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

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the 40% gross valuation misstatement penalty applies to an underpayment of tax resulting from a determination that a transaction lacks economic substance.

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STATUTORY AND REGULATORY PROVISIONS INVOLVED

Petitioner has included all pertinent statutory and regulatory provisions at *Pet. App.* 25a-44a, with the exceptions of the current version of Section 6662 of the Internal Revenue Code and Section 1409 of the Health Care and Education Reconciliation Act of 2010, Pub. Law No. 111-152, 124 Stat. 1029, 1067, both of which are reprinted in Appendix 1.

STATEMENT

In 1999, Gary Woods ("Woods"), on behalf of himself and his business associate, Billy Joe "Red" McCombs ("McCombs"), participated in a strategy known as "COBRA" on the advice of Ernst & Young and other prominent tax advisors. *Pet. App.* 16a-17a. Pursuant to such advice, two COBRA transactions were implemented: one transaction through Tesoro Drive Partners ("TDP"), a Texas general partnership and one transaction through SA Tesoro Investment Partners ("SATIP"), also a Texas general partnership.

In December 2004, the IRS issued Final Notices of Partnership Administrative Adjustment ("FPAAs") to TDP and SATIP. The FPAAs proposed to disallow in full the COBRA transactions for various reasons, including that the transactions lacked economic substance. The FPAAs also proposed accuracy-related penalties under Section 6662(a) of the Internal Revenue Code, including the 40% gross valuation misstatement penalty at issue.

Woods, as Tax Matters Partner of both TDP and SATIP, filed actions in the United States District Court for the Western District of Texas challenging the FPAAs. After Woods presented his case in chief at trial, the District Court granted the Government's motion for judgment as a matter of law. *Pet. App.* 15a, 16a. The District Court found that the COBRA transactions were lacking in economic substance and that the losses should be disregarded for tax purposes. *Pet. App*. 21a. In a subsequent order, the District Court ruled that the transactions in question were subject to a 20% accuracy-related penalty under Section 6662. *Pet. App.* 9a, 13a; *see also* 26 U.S.C. § 6662(a),(b)(1),(2); 26 C.F.R. § 1.6662-2(c). The taxpayers do not challenge this ruling.

The District Court also ruled that the 40% gross valuation misstatement penalty did not apply under controlling Fifth Circuit precedent. *Pet. App.* 6a. The Government appealed this ruling, and the Court of Appeals for the Fifth Circuit affirmed applying long-standing circuit precedent. *Pet. App.* 2a; *Todd v. Comm'r*, 862 F.2d 540 (5th Cir. 1988).

SUMMARY ARGUMENT

This case presents an obsolete issue: whether a 40% penalty applies when the tax underpayment is attributable to a transaction that lacks economic substance. Congress resolved this issue in 2010, statutorily imposing a 40% penalty in these circumstances. The outcome of this case—limiting the penalty to 20% where a determination is made that a transaction lacks economic substance—cannot occur under current law. On a going forward basis, Congress

has fully reconciled the circuit court differences identified by the Government. Further, even as a historical matter, the issue presented is unimportant, which is underscored by the Court's decision last term in *United States v. Home Concrete & Supply LLC*, 566 U.S. ----,132 S. Ct. 1836, 182 L. Ed. 746 (2012), reinforcing the three year statute of limitations in transactions involving an alleged overstatement of basis. The petition for writ of certiorari should therefore be denied.

ARGUMENT

1. The Court Should Deny the Petition Because Whether a 40% Penalty Applies to a Transaction that Lacks Economic Substance is an Obsolete Issue in Light of Congressional Action in 2010.

The Government presents to this Court a narrow and limited question: whether the 40% penalty "applies to an underpayment resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property." *Pet*. (I). Congress answered this precise question in the affirmative with the 2010 addition of subsection (i) to section 6662 of the Internal Revenue Code. *See* Health Care and Education Reconciliation Act of 2010, Pub. Law No. 111-152, § 1409(b)(2), 124 Stat. 1029, 1069 (effective for transactions entered into after Mar. 30, 2010).

Section 6662(i) imposes a 40% penalty on any portion of an underpayment attributable to a "nondisclosed noneconomic substance transaction." 26 U.S.C. § 6662(i)(1). A transaction is treated as having economic substance "only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." *See id*. §§ 6662(b)(6),(i)(2), §7701(o)(1). A transaction is nondisclosed if "the relevant facts affecting the tax treatment are not adequately disclosed in a return nor in a statement attached to the return." *See id*. § 6662(i)(2).

