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., *Respondent.*

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF NEW MILLENNIUM TRADING, LLC, AHG INVESTMENTS, LLC, NPR INVESTMENTS, LLC, ALPHA I, L.P., AND WEST VENTURES, L.P. AS *AMICI CURIAE*
in Support of Respondent and Affirmation of the United States Court of Appeals for the Fifth Circuit Opinion in No. 11-50487

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INTEREST OF THE *AMICI CURIAE*

Amici are petitioning or intervening partners in five separate partnership proceedings pending in various courts, all of which involve the question originally presented in the United States' petition for a writ of certiorari, and one of which involves the jurisdictional question on which this Court ordered briefing.[1] Amici are filing this brief on behalf of each

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[1] Pursuant to Rule 37.6, *amici* state that no counsel for a party authored this brief in whole or in part, and no person or

of the respective partnerships in which they are a partner. Amici's interest is in the proper resolution of both questions. Amici have authority to file this brief pursuant to Rule 37.3.[2] A brief description of each amicus curiae follows:

Andrew J. Filipowski, through a grantor trust, is the sole member of AJF-1, LLC, which is the petitioning partner in *New Millennium Trading, LLC v. Commissioner*, United States Tax Court, docket number 3439-06. The *New Millennium* case raises an issue virtually identical to the jurisdictional issue that the Court has raised in this case: whether the Tax Court has jurisdiction in a partnership proceeding to determine penalties that are predicated on the basis that one partner claimed in assets that the partnership distributed to him.

Alan Ginsburg is a partner in AHG Investments, LLC and the petitioner in *AHG Investments, LLC v. Commissioner*, United States Tax Court, docket number 3745-09. *AHG* involves the proper application of the valuation misstatement penalty.

Harold Nix is a partner in NPR Investments, LLC. and an intervenor-plaintiff in *NPR Investments, LLC v. United States*, a refund appeal pending in the United States Court of Appeals for the Fifth Circuit, docket number 10-41219. *NPR* involves the proper application of the valuation misstatement penalty.

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entity, other than Amici and their counsel, made a monetary contribution to the preparation or submission of the brief.

[2] As reflected in letters filed with the Clerk, petitioner and respondent have consented to the filing of this brief.

Robert Sands is a notice partner in Alpha I, L.P. and has petitioned this Court for a writ of certiorari to the United States Court of Appeals for the Federal Circuit in docket numbers 2011-5024 and 2011-5030. *See Alpha I, L.P. v. United States*, 682 F.3d 1009 (Fed. Cir. 2012), *petition for cert. filed*, (U.S. Nov. 1, 2012) (No. 12-550). The *Alpha I* case involves the proper application of the valuation misstatement penalty. Notably, the *Alpha I* case does not present the same jurisdictional issue that is present in this case, as the valuation misstatement penalty in that case was asserted based on the partnership's alleged overstated basis (i.e. "inside basis").[3]

Anthony T. Sleiman is a partner in West Ventures, L.P. and the petitioner in *West Ventures, L.P. v. Commissioner*, United States Tax Court, docket number 24683-10. *West Ventures* involves the proper application of the valuation misstatement penalty.

SUMMARY OF ARGUMENT

The district court lacked jurisdiction in the partnership proceeding to determine penalties predicated upon adjustments to outside basis. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") provides for the determination of "partnership items" in the partnership proceeding, and "affected items" (such as a partner's outside basis) in subsequent partner level proceedings. *See*

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[3] The basis that a partner has in her partnership interest is often referred to as "outside basis." "Inside basis," on the other hand, refers to the basis that a partnership has in its own assets.

26 U.S.C. §§ 6221 and 6230; *see generally* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402, 96 Stat. 324, 648-67 (codified as amended at 26 U.S.C. §§ 6221-6232). Under TEFRA, and specifically Section 6230,[4] the Internal Revenue Service (the "IRS") is required to follow deficiency procedures with respect to penalties that relate to adjustments to affected items that require partner level determinations, such as outside basis. The government's argument to the contrary rests on the nonsensical premise that a court in a TEFRA partnership proceeding, though it lacks jurisdiction to determine outside basis, nevertheless has jurisdiction to determine the applicability of penalties predicated on adjustments to outside basis.

Amici also support affirmation of the Fifth Circuit's determination below that no valuation misstatement penalty under Section 6662 may be imposed with respect to a claimed loss where the loss is disallowed for reasons unrelated to value. This determination is consistent with the IRS's longstanding interpretation of the statute, as first embodied in a litigation guideline memorandum from 1992, and as recently reaffirmed in a 2011 IRS Chief Counsel Notice.

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[4] All subsequent references to "Section" or "Code" are to the Internal Revenue Code of 1986, as amended and as it existed in 1999, unless otherwise indicated. References to regulations are to Treasury regulations as they existed in 1999.

ARGUMENT

I. The Trial Court Lacked Jurisdiction Under Section 6226(f) to Determine the Applicability of Valuation Misstatement Penalties Predicated on Adjustments to Outside Basis.

A. The Court Lacks Jurisdiction In This Case to Determine the S Corporations' Bases In the Sun Microsystems Stock and Canadian Currency Or Any Penalty That Is Predicated On An Adjustment to Their Bases.

