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No. 12-562

In the Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

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

Respondents.

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

BRIEF OF AMICI CURIAE PARTNERS IN JADE TRADING, LLC, PETALUMA FX PARTNERS, LLC, AND TIGERS EYE TRADING, LLC IN SUPPORT OF RESPONDENT S AND JURISDICTIONAL REVERSAL

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QUESTION PRESENTED[1]

Whether penalties that require the determination of the partner-level "outside basis" that partners report on their individual returns fall within partnership jurisdiction under Section 6226(f) or partner-level "affected item" deficiency jurisdiction under Section 6230(a)(2)(A) – that is, partner-level proceedings where the partners can defend themselves.

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[1] Due to the overriding importance of jurisdiction, this Court raised the jurisdictional question *sua sponte* and framed it as: "Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty." The same jurisdictional defects apply to any penalty imposed on the differing basis of the various partners in their partnership interests (commonly known as "outside basis") and so, we have stated the issue in terms of its natural breadth.

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INTEREST OF *AMICI CURIAE*[2]

All three sets of partners in *Jade*, *Petaluma*, and *Tigers Eye* face the IRS imposing penalties on a partner at the partnership level before he can defend himself. That advantage remains so important to the IRS that it has subjected *Petaluma* to a repetitive second appeal, subjected *Jade* to a repetitive second appeal, and has now asserted three stacked levels of tax (and penalties) on the same income reported by three of the five *Jade* partners. The two Tax Court opinions in *Tigers Eye* embody that tactic: the first bars the partners from presenting their reasonable cause defense on the grounds the Tax Court lacks partnership jurisdiction over partner-level defenses and the second, by way of *dicta*, purports to reject their reasonable cause defense on the merits. All *amici* seek a fair trial on their deferred Section[3] 6664(c) reasonable cause defenses in these 13 year old cases. Thus, the three sets of *amici* partners have a continuing direct interest in the jurisdictional issue which neither the trial nor Circuit Court addressed in *Woods I* and *II*. Neither litigant in this case addresses all the jurisdictional considerations addressed herein.

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[2] Counsel of record for all parties graciously consented in writing to the filing of this *amici* brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person or entity other than *amici curiae*, its members, or its counsel made a monetary contribution to its preparation or submission.

[3] Unless otherwise indicated, "Section" references are to 26 U.S.C., which correspond to sections in the Internal Revenue Code of 1986 (as amended through December 27, 1999).

SUMMARY OF ARGUMENT

Twice before the Federal Circuit in *Jade Trading II* and *IV* and twice before the D.C. Circuit in *Petaluma II* and *VI*, the IRS sought to secure the great advantage of punishing former partners at the partnership level based on *the contents of their individual returns* AND simultaneously barring those partners from defending themselves. In each instance, the IRS pressed this "flog-'em-now/try-'em-later" tactic by glossing over the same three critical distinctions that the IRS glosses over here.

One, the IRS glosses over the reality that it does not seek to impose what it calls "the basis overstatement penalty" on any tax basis reported on the partnership return and it does not seek to impose that penalty on affected items that require no further partner-level determination under Section 6230(a)(1). No, the IRS seeks to impose its "basis overstatement penalty" at the partnership level on the "outside basis" that the departed partners report solely on their returns. As four Courts of Appeal held, that outside basis constitutes an affected item which requires the partner-level determinations that Section 6230(a)(2) preserves for the partner-level deficiency proceeding.

Two, the IRS glosses over here, as it did in *Petaluma II-IV* and *Jade II-IV*, the distinction between the traditional posture of penalties *as* an affected item and the imposition of penalties *on* affected items that still require a subsequent partner-level deficiency proceeding.

And three, the IRS glosses over its extraordinary attempt to usurp both the partnership-level and the partner-level deficiency jurisdiction *of the courts*. As amended in 1997, Section 6226(f) grants "*a court* [not the IRS] … jurisdiction to determine *all partnership items of the partnership for the partnership taxable year* [not the affected items the former partners reported on their returns for their taxable years]…and *the applicability of any penalty* [that is, the essential elements of that penalty] which relates to *an adjustment* [not an abstract conceptual determination (like sham) not listed on the FPAA "Schedule of Adjustments": J.A. 91, 145]; to *a partnership item* [not the outside basis the IRS admits requires a partner-level proceeding]."

The IRS then obliterates the jurisdictional integrity of the Section 6230(a)(2)(A) partner-level affected item judicial proceeding by stretching the "computational adjustment" stage beyond its computational function. With no judicial participation at that stage, the IRS (i) unilaterally resolves all remaining essential elements of the penalty against the partner, (ii) preempts the partner-level judicial proceeding by determining each former partner's respective "outside basis," resulting loss, and resulting deficiency on his individual return, (iii) preempts any consideration of his reasonable cause (which Section 6664(c) contemplates must be determined before imposition of any Section 6662 penalty), and (iv) finally imposes, assesses, and demands payment of that penalty before the partner can defend himself. The IRS usurps the heart of the affected item deficiency jurisdiction Congress took such care to preserve.

Facing that jurisdictional trespass, the D.C. Circuit rejected the attempt by the IRS in *Petaluma II* to pick the affected-item "forbidden fruit" before its time. The Federal Circuit adopted that reasoning and much of its language in *Jade II*. The trial courts in *Petaluma III* and *Jade III* faithfully followed that reasoning on remand. The Federal Circuit promptly rejected the IRS repetitive appeal in *Jade IV*, while the repetitive IRS appeal in *Petaluma VI* awaits decision. Those repetitive appeals herald how badly the IRS wants this "flog-'em-now/try-'em-later" advantage. Worse, the IRS now contends that imposition of the defense-barred penalty is "conclusive" and "unreviewable." IRS Br. 35.

