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No. 12-562

In The
Supreme Court of the United States

UNITED STATES,

Petitioner,

vs.

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 SCOTT AND AUDREY BLUM AS AMICI CURIAE IN SUPPORT OF RESPONDENTS

CHRISTOPHER M. REIMER
Counsel of Record
LONG REIMER WINEGAR BEPPLER LLP
270 West Pearl Street, Suite 103
P.O. Box 3070
Jackson, Wyoming 83001
307.734.1908
creimer@lrw-law.com

Counsel for Amici Curiae

COCKLE LEGAL BRIEFS (800) 225-6964
WWW.COCKLELEGALBRIEFS.COM

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INTEREST OF AMICI CURIAE

Amici, Scott and Audrey Blum, are married taxpayers who have a clear interest in proper resolution of the sole substantive question before the Court. The Commissioner has sought to impose similar overvaluation penalties against them based on their 1998 participation in an investment known as the Offshore Portfolio Investment Strategy (OPIS).[1] Amici reported losses resulting from OPIS on their 1998 and 1999 federal income tax returns. In 2005, the Commissioner sought to disallow the losses, claiming that OPIS lacked economic substance, and impose accuracy-based penalties in connection with underpayments attributable to negligence and a gross valuation misstatement. The U.S. Tax Court held that OPIS lacked economic substance and, in the absence of controlling authority from the federal circuit with jurisdiction of amici's appeal, chose to apply the precedent of the U.S. Tax Court and held that amici's alleged underpayment resulting from OPIS could be attributable to a gross valuation misstatement under 26 U.S.C. § 6662 (Section 6662). Amici's appeal is currently before the U.S. Court of Appeals for the Tenth

[1] Pursuant to Supreme Court Rule 37, letters of consent from the parties have been filed with the Clerk of the Court. In accordance with Rule 37.6, amici state that no counsel for either party has authored this brief in whole or in part, and no person or entity, other than amici, has made a monetary contribution to the preparation or submission of this brief.

Circuit, which has not yet addressed the 40% penalty issue.

SUMMARY OF ARGUMENT

1. A tax underpayment resulting from a transaction disregarded as lacking economic substance cannot be attributable to a valuation misstatement under Section 6662.

a. Resolving this question begins and ends with the text of the statute. The unambiguous, plain meaning of "attributable to" makes it logically impossible for an underpayment to be caused by both a valuation misstatement and a transaction entirely lacking in economic substance. Imposition of the 40% penalty depends not on whether a taxpayer has claimed a benefit from a valuation misstatement, but on whether the misstatement itself *caused* the underpayment. An underpayment cannot have been caused by a valuation misstatement if the taxpayer's liability would have been identical regardless of the misstatement's existence.

b. The Court should refrain from using non-textual policy concerns to rewrite the plain text of the statute as adopted by a popularly elected branch of the federal government: Congress. When faced with unclear evidence of legislative intent, the safest course is to simply apply the plain meaning of the statutory language as it is written, rather than attempt to use vague and

contradictory evidence to divine Congress's true intent in enacting Section 6662.

c. Treasury Regulations deeming an underpayment resulting from a disregarded transaction as attributable to a gross valuation misstatement based on a property value of zero exceed the Department of Treasury's rulemaking authority because they are not reasonable interpretations of Section 6662.

2. Even if an underpayment resulting from a transaction lacking economic substance can be attributable to a valuation misstatement, Section 6662's 40% penalty does not apply unless there is a finding of fact that the taxpayer misstated the value of property claimed on a tax return.

ARGUMENT

The valuation misstatement penalty does not apply to an underpayment of tax resulting from a determination that a transaction lacks economic substance.

I. Tax underpayments resulting from a determination that a transaction lacks economic substance are not "attributable to" a valuation misstatement.

The Petitioner's brief goes to great lengths to construe a simple statute in a complex manner. Its tortuous position is based largely on public policy considerations not contained in the terms of the

statute. The Court should refrain from imposing a strained logical scheme on the statute to arrive at what the IRS believes to be the proper policy outcome. Instead, it should interpret Section 6662 as actually codified by Congress.

