No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS AND SA TESORO INVESTMENT PARTNERS

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

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Section 6662 of the Internal Revenue Code prescribes a penalty for an underpayment of federal income tax that is "attributable to" an overstatement of basis in property. 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1). The question presented is as follows:

Whether the overstatement 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.

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The Solicitor General, on behalf of the United States of America, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-2a) is reported at 471 Fed. Appx. 320. The opinions of the district court (App., *infra*, 3a-14a, 15a-22a) are reported at 794 F. Supp. 2d 714 and 794 F. Supp. 2d 710.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 2012. A petition for rehearing was denied on August 8, 2012 (App., *infra*, 23a-24a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The pertinent statutory and regulatory provisions are reprinted in the appendix to this petition. App., *infra*, 25a-45a.

STATEMENT

This case raises an important question for the administration of the federal tax laws that has long divided the circuits. Section 6662 of the Internal Revenue Code imposes a penalty for an underpayment of income tax that is "attributable to" an overstatement of the value or basis of property. 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1).[1] The Fifth Circuit has held that the penalty does not apply to situations where the IRS concludes that a transaction is a sham lacking economic substance and therefore treats it as a nullity in calculating a participant's tax liability, even if the taxpayer has claimed an unjustified tax benefit by artificially inflating the value or basis of property. As three members of the Fifth Circuit have acknowledged, there is "near-unanimous opposition" to that position among the other courts of appeals, with only the Ninth Circuit adopting the Fifth Circuit's approach. *Bemont Invs., L.L.C.* v. *United States*, 679 F.3d 339, 354 (5th Cir. 2012) (Prado, J., concurring, joined by Reavley and Davis, J.J.) (*Bemont Invs.*). Nevertheless, the Fifth Circuit has deemed the issue "well settled" in that circuit and has declined to reconsider its position. App., *infra*, 2a.

1. a. Our federal tax system, "relying as it does upon self-assessment and reporting," *United States* v. *Arthur*

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[1] Unless otherwise indicated, all citations to 26 U.S.C. 6662 are to that statute as it appears in the 2000 edition of the United States Code.

Young & Co., 465 U.S. 805, 815 (1984), prescribes various penalties for taxpayers who fail to report and pay all of the tax that they owe. As relevant here, the Internal Revenue Code imposes penalties if a taxpayer overstates the value of property, or the taxpayer's basis in property, on a tax return in a way that reduces the total taxes reported and paid. For example, a taxpayer might overstate the value of a painting donated to charity to obtain a larger charitable deduction. Likewise, a taxpayer might overstate her basis in shares of stock that she sold to make it appear that she realized a loss on the transaction.

To deter such overstatements, Section 6662 of the Code provides that "there shall be added to the [income] tax [owed] an amount equal to 20 percent of the portion of the underpayment * * * which is attributable to * * * [a]ny substantial valuation misstatement." 26 U.S.C. 6662(a) and (b)(3). A taxpayer commits a "substantial valuation misstatement" if, *inter alia*, "the value of any property (or the adjusted basis of any property) claimed on any [tax return] is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." 26 U.S.C. 6662(e)(1)(A). No penalty may be imposed, however, unless the underpayment exceeds $5000. 26 U.S.C. 6662(e)(2).

Section 6662 also establishes a greater penalty for a "gross valuation misstatement[]," defined to be an overstatement of the value or basis of property that is 400% or more of the correct amount. 26 U.S.C. 6662(h)(2)(A)(i).[2] "To the extent that a portion of the

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[2] Section 6662 was amended in 2006 to provide that the threshold for a "substantial valuation misstatement" is 150% (26 U.S.C. 6662(e)(1)(A)) and the threshold for a "gross valuation misstate-

underpayment [of income tax] is attributable to one or more gross valuation misstatements," a penalty equal to 40% of that portion of the underpayment is imposed on the taxpayer. 26 U.S.C. 6662(h)(1).

b. As the text of Section 6662 implicitly recognizes, cases may arise in which part of a taxpayer's underpayment of tax is "attributable to" an overstatement of value or basis, while the remainder of the underpayment is attributable to other errors (for example, failing to include all taxable income or taking an inapplicable deduction). In those circumstances, it is necessary to identify the "portion" of the underpayment of tax that is "attributable to" the overstatement in order to determine whether the overstatement penalty applies.

After the passage of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, which added the predecessor to the overstatement penalty of Section 6662,[3] the staff of Congress's Joint Committee on Taxation produced a summary of the legislation known as the

ment[]" is 200% (26 U.S.C. 6662(h)(1)). See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1) and (2), 120 Stat. 1083.

[3] The predecessor to the overstatement penalty of Section 6662 was located at 26 U.S.C. 6659 and provided a schedule of penalties for "an underpayment of [income tax] for the taxable year which is attributable to a valuation overstatement," defined to exist "if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis." 26 U.S.C. 6659(a) and (c) (1988). Section 6662 replaced Section 6659 (and other penalty provisions) in 1989. See Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, Tit. VII, Subtit. G, § 7721(a) and (c)(2), 103 Stat. 2395, 2399. The principal purpose of the change was to "improve the fairness, comprehensibility, and administrability of the[] penalties" by consolidating a number of penalty provisions in one section. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1388 (1989).

Blue Book. See Staff of the Joint Comm. on Taxation, 97th Cong., *General Explanation of the Economic Recovery Tax Act of 1981* (Comm. Print 1981) (*Blue Book*). The *Blue Book* stated that "[t]he 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." *Id.* at 333. It then set forth a formula to calculate the appropriate portion:

> [T]he 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.