The decisions by those two Courts of Appeal follow the same affected-item-deficiency reasoning adopted by two other Courts of Appeal at the urging of the IRS when the shoe was on the other foot. *Desmet v. Commissioner,* 581 F.3d 297, 304-5 (6th Cir. 2009) (despite purported elimination of outside basis via sham determination at the partnership level, outside basis remained an affected item that required partner-level deficiency procedures under Section 6230(a)(2)(A)); *Napoliello v. Commissioner*, 655 F.3d 1060, 1064 (9th Cir. 2011) (same holding). Citing *Desmet*, the D.C. Circuit in *Petaluma II* specifically rejected the IRS argument urged here that penalties can be imposed on outside basis because "elements" of outside basis are partnership items. The D.C. Circuit in *Petaluma II* (and Federal Circuit in *Jade II*) concluded that "the fact that a determination seems obvious or easy does not expand the court's jurisdiction … no matter how low the fruit hangs…" *Id*., 591 F.3d at 654-5.

With no conflict from any other Court of Appeals, these cases lead to this workable, three-prong jurisdictional rule that maintains the integrity of partnership jurisdiction, the computational function of the "computational adjustment," and partner-level affected item deficiency jurisdiction:

* A Section 6662 "Accuracy-Related Penalty on Underpayments" can be imposed at the partnership level on *adjustments* to partnership items on the partnership return (such as partnership gains and losses) that generate underpayments which can be computed with no need for a partner-level deficiency proceeding.

* Where no partner-level determination is required, the resulting underpayment and penalty can be calculated and assessed purely as a Section 6230(a)(1) "computational adjustment."

* Conversely, no Section 6662 "Accuracy-Related Penalty on Underpayments" can be imposed at the partnership level on an underpayment that cannot be computed without the Section 6230(a)(2)(A) partner-level deficiency proceeding: those penalties must be asserted in that proceeding where the partner can defend himself.

That three-prong reconciliation cures the practical and jurisdictional impossibility the IRS FPAAs raise in *Woods*. Those FPAAs disregard the partnership and treat the transactions as "engaged in directly by its purported partners." [J.A. 93, 147] Their basis in the distributed assets and any resulting deficiency and penalty can only be determined in their deficiency proceedings.

Coupled with another draconian device, the IRS tactic of imposing outside basis penalties on the partners at the partnership level before they can defend themselves will mean that many people *will never be able to defend themselves*. The IRS seeks to assess those penalties as a "computational adjustment" under Section 6230(a)(1) "without following deficiency procedures." IRS Br. 23. In such cases, no prepayment forum exists for challenging the IRS's summary determination. Instead, a partner who wishes to challenge such an assessment may only do so in a tax refund suit, and then only if the partner is able to pay the penalty in full *within six months of the date the IRS mails the notice of computational adjustment* to the partner. 26 U.S.C. § 6230(c)(1), (2)(A). *See Flora v. United States*, 362 U.S. 145, 177 (1960).

This truncated tax refund procedure under TEFRA should be contrasted with the far more taxpayer friendly procedures for the traditional tax refunds under the Code. *See* Subchapter B -- Limitations on Credit and Refund of Chapter 65 -- Abatements, Credits, and Refunds (26 U.S.C. §§ 6511-6515). Under the IRS argument, that same notice of computational adjustment contains the assessment and demand for payment of the full taxes (including the outside basis component), interest on the taxes, the 40 percent penalty, and here, 13 years of interest on the penalty. If those former partners are unable to pay those defense-barred penalties within those six months, their defenses will be barred forevermore.

ARGUMENT

By way of a brief overview of the substantive and procedural foundation for these cases, the Internal Revenue Code treats partnerships as pass-through entities which pass their tax consequences onto their partners. 26 U.S.C. § 701. The partnership files a U.S. Partnership Information Return (Form 1065) reporting those consequences and the individual partners file their own returns reporting their distributive shares of those consequences.

Of significance here, each partner takes a tax basis in his or her partnership interest (commonly referred to as that partner's "outside basis") which is generally calculated as the sum of cash and the partner's cost basis in any assets contributed to the partnership. 26 U.S.C. §§ 705, 722, 1012. *Importantly, the U.S Partnership Information Return provides no space or box for the partnership to report the varying outside basis of the different partners. Only the partners' returns reflect outside basis and then only occasionally.* The typical situation arises when a partner redeems his partnership interest for distributed assets. Section 732(b) determines the basis of those assets in his hands by substituting his outside basis for whatever basis the partnership may have had in those assets prior to distribution (the partnership's "inside basis").[4] When the former partner later sells some or all of the distributed assets, he reports the sales proceeds, his (outside) basis in those assets, and the resulting gain or loss on his return.

[4] The *Woods* partnership termination operates as a redemption, distribution, and recontribution to the S Corporation.

The substantive dispute (which the trial and appellate courts did not reach in *Woods* due to their economic substance holding) emanates from the prevailing law in 1999 as to contingent obligations. For over 50 years, the IRS successfully applied that authority to exclude contingent obligations as falling short of fixed liabilities.[5] *Woods* and the *amici* cases involve individuals who were advised to acquire long (purchased) and short (sold) foreign currency options and contribute the long option to a partnership in exchange for a partnership interest. The partners in these partnerships received lengthy opinions from large law firms and/or accounting firms advising the partner's local CPA to include the cost of the purchased option in his outside basis and to exclude the contingent short option.

The IRS audited the partnership returns and proposed adjustments in a Final Partnership Administrative Adjustment ("FPAA"). The two FPAAs issued in *Woods*, like all FPAAs, contain an "Explanation of Items" and a "Schedule of Adjustments." While the *Woods* "Explanation" contains abstract sham assertions, the *Woods* "Schedule of Adjustments" contains *no adjustment to the capital contributions or distributions reported on the partnership return*. [J.A. 91, 145] With no numerical adjustment, it improperly lists the affected-item outside basis as a partnership item.

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[5] Among many others, those cases include *Deputy v. du Pont*, 308 U.S. 488, 497 (1940) (short sale held contingent obligation); *Long v. Commissioner*, 71 T.C. 1, 10-12 (1978) (partnership basis excludes contingent obligation); *LaRue v. Commissioner,* 90 T.C. 465, 480-82 (1988) (same); *Helmer v. Commissioner,* T.C. Memo 1975-160 (1975) (same).