TEFRA requires the tax treatment of any "partnership item" to be determined at the partnership level. *See* Section 6221. In most cases, after the partnership proceeding is over the IRS may directly assess the partners for any change in tax liability that is caused by an adjustment to a partnership item. *See* Section 6230(a)(1). Where, however, the change in tax liability cannot be determined without "partner level determinations," the IRS must apply the Code's deficiency procedures. *See* Section 6230(a)(2)(A)(i). Likewise, penalties that "relate[ ] to" an adjustment to a partnership item must be determined at the partnership level. *See* Section 6221. Where the penalty is based on an item that requires partner level determinations, however, the penalty must also be determined in that partner level proceeding. *See* Section 6230(a)(2)(A)(i). The trial court lacked jurisdiction over the penalties in this case because they are based on an item—the S corporations' sales of stock and foreign currency—that requires partner level determinations.

A "partnership item" is "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." Section 6231(a)(3). The quintessential example of a "partnership item" is the "partnership aggregate and each partner's share of . . . [i]tems of income, gain, loss, deduction, or credit of the partnership." *See* Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i).

Once the partnership proceeding is over, the IRS will make a "computational adjustment" to change the tax liability of a partner to properly reflect the treatment of a partnership item. *See* Section 6231(a)(6); Temp. Treas. Reg. § 301.6231(a)(6)-1T(a). "A computational adjustment includes a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item, or any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item." Temp. Treas. Reg. § 301.6231(a)(6)-1T(a).

An "affected item" is "any item to the extent such item is affected by a partnership item." Section 6231(a)(5). There are two types of affected items: those that require "partner level determinations," and those that do not. The IRS must follow the Code's deficiency procedures before assessing partners for any additional tax that requires a partner level determination, but can directly assess partners for the change in their tax liability that is attributable to an affected item that does not require a partner level determination. *See* Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(1), (2).

Section 6230 coordinates the TEFRA provisions with the Code's deficiency procedures. The general rule is stated in the first part of the statute: "Except as provided in paragraph (2) or (3), subchapter B of this chapter [i.e., the deficiency procedures] shall not apply to the assessment or collection of any computational adjustment." Section 6230(a)(1). Section 6230(a)(2)(A)(i), in turn, provides:

> Subchapter B shall apply to any deficiency attributable to affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items).

Thus, in order to collect additional tax that reflects a change in the type of affected item that requires a partner level determination, Subchapter B (which contains the Code's deficiency procedures) requires that the IRS first issue a notice of deficiency to the partner. *See* Section 6212. The partner may then contest the notice of deficiency in the Tax Court before paying any additional tax. *See* Section 6213.

The regulations under Section 6231 provide guidance on when a partner level determination is required. A change in a partner's tax liability that is related to "the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level" is the type of affected item that may be directly assessed. *See* Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(1). On the other hand, a change in tax liability with respect to "a partner's at-risk amount to the extent it depends upon the source from which the partner obtained the funds that the partner contributed to the partnership" is a computational adjustment subject to the Code's deficiency procedures. *See* Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(2).

In most cases, including this one, outside basis is an affected item. *See, e.g., University Heights v. Comm'r*, 97 T.C. 278 (1991); *Dial v. Comm'r*, 95 T.C. 1 (1990); *Gustin v. Comm'r*, 83 T.C.M. (CCH) 1341 (2002); *Allen Family Foods, Inc. v. Comm'r*, 80 T.C.M. (CCH) 562 (2000); (*see also* Gov't Br. 32). That is because a partnership is not usually required to take its partners' outside bases into account in preparing its own tax return and the Commissioner has not identified outside basis in the regulations as an item that is more appropriately determined at the partnership level (except in circumstances not at issue here). *See* Section 6231(a)(3) (defining "partnership item" as an item having those missing characteristics). Moreover, the determination of outside basis typically depends on facts that are unique to each partner, such as how much they paid for any property they acquired and then contributed to the partnership.

Outside basis is the type of affected item that requires partner level determinations. *See Napoliello v. Comm'r,* 655 F.3d 1060, 1062 (9th Cir. 2011); *Desmet v. Comm'r,* 581 F.3d 297, 303 (6th Cir. 2009). As such, Section 6230(a)(2)(A)(i) requires that any computational adjustment relating to outside basis be subject to the Code's deficiency procedures. *See Napoliello,* 655 F.3d at 1064 ("We hold that the IRS properly sent Napoliello an affected item notice of deficiency because the deficiency [arising from the IRS's recalculation of Napoliello's outside basis] required a partner-level determination."); *Desmet*, 581 F.3d at 300-01.

In this case, the government recognizes that a determination of the S corporations' bases in the stock and currency that they sold depends on the outside bases that those S corporations had in the partnerships, which carried over to the stock and currency.[5] Amici disagree, however, with the government's repeated contention in this case that "each partner's correct outside basis in the partnerships was zero." (Gov't Br. 18; *see also* Gov't Br. 24-25, 26, 27, 32, 42.) To the contrary, each partner's correct outside basis is presently unknown, as it must be determined in subsequent partner level proceedings under the framework described above.

