, and none of the definitions that respondent cites (Br. 34 n.6) suggests that valuation is exclusively "fact-based." Respondent is wrong in contending that the "Tax Court has a longstanding practice of treating valuation issues as matters of *fact*, rather than questions of law." Br. 35. The Tax Court has explained, for example, that "three approaches are used to determine the fair market value of property" for tax purposes, and that "[t]he question of which approach to apply in a case is a question of law." *Chapman Glen Ltd.* v. *Commissioner*, Nos. 29527-07L, 27479-09, 2013 WL 2319282, at *17 (May 28, 2013) (citing *Powers* v. *Commissioner*, 312 U.S. 259, 260 (1941)). Numerous special legal rules, moreover, apply to the valuation of particular types of property. See, *e.g.*, 26 U.S.C. 170(f)(4) (remainder interest in real property donated to charity). Because all property valuations include such threshold legal determinations, "[v]aluation is a mixed question of law and fact." *Whitehouse Hotel Ltd. P'ship* v. *Commissioner*, 615 F.3d 321, 333 (5th Cir. 2010) (citation omitted).

iii. Respondent's view that Section 6662 applies only to "fact-based basis errors" also ignores the statute's reference to overstatements of *adjusted* basis. Even after a taxpayer's basis in particular property has been determined, see 26 U.S.C. 1012(a), the calculation of "adjusted basis" can entail the application of additional legal rules governing issues like depreciation and amortization. See 26 U.S.C. 1011(a), 1016. For example, the Internal Revenue Code specifies different rates of depreciation for different types of property. See 26 U.S.C. 168(c). The word "adjusted" in Section 6662(e)(1)(A) makes clear that the penalty can be imposed when a taxpayer correctly determines initial basis (see 26 U.S.C. 1012) but miscalculates the applicable adjustments. That choice would be inexplicable if Congress had intended to confine the penalty to underpayments resulting from "fact-based basis errors."

b. Even if the plain text of Section 6662 did not foreclose respondent's argument, the Treasury regulation concerning the overstatement penalty would. The regulation states, as an example of the overstatement penalty's application, that a corporation commits a "valuation misstatement" if it fails properly to take into account depreciation in computing its adjusted basis in an asset. 26 C.F.R. 1.6662-5(d), ex. 3. That regulation, which is entitled to judicial deference, see Gov't Br. 43, makes clear that basis overstatements can result from legal errors.

c. Respondent contends that, if the overstatement penalty applied to misstatements arising from legal errors, Congress would have enacted a defense for taxpayers who make reasonable legal mistakes in computing their bases in property. See Br. 41. But the Code provides for exactly such a defense by prohibiting imposition of a penalty "if it is shown that there was a reasonable cause" for the underpayment and "the taxpayer acted in good faith." 26 U.S.C.

6664(c)(1). That includes "an honest misunderstanding of fact *or* law." 26 C.F.R. 1.6664-4(b) and (c) (emphasis added).

Respondent acknowledges that Section 6664(c)(1) makes "a 'reasonable cause' defense available to most of the § 6662 penalties," but emphasizes that this "defense is not *specific* to legal mistakes." Br. 41 n.8. Respondent contrasts Section 6664(c)(1) with other provisions that focus more specifically on underpayments resulting from reasonable but wrong views of the law. See Br. 41. But the fact that Congress sometimes focuses on legal errors does not detract from the significance of Section 6664(c)(1), which applies generally to penalties imposed under Section 6662, and which by its terms applies to both legal and factual mistakes. The more natural inference from that provision is that Congress recognized that Section 6662 penalties can result from either sort of error. Section 6664(c)(1) also suggests that Congress perceived a need for a catchall "reasonable cause"/"good faith" defense that would encompass legal errors. Such a catchall provision would be superfluous, however, if Congress had enacted a separate "specifically legal defense" (Resp. Br. 42) for every penalty provision that might be triggered by legal mistakes.