The IRS filed this appeal in an attempt to impose what it calls the "basis overstatement penalty"[6] *at the partnership level* on the "outside basis" which individual partners report on their returns and which the IRS admits constitutes an affected item. IRS Br. 33-4. The IRS asserts on brief that adjustments to the capital contributions and distributions on the partnership return provide the partnership-item foundation for imposing the "basis overstatement penalty." Not only does the FPAA "Schedule of Adjustments" contain no such adjustments, the partnership return reports those items under rules that do not affect outside basis.

This penalty remains at least four steps removed from the partnership, as the Court confirmed in *Jade III*.[7] Finally, the IRS insistence upon penalizing the outside basis affected-item at the partnership level exploits the *Tigers Eye I* ruling, barring those partners from defending themselves at that level.

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[6] While outside the scope of this brief, the IRS stretches the "*Substantial Valuation Misstatement*" penalty (26 U.S.C. § 6662(e)) beyond its limits for the reasons summarized in *Woods* Arg. II. *Amici* agree with that analysis.

[7] Those steps include: (i) the partnership distributes assets to a partner in redemption of his partnership interest (here, a constructive redemption and distribution upon the termination of the *Woods* partnerships), (ii) after the distribution, Section 732(b) substitutes outside basis as the asset basis in the hands of the former partner, (iii) the outside basis (reported on the individual return) results in a subsequent gain or loss (reported on the individual return) when the partner later sells it, (iv) the gain or loss dictates the tax liability, and (v) that liability (along with any Section 6664(c) reasonable cause) determines the applicability of the Section 6662 percentage penalty.

A. CONGRESS CREATED THREE DISTINCT LEVELS OF JURISDICTION: PARTNERSHIP, COMPUTATIONAL ADJUSTMENT, AND PARTNER-LEVEL "AFFECTED ITEM" DEFICIENCY JURISDICTION.

In 1982, Congress adopted the Uniform Partnership Procedures (26 U.S.C. §§ 6221-6231) as part of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248: "TEFRA"). Those procedures created three distinct levels for the resolution of partnership and partner tax disputes:

(i) The partnership level proceeding under Sections 6221 and 6226(f) – deals exclusively with "partnership items" (and is jurisdictionally barred from determining any partner-level affected item or other nonpartnership items);

(ii) The computational adjustment assessment proceeding under Section 6230(a)(1) – implements partnership adjustments by assessing any change in the partners' tax liability that does not require additional partner-level determinations; and

(iii) The partner-level "affected item" deficiency proceeding under Section 6230(a)(2) – required when partner-level determinations are needed.

In 1997, Congress expanded partnership proceedings under Section 6226(f) to include "the applicability of any penalty … which relates to an adjustment to a partnership item." Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238, 111 Stat. 788, 1026.

Section 6230 distinguishes between the normal circumstance (adjustments to items on partnership returns that result in tax consequences that can be computed and assessed with no need for partner-level proceedings) and circumstances such as this (unresolved affected items that require a partner-level proceeding to determine a deficiency – and any penalty on that deficiency). Where the partnership item adjustment yields a deficiency with no need for partner-level determinations, the IRS assesses applicable penalties against a partner. He can only contest them by paying and suing for a refund – akin to forcing a defendant to pay punitive damages before defending himself.

Conversely, penalties that relate to an adjustment to an affected item must be addressed in the partner-level affected item proceeding. *Jade II*, 598 F.3d at 1380.[8] *See also, Petaluma II*, 591 F.3d at 655. Hence, *Petaluma II* and *Jade II* honor the Congressional mandate in Section 6230(a)(2) that determining any underpayment (on which the Section 6662 underpayment penalty is based) must await conclusion of the partner-level affected item proceeding; it respects the delineation between the two types of affected items (Temp. Reg. §§ 301.6231(a)(6)-1T(a)(1) and (a)(2)); and it avoids requiring a trial court to do the impossible. No trial court should be asked to determine the applicability of a percentage-penalty to an affected item that, as a jurisdictional matter, cannot be determined yet.

[8] *Jade II* better illustrates the select partner aspect than *Woods*: on the same arguments pressed here, the IRS tried to penalize the outside basis of only three out of five partners.

B. THE IRS SEEKS TO USURP JUDICIAL AUTHORITY AT BOTH THE PARTNERSHIP AND PARTNER LEVELS.

Under Sections 6226(f) and 6230(a)(2), the Courts – not the IRS – possess jurisdiction to determine the applicability of penalties that relate to adjustments to partnership items (at the partnership level) and to affected items which require a deficiency proceeding (at the partner level). *Petaluma II*, 591 F.3d at 155-56. Yet, the IRS usurps the judicial authority at both levels so that the IRS can impose penalties on select partners while the IRS regulations bar them from defending themselves.

The IRS first seeks to usurp the authority of the Court at the partnership level by not asking the Court to determine the "applicability" of the Section 6662 Accuracy-Related Underpayment Penalty. No, the IRS asks the Court only to offer an abstract (declaratory) opinion as to one element of the penalty (say sham), even though neither the underpayment nor the penalty can be computed without outside basis and even though the IRS admits that outside basis constitutes a partner-level affected item that requires a partner-level deficiency proceeding. From that springboard, the IRS bestows upon itself the jurisdiction to determine all other elements of the Section 6662 penalty at the "computational adjustment" stage – including determination of the "forbidden fruit" (the partner's outside basis, resulting loss, and deficiency). IRS Br. 18. In sum, the IRS usurps both levels of judicial authority so it can punish the partner on forbidden fruit while *Tigers Eye I* gags him.