Ibid.[4] To illustrate the application of this formula, the *Blue Book* included the following example:

> Assume that in 1982 an individual files a joint return showing taxable income of $40,000 and tax liability of $9,195. Assume, further, that a $30,000 deduction which was claimed by the taxpayer as the result of a valuation overstatement is adjusted down to $10,000, and that another deduction of $20,000 is disallowed totally for reasons apart from the valuation overstatement. These adjustments result in correct taxable income of $80,000 and correct tax liability of $27,505. Accordingly, the underpayment due to the

[4] An almost identical explanation appears in the legislative history of a similar penalty provision enacted in 1986. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 763 (1985).

> valuation overstatement is the difference between the tax on $80,000 ($27,505) and the tax on $60,000 ($17,505) (i.e., actual tax liability reduced by taking into account the deductions disallowed because of the valuation overstatement), or $9,800.

Id. at 333 n.2.[5]

c. In 1991, the Treasury Department promulgated a regulation addressing various issues with respect to overstatement penalties under Section 6662. See 26 C.F.R. 1.6662-5. Subsection (g) of that regulation provides that where the correct value or basis of property is zero—and thus the overstatement percentage would technically be infinite or undefined—any overstatement is a gross valuation misstatement. 26 C.F.R. 1.6662-5(g). The regulation also clarifies that the $5000 minimum underpayment to trigger the penalties applies to both substantial and gross valuation misstatements. See 26 C.F.R. 1.6662-5(b).

2. In November 1999, respondent and another individual, Billy Joe "Red" McCombs, elected to participate in an abusive tax shelter called Current Options Bring Reward Alternatives, or COBRA. App., *infra*, 4a-5a & n.2. The purpose of COBRA is to generate a large paper loss that can offset real gains that the taxpayer realizes in a given tax year. *Id.* at 5a. McCombs, at one time the owner of the NBA's San Antonio Spurs and the NFL's Minnesota Vikings, expected to realize significant income in 1999 from the expansion of the NFL to include the resurrected Cleveland Browns franchise. *Id.* at 16a;

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[5] In what appears to have been an inadvertent error, the *Blue Book* example incorrectly calculated the underpayment attributable to the basis overstatement to be $9800 rather than $10,000 (*i.e.*, $27,505 minus $17,505).

9/15/2010 Trial Tr. (Afternoon Sess.) 76-77. Respondent Woods was a long-time business associate of McCombs. App., *infra*, 16a.

Like a number of other tax shelters that proliferated during the late 1990s and early 2000s, COBRA was designed to enable a taxpayer to claim an unlawful tax loss by artificially inflating her basis in a particular asset. When the asset is sold for far less than the asserted basis, the taxpayer claims a large loss on that sale that can be used to offset real gains from other transactions. App., *infra*, 5a.

To execute COBRA, a taxpayer purchases and sells largely offsetting short-term options on a foreign currency. See generally *RA Invs. I, LLC* v. *Deutsche Bank AG*, No. 3:04-cv-1565, 2005 WL 1356446, at *1 (N.D. Tex. June 6, 2005) (describing COBRA). For example, the taxpayer might purchase a 30-day option on a foreign currency valued at $100 million while selling a 30-day option on the same currency worth $95 million—for an out-of-pocket expenditure of $5 million. The taxpayer contributes both of those positions, plus a relatively small amount of cash (*e.g.*, $3 million), to a partnership established with another COBRA participant solely for the purpose of the transaction. The partnership then purchases a relatively small quantity of assets (say, $2 million worth of publicly traded stock or a foreign currency). When the offsetting options expire, the partnership is immediately dissolved and the assets are distributed to the partners. The taxpayer then sells the distributed assets, but claims a basis in them equal to the value of the purchased option plus the cash contributed to the dissolved partnership—in this example, $103 million, generating a $101 million artificial tax loss.

In order to achieve that large paper loss, the taxpayer includes the cost of the purchased option she contributed to the partnership in calculating her basis in her interest, but she does not reduce the basis by the amount of the nearly offsetting sold option. See App., *infra*, 19a. A (nonprecedential) Tax Court memorandum opinion from 1975 had held that, for purposes of the partnership basis rules, a sold option is a contingent liability—*i.e.*, a liability that a partner need not account for in determining her basis in the partnership. See *Helmer* v. *Commissioner*, 44 T.C.M. (P-H) ¶ 75,160, at 712 (1975).[6] Taxpayers who participated in COBRA exploited that opinion to generate an artificially high basis in the assets distributed by the sham partnership upon dissolution. In the example described above, the taxpayer claims on her tax return that her basis in the partnership—and therefore her basis in the assets distributed by the partnership at dissolution, see 26 U.S.C. 732(b)—is $103 million, even though she contributed only $8 million to the partnership (the $5 million difference between the prices of the offsetting options, plus the $3 million in cash).

Woods and McCombs together engaged in two COBRA transactions with two sham partnerships—one to generate ordinary losses and one to generate capital losses. App., *infra*, 5a-6a, 17a. After limited liability companies owned by Woods and McCombs contributed the requisite offsetting options, the partnerships purchased relatively small amounts of Canadian dollars and Sun Microsystems stock. *Id.* at 18a. When the partnerships dissolved and their assets were distributed to S corporations owned by Woods and McCombs, those

[6] *Helmer* was superseded by regulations initially proposed in 2003. See 26 C.F.R. 1.752-1(a)(4)(ii).

assets were sold for small economic gains. See *id.* at 5a; Trial Exs. 252, 254. But by counting the cost of the purchased options as part of the bases in those assets, Woods and McCombs claimed huge losses on the 1999 returns of the S corporations (which were then allocated to the taxpayers individually). App., *infra*, 19a. Taking into account fees paid to other entities to participate in COBRA, Woods and McCombs together lost only $1.37 million on the transactions, but they reported more than $45 million in losses. See *ibid.*; 9/16/2010 Trial Tr. (Morning Sess.) 25-26.