If the Court applies the statute as written, the answer to the sole substantive issue in this case is simple: an underpayment resulting from a loss that was disallowed for lack of economic substance cannot have been caused by (and therefore "attributable to") a valuation misstatement of any kind because the value of property used in a disregarded transaction (and, therefore, the taxpayer's basis) is a mere nullity, having no effect on the taxpayer's ultimate income tax liability. No attempt to recharacterize a transaction lacking economic substance, itself, as a gross valuation misstatement can change this simple statutory analysis.

A. Under the plain text of Section 6662, an underpayment resulting from the disallowance of a transaction lacking economic substance is not "attributable" to a valuation misstatement.

Compared to other sections of an increasingly dense Internal Revenue Code, the statutory provisions involved in this case are straightforward. Section 6662 imposes a 20% penalty on an underpayment attributable to a substantial valuation misstatement. 26 U.S.C. § 6662(a), (b)(3). A taxpayer

makes a substantial valuation misstatement if he or she claims the value or adjusted basis of property on an income tax return that is 150% or more of the correct amount. *Id.* § 6662(e)(1)(A). The penalty increases to 40% if the underpayment is attributable to a gross valuation misstatement, which includes a misstatement of property value that is 400% or more of the correct amount. *Id.* § 6662(h)(1).

Regardless of the severity of the graduated valuation misstatement penalties, their common element is the requirement that the taxpayer's underpayment be "attributable" to the misstatement. It is not enough for the Commissioner to show that a valuation misstatement occurred: there must be a causal connection between the misstatement and the taxpayer's resulting tax underpayment. The crux of this case involves the question of whether an underpayment caused by a transaction that has been treated as a nullity under the economic substance doctrine can be logically "attributable" to a valuation misstatement.

The Court's rules of statutory construction are well known: "'[W]e start, of course, with the statutory text,' and proceed from the understanding that '[u]nless otherwise defined, statutory terms are generally interpreted in accordance with their ordinary meaning.'" *Sebelius v. Cloer*, 133 S. Ct. 1886, 1893 (2013) (quoting *BP America Prod. Co. v. Burton*, 549 U.S. 84, 91 (2006)). The Court presumes that Congress "says in a statute what it means and means in a statute what it says." *BedRoc Ltd. v. United States*, 541 U.S.

176, 183 (2004). Consequently, the Court's "inquiry ceases [in a statutory construction case] if the statutory language is unambiguous and the statutory scheme is coherent and consistent." *Cloer*, 133 S. Ct. at 1895 (internal quotation marks omitted).

The Internal Revenue Code does not define the meaning of the phrase "attributable to" for the purpose of Section 6662. The Court should therefore apply its ordinary meaning. *Id.* at 1893. The meaning of "attribute," the root verb of "attributable," is not controversial: "to regard as resulting from a specified cause; consider as caused by something indicated (usually by *to*)." *Attributable Definition*, Dictionary.com, http://dictionary.reference.com/browse/attributable (last visited Nov. 17, 2012); *accord Webster's II New Riverside Dictionary* 46 (Rev. ed. 1996) ("To regard or explain as arising or resulting from a source or cause."). The IRS' brief cites a similar definition. *See Webster's Third New International Dictionary of the English Language* 141, 142 (1993). The common feature of each definition is that there must be a causal connection between the occurrence of one item and another. It is not enough that an income tax underpayment and a valuation misstatement coincide – the misstatement must have been the specific *cause* of the underpayment.

No amount of clever reasoning can negate the clear meaning of the language of Section 6662. The 40% penalty is inappropriate unless the taxpayer's underpayment has been caused by a valuation misstatement. An event (i.e., an income tax underpayment) is

not caused[2] by a prior event (i.e., a valuation misstatement) if the event would have occurred in the exact same manner regardless of whether the prior event happened or not.