1. The Analysis Begins with the Section 6226(f) "SCOPE OF JUDICIAL REVIEW".

Section 6226(f) bestows partnership jurisdiction upon trial courts as follows:

> SEC. 6226. JUDICIAL REVIEW OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENTS.
>
> * * *
>
> (f) SCOPE OF JUDICIAL REVIEW.—***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 … and ***the applicability of any penalty*** … which **relates to *an adjustment to a partnership item***. (Emphasis added).

Thus, partnership penalty jurisdiction depends upon three conjunctive elements. One, Congress bestowed the "jurisdiction to determine" the penalty upon "a court," not the IRS. Two, the court possesses the jurisdiction to determine "the applicability" of the penalty. And three, the applicable penalty must "relate to an adjustment to a partnership item" – not to a naked "partnership item" (void of any adjustment) and not "to an adjustment to an affected item". Rather than focus upon the operative words, the IRS devotes most of its energies to the transitional reference which applies with equal ease to the category Congress did not include in partnership jurisdiction – "relates to an adjustment to an affected item." *Petaluma II*, 591 F.3d at 655.

2. Congress Bestowed Partnership Jurisdiction Upon "A *Court* … to Determine the *Applicability* of [the Section 6662] Penalty" – Not Upon the IRS.

Section 6226(f) bestows partnership jurisdiction upon "*a court* … to determine *the applicability*" of any penalty …" – not the IRS. The "applicability" of the Section 6662 "IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS" starts with Section 7491(c), which imposes the burden of production for any penalty on the IRS to establish a *prima facie* case. 26 U.S.C. § 7491(c); *Higbee v. Commissioner*, 116 T.C. 438, 449 (2001) (Section 7491(c) requires IRS to produce sufficient evidence to establish essential elements of *prima facie* case). If one essential element fails, no penalty is "applicable." The essential elements of the penalty include (i) an inaccuracy, (ii) reported on the partnership return, (iii) as to an item that could create an underpayment,[9] (iv) prohibited conduct such as negligence, (v) a tax deficiency resulting from that conduct, and (vi) lack of substantial authority and/or a reasonable belief as to the likely accuracy.

The question arises: "applicable" to what? The IRS first says "outside basis." However, no "basis overstatement penalty" can be "applicable" to "outside basis" at the partnership level because the partnership return contains no accurate or inaccurate statement of outside basis.

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[9] Many non-income/deduction items on a partnership return cannot create an understatement or support a penalty, such as identifying information, balance sheet content, and Schedule M-2 capital account data (including capital contributions).

Moreover, the partnership returns accurately reported the two alternate items which the IRS raises for the first time on brief (the capital contributions and the distributed assets). Indeed, those reported items do not affect outside basis.[10]

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[10] The partnership return drafted by the IRS requires that the partnership report the "capital contributions" in the "Schedule M-2 Capital Account" section. That section uses financial accounting principles that govern capital accounts to report capital contributions based on net fair market value (net of obligations like the contingent short option obligation) – not tax basis. LARRY E. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES § 17:10 fn. 29 (2 ed., West 2012) ("The contributing partner only receives an increase in the capital account for the net fair market value of the property contributed"); LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K 32 (2d ed., West Group 2000); *Mitchell v. Commissioner*, T.C. Memo 1997-382, 1997 WL 473178 at *3, n.5, *citing* Treas. Reg. §§ 1.705-1(a)(1), 1.704-1(b)(2)(iv)(b). The net fair market value considers the contingent obligations which outside basis excludes. 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS 7-20 (4th ed., W.G.&L. 2007) ("[w]here real property is burdened by a contingent obligation ... the obligation is real and affects the value of the property. However, because it is contingent, incurring the obligation does not add to the basis of the property ... the obligation is not a 'liability' under Regulations § 1.752-1(a)(4)(i)"); *Deputy*, 308 U.S. at 494-95 (short option is not an indebtedness); *LaRue*, 90 T.C. at 480-82; *Helmer*, T.C. Memo 1975-160 (IRS established that short option excluded from Section 752 liability).

The Form 1065 reports distributed assets at Schedule K (line 23) at the partnership's "inside basis" (generally the cost the partnership paid for those assets). Form 1065 Instructions; 26 U.S.C. § 1012. As noted, Section 732(b) substitutes the "outside basis" for the distributed asset basis in the hands of the former partner. Consequently, neither the reported capital contributions nor the "inside basis" have any effect on the "outside basis," the resulting loss, or any underpayment.

Like so many information items on partnership information returns, they cannot possibly create an underpayment here. The IRS also points to no inaccuracy in the reported net fair market value of the contributions or the cost basis of the distributed assets.

Even when one disregards the partnerships and "treats the transactions as if they were engaged in directly by its purported partners" as the FPAA asserts (and the District Court sustained), the net fair market value of the capital contributions still makes no difference and the cost basis of the distributed assets reported on the partnership return remains the same amount. The FPAA "Schedule of Adjustment" contains no "adjustment" to the capital contributions and distributions reported on the partnership return, because they are neither mathematically relevant to any understatement/ deficiency nor inaccurate.

The IRS in essence asks this Court to hold that "applicability" does not mean "applicable" in the sense the "court" considers the (*prima facie*) essential elements. The IRS asks the court to only make an abstract threshold determination at the partnership level as to sham or negligence. The IRS brief leaves no doubt as to whom the IRS advocates as the arbiter of all the remaining essential elements – why, the IRS, of course, at the so-called "computational adjustment" stage. IRS Br. 13, 28-29. The IRS couples that tactic with other draconian devices to gag the defenses of many taxpayers forever.

The government argues at page 13 of its brief:

> "Once partnership-level proceedings conclude, *the IRS evaluates* partners' individual returns in light of the partnership-level adjustments. ... *the IRS may assess* penalties against individual partners immediately through computational adjustments without issuing a notice of deficiency. See 26 U.S.C. 6230(a)(2). A partner may then file a refund claim ... Again, however, any determination by the FPAA or by a court in a partnership-level proceeding regarding the applicability of the penalty is 'conclusive' ... ." (Emphasis added).