3. The IRS disallowed the tax treatment of the COBRA transactions on various grounds, including that they lacked economic substance. Under the economic-substance doctrine, a longstanding common-law principle codified by Congress in 2010, "tax benefits * * * with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." 26 U.S.C. 7701(o)(5)(A) (Supp. V 2011). In this case, the IRS determined that each "purported partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its purported partners." Trial Ex. 198, at D0198.0032; Trial Ex. 199, at D0199.0032. The IRS further determined that "a 40 percent penalty shall be imposed on the portion of any underpayment attributable to the gross valuation misstatement[s]." Trial Ex. 198, at D0198.0034; Trial Ex. 199, at D0199.0034.

4. Respondent Woods, as Tax Matters Partner for the two partnerships, sued the United States to challenge both the IRS's conclusion that the COBRA transactions lacked economic substance and the applicability of the penalties imposed.

The district court upheld the IRS's determination that the transactions lacked economic substance. App., *infra*, 19a-21a. The "central theory of COBRA," the court explained, "was that the basis of each partnership's property was the cost of the 'long' currency options, while the 'short' options could be disregarded for tax purposes." *Id.* at 19a. The court further explained that the "use of two partnerships with a six-week life span to conduct that trading [was] for the sole purpose of generating a paper loss" via this artificially high basis. *Id.* at 20a. The court concluded that the COBRA transaction "was totally lacking in economic substance," and that "both the ordinary loss and the capital loss claimed by the respective partnerships should be disregarded for tax purposes." *Id.* at 21a.

In a subsequent opinion, however, the district court held that the overstatement penalty under Section 6662 was inapplicable. App., *infra*, 3a-14a. Citing the Fifth Circuit's decision in *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), the court stated that "[i]n this Circuit * * * it is clearly established that whenever the Internal Revenue Service totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction." App., *infra*, 6a. It explained that "until and unless *Heasley* is overruled by the Court of Appeals or the Supreme Court, this Court is bound by its holding." *Ibid.*

5. While the government's appeal of the district court's penalty ruling was pending, the Fifth Circuit issued a decision in *Bemont Investments*, another case involving a tax shelter designed to "creat[e] an artificially high basis in partnership interests." 679 F.3d at 341. Relying on *Heasley*, *supra*, as well as the prior decision in *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988),

the court held that the overstatement penalty cannot apply when the IRS treats "transactions as a sham, and disallow[s] all tax attributes flowing from the transactions in full." *Bemont Invs.*, 679 F.3d at 347-348.

Judge Prado issued a concurring opinion, which was joined by the other two members of the panel. *Bemont Invs.*, 679 F.3d at 351. The concurring opinion explained that, although "a routine application of the *Todd/Heasley* rule decides this case," that "rule may be misguided." *Id.* at 351, 353. Judge Prado explained that "[a]rguably, if the *Todd/Heasley* rule did not bind us, tax underpayment in this case would be 'attributable to' a valuation overstatement." *Id.* at 353. The "basis misstatement and the transaction's lack of economic substance," Judge Prado reasoned, "are inextricably intertwined" because "[t]he basis misstatement was the engine of, the vehicle behind the sham transaction." *Id.* at 354. The concurrence further observed that "disregarding the deduction for a lack of economic substance pulls the correct basis to zero, which eliminates the claimed loss, and renders the tax underpaid." *Ibid.* As a result, "disregarding the transaction for a lack of economic substance does not alter the reality that the tax underpayment was ultimately 'attributable to' the basis misstatement—or so one could argue, in a world without *Todd/Heasley*." *Ibid.*

In his *Bemont Investments* concurrence, Judge Prado also noted "[t]he near-unanimous opposition to the *Todd/Heasley* rule" among other courts of appeals. 679 F.3d at 354. "Except for the Ninth Circuit," he explained, "every sister circuit that has considered the issue has concluded that the valuation misstatement penalty may apply even if the deduction is totally disallowed because the underlying transaction lacked economic substance." *Ibid.* And although "the Ninth Circuit has not joined the majority because it is bound by its own precedent to follow the *Todd/Heasley* rule, it has questioned the rule's wisdom." *Id.* at 355 (citing *Keller* v. *Commissioner*, 556 F.3d 1056, 1060-1061 (9th Cir. 2009)).

Judge Prado further observed that "the *Todd/Heasley* rule could incentivize improper tax behavior" because it rewards taxpayers who do not merely misstate their basis in property but who "craft[] a more extreme scheme." *Bemont Invs.*, 679 F.3d at 355. As a result, "[a] taxpayer could generate an enormous improper tax benefit by overstating an asset's basis, but then could escape the overvaluation penalty by strategically conceding a deficiency on the ground of economic substance." *Ibid.* Despite their misgivings about the *Todd/Heasley* rule, however, Judge Prado and the other panel members ultimately concluded that, in light of binding circuit precedent, "our hands are tied." *Ibid.*

6. Citing *Bemont Investments*, as well as *Todd* and *Heasley*, a different panel of the Fifth Circuit affirmed the district court's penalty ruling in this case in a one-paragraph per curiam opinion, App., *infra*, 1a-2a, stating that "[w]e are convinced this issue is well settled," *id.* at 2a.

The government filed petitions for rehearing en banc in both *Bemont Investments* and this case. *Bemont Investments* became moot when the taxpayer elected to pay the overstatement penalty, see 10-41132 Docket entry (5th Cir. Aug. 2, 2012), and the Fifth Circuit denied rehearing in this case, App., *infra*, 23a-24a.