The S corporations' bases in the stock and foreign currency must be determined before any underpayment, or related penalty, can be determined. A court will have to determine "the portion of the stock [and currency] actually sold, the holding period for the stock [and currency], and the character of any gain or loss." *See Desmet*, 581 F.3d at 303 (quoting *Domulewicz v. Comm'r*, 129 T.C. 11 (2007)). The court will also have to determine the dollar amount of the basis. To use the government's

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[5] The IRS is seeking to impose penalties in this case based on the purported underpayments of tax that resulted from the S corporations purportedly claiming an "inflated" carryover basis in the Sun Microsystems stock and Canadian dollars that they sold. As the government says it, "[a]ny overstatement penalty assessed in this case will be assessed because the partners claimed a basis higher than zero in those assets." (Gov't Br. 32.)

hypothetical numbers from pages 15 and 16 of its brief, it appears that the basis in the distributed assets would be $8 million, reflecting the $3 million in cash and $5 million net premium paid for the option positions, adjusted by any gains or losses reported by the partnerships, less any other cash that the partnerships distributed to the partners. *See* Sections 705, 722 and 732(b). Or perhaps the partners should be treated as having directly acquired the stock and currency, giving them a $2 million basis, equal to what the partnerships paid for those assets. Or perhaps the government is correct that the S corporations' bases in the assets should be zero as a punitive consequence for having engaged in a transaction that lacks economic substance, notwithstanding that the partners effectively paid $8 million for the stock and currency. Regardless, that is not a determination that the trial court had jurisdiction to make in this case, as the S corporations' bases in the stock and currency is not a partnership item. It is an affected item that requires partner level determinations to be made in separate proceedings after this partnership proceeding is concluded.

In other cases like this one, the government has agreed that basis in distributed assets must be determined in partner level proceedings after the partnership proceeding is concluded, and that basis might be determined to be something other than zero. *See, e.g.*, Brief for the Appellant at 37, *Petaluma FX Partners, LLC v. Comm'r*, 109 A.F.T.R.2d 2012-2238 (D.C. Cir. 2012) (No. 11-1084), 2011 WL 3382390 ("The shamming of the partnership and the disallowance of the capital contributions will be taken into account in the computational adjustment by either reducing to zero the bases the partners claimed in the Scient stock or by substituting Petaluma's basis in this stock for the bases the partners claimed on their returns."). The government's repeated claim in this case that basis is "zero" is apparently meant to suggest that the determination of outside basis and, apparently, the bases in the Sun Microsystems stock and Canadian currency is a *fait accompli*. That suggestion would be wrong, however, because the trial court in this partnership proceeding does not have jurisdiction to determine the S corporations' bases in the stock and currency and their bases may or may not be zero.

The trial court also did not have jurisdiction in this partnership proceeding to determine whether the valuation misstatement penalty applied because that penalty is directly predicted on assertions that the trial court lacks jurisdiction to determine (i.e., that the S corporations' bases in the stock and currency was zero). It would be "putting the cart before the horse" to find that the trial court *has* jurisdiction to determine a penalty that is predicated on a determination that the trial court *lacks* jurisdiction to make.

B. The Government's Position Would Require Three Different Proceedings to Determine Outside Basis and The Valuation Misstatement Penalty.

The government has argued that the trial court has jurisdiction in the partnership proceeding to abstractly determine the partners' outside bases solely for purposes of determining whether the penalties may apply. This Court has rejected the concept of "hypothetical jurisdiction." *Steel Co. v.*

Citizens for a Better Env't, 523 U.S. 83, 94 (1998) (citing *Ex parte McCardle*, 7 Wall. 506, 514 (1868)). Moreover, the government's position would directly undermine the efficiencies that Congress achieved in TEFRA, as it would require three different proceedings to finally determine the partners' bases (and the carryover bases that the S corporations claimed in the stock and currency) and any penalty that is predicated on an adjustment to their bases.

The procedure the government seeks to impose is first to reach a determination in the partnership case that the penalty is abstractly applicable. This would apparently be based on a tentative determination that the bases in the stock and currency sold by the S corporations was overstated by more than 400% which, in the government's view, is sufficient to cause the gross valuation misstatement penalty to apply. However, after the partnership proceeding is complete it would be necessary for the IRS to issue notices of deficiency to McComb and Woods to actually adjust the S corporations' bases in the stock and currency that they received from the partnerships. *See* Section 6230(a)(2)(A)(i); *Napoliello*, 655 F.3d at 1062; *Desmet*, 581 F.3d at 300-01. The partners could then contest those proposed adjustments in a second judicial proceeding. Under its proposed procedures, the IRS would not issue notices of deficiency to assess any penalties that were abstractly determined to be applicable; rather, the government claims that the IRS may directly assess those penalties, without following normal deficiency procedures. (*See* Gov't Br. 13, 23.) The partners then would have six months to pay the penalties and sue for refunds, starting a third judicial proceeding for each of them.

In that proceeding, the partners will presumably be entitled to challenge the first court's tentative computation of basis and raise any partner level reasonable cause defense to the penalties.

It is hard to believe that Congress envisioned that convoluted procedural framework when it enacted TEFRA or made changes to it in 1997.[6] Instead, as discussed next, TEFRA unambiguously requires that affected items requiring partner level determinations and penalties predicated thereon be determined in the same partner level deficiency proceeding.

C. The Government Must Follow Deficiency Procedures for Penalties that Require "Partner Level Determinations."

Prior to 1997, trial courts did not determine penalties in TEFRA cases. *See N.C.F. Energy Partners v. Comm'r*, 89 T.C. 741, 744-45 (1987), *superseded by statute*, Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238(a), 111 Stat. 788, 1026. Under the old scheme, trial courts considering a

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[6] The relationship between the three different proceedings raises a quagmire of issues. For example, how should the court's preliminary computation of basis and imposition of the penalty in the partnership case be reconciled with the final computation of basis and penalties in the partner level proceedings? How would the government collect additional penalties in the partner level proceedings if, as the government claims, penalties must be determined in the partnership proceeding? What would happen, for example, if the trial court in the partnership case abstractly determined outside basis to be overstated by less than the 400% that the government claims is necessary to impose the gross valuation misstatement penalty, but outside basis is finally determined at the partner level to be overstated by more than 400%?