The COBRA transaction in this case would undisputedly be subject to this 40% penalty regime established by Section 6662(i). The District Court found that the transaction "was totally lacking in economic substance and was for the sole purpose of creating a tax benefit." *Pet. App.* 21a. Further, none of the taxpayers at issue filed a Form 8275 Disclosure Statement with the IRS disclosing the relevant facts affecting the tax treatment of the transactions.[1] Thus for COBRA and similar transactions entered into after March 30, 2010, the issue presented by this case is obsolete. A 40% penalty would apply under Section 6662(i) regardless of whether the tax underpayment

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[1] IRS Notice 2010-62 (Sept. 13, 2010) ("The disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications, or other guidance subsequently published by the IRS").

was also attributable to an item giving rise to a gross valuation misstatement.

In effect, Section 6662(i) has eliminated any arguable importance the issue in this case might have possessed. Even the Government acknowledges that Section 6662(i) would impose a 40% penalty in cases, such as this case, where the tax underpayment is attributable to a transaction that lacks economic substance. *Pet*. 31. The enactment of Section 6662(i) has further eliminated any practical significance of the disagreement among the circuits identified by the Government. Going forward, the Fifth and Ninth Circuits must follow Section 6662(i). For this reason, the petition for writ of certiorari should be denied.

2. The Court Should Deny the Petition Because the Imposition of the 40% Penalty in Cases Where the 20% Penalty Applies is Not an Important Matter.

The historical disagreement among the circuits on the application of the 40% valuation misstatement penalty simply does not warrant this Court's review.

The issue is extremely narrow. As discussed, Congress has resolved this issue for all transactions since 2010. And even for those transactions before 2010, what is ultimately at stake is the *amount* of penalty that will be assessed—not *whether* a penalty will be assessed. In essence, the question the Government seeks to bring before the Court is whether Woods and McCombs, currently subject to a 20% penalty, should instead face a 40% penalty. This is not a question of any great importance.

The issue also has limited applicability. The Government contends that under the Fifth and Ninth Circuit's interpretation of the valuation misstatement penalty, "the federal government will be deprived of substantial revenue that is owed by wealthy individuals or companies that attempted to avoid their tax obligations by participating in abusive tax shelters." *Pet*. 30. The Government does not claim, nor can it truthfully claim, that the issue affects all taxpayers or even most taxpayers. It freely admits that the issue only affects a select few high net-worth taxpayers that were approached by the Top Four Accounting Firms with a sophisticated tax strategy during a brief period ending in the early 2000s. *See Pet. App.* 5a. Moreover, the Government offers no support for its sensationalized claim that the issue is costing "the federal fisc hundreds of millions of dollars in forgone penalties . . . ." *Pet*. 29.

Any arguable importance of this issue for transactions before 2010 is significantly diminished by the three-year statute of limitations in 26 U.S.C. § 6501(a). This Court reaffirmed last term in *United States v. Home Concrete & Supply LLC*, 566 U.S. ---, 132 S. Ct. 1836, 182 L. Ed. 746 (2012), that the limitations period in Section 6501(a) generally applies in cases involving deficiencies arising from an overstatement of basis, including decisions based on a finding that a transaction lacks economic substance. As the Government effectively recognized in asking this Court to grant certiorari in *Home Concrete*, the Government's position that the six-year period applied was key to its efforts to pursue certain transactions (including COBRA transactions) that became prevalent in the late 1990s and 2000s. *See* Br. for the

Respondent, *Beard v. Comm'r*, No. 10-1553, at 20 (recommending certiorari). The Court's decision in *Home Concrete* – which rejected the Government's position – significantly reduces the number of cases in which the resolution of the circuit disagreement identified by the Government could matter.

The reality is that the disagreement among the circuits on this narrow issue of a 40% versus a 20% penalty is not an important matter. Accordingly, the Court should deny the petition for writ of certiorari.

CONCLUSION

At the end of the day, the Government ultimately is asking this Court for error correction in a case in which the taxpayers already have been assessed a 20% penalty, in order to resolve an issue that Congress has definitively addressed for any transaction arising in 2010 or later. Moreover, the Government's claim that this Court's intervention is needed is further undercut by the fact that the circuit differences identified by the Government have existed for nearly 25 years (since the Fifth Circuit's decision in *Todd*). Yet, there is no evidence that the IRS's enforcement efforts have been materially impacted during that period – even in the Fifth Circuit itself. That presumably explains why the Government never previously petitioned for writ of certiorari on this issue, even before the enactment of Section 6662(i), which resolves the issue. Especially in the wake of Section 6662(i), there is no need for the Court to devote its scarce resources to this issue now. The petition for writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX

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APPENDIX 1

26 U.S.C. § 6662 (2011)

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.