Computational adjustments that do not require any partner-level determinations are exempt from the deficiency procedures, and therefore are assessed without the prior issuance of a notice of deficiency. 26 U.S.C. § 6230(a)(1). In such cases, there is no prepayment forum for challenging the IRS's summary determination. Instead, a partner who wishes to challenge such an assessment may only do it in a tax refund suit, but only if the partner pays the penalty in full within six months of the date the IRS mailed the notice of computational adjustment to the partner. 26 U.S.C. § 6230(c)(1), (2)(A). *See Flora v. United States*, 362 U.S. 145, 177 (1960). This truncated tax refund procedure under TEFRA should be contrasted with the far more taxpayer friendly procedures for the traditional tax refunds under the Code. *See* Subchapter B -- Limitations on Credit and Refund of Chapter 65 -- Abatements, Credits, and Refunds (26 U.S.C. §§ 6511-6515).

3. The "*Applicability*" of a Penalty to "an *Adjustment to a Partnership Item*" Does Not Mean an Abstract Concept Nor "an *Adjustment to an Affected Item*."

The D.C. Circuit in *Petaluma II*, and the Federal Circuit in *Jade II* and *IV*, resolved the critical question here: is a Section 6662 underpayment penalty "applicable" to "an adjustment to a partnership item" OR to "an adjustment to an affected item" where the underpayment requires a partner-level affected-item proceeding under Section 6230(a)(2)? With no conflict from any other circuit, both the D.C. Circuit and the Federal Circuit harmonized the Section 6226(f) partnership jurisdiction and Section 6230(a)(2) partner-level jurisdiction in the most practical way – where the underpayment penalty cannot be computed without a partner-level proceeding, its "applicability" must await the partner-level proceeding.

That resolution by the consistent circuit authority comports with Section 6230(a) which coordinates the partnership-level proceedings with the partner-level proceedings. Subsection (a)(1) permits the IRS to assess "computational adjustments" against the partners without resorting to the Subchapter B deficiency procedures – "[e]xcept as provided in paragraph (2) or (3)." Section 6230(a)(2) guarantees the partner that right to trial under the deficiency procedures on the affected items which require partner-level determinations. The Subchapter B deficiency procedures bar any assessment until after IRS issues a notice of deficiency and the taxpayer exhausts his right to trial. 26 U.S.C. §§ 6211, *et seq.*

Section 6230(a)(2) tracks Section 6226(f) by only excluding penalties that relate to adjustments to partnership items – *not penalties that relate solely to partnership items with no adjustment nor to affected item adjustments*. That provokes three observations.

First, the IRS attempt to reduce the numerical "adjustment" to statutory surplusage trailing an abstract partnership item must fail. The word, statute, and context confirm that "adjustment" remains a concrete numerical act within the tax code. Abstract concepts like sham may constitute "partnership items" but Congress did not incorporate "penalt[ies] that relate to partnership items" into partnership jurisdiction: Congress only incorporated "penalt[ies] that relate to *adjustments* to partnership items." The "applicability" of those numerically-driven "penalties" requires a numerical "adjustment." TEFRA uses the same numerical "adjustment" standard in the Section 6227 "Administrative *Adjustment* Request" – which the IRS itself recognizes as numerical in nature. Internal Revenue Manual pt. 8.19.7.2 (March 9, 2009). The "Schedule of Adjustments" in the two *Woods* FPAAs prove the same point. While that Schedule improperly uses the non-numerical asterisk reference to "Outside Partnership Basis," the Schedule calls for a numerical "adjustment" and the remaining "Schedule of Adjustments" is limited to reversing the numerical income reported by the two partnerships (totaling $700,000). This Section 6226(f) concrete "adjustment" requirement fulfills the essential role of setting the stage for the next act under the TEFRA procedures – the numerical "computational adjustment."

Second, the "outside basis" foundation for what the IRS recasts as its "basis overstatement penalty" constitutes an "affected item" that requires a partner-level deficiency proceeding under Section 6230(a)(2). All four Courts of Appeal to address this issue agree that outside basis constitutes an affected item requiring a deficiency proceeding. The IRS again concedes here, as it conceded in *Petaluma II*, *IV*, and *VI* and in *Jade II* and *IV*, that "outside basis" constitutes such an "affected item."[11]

Third, the IRS itself established in *Desmet* the opposite of what it argues here. It matters not that part or all of the components of outside basis consists of "partnership items": it remains an "affected item" which must await the partner-level proceeding. *Desmet*, 581 F.3d at 304. Relying on *Desmet*, the D.C. Circuit rejected the IRS "elements" argument:

> On appeal the Commissioner concedes that outside basis is not a partnership item in this case. Instead, he asserts that outside basis is an affected item whose *elements* are mainly or entirely partnership items. He maintains that the Tax Court had jurisdiction to state the "obvious conclusion" that a partner cannot have any basis in a disregarded partnership. The correctness of this conclusion is immaterial, however, for the question is not whether the Tax Court's determination was correct, but whether the Tax Court had jurisdiction to make that determination at all in this partnership-level proceeding.

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[11] That concession renders the IRS dominant reliance on the thin plurality opinion in *Tigers Eye II* (6-3-6) curious.

* * *

> Under § 6226(f), the Tax Court had jurisdiction to determine partnership items, but it did not have jurisdiction to determine affected items. We have already rejected the Tax Court's conclusion that outside basis was a partnership item in this case, and we likewise reject the Commissioner's contention that outside basis, although it is an affected item, could nonetheless be determined in the partnership-level proceeding. The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. In other words, ***it does not matter how low the fruit hangs when one is forbidden to pick it.*** *Petaluma II*, 591 F.3d at 654-5 (emphasis added).

Despite embracing "the larger statutory context" and "the threshold determination" (IRS Br. 13, 28), the IRS refuses to draw the "larger statutory context" threshold distinction between (i) no "adjustment," (ii) "adjustments" to partnership return items that cannot possibly create a Section 6662 Underpayment here (such as capital contributions and distributed asset "inside basis"), (iii) "adjustments" to partnership return items that create a Section 6662 Underpayment with no need for a partner-level affected-item deficiency proceeding, and (iv) "adjustments which relate to affected items" which require partner-level deficiency proceedings. *Petaluma II*, 591 F.3d at 654-55.