TEFRA partnership case were limited to determining partnership items. If the trial court sustained the IRS's adjustments in any given case, the applicability of any penalty would then be determined in subsequent proceedings on a partner-by-partner basis (e.g., to determine whether a particular partner was negligent). *Id.*

Congress recognized that this system was inefficient:

> Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

H.R. REP. NO. 105-148 at 594 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678, 988. Recognizing that the relevant conduct "often" occurs at the partnership level, Congress changed the law in 1997 so that now "the tax treatment of any partnership item (and the applicability of any penalty . . . <u>which relates to an adjustment to a partnership item</u>) shall be determined at the partnership level." *See* Section 6221 (emphasis added).

At the same time, Congress specifically extended the jurisdiction of courts to determine penalties in partnership cases by amending Section 6226(f) which states in its present form:

> A court with which a petition is filed in accordance with this section shall have

> jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, <u>and the applicability of any penalty</u> . . . <u>which relates to an adjustment to a partnership item.</u>

Section 6226(f) (emphasis added). The determination at the partnership level of the applicability of any penalty that relates to an adjustment to a partnership item is conclusive, although a "partner shall be allowed to assert any partner level defenses that may apply." *See* Section 6230(c)(4).

Sections 6221 and 6226(f) in their present form provide courts with jurisdiction in the partnership proceeding to determine the applicability of any penalty "which relates to an adjustment to a partnership item." They do not provide the courts in a partnership case with jurisdiction over any penalty that relates to an adjustment to an affected item. Where the penalty relates to an adjustment to an affected item, the IRS must directly assess the penalty if no partner level determinations are required. *See* Section 6230(a)(1). Where, as here, the penalty relates to the type of affected item that requires a partner level determination, the IRS must follow the Code's deficiency procedures to collect the additional tax and related penalty. *See* Section 6230(a)(2)(A)(i).

Section 6230(a)(2)(A)(i) makes the deficiency procedures applicable to "affected items which require partner level determinations" but carves out a limited exception for penalties "that relate to adjustments to partnership items." *Id.* Congress' qualification of the exception to only penalties "that relate to adjustments to partnership items" reflects Congress' understanding, as expressed in the legislative history, that "[w]ith respect to partnerships, the relevant conduct often occurs at the partnership level." H.R. REP. NO. 105-148 at 594 (1997). If the government were correct that Congress intended the applicability of all penalties to be determined in the partnership proceeding, Congress would not have put the clause "that relates to adjustments to partnership items" in Section 6230(a)(2)(A)(i). Indeed, that clause is meaningless under the government's interpretation, as Congress could have made the deficiency procedures inapplicable to all penalties by simply stating "other than penalties." "Often" does not mean "always." Read in context, Section 6230(a)(2)(A)(i) makes clear that when, as in this case, the conduct that could give rise to the penalty occurs at the partner level, the penalty must be determined at the partner level.

It is notable that the government does not contend that all facts necessary to impose the penalty must be determined at the partnership level. That is because the penalty that may be imposed on a particular partner cannot be computed until that partner's tax liability is determined, as the accuracy-related penalties are computed as a percentage of any underpayment. *See* Section 6662. As the government explains, some penalties do not apply until certain thresholds are met, and no accuracy-related penalty would apply if the partner did not underpay her income tax (e.g., because she had unrelated losses). (*See* Gov't Br. 13, 35.) The government contends that these determinations are not subject to Section 6230(a)(2)(A)(i) because, according to the government, they are "partner level defenses" to be raised by partners in refund proceedings after payment of the asserted penalties. (*Id.*)

Thus, according to the government, all facts related to any penalty determination in a TEFRA case fall into one of two camps: 1) those pertaining to the applicability of a penalty that relates to an adjustment to a partnership item, that are appropriately determined in the partnership proceeding, and 2) those that relate to "partner level defenses," that are appropriately determined in partner level refund proceedings. (Govt. Br. 13); Treas. Reg. § 301.6221-1(d). The government apparently believes that it is never appropriate to determine any aspect of the penalty in deficiency proceedings.

The government's reading of TEFRA is flawed and leads to obviously unintended consequences. It is strained to call a threshold issue like "whether the taxpayer's individual return understated the tax owed by at least $5000," (Govt. Br. 13), a "defense" to the penalty. It is even more strained to call the question whether the partner has even underpaid her tax a "defense." (*See* Gov't Br. 35.) The flaw in the government's analysis is most apparent, however, when one considers its practical consequences. Consider the government's claim that whether a taxpayer has actually underpaid her taxes (e.g., because she has other legitimate losses) is a "partner level defense" that can only be asserted in a refund proceeding after the partner pays the penalty. (Gov't Br. 35.) If the IRS finds that the taxpayer has underpaid her taxes for reasons unrelated to the partnership, however, it will issue a notice of deficiency, allowing the taxpayer to go to the Tax Court. *See* Section 6213. In that scenario, two different courts will be faced with the same issue: whether the taxpayer underpaid her taxes. It seems implausible that Congress would have intentionally crafted such a framework.

The proper and far more logical reading of TEFRA is that a penalty may not be determined at the partnership level if it relates to an adjustment to an affected item that requires partner level determinations within the meaning of Section 6230(a)(2)(A)(i).