The common law economic substance doctrine and related anti-tax abuse doctrines have been in use at least since 1935, when the Court issued its *Gregory v. Helvering* decision. 293 U.S. 465 (1935). Despite common sources and principles, different courts have articulated varying interpretations of how to apply the economic substance doctrine to a particular case. Deciding whether a transaction should be disregarded for lack of economic substance often depends on extrinsic factors, including the taxpayer's motives and expert economic analyses of the profit potential of complex transactions. For example, the U.S. Court of Appeals for the Tenth Circuit, the court before which amici's appeal of their own 40% penalty lies, applies a two-prong test, examining a transaction's objective and subjective characteristics not as separate prongs, but as "more precise factors to consider in the determination of whether the transaction has any

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[2] Causation can raise thorny metaphysical questions, which would bring us far afield from the issues before the Court. Nonetheless, counterfactuals provide a useful method of determining whether event *x* "caused" event *y*. *See* Peter Menzies, *Counterfactual Theories of Causation*, Stanford Encyclopedia of Philosophy (2001) (citing David Hume, *An Enquiry Concerning Human Understanding* (1748)), http://plato.stanford.edu/entries/causation-counterfactual/. If event *y* would have happened regardless of the occurrence of event *x*, then *x* cannot be said to have caused *y*.

practical economic effects other than the creation of income tax losses." *James v. Comm'r*, 899 F.2d 905, 908-09 (10th Cir. 1990) (internal brackets and quotation marks omitted).

In both Woods's and amici's cases, the relevant trial court applied the economic substance doctrine and found that the relevant investment lacked economic substance. *See Woods v. United States*, 794 F. Supp. 2d 714, 716 (W.D. Tex. 2011); *Blum v. Comm'r*, T.C. Memo. 2012-16, at *3. Consequently, each court disregarded the transactions in their entirety and held that taxpayers were not entitled to claim losses from their respective transactions. *See Woods*, 794 F. Supp. 2d at 717; *Blum*, T.C. Memo. 2012-16, at *40. They did so not because the taxpayers claimed an incorrect basis in property, but because the transactions lacked subjective and objective economic substance. It is true that the taxpayers claimed different tax benefits based on the sizes of their respective cost bases (and thus the claimed losses). However, regardless of the size of the tax benefit allegedly sought by the taxpayer, the resulting tax liability (and thus the underpayment) would be the same. Whether Woods claimed the options involved in his COBRA investment had a basis of $0 or $1 billion, the entire transaction would be disregarded, thereby preventing him from claiming any COBRA losses and resulting in the same income tax underpayment.

The statute does not impose a penalty based on the mere existence of a valuation misstatement. It

also does not impose a penalty based on whether a taxpayer attempted to claim a benefit from a valuation misstatement. Congress could have codified those grounds for a valuation misstatement penalty when it adopted the version of Section 6662, as it existed during Woods's COBRA transaction. It also could have provided an independent basis for imposing a penalty on transactions lacking economic substance, as it in fact did when it codified the economic substance doctrine in 2010. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), (b)(1) (2010). This would have accomplished the goal Petitioner attributes to Congress in a much less convoluted fashion than expecting the IRS, taxpayers, and courts to realize that transactions lacking economic substance represent valuation misstatements in themselves. Regardless of whether the IRS now believes that such a codification would have been an advisable means of deterring abusive tax shelters, Congress failed to address these concerns in the statutory text.

Having repeatedly failed to challenge the 40% rule articulated by the Fifth and Ninth Circuits in *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988) and *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990) on policy grounds, the IRS' brief proposes a more nuanced argument. It proposes that Section 6662 imposes a 40% penalty not only on underpayments attributable to factual valuation misstatements, but also on those attributable to what the IRS characterizes as basis misstatement resulting from the

operation of law. (Br. for the United States 41.) The IRS goes on to argue that the distinction between a factual and legal valuation misstatement is inconsequential and that, in either case, the taxpayer is subject to the same 40% penalty for a payment attributable to a valuation misstatement.

To arrive at this conclusion, the IRS cites the district court's finding that "the whole point of the COBRA strategy" was to create a paper loss through a misstatement of the basis of partnership property. (Br. for the United States 40). At most, this shows that the taxpayers or COBRA promoters subjectively intended to receive a tax benefit from a valuation misstatement. It does not show that a valuation misstatement caused the parties' actual underpayment.