4. The IRS Arguments Would Obliterate the Category of Penalties That Relate to an Adjustment to Affected Items Which Require a Partner-Level Proceeding.

Contrary to *Petaluma II*, *Jade II*, and the underlying statutes, the IRS seems to categorically deny the existence of penalties that are applicable/ relate to affected items which require partner-level proceedings under Section 6230(a)(2). That view contravenes the Commissioner's own regulations. In its 1999 temporary form (and now in its final form), the same regulation that the IRS cites at pages 32-33 as compelling the IRS concession that outside basis constitutes an affected-item – has also recognized since 1987 that penalties constitute affected items. Temp. Reg. § 301.6231(a)(5)-1T(b) casts outside basis as an affected-item and then subsection (d) casts all penalties as affected items:[12]

> (d) *Additions to tax or additional amount*— (1) *In general.* The term "affected item" includes any addition to tax or additional amount provided by subchapter A of chapter 68 of the Internal Revenue Code of 1954 to the extent provided in this paragraph (d).

The 1997 amendment to Section 6221 and 6226(f) restricted the jurisdictional transfer to the applicability of penalties to adjustments to partnership items and left all else within the realm of the partner-level deficiency proceeding.

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[12] Temp. Reg. § 301.6231(a)(5)-1T(d)(1) speaks in terms of "additions to tax" which include penalties such as the Section 6661 predecessor to Section 6662.

Petaluma II and *III* and *Jade II - IV* confirm that penalties applicable to affected item adjustments still must be determined at the partner level. Yet, the IRS effectively denies the existence of that viable category via four errors.

One, the IRS proceeds as if all penalties on affected items fall within partnership jurisdiction because affected items are affected by partnership items. IRS Br. 33-4. However, the IRS then attempts to extract some retained affected item penalty vitality by resorting to pure nonpartnership items that have nothing to do with the partnership. Those items are not subject to any aspect of the TEFRA procedures – including the affected item proceeding.

Two, the IRS repeatedly resorts to the payment red herring (that partners, not partnerships, pay taxes) as a means of avoiding the critical distinction recognized by *Petaluma II* and *Jade II* as to the ability to compute the penalty. That is, the IRS masks the practical jurisdictional differences between (i) the *ability* to compute the underpayment and any applicable underpayment penalty flowing from disallowed partnership losses and (ii) the jurisdictional *inability* to compute the underpayment and any applicable underpayment penalty from the former partner's post-partnership losses. IRS Br. at 27. Where, as here, the penalty/reasonable cause determination is ultimately based on the contents of the partner's return (outside basis and resulting losses), the targeted activity constitutes partner activity, not the partnership conduct targeted by the 1997 amendment.

Three, ignoring the computation ability/inability distinction defies the Section 6230(a)(2) partner-level deficiency proceeding. By definition, deficiency proceedings precede assessment. 26 U.S.C. § 6211. If the IRS succeeds in pre-empting the partner-level jurisdiction by computing and assessing the affected-item underpayment and penalty at the "computational adjustment" stage, that will eliminate the deficiency and thus the deficiency proceeding in virtually every instance involving penalties on affected item which require partner-level deficiency proceedings.

Four, the IRS focuses almost exclusively upon the two word transitional reference "relates to" with little regard to the operative "applicability of any penalty" and "adjustment" or the statutory scheme. IRS Br. at 27-34. In that context, an accuracy-related underpayment penalty that remains inapplicable to a partnership item (based on most of the conjunctive elements of the penalty) does NOT "relate to" an "adjustment partnership item" – an item that, at most, constitutes an "element" of outside basis that requires a partner-level proceeding for the affected-partners. *Petaluma II*, 591 F.3d at 655-56; *Jade II*, 598 F.3d at 1380.

Congress could not have possibly intended the result the IRS seeks: empower the IRS at the "computational adjustment" stage to pre-empt the determination of the deficiency (and any penalties applicable to affected-items which require a deficiency proceeding) in the Section 6230(a)(2) partner-level jurisdictional proceeding.

5. The IRS Relies Most Heavily Upon the Untested *Tigers Eye II* Thin Plurality Opinion and its Jurisdictional Contradictions.

The IRS relies most heavily upon the thin plurality opinion in *Tigers Eye II* (6-3-6), the only partnership opinion that supports the IRS position (which we believe was on the verge of being reversed when this Court accepted *Woods* for review). The *Tigers Eye II* plurality actually demonstrates the internal contradictions urged by the IRS here:

(i) The *Tigers Eye II* plurality bottomed its imposition of penalties on the outside basis at the partnership level on its conclusion that outside basis constitutes a partnership item (138 T.C. at 69-70) – which the IRS D.C. Circuit brief in *Tigers Eye III* concedes is flat wrong.

(ii) A comparison of *Tigers Eye I* and *II* embodies the jurisdictional conflict: on jurisdictional grounds, *Tigers Eye I* bars the partners from asserting their Section 6664(c) reasonable cause/reliance defense of their outside basis. The *Tigers Eye II* plurality opinion not only imposes the "Valuation Misstatement" penalty on that same outside basis – it purports to reject the merits of the partners' reasonable cause/ reliance defense the Court previously barred.

(iii) The dissent by Judge Holmes artfully summarizes the problems in the plurality opinion, including defiance of circuit precedent.

As a final practical matter, a procedural rule that requires a 126-page explanation cannot be right.

C. PENALTY JURISDICTION CANNOT SIMULTANEOUSLY PUNISH PARTNERS BASED ON THE CONTENTS OF THEIR RETURNS AND BAR THEIR DEFENSE.