REASONS FOR GRANTING THE PETITION

The Fifth Circuit's interpretation of Section 6662 is inconsistent with the statute's text and basic purpose, and it conflicts with the holdings of eight other courts of appeals. Numerous similar cases, arising out of a wave of abusive tax shelters that were marketed to wealthy taxpayers primarily in the late 1990s and early 2000s, are currently pending in the Fifth and Ninth Circuits. This Court's review is necessary to prevent the federal fisc from being deprived of hundreds of millions of dollars in penalties from the worst tax scofflaws.

A. The Court Of Appeals Erred In Holding That Section 6662 Does Not Impose An Overstatement Penalty Where A Transaction Is Disregarded As Lacking Economic Substance

1. When a transaction designed to generate an artificially high basis in property is disregarded as lacking economic substance, the resulting underpayment of tax is "attributable to" an overstatement of basis within the meaning of Section 6662.

a. Section 6662 provides that the overstatement penalty shall apply to "the portion of any underpayment which is attributable to * * * [a] substantial valuation misstatement." 26 U.S.C. 6662(b)(3); see 26 U.S.C. 6662(h)(1) (applying greater penalty to the "portion of the underpayment * * * attributable to one or more gross valuation misstatements"). The word "attributable" means "capable of being attributed," and to "attribute" is to "explain as caused or brought about by." *Webster's Third New International Dictionary of the English Language* 141, 142 (1993). As this Court explained in construing the words "gain attributable to such property" in another provision of the Internal Revenue Code, "the phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question." *Braunstein* v. *Commissioner*, 374 U.S. 65, 70 (1963). An underpayment of tax therefore is "attributable to" an overstatement of value or basis if the overstatement caused the underpayment.

Accordingly, when a taxpayer has underpaid income tax as a result of a tax shelter designed to generate tax losses by artificially inflating his basis in property, the underpayment is "attributable to" an overstatement of basis. The COBRA tax-avoidance mechanism employed by respondent provides an apt illustration. As the district court explained, "the whole point of the COBRA strategy" was to create a huge paper loss by claiming that "the basis of each partnership's property was the cost of the 'long' currency options, while the 'short' options could be disregarded for tax purposes." App., *infra*, 19a. When assets of the two partnerships (stock in Sun Microsystems and Canadian dollars) were sold, the taxpayers, through their S corporations, claimed a basis in those assets equal to the price of the long options (more than $45 million) plus a small amount of cash contributed to the partnerships. The IRS determined, however, that because the transaction had no purpose other than to achieve a tax loss, the transaction must be disregarded in calculating tax liability, and that the correct basis therefore was zero. See *ibid.*; Trial Ex. 198, at D0198.0014; Trial Ex. 199, at D0198.0014.

For purposes of computing a taxpayer's gain or loss from the sale of property, "the loss shall be the excess of the adjusted basis * * * over the amount realized" from the sale. 26 U.S.C. 1001(a). The impropriety of the deductions that Woods and McCombs claimed did not result from any misrepresentation concerning the amounts they had realized from the sale of the distributed partnership assets. Rather, the deductions were improper because the claimed losses were premised on asserted bases that the IRS subsequently determined to be unfounded.

In its Notice of Final Partnership Administrative Adjustment, the IRS concluded that the taxpayers had "not established adjusted bases in their respective partnership interests in an amount greater than zero." Trial Ex. 198, at D0198.0032; Trial Ex. 199, at D0199.0032. If Woods and McCombs had used that zero figure in calculating their own tax liabilities, they would have paid substantially more tax. It follows that Woods's and McCombs's underpayments of tax were "attributable to"—that is, were caused by—the overstatement of their basis in their partnership interests. "Had it not been for the valuation overstatement," Woods and McCombs "would not have underpaid [their] taxes." *Illes* v. *Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992) (per curiam), cert. denied, 507 U.S. 984 (1993).

b. The fact that Woods and McCombs were not allowed to take any deduction at all provides no sound reason to treat Section 6662's overstatement penalty as inapplicable. The statute sets forth "no exception for when the valuation or basis misstatements are so egregious that the entire tax benefit is disallowed, and no suggestion that the penalty should not apply when the correct basis or value is determined to be zero because the transaction is completely lacking in economic substance." *Gustashaw* v. *Commissioner*, No. 11-15406, 2012 WL 4465190, at *10 (11th Cir. Sept. 28, 2012). Regardless whether an underpayment of tax results from an overstatement of a zero basis or an overstatement of a basis greater than zero, it is "attributable to" an overstatement of basis.

Even if Section 6662 were ambiguous on this question, the issue was resolved in 1991 by Treasury Regulation 1.6662-5(g), which provides that "[t]he 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." 26 C.F.R. 1.6662-5(g). In that circumstance, "[t]here is a gross valuation misstatement with respect to such property." *Ibid.* That regulation reflects a reasonable interpretation of Section 6662 and is accordingly entitled to judicial deference. See *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842-845 (1984); see also *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704, 711-714 (2011) ("We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.").