(6) Any disallowance of claimed tax benefits by

reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

(7) Any undisclosed foreign financial asset understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663. Except as provided in paragraph (1) or (2)(B) of section 6662A(e), this section shall not apply to the portion of any underpayment which is attributable to a reportable transaction understatement on which a penalty is imposed under section 6662A.

(c) Negligence.--For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

(d) Substantial understatement of income tax.--

(1) Substantial understatement.--

(A) In general.--For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of--

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) Special rule for corporations.--In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of--

(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or

(ii) $10,000,000.

(2) Understatement.--

(A) In general.--For purposes of paragraph (1), the term "understatement" means the excess of--

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)). The

excess under the preceding sentence shall be determined without regard to items to which section 6662A applies.

(B) Reduction for understatement due to position of taxpayer or disclosed item.--The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to--

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if--

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such

treatment does not clearly reflect the income of the corporation.

(C) Reduction not to apply to tax shelters.--

(i) In general.--Subparagraph (B) shall not apply to any item attributable to a tax shelter.

(ii) Tax shelter.--For purposes of clause (i), the term "tax shelter" means--

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(3) Secretarial list.--The Secretary may prescribe a list of positions which the Secretary believes do not meet 1 or more of the standards specified in paragraph (2)(B)(i), section 6664(d)(2), and section 6694(a)(1). Such list (and any revisions thereof) shall be published in the Federal Register or the Internal Revenue Bulletin.

(e) Substantial valuation misstatement under chapter 1.--

(1) In general.--For purposes of this section, there

is a substantial valuation misstatement under chapter 1 if--

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation.--No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

(3) Net section 482 transfer price adjustment.--For purposes of this subsection--

(A) In general.--The term "net section 482 transfer price adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under section 482 in the price for any property or services (or for the use of property).

(B) Certain adjustments excluded in determining threshold.--For purposes of determining whether the threshold requirements of paragraph (1)(B)(ii) are met, the following shall be excluded:

(i) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to any redetermination of a price if--

(I) it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the regulations prescribed under section 482 and that the taxpayer's use of such method was reasonable,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.

(ii) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to a redetermination of price where such price was not determined in accordance with such a specific pricing method if--

(I) the taxpayer establishes that none of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price, and such other pricing method was likely to result in a price that would clearly reflect income,

(II) the taxpayer has documentation (which was in

existence as of the time of filing the return) which sets forth the determination of such price in accordance with such other method and which establishes that the requirements of subclause (I) were satisfied, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.

(iii) Any portion of such net increase which is attributable to any transaction solely between foreign corporations unless, in the case of any such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(C) Special rule.--If the regular tax (as defined in section 55(c)) imposed by chapter 1 on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of this paragraph.

(D) Coordination with reasonable cause exception.--For purposes of section 6664(c) the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the requirements of clause (i), (ii), or (iii) of subparagraph (B) with respect to such portion.

(f) Substantial overstatement of pension liabilities.--

(1) In general.--For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

(2) Limitation.--No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

(g) Substantial estate or gift tax valuation understatement.--

(1) In general.--For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property

claimed on any return of tax imposed by subtitle B is 65 percent or less of the amount determined to be the correct amount of such valuation.

(2) Limitation.--No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

(h) Increase in penalty in case of gross valuation misstatements.--

(1) In general.--To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Gross valuation misstatements.--The term "gross valuation misstatements" means--

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting--

(i) in paragraph (1)(A), "200 percent" for "150 percent",

(ii) in paragraph (1)(B)(i)--

(I) "400 percent" for "200 percent",

and

(II) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)--

(I) "$20,000,000" for "$5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "40 percent" for "65 percent".

(i) Increase in penalty in case of nondisclosed noneconomic substance transactions.--

(1) In general.--In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Nondisclosed noneconomic substance transactions.--For purposes of this subsection, the term "nondisclosed noneconomic substance transaction" means any portion of a transaction described in subsection (b)(6) with respect to

which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

(3) Special rule for amended returns.--In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.

(j) Undisclosed foreign financial asset understatement.--

(1) In general.--For purposes of this section, the term "undisclosed foreign financial asset understatement" means, for any taxable year, the portion of the understatement for such taxable year which is attributable to any transaction involving an undisclosed foreign financial asset.