Every civilized society since the ancient Greeks has recognized that penalties must be narrowly construed, because a man or woman cannot be punished for an act or word the law failed to clearly prohibit. Through Lycurgus, the early Spartans extended the principle a step further by prohibiting any written law, on the belief that no man or woman could be punished for failing to abide by a law too complex to be remembered.

For both reasons, tax penalty provisions should be narrowly construed.[13] *Ivan Allen Co. v. United States,* 422 U.S. 617, 641 (1975) ("[T]he tax is, as the Court concedes, a penalty and therefore must be strictly construed ...") (internal quotations omitted); *Commissioner v. Acker*, 361 U.S. 87, 91 (1959) ("We are here concerned with a taxing Act which imposes

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[13] Perhaps Judge Campbell of the Seventh Circuit Court of Appeals put it best: "[T]here is an additional consideration which reinforces, and to my mind solidifies, this analysis: *odioso restinjenda sunt* (translation: things odious must be strictly construed). This ancient principle of common law is so venerated that it is even applied to the tax gatherer ..." *Brockhouse v. United States*, 749 F.2d 1248, 1255 (7th Cir. 1984) (Campbell, J., dissenting). Judge Campbell goes on to cite *Federal Communications Commission v. American Broadcasting Co.,* 347 U.S. 284, 296 (1954), for the principle that penal statutes must be construed strictly and *Commissioner v. Acker,* 361 U.S. 87, 91 (1959), for the principle that a tax penalty applies only if the words of the statute plainly impose it.

a penalty. The law is settled that 'penal statutes are to be construed strictly.'"), *quoting Federal Communications Commission v. American Broadcasting Co.*, 347 U.S. 284, 296 (1954); *Bradley v. United States*, 817 F.2d 1400, 1403 (9th Cir. 1987) ("A tax provision which imposes a penalty is to be construed strictly"); *Central Motor Co. v. United States*, 583 F.2d 470, 481 (10th Cir. 1978) ("And we must remember we are dealing with a tax penalty statute which is to be strictly construed"); *Howell v. Commissioner*, 77 T.C. 916, 933 (1981) (Fay, J., concurring), *citing Acker*, 361 U.S. at 91. More to the point, the partnership penalty jurisdictional statute cannot be stretched beyond its limits ("court," "adjustment," "partnership item") to seize the territory Congress preserved for partner-level deficiency jurisdiction.

The penalty advantage the IRS seeks turns this fundamental principle on its head. Consider the cumulative effect of what the IRS advocates:

(i) The IRS seeks to impose heightened penalties on the former partners at the partnership level based on the contents of their individual returns;

(ii) At the partnership level, the IRS specifically seeks to impose what it calls the "basis overstatement penalty" on the "outside basis" that the partnership never reports, the former partners alone report on their individual returns, and that the IRS (along with four Courts of Appeal) admits constitutes an affected-item that requires a partner-level deficiency proceeding under Section 6230(a)(2);

(iii) The IRS seeks to impose the penalty on those partner-level items while barring those partners from defending themselves; and

(iv) For the first time in any of these cases, the IRS now insists that the IRS not only imposes those penalties on those partner-items of those partners while they are gagged by Temp. Reg. §§ 301.6221-1T(c), (d), and *Tigers Eye I* – the IRS insists the penalty determination is "conclusive" and "unreviewable." IRS Br. 23, 35.

That "flog-'em-now/try-em-later" tactic certainly serves the efficient-justice concept the IRS advocates as its sole policy argument. For that matter, it would be so much more efficient if we just did away with defenses and trials altogether. The IRS suggests no other policy considerations apply. IRS Br. 37.

The right to a fair trial prior to the imposition of a penalty, the right to defend one's self before being punished and prejudiced in the later partner-level litigation with a "conclusive" penalty finding, and the purpose reflected by the interplay between Sections 6226(f) and 6230(a) of dealing with the partnership return at the partnership level and the partner return at the partner level – all constitute self-evident, worthwhile, policy considerations, with Fifth (substantive due process), Sixth (right to fair trial), and Eighth (excessive fines and penalties) Amendment overtones.

Better than anyone, the IRS knows that barred defenses will be the permanent result for many people because the IRS couples its pre-defense demand for payment of all outside-basis driven taxes, interest, and 40 percent penalty with another draconian device – a six month accelerated payment limitations period many will not be able to meet.

Three aspects set that heavy-handed approach in context. First, the tactic violates the spirit and the letter of Section 6664(c). Section 6664(c) bars the imposition of penalties on underpayments in the face of good faith reasonable cause. Congress enacted that protection in 1989 – after adopting TEFRA in 1982 – to ensure "a *standardized exception criterion* for all … accuracy-related penalties." H.R. Rep. No. 101-247, at 1392-3 (1989), reprinted in U.S.C.C.A.N. 1906, 2862-3. No doubt exists as to why: "The committee is concerned that the present-law accuracy-related penalties (particularly the penalty for substantial understatement of tax liability) have been determined too routinely and automatically by the IRS." *Id.* Every aspect of that statute and its legislative history opposes the litigation tactic the IRS seeks to apply here – imposing underpayment penalties at the partnership level on select partners with respect to the partner-specific options, basis, and losses they reported on their individual returns BEFORE they can defend themselves. Second, that tactic offends the traditional tax prepayment safeguard – the long-held right of taxpayers to litigate IRS income tax deficiencies without having to pay before the correct amount is determined. *See, e.g.,* 26 U.S.C. §§ 6201(a), 6211, 6213(a), and their predecessors.

The IRS argues the exact opposite point here that it urged upon the Ninth Circuit in defense of the notice of deficiency it issued in *Napoliello*:

> By issuing a notice of deficiency, the IRS permits a partner to dispute the amount owed before paying the tax. If the IRS assesses taxes through a direct computational adjustment, a partner's only recourse is to pay the tax and to file a refund suit. *Napoliello,* 655 F.3d at 1064 (citations omitted).

There, the Ninth Circuit recognized the right to a pre-payment forum as a "procedural safeguard." With the exception of only those penalties that "relate to *adjustments to partnership* items," Section 6230(a)(2) guarantees that important safeguard to all partners with unresolved affected items that require a partner-level proceeding – *a la Woods*.