2. In holding that Section 6662's overstatement penalty does not apply where a basis-inflating transaction is entirely disregarded, the Fifth Circuit has "misread the *Blue Book*'s elementary guidance." *Bemont Invs., L.L.C.* v. *United States*, 679 F.3d 339, 352 (5th Cir. 2012) (Prado, J., concurring) (discussing *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988)). As another court of appeals has explained, the Fifth Circuit arrived at its interpretation "not by considering how the 'attributable to' language should be read in light of its purpose * * * but rather because it glossed that requirement by reading language in a congressional tax document." *Fidelity Int'l Currency Advisor A Fund, LLC* v. *United States*, 661 F.3d 667, 673 (1st Cir. 2011) (*Fidelity*).

a. In *Todd*, the Fifth Circuit considered whether the overstatement penalty could be imposed on taxpayers who had claimed large deductions and tax credits as part of a scheme involving the purchase of refrigerated containers for agricultural products. See 862 F.2d at 540-541. The IRS had concluded that for many participating taxpayers, including the plaintiffs, the deductions and credits were improper in their entirety because the containers had not been placed in service in the years in which the deductions had been taken. See *id.* at 541. It had also determined that all participating taxpayers had vastly overstated their bases in the property by counting as part of the purchase price of each container not only the cash paid, but also the principal amount of an illusory promissory note. See *ibid.*

The Fifth Circuit held that the penalty could not be imposed on the plaintiffs because their underpayment of tax was "attributable to" the disallowance of the deduction for failure to place the units in service during the relevant tax years, rather than to the overstatement of basis in the refrigerated units. See *Todd*, 862 F.2d at 541-545. The court deemed the words "attributable to" ambiguous as applied to a deduction that is disallowed in its entirety for a reason independent of the overstatement of basis. Finding the "formal legislative history" of the Economic Recovery Tax Act of 1981 unhelpful on the question, the court turned to the formula set forth in the *Blue Book*. *Id.* at 542-543; see *Blue Book* 333. The Fifth Circuit reasoned that the plaintiffs' "actual tax liability" was no greater than their "actual tax liability as reduced by taking into account the valuation overstatement," because in either case the plaintiffs' deductions and credits would be completely disallowed for failure to place the refrigerated units in service in the relevant tax years. See *Todd*, 862 F.2d at 542-543 (citations omitted).

That conclusion rested on a clear misreading of the statute. Under the plain terms of Section 6662, the relevant question is whether the underpayment of tax is "attributable to" an overstatement of value or basis. By overstating their basis in the property, the plaintiffs in *Todd* claimed a larger deduction—and thus made a larger underpayment of tax—than they would have made if their basis in the refrigerated units had been accurately reported. To be sure, even accurate reporting of the plaintiffs' basis in the units would have resulted in *some* underpayment of tax, given the IRS's determination that no deduction was permissible because the units had not been placed in service. But the difference between that smaller underpayment and the larger underpayment that actually occurred is naturally characterized as "attributable to" the basis overstatement. See *Todd* v. *Commissioner*, 89 T.C. 912, 914 (1987) (noting that the government sought the basis-overstatement penalty "only with respect to the difference between the basis claimed on the return * * * and [the plaintiffs'] cash investment"), aff'd, 862 F.2d 540 (5th Cir. 1988). And "a[n] interpretation of the statute that allows imposition of a valuation misstatement penalty even when other grounds are asserted furthers the congressional policy of deterring abusive tax avoidance schemes." *Alpha I, L.P.* v. *United States*, 682 F.3d 1009, 1030 (Fed. Cir. 2012), petition for cert. pending, No. 12-550 (filed Nov. 1, 2012); cf. *Saudi Arabia* v. *Nelson*, 507 U.S. 349, 375 (1993) (Kennedy, J., concurring in part and dissenting in part) (explaining that "a single injury can arise from multiple causes, each of which constitutes an actionable wrong") (citing Restatement (Second) of Torts §§ 447-449, at 478-482 (1965)).[7]

[7] The anomalous nature of the Fifth Circuit's approach in *Todd* is particularly apparent given the treatment of other investors involved in the same Tax Court proceedings. Those other investors had actu-

As numerous judges have observed, the court in *Todd* simply misapplied the *Blue Book*'s guidance. The *Blue Book* described a case involving two *different* improper deductions, one of which is excessive because it is based on a valuation overstatement, and the other of which "is disallowed totally for reasons apart from the valuation overstatement." *Blue Book* 333 n.2. The question in *Todd*, by contrast, was how to apply Section 6662 when a single deduction is tainted both by a basis misstatement and by an unrelated legal defect. The *Blue Book* does not speak directly to that question.

b. In *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), the Fifth Circuit "exacerbated *Todd*'s misunderstanding," *Bemont Invs.*, 679 F.3d at 352 (Prado, J., concurring), by holding that Section 6662 is inapplicable to *any* deduction that is disallowed in full, even when the ground for disallowance is intimately connected to a value or basis overstatement. The Heasleys had claimed an investment tax credit based on a hugely inflated basis in certain energy savings units, each of which they had valued at $100,000, even though they were worth only $4800. See 902 F.2d at 381-382 & nn. 2, 4. The IRS had disallowed the tax credit in its entirety on a number of factually related grounds, including that the taxpayers "did not have a profit objective" and "that the units were overvalued." *Heasley* v. *Commissioner*, 57 T.C.M.

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ally placed their refrigerated units in service but (like the Todds) had claimed inflated bases in the assets. The Tax Court held that those taxpayers *were* liable for penalties for the "portions of their tax deficiencies 'attributable to valuation overstatements.'" *Todd*, 862 F.2d at 541 (brackets omitted) (discussing Tax Court proceedings). The effect of the Fifth Circuit's approach thus was to treat the *additional* flaw in the Todds' claimed deduction (*i.e.*, their failure to place the units in service) as a ground for *avoiding* the overstatement penalty.