The government's claim that requiring it to follow deficiency procedures for penalties that require partner level determinations would nullify the 1997 changes to TEFRA because "[p]enalties virtually always require further partner-level determinations," (Gov't Br. 11, 22), is greatly exaggerated. To the contrary, the 1997 changes make partner level determinations unnecessary with respect to most penalties. The change in a partner's tax liability that reflects an adjustment to a partnership item likewise could be said to "virtually always require partner-level determinations" yet, as the government explains, no partner level determination is required "in the case of a purely mathematical change to the partner's return." (Gov't Br. 10.) In most cases, therefore, the additional tax that results from an adjustment to a partnership item can be directly assessed because it is purely mathematical. Likewise, most penalties do not require partner level determinations because they are purely mathematical, as they are generally calculated as a percentage of the underpayment. *See* Section 6662.

For example, in the common situation where the IRS adjusts the income or loss reported by a partnership, the change in the partners' tax liability that results from the adjustment at the partnership level will almost always be purely mathematical. It would therefore usually be appropriate for the IRS to directly assess the change in the partners' tax liability that results from the adjustment to the partnership's income or loss. *See* Section 6230(a)(1); Temp. Treas. Reg. § 301.6231(a)(6)-1T(a)(1). If the IRS asserts that the partnership was negligent, the "applicability of that penalty" is properly determined at the partnership level because no partner level determinations need be made to establish the factual support for that penalty.[7]

Before the changes to TEFRA in 1997, the applicability of the negligence penalty was a partner level determination that was made after the partnership proceeding was concluded. *See, e.g.*, *N.C.F. Energy Partners v. Comm'r*, 89 T.C. 741, 745 (1987). The partner level determinations that were required under prior law (i.e., whether each partner was negligent) are no longer required and the negligence penalty may be directly assessed (in this example) because it is purely mathematical. The 1997 changes therefore have had great effect.

The government's claim that "[p]enalties virtually always require further partner-level determinations" is also inconsistent with its (equally incorrect) claim that application of the penalty in this case "does not

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[7] The partner may assert partner level defenses, such as that he acted reasonably and in good faith, in a separate refund proceeding. *See* Section 6230(c)(4).

depend on factors specific to any individual partner." (Gov't Br. 23, 37.) The applicability of the penalty in this case most certainly depends on factors specific to an individual partner. As the government repeatedly explains, the penalty at issue in this case is directly predicated on the outside bases that carried over to the stock and currency that the partnerships distributed to the S corporations. (*See* Gov't Br. 18 ("the IRS concluded . . . that each partner's correct outside basis in the partnerships was zero. For that reason, the FPAAs determined that a 40% penalty for a gross misstatement of basis would apply . . . .").) The partners' outside bases was not reported on the partnership returns and is personal to each partner. Indeed, in many cases, including in some of the cases involving Amici, the IRS has asserted that only some, but not all, of the partners in those partnerships overstated their outside bases. To paraphrase the government, logically it makes perfect sense to determine whether the valuation misstatement penalty applies at the partner level because that penalty may apply against one partner (who overstated his basis) but not against another (who did not). (*See* Gov't Br. 31.)

Finally, the courts have repeatedly rejected the expansive view of jurisdiction that the government presses here in a closely analogous context. The jurisdictional statute Section 7422(h) provides that "[n]o action may be brought for a refund attributable to partnership items (as defined in section 6231(a)(3)) except as provided in section 6228(b) or section 6230(c)." The government has sought to define "attributable to" for purposes of Section 7422(h) as it seeks to have this Court now define "relates to" for purposes of Section 6221 and Section

6226(f). In both cases, the government's position is that the phrase should broadly be defined to include any item that is in any way connected to an adjustment to a partnership item. The courts have universally rejected that position for purposes of Section 7422(h) and there is no reason for the outcome to differ for purposes of Sections 6221 and 6226(f). The Second Circuit described the issue like this:

> At some level of generality, of course, most refund actions involving the taxation of a partnership can be described as seeking a refund "attributable to partnership items," I.R.C. § 7422(h). . . . But such a reading of the phrase "attributable to partnership items" would make most or all refund claims arising out of the taxation of partnerships, even those entirely about and entirely dependent on facts peculiar to a single partner, claims for refunds "attributable to partnership items."

Monti v. United States, 223 F.3d 76, 82 (2d Cir. 2000).

The courts have therefore repeatedly rejected the government's broad definition of "attributable to" in the Section 7422(h) context to preserve the dichotomy between partnership items and affected items. *See Prochorenko v. United States,* 243 F.3d 1359, 1363 (Fed. Cir. 2001) ("Construing the phrase 'attributable to partnership items' so broadly as to cover claims that depend on the unique circumstances of an individual partner, and that only affect that partner, would be contrary to the system of separate treatment of partnership items and nonpartnership items established by Congress in enacting TEFRA.");

Field v. United States, 328 F.3d 58, 59-60 (2d Cir. 2003) (determining that Section 6621(c) penalty interest is an affected item and a refund claim for such interest is not foreclosed); *Rigas v. United States*, 486 F. App'x 491, 500-01 (5th Cir. 2012) (narrowly defining phrase "attributable to partnership items" to exclude right to consistent settlement of partnership items); *Clark v. United States*, 68 F. Supp. 2d 1333, 1347-48 (N.D. Ga. 1999) (noting that Section 7422(h) did not bar jurisdiction over affected items such as penalties for negligence and valuation overstatement that require factual determinations at the partner level).