Nor is there anything objectionable about the fact that basis overstatements arising from sham transactions will nearly always trigger the 40% penalty for gross misstatements. See Resp. Br. 42-43. The most egregious misconduct—engaging in phony transactions to create an artificial basis—warrants the most severe sanction.

d. None of the legislative-history materials on which respondent relies (Br. 35-36) even hints that the penalty at issue here does not apply to misrepresentations of basis or value that arise from legally erroneous computations. The statement that "valuation issues *frequently* involve difficult questions of fact," H.R. Rep. No. 201, 97th Cong., 1st Sess. 243 (1989) (emphasis added), implies that they *can* involve other sorts of issues, consistent with the courts' view that valuation issues raise mixed questions of law and fact. And the 1989 testimony by a member of an accountants' organization—which respondent attributes to "Congress" (Br. 36)—does little more than explain that valuation can be difficult. *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings on H.R. 2528 Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 101st Cong., 1st Sess. 114 (1989). Particularly given the fact that the witness "wholeheartedly recommend[ed] repeal of the[] valuation penalty sections," *ibid.*, that testimony sheds no meaningful light on the meaning of the statutory language that Congress enacted and subsequently retained.

e. Ultimately, any attempt to limit the valuation-misstatement penalty to "fact-based" errors would lead to impossible conceptual questions and consequences that Congress could not have intended. As discussed, property valuation begins with a threshold legal determination of which valuation method to use. See, *e.g.*, *Whitehouse Hotel*, 615 F.3d at 333. Taken to its logical conclusion, respondent's theory would permit a taxpayer who misvalued property to avoid the overstatement penalty merely by claiming that he had used a legally erroneous methodology rather than committing a "fact-based" error. And even if respondent's theory were not embraced to that extent, shielding basis misstatements premised on legal errors from the penalty would immunize a wide array of misstatements, such as use of the wrong depreciation rate. See Resp. Br. 42.

Nor is there any sound reason to create a special exemption for the type of legal error at issue here. It is well-settled that a taxpayer may not compute his basis in an asset using transactions that lacked economic substance. That is a necessary principle of tax law because the complexity of the rules governing income-tax computation creates opportunities for manipulation by sophisticated parties. In attempting to characterize this error as different in kind from other basis errors, respondent describes the district court as holding that "the property should be deemed not to exist." Br. 32-33. In fact, the court did not cast doubt on the existence of the sold property (*i.e.*, the assets distributed upon dissolution of the partnerships). Rather, it held that because the partnerships and their transactions lacked economic substance, the partners could not use the rules normally applicable to those types of transactions in computing the S corporations' basis in the distributed property. See Pet. App. 20a-21a. To the extent they improperly relied on those rules to make that computation, the partners misstated "the adjusted basis of * * * property."

2. Any underpayment of tax resulting from COBRA was "attributable to" a basis overstatement

a. Respondent devotes only five pages of his merits brief (46-51) to the rationale on which the court of appeals ruled in his favor: that when a taxpayer uses sham transactions to claim an unlawfully high basis figure on his tax return, any resulting underpayment of tax is not "attributable to" a basis overstatement.

Respondent's abbreviated defense of that holding rests on the court of appeals' view that a determination that a basis-inflating transaction lacks economic substance is an "independent legal ground" for disallowing any resulting tax deduction. Br. 46.

As the government's opening brief explains (at 46-48), that position is erroneous. The existence of an independent ground to disallow a deduction does not break the causal link between the basis overstatement and the underpayment of tax. And even if it did, the economic-substance determination here was not independent of the basis overstatement. The sham nature of the partnership transactions was the reason that the basis figures were overstated, not a separate legal defect. Indeed, if Woods and McCombs had merely purchased and sold options of lesser value as part of the COBRA scheme, and had ultimately claimed a smaller basis in the assets, they would have paid more tax than they did. Any underpayment resulting from COBRA was therefore "attributable to," because it was caused by, a basis overstatement.