(P-H) ¶ 88,408, at 2039 (1988).[8] In imposing the overstatement penalty, the Tax Court had distinguished *Todd* on the ground that "[i]n the instant case, we made specific findings as to value," which led it to conclude that, "to the extent the underpayment is due to the disallowed credits, the underpayment is attributable to a valuation overstatement." *Ibid.*

Seeing "no reason to treat this case any differently than *Todd*," the Fifth Circuit reversed and held that "[w]henever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." *Heasley*, 902 F.2d at 383. "In such a case," it concluded, "the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit." *Ibid.* That was so "even if the possible grounds for denying the same deduction—overvaluation and lack of economic substance, for example—emerge from the same factual nucleus." *Bemont Invs.*, 679 F.3d at 353 (Prado, J., concurring). And, as in *Todd*, the Fifth Circuit in *Heasley* applied that approach even though it was evident that the taxpayers' overstatement of basis had caused the size of the claimed deduction (and thus the amount of their underpayment) to be greater than it would otherwise have been.

c. In this case, the taxpayers' overstatements of their bases in the purported partnership were integral to their tax-avoidance scheme. As explained above, a taxpayer's "loss" from the sale of property is "the excess of the adjusted basis * * * over the amount realized." 26

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[8] In *Soriano* v. *Commissioner*, 90 T.C. 44 (1988), the test case for the transaction at issue in *Heasley*, the court couched its analysis in terms of economic substance.

U.S.C. 1001(a). The district court ultimately determined that Woods and McCombs each had an adjusted basis of zero in his partnership interests in the two partnerships. If Woods and McCombs had used that zero figure in calculating their own tax liabilities, they would not have claimed a loss on the sale of the distributed partnership assets, and their reported tax liabilities would have been much higher. The underpayments that actually occurred therefore were "attributable to" the basis overstatements under any usual understanding of that term.

d. The Fifth Circuit's interpretation of Section 6662 frustrates the obvious purpose of the overstatement penalty of deterring taxpayers from misrepresenting their bases in property to achieve unwarranted tax reductions. See *Fidelity*, 661 F.3d at 673-674. It exempts from the penalty taxpayers who engage in transactions specifically designed to inflate the value or basis in property merely because it is determined that they should not have taken any deduction at all. Congress could not have envisioned that outcome. As one court has remarked, "it is particularly dubious that Congress intended to confer * * * largesse upon participants in tax shelters, whose intricate plans for tax avoidance often run afoul of the economic substance doctrine." *Clearmeadow Invs., LLC* v. *United States*, 87 Fed. Cl. 509, 534 (2009).

B. Eight Circuits Have Rejected The Fifth Circuit's Interpretation Of Section 6662's Overstatement Penalty, While Only The Ninth Circuit Has Adopted It

There is a lopsided but intractable division among the circuits over whether a taxpayer's underpayment of tax can be "attributable to" a misstatement of basis where the transaction that created an inflated basis is disregarded in its entirety as lacking economic substance.

Eight circuits have concluded that "when an underpayment stems from deductions that are disallowed due to a lack of economic substance, the deficiency is attributable to an overstatement of value and is subject to the penalty of [Section 6662]." *Merino* v. *Commissioner*, 196 F.3d 147, 155 (3d Cir. 1999) (quoting *Zfass* v. *Commissioner*, 118 F.3d 184, 190 (4th Cir. 1997)). Only the Ninth Circuit has adopted the Fifth Circuit's interpretation, although some judges on the Ninth Circuit (like the members of the *Bemont Investments* panel) have expressed skepticism about that approach. See *Keller* v. *Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009). In denying rehearing en banc in this case despite Judge Prado's concurrence in *Bemont Investments*, the Fifth Circuit has now made clear that it has no intention of revisiting its "well settled" precedent. App., *infra*, 2a. This Court should accordingly resolve the circuit conflict.

1. There is "near-unanimous opposition to the *Todd/Heasley* rule" among federal courts of appeals. *Bemont Invs.*, 679 F.3d at 354 (Prado, J., concurring). Eight of the ten circuits that have considered the question have held that the overstatement penalty can apply where a transaction is disregarded as lacking economic substance.

a. In *Massengill* v. *Commissioner*, 876 F.2d 616 (1989), decided one year before *Heasley*, the Eighth Circuit upheld the Tax Court's imposition of the overstatement penalty on taxpayers whose depreciation deductions for cattle were disallowed in full because their purchase of the cattle was a sham. See *id.* at 618. Reasoning that the taxpayers' "correct basis in the cows was zero because no sale had taken place," the court held that "[w]hen an underpayment stems from disallowed depreciation deductions or investment credit[s] due to lack of economic substance, the deficiency is attributable to [an] overstatement of value, and subject to the penalty." *Id*. at 619-620.[9]

Two years later, the Second Circuit reached the same conclusion in *Gilman* v. *Commissioner*, 933 F.2d 143 (1991), cert. denied, 502 U.S. 1031 (1992). The court in *Gilman* approved the Tax Court's imposition of the overstatement penalty on a taxpayer who had participated in a sham sale-leaseback arrangement that had the effect of assigning an artificially high purchase price to computer equipment, enabling the taxpayer to take large depreciation deductions. See *id.* at 145. Although the Second Circuit believed that "the application of [the overstatement penalty] to a transaction determined to be without economic substance is not self-evident," the court ultimately "agree[d] with the Tax Court and with the Eighth Circuit" that "[w]here a transaction is not respected for lack of economic substance, the resulting underpayment is attributable to the implicit overvaluation." *Id.* at 151-152. The Second Circuit expressly rejected that taxpayer's reliance on *Todd* and *Heasley* and noted that "application of the [overstatement] penalty" to transactions lacking economic substance "surely reinforces the Congressional objective of lessening tax shelter abuse." *Id.* at 151.