Even if the IRS is correct that a transaction lacking economic substance represents a legal, rather than a factual, valuation misstatement, that does not mean that the taxpayer's resulting underpayment was *caused* by that misstatement. It simply begs the question of whether the taxpayer's underpayment was caused by (and therefore attributable) to a valuation misstatement or, perhaps, whether the underpayment and legal valuation misstatement were both caused by a third event: the fact that the transaction lacked economic substance. One of the classic problems of causation involves the question of whether one event really caused another. For example, the two events may simply coincide with no causal connection

to each other. Another possibility more relevant to this case is that a third event caused both events. Here, the latter possibility is likely. Rather than being caused by a valuation misstatement, Woods's underpayment and the valuation misstatement (to the extent that there was one) both resulted from the same source: the fact that COBRA had no economic substance. The economic substance doctrine's primary effect is to prevent Woods from claiming any losses from COBRA. Perhaps, in a technical sense, that also caused there to be no basis in Woods's property.[3] But that does not demonstrate that Woods's underpayment was *attributable to* a valuation misstatement. The effect on the basis is simply an irrelevant side product of the economic substance doctrine, with no practical effect on Woods's ultimate tax liability because the entire transaction is deemed to have not taken place.

[3] It is not necessarily the case that property involved in a disregarded transaction has a basis of zero. The truth of taxpayer's value and basis representations is akin to the truth of the phrase, "The present King of France is bald." *See* Bertrand Russell, *On Denoting*, 14 Mind 479, *reprinted in, The Collected Papers of Bertrand Russell, Vol. IV: Foundations of Logic* 414, 419 (A. Urquhart & A. Lewis eds., 1994). As in that sentence, there is a sense in which the claimed basis is neither true nor false, since there is no present King of France; similarly the transaction in question is a nullity.

B. The Court should apply the plain meaning of the statute as codified by Congress, regardless of non-textual considerations of legislative policy.

As the IRS points out, many lower courts have rejected or criticized the valuation misstatement rule articulated by Woods and the Fifth and Ninth Circuit appellate courts. *See, e.g.*, *Merino v. Comm'r*, 196 F.3d 147, 155 (3d Cir. 1999). At first blush, this approach can seem reasonable because it allows the IRS to impose harsher penalties on taxpayers who have engaged in allegedly more serious tax misconduct. These kinds of policy intuitions may provide the primary explanation for why so many appellate courts have concluded in the Commissioner's favor on this issue. *See, e.g.*, *Gustashaw v. Comm'r*, 696 F.3d 1124, 1136-37 (11th Cir. 2012) (referring to the need to "penalize and discourage" valuation misstatements); *Fidelity Int'l Currency Adv. A Fund, LLC ex rel. Tax Matters Partner v. Comm'r*, 661 F.3d 667, 673 (1st Cir. 2011) (same); *Clearmeadow Invs., LLC v. United State*s, 87 Fed. Cl. 509, 534 (2009) (arguing that Congress could not have intended this result). "Why," the common sense argument goes, "should a taxpayer who engages in a transaction that is illegitimate in its entirety be given more favorable treatment than a taxpayer who engages in a legitimate transaction, but claims an inflated basis in property on his or her tax return?"

While perhaps well meaning, this post hoc, results-driven approach misunderstands the federal

executive and judicial branches' authority to interpret and enforce federal tax statutes. Our government consists of multiple branches, each with its own constitutionally prescribed powers and duties. *See* The Federalist No. 47, at 233-34 (James Madison) (Terence Ball ed., 2003) (articulating the philosophical basis for the separation of powers as a bulwark against tyranny). Simply put, Congress writes laws, executive agencies enforce them, and courts interpret them. Sometimes, Congress (like all legislatures) makes what turn out to be, in arguable hindsight, bad decisions. That may be inevitable for a popularly elected body adopting generally applicable laws to address future problems. But that does not mean that courts get to go back and second-guess Congress's policy decisions after the fact, no matter how much the courts may disagree with those decisions. In our framework of divided government, the role of this Court is merely to interpret laws and, if they have an unambiguous plain meaning that does not violate the U.S. Constitution, enforce that meaning.

The Petitioner's arguments about Congress's broader purpose of deterring abusive tax shelters are similarly unavailing. Congress is a heterogeneous body composed of a multitude of competing interests. Even when it is seemingly unanimous about fighting a commonly recognized evil, such as tax shelters, its members must address those vague purposes with concrete statutory language, often requiring difficult compromises over the final wording of a statute. *Bd. of Governors of Fed. Res. Sys. v. Dimension Fin.*

Corp., 474 U.S. 361, 373-74 (1986). This is particularly true in the context of U.S. fiscal policy. As this Court recognized over a century ago:

> What is termed the policy of the government with reference to any particular legislation is generally a very uncertain thing, upon which all sorts of opinions, each variant from the other, may be formed by different persons. It is a ground much too unstable upon which to rest the judgment of the court in the interpretation of statutes. Where the language of the act is explicit, this court has said, there is great danger in departing from the words used, to give an effect to the law which may be supposed to have been designed by the legislature. . . . It is not for the court to say, where the language of the statute is clear, that it shall be so construed as to embrace cases because no good reason can be assigned why they were excluded from its provisions.