Third, another important safeguard arises from the historic right of a taxpayer to pay the disputed income tax deficiency, file a claim for refund (within the later of three years from the due date of the return or two years from payment), and, if denied, sue on that claim for refund (within two years of the denial). Contrast those safeguards with the dictate that the taxpayer pay any penalty assessed within six months of receipt of a "computational adjustment" notice OR BE FOREVER BARRED.

CONCLUSION

On behalf of the partners in *Petaluma*, *Jade*, and *Tigers Eye*, we urge this Court to adopt the three-prong reconciliation set forth in our Summary of Argument, bar the premature imposition of penalties that require partner-level deficiency proceedings, and reverse the imposition of Section 6662 penalties that cannot be computed without outside basis.

Respectfully submitted,

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APPENDIX OF PERTINENT STATUTORY AND REGLULATORY AUTHORITY

Internal Revenue Code of 1986 (26 U.S.C.)
(as amended through December 27, 1999)

§ 722 BASIS OF CONTRIBUTING PARTNER'S INTEREST.

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

§ 732 BASIS OF DISTRIBUTED PROPERTY OTHER THAN MONEY.

(a) DISTRIBUTIONS OTHER THAN IN LIQUIDATION OF A PARTNER'S INTEREST.—

(1) GENERAL RULE.—The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

(2) LIMITATION.—The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(b) DISTRIBUTIONS IN LIQUIDATION.—The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

§ 752 **TREATMENT OF CERTAIN LIABILITIES.**

* * *

(b) DECREASE IN PARTNER'S LIABILITIES.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

§ 1012 **BASIS OF PROPERTY—COST.**

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not

include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

§ 6226 JUDICIAL REVIEW OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENTS.

* * *

(f) SCOPE OF JUDICIAL REVIEW.—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, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

§ 6230 ADDITIONAL ADMINISTRATIVE PROVISIONS.

(a) COORDINATION WITH DEFICIENCY PROCEEDINGS.—

(1) IN GENERAL.—Except as provided in paragraph (2) or (3), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) DEFICIENCY PROCEEDINGS TO APPLY IN CERTAIN CASES.—

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or

(ii) items which have become nonpartnership items (other than by reason of section 6231(b)(1)(C)) and are described in section 6231(e)(1)(B).

(B) Subchapter B shall be applied separately with respect to each deficiency described in subparagraph (A) attributable to each partnership.

§ 6231 DEFINITIONS AND SPECIAL RULES.

(a) DEFINITIONS.—For purposes of this subchapter—

* * *

(3) PARTNERSHIP ITEM.—The term "partnership item" means, with respect to a partnership, 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.

*   *   *

(5) AFFECTED ITEM.—The term "affected item" means any item to the extent such item is affected by a partnership item.

§ 6662. IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS.

(a) IMPOSITION OF PENALTY.—If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) PORTION OF UNDERPAYMENT TO WHICH SECTION APPLIES.—This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.
(2) Any substantial understatement of income tax.
(3) Any substantial valuation misstatement under chapter 1.
(4) Any substantial overstatement of pension liabilities.
(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

§ 6664 **DEFINITIONS AND SPECIAL RULES.**

* * *

(c) REASONABLE CAUSE EXCEPTION.—

(1) IN GENERAL.—No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

§ 7491 **BURDEN OF PROOF.**

* * *

(c) PENALTIES.—Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

Treasury Regulations (26 C.F.R.)
(as amended through December 27, 1999)

§ 301.6221-1T. **Tax treatment determined at partnership level (Temporary).**

* * *

(c) *Penalties determined at partnership level (partnership taxable years ending after August 5, 1997).* Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, shall be determined at the partnership level. Partner level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership level determinations. Partnership level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount, other than partner level defenses specified in paragraph (d) of this section.

(d) *Partner level defenses.* Partner level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, may not be asserted in the partnership level proceeding, but may be asserted through separate refund actions following assessment and payment. See section 6230(c)(4). Partner level defenses are limited to those that are personal to the partner or are dependant upon the partner's separate return, and cannot be determined at the partnership level.

Examples of these determinations are: whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of section 6664(b) (penalties applicable only where return is filed), or section 6664(c)(l) (reasonable cause exception) subject to partnership level determinations as to the applicability of section 6664(c)(2).

§ 301.6231(a)(5)-1T. **Definition of affected item (Temporary).**

* * *

(b) *Partner's basis in his partnership interest*. A partner's basis in his interest in the partnership is an affected item to the extent it is not a partnership item.

* * *

(d) *Addition to tax or additional amounts*—(1) *In general*. The term "affected item" includes addition to tax or additional amount provided in subchapter A of chapter 68 of the Internal Revenue Code of 1954 to the extent provided in paragraph (d).

§ 301.6231(a)(6)-1T. **Computational adjustments (Temporary).**

(a) *In general*. * * *

(1) Changes in a partner's tax liability with respect to affected items that do not require partner level determinations (such as the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level) are computational adjustments that are directly assessed. When making computational adjustments, the Service may assume that amounts the partner reported on the partner's individual return include all amounts reported to the partner by the partnership, absent contrary notice to the Service (for example, a "Notice of Inconsistent Treatment"). Such an assumption by the Service does not constitute a partner level determination. Moreover, substituting redetermined partnership items for the partner's previously reported partnership items (including partnership items included in carryover amounts) does not constitute a partner level determination where the Service otherwise accepts all nonpartnership items (including, for example, nonpartnership item components of carryover amounts) as reported.

(2) Changes in a partner's tax liability with respect to affected items that require partner level determinations (such as 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) are computational adjustments subject to deficiency procedures. Nevertheless, any penalty, addition to tax, or

additional amount that relates to an adjustment to a partnership item may be directly assessed following a partnership proceeding, based on determinations in that proceeding, regardless of whether partner level determinations are required.