In *Illes*, *supra*, the Sixth Circuit followed *Massengill* and *Gilman* in upholding the imposition of the overstatement penalty on a taxpayer who had claimed de-

[9] The Eighth Circuit distinguished *Todd* on the ground that "[t]he taxpayer in *Todd* had acquired property"—*i.e.*, the transactions had not been disregarded due to a lack of economic substance, but the deduction had been disallowed for a reason unrelated to the basis overstatement. See *Massengill*, 876 F.2d at 619.

preciation deductions and investment tax credits for certain master recordings leased in connection with a sham business enterprise. See *Illes*, 982 F.2d at 165-166. As part of the scheme, the taxpayer had claimed an interest in the recordings that "exceeded their correct value by more than 250%." *Id.* at 166. The court rejected the premise of *Heasley* that "[s]ince [the taxpayer's] underpayment is the result of the [shelter] being an economic sham * * * the underpayment is attributable to his claiming an improper deduction rather than a valuation overstatement," calling that "a false distinction." *Id.* at 166-167. The taxpayer's underpayment of tax, the Sixth Circuit reasoned, "[p]lainly * * * was attributable to his valuation overstatement" because "[t]he entire artifice of the [tax] shelter was constructed on the foundation of the overvaluation of its assets." *Id.* at 167. Simply stated, "[h]ad it not been for the valuation overstatement, [the taxpayer] would not have underpaid his taxes." *Ibid.*[10]

The Third and Fourth Circuits subsequently reached the same conclusion. See *Merino*, 196 F.3d at 155; *Zfass*, 118 F.3d at 190-191. Those courts have expressly rejected *Heasley* in favor of the rule adopted by "[t]he Second, Sixth, and Eighth Circuits * * * that when an underpayment stems from deductions that are disallowed due to a lack of economic substance, the deficien-

[10] Although the taxpayer in *Illes* did not rely on *Heasley*, the court cited an unpublished opinion in which it had rejected the *Heasley* analysis in favor of the Second Circuit's approach in *Gilman*. *Illes*, 982 F.2d at 167 n.1; see *Donahue* v. *Commissioner*, No. 91-1849, 1992 WL 70174, at *4 (6th Cir. Apr. 7, 1992) (959 F.2d 234 (6th Cir. 1992) (Table)). Like the Eighth Circuit in *Massengill*, the Sixth Circuit distinguished *Todd* on the ground that, in that case, "the claimed deduction was improper without regard to whether the investors overvalued their interests in the property." *Illes*, 982 F.2d at 167.

cy is attributable to an overstatement of value and is subject to penalty." *Zfass*, 118 F.3d at 190; see *Merino*, 196 F.3d at 155, 158 (joining the "majority of the Courts of Appeals that have addressed this issue" in upholding the imposition of the overstatement penalty where "the overvaluation of the property in question * * * is an essential component of the tax avoidance scheme" disregarded as lacking economic substance). Both courts also suggested that the decision in *Heasley* "appear[ed] to have been driven by understandable sympathy for the Heasleys rather than by a technical analysis of the statute." *Merino*, 196 F.3d at 158; see *Zfass*, 118 F.3d at 190 n.8.

b. These earlier decisions applying the overstatement penalty to transactions lacking economic substance concerned relatively simple schemes in which the sham transaction was designed to facilitate depreciation deductions or investment credits for overvalued assets. Recent decisions of the First, Federal, and Eleventh Circuits have adopted the majority interpretation and applied it to sophisticated tax shelters similar to COBRA.

In *Fidelity*, the First Circuit held the overstatement penalty applicable to two tax shelters that, like COBRA, involved the contribution of offsetting option positions to a partnership in order to generate an artificially high basis in a partnership interest. See 661 F.3d at 668-670. The court rejected the taxpayer's argument that, because there were multiple legal grounds for denying the deduction, all "stemming from the same central finding that the transactions lacked economic purpose," the penalty could not apply. *Id.* at 672-673. "Congress' phrase 'attributable to,'" it explained, "is easily read to cover the role of the misstatements in lowering [the taxpayer's] taxes and that reading serves the underlying policy" of the penalty. *Id.* at 673. The First Circuit also observed, citing the 5-to-2 circuit conflict that existed at that time, that "[m]ost circuit courts that have confronted variations of [the taxpayer's] argument in the lack of economic substance context have rejected it"; and it concluded that the Fifth Circuit's approach "rests on a misunderstanding of the sources relied on" (*e.g.*, the *Blue Book*). *Ibid.*

Shortly after the Fifth Circuit issued its opinion in *Bemont Investments*, the Federal Circuit also addressed the applicability of the overstatement penalty to a shelter designed to generate an artificially high basis in property contributed to a partnership. See *Alpha I, L.P.*, 682 F.3d at 1013-1014. The Court of Federal Claims had granted summary judgment to the taxpayer on the ground that, under the reasoning of *Todd*, the penalty did not apply because the taxpayer had conceded that it was not entitled to a deduction on a ground unrelated to the basis misstatement. See *id.* at 1026-1027. The Federal Circuit reversed that holding. The court stated that it "disagree[d] with the legal analysis employed in *Todd*[,] * * * finding it flawed in material respects," pointing to the same misapplication of the *Blue Book*'s guidance that Judge Prado had identified. *Id.* at 1028-1029. It noted that "every circuit court to have addressed the issue, except the Ninth Circuit * * * , has rejected *Todd*'s reasoning." *Id.* at 1030. The court also made clear that on remand, the Court of Federal Claims was not free to follow *Heasley*'s extension of *Todd* either, instructing the court to "focus[] on the role that any valuation misstatements played in attaining any improper tax benefits" and citing *Fidelity*, *Gilman*, and *Merino*. *Id.* at 1030-1031.

Most recently, in *Gustashaw*, the Eleventh Circuit upheld the imposition of the overstatement penalty in the context of another basis-inflating shelter disregarded for lack of economic substance. Finding "no suggestion" in the statute "that the penalty should not apply when the correct basis or value is determined to be zero because the transaction is completely lacking in economic substance," the court noted that *Alpha I*, *Fidelity*, *Merino*, *Zfass*, *Illes*, *Gilman*, and *Massengill* were all in accord with its view. *Gustashaw*, 2012 WL 4465190, at *10. It found "the majority rule to be the better interpretation" of Section 6662 because that "rule rests upon the fact that the abusive tax shelter is built upon the basis misstatement, and the transaction's lack of economic substance is directly attributable to that misstatement." *Id.* at *11.