Bate Refrigerating Co. v. Sulzberger, 157 U.S. 1, 37 (1895) (quoting *Denn v. Reid*, 35 U.S. 524, 527 (1836)) (internal quotation marks omitted).

Perhaps Congress could have better addressed the tax shelter problem by codifying a basis for imposing a 40% penalty on transactions lacking economic substance. But, despite having opportunities to fix what the IRS views as a mistake, Congress did not impose such a penalty until 2010. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), (b)(1) (2010). Even when it did impose a penalty, it opted to do so not by clarifying

application of the valuation misstatement penalty, but by codifying an entirely new penalty based on economic substance itself. *See* 26 U.S.C. § 6662(b)(6). Whether Congress should have adopted this kind of legislation decades earlier or clarified the proper application of the valuation misstatement penalty presents academic questions for political economists. In the late 1990s, when promoters encouraged transactions like COBRA and OPIS, the Commissioner had the authority to impose only those penalties authorized by the statutory language then in effect. At that time, a 40% penalty was only permissible if a taxpayer's underpayment was attributable to a gross valuation misstatement.

Even if the statute is ambiguous and the Court may consider non-textual considerations, it is far from clear that policy and equitable considerations demand imposing the 40% penalty. Punishment of taxpayers who take advantage of abusive tax shelters may not have been the only legislative policy consideration before Congress. The small amount of information we have about Congress's intentions in adopting valuation penalties includes the fact that Congress likely enacted Section 6662's predecessor statute, 26 U.S.C. § 6659, to discourage taxpayers from overvaluing property in order to "divide the difference" with the IRS. *Todd*, 862 F.2d at 542 (citing H.R. Rep. No. 97-201, at 243 (1981)). First, this policy preference does not justify the IRS' attempt to recast losses claimed from a transaction lacking economic substance as a valuation misstatement. The plain

meaning of the statutory text trumps the amorphous intent that Congress did not codify into statutory language.

Second, the policy of deterrence through punishment must be balanced against other concerns, including the efficient use of judicial resources. It is plausible that Congress may have chosen not to impose a 40% penalty on transactions lacking economic substance in order to avoid forcing courts into unnecessarily complicated valuation disputes when a case can be more simply resolved with the common law economic substance doctrine.

As identified by both parties, the little legislative history available comes from the informal guidance of the *General Explanation of the Economic Recovery Tax Act of 1981*, or the "Blue Book," prepared by the Staff of the Joint Committee on Taxation. The Blue Book provides the most contemporary account of how Congress intended for courts and the IRS to apply the predecessor statute's version of the valuation misstatement penalty if underpayments are attributable to multiple adjustments. *See id.* at 333. It does so through a simple formula:

> 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. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from

> a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

Id. The formal legislative history of an analogous penalty modeled on the predecessor to § 6662 suggests that this is the proper formula for determining the value of an underpayment attributable to a valuation misstatement. *Gainer*, 893 F.2d at 228 (citing H.R. Rep. No. 99-426, at 763 (1985)).

This guidance greatly simplifies the process of determining the amount of a taxpayer's penalty in this case, as well as in amici's OPIS investment.[4] One simply determines the difference between the taxpayer's tax liability if the taxpayer had correctly reported the basis of all property used in the transaction and the liability as reduced by the valuation misstatement. If the transaction itself lacks economic substance, then the taxpayer would have the exact same income tax liability regardless of proper valuation of property claimed on his or her income tax return. It would therefore be improper to hold a taxpayer in Woods's position liable for a 40% penalty

[4] Woods's merits brief provides persuasive argumentation for why this kind of simplicity was one of the primary goals of the valuation misstatement penalties provided by Section 6662 and its predecessor statute. (Br. for Resp't 35.)

because *none* of his alleged underpayment is attributable to a valuation misstatement.