These courts recognized the well-settled principle in TEFRA that issues that are unique to certain partners are more appropriately determined in partner level proceedings. *See, e.g.*, *Prochorenko*, 243 F.3d at 1363; *Monti*, 223 F.3d at 82.

That same principle applies with equal force in this case, as the asserted penalties are dependent on facts unique to the individual partners—i.e., their purported overstatements of basis. It would be very peculiar for the court to determine a penalty in the partnership proceeding (and thus against all of its partners) that is based on the conduct of a single partner (i.e., because that partner overstated his outside basis).

The Court should follow the reasoning of the courts that have interpreted Section 7422(h) and hold that when the penalty is predicated on partner level conduct that requires partner level determinations within the meaning of Section 6230(a), the court in the partnership proceeding has no jurisdiction to determine the applicability of that penalty.

II. The Valuation Misstatement Penalties Do Not Apply To An Underpayment Of Tax Resulting From the Disallowance of A Loss For Reasons Unrelated to Value.[8]

The Internal Revenue Code imposes an accuracy-related penalty on certain underpayments of tax. *See* Section 6662. Included within these penalties are the penalties for "substantial valuation misstatements" and "gross valuation misstatements." Section 6662(e), (h). There is a 20% penalty on any underpayment of tax that is "attributable to" a "substantial valuation misstatement" and a 40% penalty on any underpayment of tax that is "attributable to" a "gross valuation misstatement." *Id.* A "substantial valuation misstatement" exists if "the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 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)." Section 6662(e). A "gross valuation misstatement"

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[8] A petition for writ of certiorari is pending in *Alpha I*. *See Alpha I, L.P. v. United States*, 682 F.3d 1009 (Fed. Cir. 2012), *petition for cert. filed*, (U.S. Nov. 1, 2012) (No. 12-550). That petition also raises the issue of the proper interpretation and application of the valuation misstatement penalties. Unlike in this case, however, there is no question about the jurisdiction of the courts to consider those issues, because the penalty in *Alpha I* is predicated on the "inside basis" that the partnership claimed on the sale of stock. If the Court determines that jurisdiction is lacking in this case, it should grant the petition that is pending *Alpha I* to allow it to decide the questions surrounding the valuation misstatement penalties.

exists if the value or basis is overstated by 400% or more. Section 6662(h).

The valuation misstatement penalty was enacted "to deal with various problems related to valuation of property." H.R. REP. NO. 97-201, at 243 (1981). The House Report explains:

> This particular need is illustrated by the fact that there are about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance. These cases alone involve approximately $2.5 billion in tax attributable to the valuation issues.
>
> The committee recognizes that valuation issues frequently involve difficult questions of fact. Often, these issues seem to be resolved simply by "dividing the difference" in the values asserted by the Internal Revenue Service and those claimed by the taxpayer. Because of this approach to valuation questions, the committee believes that taxpayers have been encouraged to overvalue certain types of property and to delay the resolution of valuation issues. Because the tax interest rate has been below the prevailing cost of borrowing, this tendency probably has been accentuated somewhat.

Id.

Amici agree with Respondents that the valuation misstatement penalties only apply to underpayments of tax that are caused by a taxpayer overstating the value of an asset. The Fifth Circuit's holding below should also be affirmed for the alternative reason that it reflects the agency's own longstanding interpretation of the penalty statute.

In 1992, the IRS issued a "Litigation Guideline Memorandum," the purpose of which was "to outline the Service's current litigating position regarding the application" of the valuation misstatement penalties, as well as other penalties containing the phrase "attributable to." Litigation Guideline Memorandum TL-68 (Rev.), 1992 LGM LEXIS 14 (Aug. 12, 1992) ("LGM TL-68").[9] LGM TL-68 contains a thorough analysis of the valuation misstatement penalty statute, its legislative history, and the extant case law. LGM TL-68 remains in effect today; indeed, the IRS recently reiterated its continuing vitality. *See* I.R.S. Chief Couns. Notice CC-2012-001, 2011 CCN LEXIS 18 (Oct. 5, 2011) (discussing application of LGM TL-68 in connection with taxpayer concessions). As a thoughtful statement of agency position, LGM TL-68 is entitled to substantial deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). "The fair measure of deference to an agency administering its own statute has been understood to vary with circumstances, and courts

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[9] LGMs "provide information and instruction relating to litigating procedures and methods, and standards and criteria on issues and matters of significant interest to litigating attorneys in the Office of Chief Counsel." *See* I.R.S. Ann. 99-81, 1999-32 I.R.B. 244 (quoting Chief Counsel Notice N(32)210-1 (April 18, 1988)). Although the government calls LGM TL-68 "non-binding," (Gov't Br. 48 n.9), it is a document that the IRS uses to train the thousands of IRS lawyers who are tasked with enforcing the tax laws. That it may be "non-binding" is hardly any reason not to accept it as a statement of the agency's position on the issue under consideration.

have looked to the degree of the agency's care, its consistency, formality, and relative expertness, and to the persuasiveness of the agency's position." *United States v. Mead Corp.*, 533 U.S. 218, 228 (2001) (citing *Skidmore*, 323 U.S. at 139-40).