Respondent observes that, in some factual scenarios, the government's position "would force a court to decide valuation issues for the sole purpose of imposing a valuation misstatement penalty," even though the valuation will have no ultimate effect on the amount of tax owed. Br. 47 (citation omitted). That could be true, for example, when a deduction that is alleged to rest on a misstatement of value or basis is wholly disallowed on an independent ground that does not give rise to penalties. See Gov't Br. 44-45 (discussing *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988)). There is no reason to suppose, however, that conducting such additional inquiries to determine whether penalties should be imposed is contrary to Congress's intent. Ascertaining a taxpayer's liability for penalties will often require additional inquiries (*e.g.*, whether there was "reasonable cause" for all or part of an underpayment, and whether "the taxpayer acted in good faith," 26 U.S.C. 6664(c)(1)) beyond those needed to determine whether an underpayment of tax exists. And the alternative to that approach—*i.e.*, treating the existence of an *additional* ground for disallowing a claimed deduction as a reason to exempt the taxpayer from penalties to which he would otherwise be subject—creates anomalous and unfair results. See Gov't Br. 46.

In any event, the present case does not involve valuation issues whose relevance is limited to the imposition of penalties. The district court's determination that the relevant partnerships and transactions were shams, which means that the correct basis in the pertinent assets is zero, is integral to the determination of Woods's and McCombs's liability for additional taxes owed.

b. Respondent also relies on the post-enactment discussion of the overstatement penalty in the *Blue Book*. Br. 48-51; see Gov't Br. 5-7. Although that document can be useful for construing ambiguous provisions of the Code, there is no ambiguity here. In any event, respondent does not address the explanation in our opening brief that the *Blue Book*'s formula was designed for two *unrelated* deductions, not two alternative grounds for disallowing the *same* deduction. See Gov't Br. 45-46.

In a case like this one, moreover, the sham determination is not an alternative "adjustment" from the corrected basis; it is the very reason that the basis was overstated. Although respondent correctly observes that "[t]he district court treated the operation of the economic substance doctrine as fatal *in and of itself* to the reported losses" (Br. 49), he does not acknowledge that in an abusive tax shelter like COBRA, the "basis misstatement [is] the engine of, the vehicle behind the sham transaction." *Bemont Invs. LLC* v. *United States*, 679 F.3d 339, 353 (5th Cir. 2012) (Prado, J., concurring).[6]

3. Neither the 2010 statutory amendment nor any applicable canon of construction supports respondent's constricted interpretation of the basis-overstatement penalty

a. Although the basis-overstatement penalty was first enacted in 1981, and amended and recodified in 1989, respondent argues that this Court should inter-

[6] Contrary to respondent's characterization (Br. 50-51), the government claims *Chevron* deference on this question only insofar as Treasury regulations refute the court of appeals' holding that the total disallowance of a deduction categorically precludes the overstatement penalty. See Gov't Br. 43.

Amici contend that non-binding litigation guidelines issued in 1992 and 2011 by the IRS for its attorneys support the court of appeals' holding. See New Millennium Trading Amicus Br. 25-29. In fact, those guidelines consistently maintained that the overstatement penalty applies in cases like this one. See Litigation Guideline Memorandum, IRS LGM TL-68, 1992 WL 1355877 (Aug. 12, 1992); Chief Counsel Notice, IRS CC-2012-001, at 4 (Oct. 5, 2011), http://www.irs.gov/pub/irs-ccdm/cc-012-001.pdf. Relying on Tax Court decisions that have distinguished between pre- and post-trial concessions, the 1992 memorandum recommended that attorneys not seek the penalty when the taxpayer has conceded a truly alternative ground for disallowance prior to trial. The 2011 memorandum, however, instructed attorneys to address such concessions "on a case-by-case basis."

pret Section 6662(e)(1)(A) in light of a 2010 amendment to Section 6662. See Br. 44-46, 53-55. That amendment imposes a penalty of 40% of the underpayment of tax attributable to a transaction deemed to lack economic substance that was not disclosed to the IRS. See 26 U.S.C. 6662(b)(6) and (i). Respondent variously contends that the amendment either changes the meaning of the overstatement penalty or "sheds light" on its original meaning, on the theory that "[i]f Congress had adopted the broad-based 'basis-overstatement penalty' advanced by the government, there would have been no need for Congress to adopt this new penalty." Br. 45.