Despite Petitioner's claims to the contrary, the Blue Book says nothing about its formula applying only to special situations in which underpayments attributable to a valuation misstatement must be distinguished from those attributable to other adjustments. While the Blue Book notes that the portion of a tax underpayment attributable to an overstatement is determined after taking other adjustments into account, its language stating how to apply the penalty contains no qualifying language. Staff of the Jt. Comm. on Tax., *supra*, at 333. An additional Blue Book example supports this interpretation by determining an overvaluation penalty regarding the charitable donation of a painting (e.g., the amount of underpayment attributable to the overvaluation) solely based on the amount by which the overvaluation reduced the taxpayer's income tax liability. *Id.* at 334.

Finally, to the extent that there is a true ambiguity regarding how to apply Section 6662's governmental penalties, after considering the text, structure, history, and purpose of the statute, *see Maracich v. Spears*, 133 S. Ct. 2191, 2222 (2013), then the Court should apply the rule of lenity and resolve the question of construction in Woods's favor.

C. Treasury Regulations treating an underpayment resulting from a transaction disallowed under the economic substance doctrine as attributable to a valuation misstatement are erroneous and entitled to no deference.

Finally, the IRS argues that regulations adopted by the U.S. Department of Treasury require that Woods's underpayment be deemed attributable to a valuation misstatement. *See* 26 C.F.R. § 1.6662-5(g). According to that rule,

> The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent.

Id. The IRS argues that, since property used in a disregarded transaction has a basis of zero, the taxpayer's basis misstatement is necessarily 400% or more of the correct amount, requiring imposition of Section 6662's gross valuation misstatement penalty.

This argument assumes not only that the basis of property involved in a disregarded transaction has a value of zero, but also that the economic substance doctrine somehow causes the taxpayer's underpayment to be attributable to a valuation misstatement. Even if a disregarded transaction technically results in a basis of zero, that basis adjustment did not cause the taxpayer's underpayment and the underpayment

still cannot be properly attributed to the valuation misstatement.

As argued above, Congress's intent is clear. The plain language of the statute unambiguously provides that a 40% penalty is inappropriate in connection with an underpayment resulting from a transaction disregarded under the economic substance doctrine. If the statutory language is clear and unambiguous, that is the end of the matter and the agency is entitled to no deference. *See Chevron U.S.A. Inc. v. Nat. Res. Def. Cncl., Inc.*, 467 U.S. 837, 842-43 (1984). A Treasury Regulation in conflict with the plain meaning of Section 6662 is per se unreasonable and there is no need to make a multi-step *Chevron* analysis of whether the rules are unreasonable, *see United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1847 n.1 (2012) (citing Matthew C. Stephenson & Adrian Vermeule, Chevron *Has Only One Step*, 95 Va. L. Rev. 597, 599 (2009)), or to determine the amount of deference owed to the Department of Treasury by this Court, *see Smith v. City of Jackson, Miss.*, 544 U.S. 228, 267 (2005) ("[N]o deference is due to agency interpretations at odds with the plain language of the statute itself.") (internal quotation marks omitted).

II. The valuation misstatement penalty applies only to a factual misrepresentation of the value of property claimed on an income tax return, not to a basis reduced to zero by operation of law.

Even if the IRS is correct that an underpayment resulting from a transaction without economic substance can be attributable to a valuation misstatement, that simply raises the issue of how one should determine whether a valuation misstatement occurred in the first place. The IRS has argued that so-called "basis inflating" tax shelters disregarded on economic substance grounds necessarily constitute legal, if not factual, valuation misstatements. It therefore concludes that all such transactions trigger Section 6662's 40% penalty.

Assume for the sake of argument that a transaction's invalidation on economic substance grounds can have the legal effect of reducing the taxpayer's interest in property involved in the transaction (whether cattle, shipping containers, or complex financial derivatives) to zero. But this simply raises the question of whether this effect represents the kind of "valuation misstatement" contemplated by the text of Section 6662's 40% penalty.