(2) Undisclosed foreign financial asset.--For purposes of this subsection, the term "undisclosed foreign financial asset" means, with respect to any taxable year, any asset with respect to which information was required to be provided under section 6038, 6038B, 6038D, 6046A, or 6048 for such taxable year but was not provided by the taxpayer as required under the provisions of those sections.

(3) Increase in penalty for undisclosed foreign financial asset understatements.--In the case of any portion of an underpayment which is attributable to any undisclosed foreign financial asset understatement, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

Health Care and Education Reconciliation Act of 2010, Pub. Law No. 111-152, §1409, 124 Stat. 1029, 1067

SEC. 1409. CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE AND PENALTIES.

(a) IN GENERAL.—Section 7701 of the Internal Revenue Code of 1986 is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

"**(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—**

"**(1) APPLICATION OF DOCTRINE.**—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

"**(A)** the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

"**(B)** the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

"**(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—**

"**(A) IN GENERAL.**—The potential for profit of a transaction shall be taken into account in determining whether the

requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

"**(B) TREATMENT OF FEES AND FOREIGN TAXES.**—Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

"**(3) STATE AND LOCAL TAX BENEFITS.**—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

"**(4) FINANCIAL ACCOUNTING BENEFITS.**—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

"**(5) DEFINITIONS AND SPECIAL RULES.**—For purposes of this subsection—

"**(A) ECONOMIC SUBSTANCE DOCTRINE.**—The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

"**(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.**—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

"**(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.**—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

"(D) **TRANSACTION.**—The term 'transaction' includes a series of transactions.".

(b) PENALTY FOR UNDERPAYMENTS ATTRIBUTABLE TO TRANSACTIONS LACKING ECONOMIC SUBSTANCE.—

(1) IN GENERAL.—Subsection (b) of section 6662 is amended by inserting after paragraph (5) the following new paragraph: "(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of

section 7701(o)) or failing to meet the requirements of any similar rule of law.".

(2) INCREASED PENALTY FOR NONDISCLOSED TRANSACTIONS.—Section 6662 is amended by adding at the end the following new subsection:

'**(i) INCREASE IN PENALTY IN CASE OF NONDISCLOSED NON-ECONOMIC SUBSTANCE TRANSACTIONS.—**

"**(1) IN GENERAL.**—In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

"(2) **NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.—**For purposes of this subsection, the term 'nondisclosed noneconomic substance transaction' means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

"**(3) SPECIAL RULE FOR AMENDED RETURNS.**—In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this

subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.".

(3) CONFORMING AMENDMENT.—Subparagraph (B) of section 6662A(e)(2) is amended—

(A) by striking "section 6662(h)" and inserting "subsections (h) or (i) of section 6662"; and

(B) by striking "GROSS VALUATION MISSTATEMENT PENALTY" in the heading and inserting "CERTAIN INCREASED UNDERPAYMENT PENALTIES".

(c) REASONABLE CAUSE EXCEPTION NOT APPLICABLE TO NONECONOMIC SUBSTANCE TRANSACTIONS.—

(1) REASONABLE CAUSE EXCEPTION FOR UNDERPAYMENTS.— Subsection (c) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking "paragraph (2)" in paragraph (4)(A), as so redesignated, and inserting "paragraph (3)"; and

(C) by inserting after paragraph (1) the following new paragraph:

"**(2) EXCEPTION.**—Paragraph (1) shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6)."

(2) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS.—Subsection (d) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking "paragraph (2)(C)" in paragraph (4), as so redesignated, and inserting "paragraph (3)(C)"; and (C) by inserting after paragraph (1) the following new paragraph:

"**(2) EXCEPTION**.—Paragraph (1) shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6).".

(d) APPLICATION OF PENALTY FOR ERRONEOUS CLAIM FOR REFUND OR CREDIT TO NONECONOMIC SUBSTANCE TRANSACTIONS.— Section 6676 is amended by redesignating subsection (c) as subsection (d) and inserting after subsection (b) the following new subsection:

"**(c) NONECONOMIC SUBSTANCE TRANSACTIONS TREATED AS LACKING REASONABLE BASIS.**—For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.".

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to transactions entered into after the date of the enactment of this Act.

(2) UNDERPAYMENTS.—The amendments made by subsections (b) and (c)(1) shall apply to underpayments attributable to transactions entered into after the date of the enactment of this Act.

(3) UNDERSTATEMENTS.—The amendments made by subsection (c)(2) shall apply to understatements attributable to transactions entered into after the date of the enactment of this Act.

(4) REFUNDS AND CREDITS.—The amendment made by subsection (d) shall apply to refunds and credits attributable to transactions entered into after the date of the enactment of this Act.