LGM TL-68 essentially adopts the "Blue Book" formula as the appropriate means to determine "the portion of an underpayment that is 'attributable to' overvaluation." LGM TL-68, at *16-17 (citing STAFF OF JOINT COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 333 (Comm. Print 1981) (the "Blue Book")). The formula expressed in LGM TL-68 is:

> (1) calculate the amount of tax liability for each year as if all items had been reported properly; (2) without taking into account any adjustments that are attributable to the valuation overstatement (including adjustments which are inseparable from the overstatement issue), calculate the amount of tax liability as if all other items had been reported properly; and (3) calculate the difference between (1) and (2); the difference between (1) and (2) is the underpayment attributable to the valuation understatement.

LGM TL-68, at *16-17. LGM TL-68 explains that the "formal legislative history surrounding the enactment of section 6659A before its repeal by the Revenue Reconciliation Act of 1989 also supports the interpretation and the application of the formula," and that Treas. Reg. § 301.6621-2T, Q & A-5 applies an identical formula for purposes of determining the portion of an underpayment attributable to a "tax motivated transaction." *Id.*, at *17.

With respect to the specific issue being addressed here, LGM TL-68 explains that "[o]ne result of applying the formula is that where a taxpayer claims a deduction or credit that is disallowed for reasons unrelated to a valuation overstatement, none of the underpayment is attributable to the valuation overstatement, *even if there is also a valuation overstatement with respect to that same deduction or credit*." *Id.*, at *17-18 (emphasis added). That interpretation is consistent with the statement in the Blue Book that the "portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability." Blue Book at 333. Nothing in the statute or its legislative history suggests that the phrase "any other adjustments" does not include other adjustments to the deduction that could support the valuation misstatement penalty. LGM TL-68 therefore concluded that "[w]here a taxpayer claims a deduction or credit that is disallowed on grounds unrelated to a valuation overstatement, none of the underpayment is attributable to a valuation overstatement, even if the taxpayer also made a valuation overstatement with respect to that same deduction or credit." LGM TL-68, at *17. LGM TL-68 determined that the penalty should be imposed, however, "where the grounds for disallowing a deduction or credit are 'an integral part of or inseparable from' overvaluation," and it modified the Blue Book formula to reflect that position. *Id.*, at *15.

The government's main argument for imposing the penalty in this case must be rejected because it contradicts the IRS's longstanding interpretation of the statute. The government argues that the Fifth Circuit misinterpreted the Blue Book because:

> The relevant passage describes a situation in which two *different* deductions are improper, one because of a basis overstatement and one for a separate reason. . . . In *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), however, the court of appeals misinterpreted that passage to foreclose the overstatement penalty where the *same* deduction that reflects a basis overstatement is invalid on an alternative ground as well. *See id.* at 542-43. The *Blue Book* formula was not intended for that purpose, and the court's holding has no support in the statute's text.

(Gov't Br. 25.) In other words, the government's main argument in this case is that the penalty *should* apply where a deduction "reflects a basis overstatement" even though the deduction is disallowed on grounds unrelated to valuation. That argument must be rejected because it directly contradicts the IRS's interpretation (as expressed in LGM TL-68) that the penalty *should not* apply "where a taxpayer claims a deduction or credit that is disallowed for reasons unrelated to a valuation overstatement . . . even if there is also a valuation overstatement with respect to that same deduction or credit."[10] LGM TL-68, at *17-18. The IRS's

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[10] The government alternatively argues that the penalty should be imposed in this case because the "determination that COBRA lacked economic substance was not a ground for disallowance that was independent of the basis overstatement." (Gov't Br. 25.) As noted above, LGM TL-68 similarly finds that

considered, valid, longstanding interpretation under LGM TL-68 is entitled to significant weight. *See United States v. Mead*, 533 U.S. 218, 228 (2001) (citing *Skidmore*); *Reimels v. Comm'r*, 436 F.3d 344, 347-48 & n.2 (2d Cir. 2006) (citing *Skidmore* and following a longstanding Revenue Ruling in light of "the persuasiveness of its reasoning") *Rubie's Costume Co. v. United States*, 337 F.3d 1350, 1360 (Fed. Cir. 2003) (deferring under *Skidmore* to Customs classification ruling in light of "Customs's specialized experience"); *Heartland By-Products, Inc. v. United States*, 264 F.3d 1126, 1134 (Fed. Cir. 2001) (deferring under *Skidmore* to Customs revocation ruling because of its persuasiveness and Customs' "specialized expertise").

The IRS's interpretation as expressed in LGM TL-68 serves Congress's purpose for enacting the penalty. As LGM TL-68 explains, numerous taxpayers have conceded that an item is not deductible or creditable on grounds unrelated to value in order to avoid the valuation misstatement penalty. LGM TL-68, at *21-28. Until recently, the courts generally agreed that such concessions served the purpose of the penalty, and held that the penalty could not be imposed in those circumstances. *See Weiner v. Comm'r*, 389 F.3d 152, 161-63 (5th Cir. 2004); *McCrary v. Comm'r*, 92 T.C. 827, 851-55 (1989); *Rogers v. Comm'r*, 60 T.C.M. (CCH) 1386

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the valuation misstatement penalty should apply "where the grounds for disallowing a deduction or credit are 'an integral part of or inseparable from' overvaluation." LGM TL-68, at *15. Amici take no position on the government's alternative argument.

(1990); *Schachter v. Comm'r*, 67 T.C.M. (CCH) 3092 (1994).[11] As the Fifth Circuit explained in *Weiner*, imposing the penalty in that situation would conflict with the purpose of the penalty because it would do "nothing to relieve the Tax Court's backlog." *Weiner*, 389 F.3d at 163. *See also Schachter*, 67 T.C.M. at 3094 ("The objectives of administrative efficiency and judicial economy have been well served by the closing agreement and petitioner's concession. Those objectives would not be served by requiring a trial on the substantive issues for the sole purpose of determining whether petitioner is liable for [the increased interest penalty].")