As argued in Woods's merits brief (Br. for Resp't 35),[5] Section 6662's use of the term "valuation

[5] Woods's brief makes other persuasive arguments based on the text, structure, and legislative history of Section 6662 for

(Continued on following page)

misstatement" strongly suggests that the 40% penalty requires a factual misstatement of the basis of property claimed on a tax return. *See* 26 U.S.C. § 6662(b). Questions of value, themselves, are matters determined by the trier of fact based on the entire record. *See, e.g.*, *Yates v. Comm'r*, T.C. Memo. 2013-28, at *12. Sitting as triers of fact, courts often determine issues of valuation in reliance on expert witness testimony. *Estate of Gallagher v. Comm'r*, T.C. Memo. 2011-148, at *5 (citing *Helvering v. Nat. Grocery Co.*, 304 U.S. 282, 295 (1938)). These kinds of questions can be very complicated, requiring a court to review a wide range of complex and often conflicting evidence, which helps to explain the very backlog of valuation cases that motivated enactment of the valuation misstatement penalty's predecessor provision, 26 U.S.C. § 6659, in the first place. *See* H.R. Rep. No. 97-201, at 243 (1981).

Whether a court should use the common law economic substance doctrine to invalidate an entire transaction is, by contrast, generally a question of law. The doctrine has its origins not in federal statutes, but has gradually evolved through a variety of related common law anti-abuse principles created by federal judges. *See Moline Props. Inc. v. Comm'r*, 319 U.S. 436 (1943) (sham transaction doctrine); *Sala v.*

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why a transaction lacking economic substance as a matter of law does not necessarily demonstrate that kind of factual valuation misstatement required to impose the 40% penalty. (Br. for Resp't 33-46.)

United States, 613 F.3d 1249, 1253 (10th Cir. 2010) (economic substance doctrine); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (business purpose doctrine); *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938) (substance over form doctrine); *Comm'r v. Gordon*, 391 U.S. 83 (1968) (step transaction doctrine). A unifying theme of these common law doctrines has been that invalidation of a transaction is generally a question of law. For example, while determining whether a transaction lacks economic substance arguably raises mixed questions of law and fact, the U.S. Court of Appeals for the Tenth Circuit treats such determinations like questions of law and subjects them to de novo review. *Sala*, 613 F.3d at 1252.

Courts' disparate treatment of questions of valuation and those of economic substance illustrates the stark differences between the situations to which Section 6662's 40% penalty applies and transactions disregarded for lack of economic substance. The two inquiries pose separate questions, which the IRS has improperly sought to conflate into a single question whereby every alleged basis inflating transaction lacking economic substance (a question of law) necessarily leads to a finding of fact that a taxpayer misstated the value of property on his or her return (the so-called "basis-overstatement penalty").

Take, for example, the case of amici. The IRS sought to disallow losses connected to their investment in OPIS, which was a complex series of investments in derivatives based on the price of UBS stock.

They fell afoul of the economic substance doctrine by allegedly executing a series of prearranged steps, the objective and subjective features of which the IRS and U.S. Tax Court determined were undertaken to create artificial tax losses, rather than reasonable profits. *See Blum*, T.C. Memo. 2012-16, at *31. Notably, the Tax Court did not address the questions of whether amici engaged in the trades composing OPIS nor the actual value of the options involved. Rather, it held that the issue of value or basis in the OPIS options was moot "[b]ecause . . . the OPIS transaction lacked economic substance and related losses are disallowed without regard to the value or basis of the assets." *Id.* at *38 n.22. Assuming OPIS lacked economic substance, the Tax Court would have been correct that it should be disregarded as a matter of law and that no valuation of amici's basis in the options would be necessary. However, the court erred in assuming that this inevitably led to the conclusion that amici were liable for a gross valuation misstatement penalty, which, based on the plain language, structure and legislative history of Section 6662, applies only to a factual misstatement of property value claimed on a tax return. Imposing a 40% penalty in such a situation would be inappropriate because the taxpayers would not have engaged in the conduct designed by Congress as triggering the penalty (a gross misvaluation of property as a matter of fact).

CONCLUSION

For these reasons, and those in Respondent's brief, the Court should affirm the court of appeals' decision that an underpayment resulting from a transaction lacking economic substance is not attributable to a valuation misstatement.

Respectfully submitted,

CHRISTOPHER M. REIMER
Counsel of Record
LONG REIMER WINEGAR
BEPPLER LLP
270 West Pearl Street, Suite 103
P.O. Box 3070
Jackson, Wyoming 83001
307.734.1908
creimer@lrw-law.com

Counsel for Amici Curiae