Those arguments lack merit. The 2010 amendment does not apply to this case, and it did not alter the text of either Section 6662(b)(3) (which establishes the penalty for underpayments of tax resulting from substantial valuation misstatements) or Section 6662(e)(1)(A) (which defines "substantial valuation misstatement" to include overstatements of adjusted basis). There is also no logical inconsistency between the government's reading of Section 6662(e)(1)(A) and Congress's decision to enact the 2010 amendment. Like the circles of a Venn diagram, the two penalties overlap, but each applies to some conduct to which the other does not. The new penalty applies to all sham transactions, not only those that result in an overstatement of basis. The basis-overstatement penalty is not limited to overstatements of adjusted basis that result from sham transactions.

The existence of some overlap between the two penalties does not render either superfluous. There is also substantial overlap between, for example, the overstatement penalty and the negligence penalty or the income-tax understatement penalty. See 26 U.S.C. 6662(b)(1) and (2). Congress has enacted various anti-stacking provisions to prevent the cumulative imposition of two distinct penalties for the same underpayment of tax. See 26 U.S.C. 6662(b) (last two sentences), 6662A(e), 6701(f)(2) and (3); see also 26 C.F.R. 1.6662-2(c). Those provisions limit taxpayers' potential exposure to penalties. And by demonstrating that Congress anticipated cases in which particular transactions or underpayments would implicate more than one penalty provision, the anti-stacking provisions refute respondent's contention that the enactment of new Section 6662(b)(6) and (i) is a reason to hold Section 6662(e)(1)(A) inapplicable. Congress, moreover, had ample reason to establish overlapping penalty coverage for schemes like COBRA given the longstanding outlier interpretations of the overstatement penalty adopted by the Fifth and Ninth Circuits. See Pet. 27-29.

Although the two penalties are harmonious under the government's reading, respondent's interpretation would leave a large gap in their coverage. Because respondent maintains that "Congress did not intend to reach legal errors with the valuation misstatement penalty" (Br. 41), his interpretation would shield from both penalties all "legal" basis errors—even for basis figures far exceeding the threshold for a gross valuation misstatement—other than those resulting from application of the economic-substance doctrine. Adoption of that view would produce far more serious anomalies than concluding that both penalties apply in certain tax-shelter cases.[7]

[7] Respondent is similarly wrong in pointing to (Br. 54-55) the 2004 enactment of certain penalties relating to reportable transac-

b. Respondent finally contends (Br. 51-52) that Section 6662 is sufficiently ambiguous that it should be construed not to apply to schemes in which taxpayers engage in sham transactions with the specific purpose of claiming an unlawfully high basis in an asset. Although ambiguous Internal Revenue Code penalties should be construed in favor of the taxpayer, see *Commissioner* v. *Acker*, 361 U.S. 87, 91 (1959), at least where the "penalty can[not] be easily avoided," *Fulman* v. *United States*, 434 U.S. 528, 533 n.8 (1978), no ambiguity exists here.

Woods and McCombs engaged in a series of sham transactions to create the illusion that their S corporations' basis in assets distributed by the partnerships was $45 million, even though they expended only a tiny fraction of that amount in conducting the transactions. Any resulting underpayments were plainly "attributable to" an overstatement of "the adjusted basis of * * * property," and there is no plausible reason why Congress would have intended to exempt such egregious misconduct from the penalty. Subjecting those who employ sophisticated schemes like COBRA to the same penalty that applies to ordinary taxpayers is the most appropriate way to "ensure that the tax laws are not abused." Resp. Br. 51.

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tions. Contrary to a suggestion in an internal IRS memorandum cited by respondent, the IRS does not take the position that both the Section 6662A penalty and the basis-overstatement penalty can cumulatively be imposed for the same error—an interpretation foreclosed by Sections 6662(b) and 6662A(e)(2)(B). And the Section 6707A penalty that respondent cites is capped at specific dollar figures.

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For the foregoing reasons and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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Solicitor General

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