LGM TL-68 likewise concluded that taxpayer concessions serve Congress's goal for enacting the valuation misstatement penalty, and instructs all IRS attorneys to analyze taxpayer concessions under the following framework:

> [W]here a taxpayer establishes that a deduction or credit is not allowable for reasons unrelated to valuation or a tax motivated transaction, it follows that sections 6659[12] and 6621(c) should not be imposed with respect to the underlying underpayment, if the taxpayer

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[11] Some of these cases analyzed the now-repealed "tax motivated" interest penalty. These cases are instructive because "both [penalties] employ the same 'attributable to' language." *Weiner*, 389 F.3d at 160.

[12] Section 6659 was the predecessor to Section 6662. *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 323(a), 96 Stat. 324, 613-15; Tax Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 722(a)(1), 95 Stat. 172, 341-43.

timely concedes the deduction or credit prior to trial on a ground "independent of and wholly separable from" overvaluation or a tax motivated transaction.

However, where, in order to avoid the sanctions of sections 6659 and 6621(c), a taxpayer concedes, post-trial, a ground for the disallowance of deductions and credits that does not involve a finding of overvaluation or a tax motivated transaction, the concession should be rejected. We believe that the distinctions made by the Tax Court between pre-trial and post-trial are valid ones. Concessions, as all pleadings, should be timely made in order to avoid protracted and costly proceedings. Where respondent has undertaken extensive preparations and has gone through a trial, respondent should oppose concessions that limit the taxpayer's exposure. Counsel should argue that the court, in its discretion, should determine all issues tried, including those making applicable the sections 6659 and 6621(c) additions. This position, we believe, is consistent with the legislative intent of sections 6659 and 6621(c). *The legislative history of sections 6659 and 6621(c) suggests that Congress enacted those sections to provide the court tools for managing the large backlog of valuation and tax shelter cases. Consistent with this, the taxpayer's concession should be timely to avoid trial.*

LGM TL-68, *29-30 (emphasis added).[13]

Some courts have recently held, however, that a taxpayer may not avoid imposition of the penalty by conceding a deduction on grounds unrelated to value. These courts accepted the same legally erroneous contention that the government makes here: that the Blue Book formula purportedly only addresses the appropriate computation in cases involving two or more unrelated deductions. *See Alpha I, L.P. v. United States*, 682 F.3d 1009, 1029-30 (Fed. Cir. 2012); *Gustashaw v. Comm'r*, 696 F.3d 1124, 1136-37 (11th Cir. 2012) (dicta); *AHG Invs., LLC v. Comm'r*, 140 T.C. No. 7 (2013). The Tax Court recognized that this "may reduce the number of cases conceded by taxpayers attempting to avoid gross valuation misstatement penalties" and "lead to more trials on questions of valuation," but determined that "concerns relating to judicial economy are not a sufficient reason to disregard or continue to incorrectly apply the clear formula and example in the Blue Book." *AHG Invs.*, 140 T.C. No. 7, 2013 WL 999916, at *8 & n.12. Indeed, to continue to impose this penalty when the taxpayer has conceded the

[13] The IRS Chief Counsel recently confirmed the continuing vitality of the LGM but advised IRS lawyers that it is their responsibility to oppose purportedly "abusive" concessions. *See* IRS Chief Couns. Notice CC-2012-001. The Notice does not explain, however, what causes a particular concession to be "abusive", in light of LGM TL-68's careful finding that concessions serve Congress's purpose "to provide the court tools for managing the large backlog of valuation and tax shelter cases." LGM TL-68, at *30. In any event, trial courts are not required to accept "abusive" concessions. *See, e.g.*, Fed. R. Civ. P. 15(a)(2).

underlying adjustment will have exactly the opposite of Congress's intended effect because taxpayers will have nothing to lose by continuing to litigate and forcing the courts to decide difficult valuation issues—exactly what Congress was trying to avoid. That will place a significant burden on trial courts because it *requires* them to determine whether *any* ground that the IRS raises in support of an adjustment could support the penalty, and also because valuation issues are generally not susceptible to summary judgment.

The position urged by the government in this case has accordingly caused certain courts to *apply* the penalty in a manner that defeats the purpose *of* the penalty.[14] This Court should fix what the government has broken. It should affirm the judgment of the court of appeals because it accords with the agency's own interpretation of the penalty statute whereas the government's position frustrates the purpose of the statute.

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[14] The government concludes by claiming that it would unfair to impose the valuation misstatement penalty on "taxpayers who make simple errors in computing their bases in property" and not to impose it in this case. (Gov't Br. 49.) The penalty would not be imposed on taxpayers who make simple errors because the Code exempts from the penalty any understatement for which the taxpayer acted reasonably and in good faith. *See* Section 6664(c).

CONCLUSION

Amici respectfully request that the Court find that the district court lacked jurisdiction, in a partnership proceeding, to consider penalties that are predicated on an adjustment to outside basis, and accordingly remand the case with orders to dismiss. If the Court finds that jurisdiction exists to consider the valuation misstatement penalties in this case, Amici respectfully request that the Court find that the valuation misstatement penalty may not be impose where the IRS has completely disallowed the underlying loss for reasons unrelated to value.

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Respectfully submitted,

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