2. Departing from the approach taken by the majority of circuits, the Ninth Circuit has adopted the holdings of both *Todd* and *Heasley*. As a result, the IRS has been prevented from collecting overstatement penalties from taxpayers who employ abusive tax shelters in circuits covering more than 90 million people.

The Ninth Circuit adopted the *Todd* rule in *Gainer* v. *Commissioner*, 893 F.2d 225 (1990), which arose out of the same refrigerated-units scheme involved in *Todd*.[11] The Ninth Circuit agreed with the Fifth Circuit that the phrase "attributable to" is ambiguous and that the "formal legislative history * * * does not discuss how to determine whether a tax underpayment is 'attributable to' an overvaluation of property." *Id.* at 227. Like the Fifth Circuit, it went on to read the *Blue Book*'s guid-

[11] As in *Todd*, the deductions and credits in *Gainer* had been disallowed because the property had not been placed in service in the relevant tax years.

ance to mean that where there are two independent causes of the same under-reporting error, only one of which is an overstatement of value or basis, the penalty cannot apply. See *id.* at 227-228.

The Ninth Circuit then adopted *Heasley* in *Keller*, *supra*. *Keller* involved a shelter designed to generate depreciation deductions by inflating the taxpayer's basis in cattle that he had never truly acquired. See 556 F.3d at 1057-1058. The Tax Court had held that, because the taxpayer "had in fact not acquired any cattle, his basis in the cattle would be zero for the relevant tax years, far below the claimed bases, and thus supported the 40 percent penalty for gross valuation misstatements." *Id.* at 1058. Reversing, the Ninth Circuit found *Gainer* "directly on point" and held that "[w]hen a depreciation deduction is disallowed in total, any overvaluation is subsumed in that disallowance, and an associated tax underpayment is 'attributable to' the invalid deduction, not the overvaluation of the asset." *Id.* at 1060-1061. It concluded that the taxpayer's "tax deficiency was 'attributable to' taking a depreciation deduction to which he was not entitled (at all) rather than 'attributable to' overvaluation." *Ibid.*

The court in *Keller* "recognize[d] that many other circuits have concluded that when overvaluation is intertwined with a tax avoidance scheme that lacks economic substance, an overvaluation penalty can apply." 556 F.3d at 1061; see *id.* at 1061 n.5 (explaining that in *Heasley* the "Fifth Circuit * * * interpreted its holding in *Todd* the same way" as the court was interpreting *Gainer*). The court further acknowledged that "[t]his sensible method of resolving overvaluation cases cuts off at the pass what might seem to be an anomalous result—allowing a party to avoid tax penalties by engaging in behavior one might suppose would implicate more tax penalties, not fewer." *Id.* at 1061. But it deemed itself "constrained by *Gainer*" to adopt the minority rule. *Ibid.* The Ninth Circuit denied the government's petition for rehearing en banc, even though two panel members favored further review. See 06-75441 Docket entry No. 65 (May 20, 2009).

3. The conflict of authority is ripe for resolution. Every court of appeals except the Seventh, Tenth, and D.C. Circuits has addressed the issue, and eight have adopted the government's reading of the statute. Both the Fifth and Ninth Circuits have denied the government's petitions for rehearing en banc in recent years, and the Fifth Circuit has stated that the issue is "well settled" in that circuit. App., *infra*, 2a. Absent further review by this Court, taxpayers in different States therefore will continue to be subject to different IRS enforcement regimes.

This case is a suitable vehicle to resolve the issue. The question is squarely presented, and respondent did not appeal the district court's conclusion that COBRA was a transaction lacking economic substance designed to artificially inflate the basis in partnership interests.[12]

C. The Question Presented Is Important To The Efficient And Fair Administration Of The Internal Revenue Code

If left undisturbed, the minority rule of the Fifth and Ninth Circuits will continue to cost the federal fisc hundreds of millions of dollars in forgone penalties from taxpayers who have employed abusive tax shelters. The

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[12] Respondent filed a notice of appeal from the district court's judgment but later voluntarily withdrew his appeal. See 11-50487 Docket entry (5th Cir. Dec. 13, 2011).

entrenched position of those circuits has also led to arbitrary and unfair variation in the federal government's enforcement of the Internal Revenue Code.

1. a. In the decade preceding the 2008 financial crisis, there was a substantial increase in high-dollar, basis-inflating tax shelters employed by U.S. taxpayers. See Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs, *The Role of Professional Firms in the U.S. Tax Shelter Industry*, S. Rep. No. 54, 109th Cong., 1st Sess. 9-11 (2005). Unlike in previous eras, "the U.S. tax shelter industry was no longer focused primarily on providing individualized tax advice to persons who initiate contact with a tax advisor," but rather was "developing a steady supply of generic 'tax products' that [were] aggressively marketed to multiple clients." *Id.* at 9. Those standardized shelters, with names like COBRA, BOSS, BLIPS, and FLIP, were marketed to wealthy individuals by accounting firms, law firms, investment banks, and others. See *id.* at 5-7.

As a consequence of this wave of abusive tax shelters, there has been an explosion of litigation in the federal courts involving the IRS's attempts to recoup unpaid taxes and impose penalties on those who participated in and marketed these shelters. Many of the cases appealable to the Fifth or Ninth Circuit involve millions of dollars in potential penalties. See, *e.g.*, *Chemtech Royalty Ass'n LLP* v. *United States*, No. 3:05-cv-944 (M.D. La. trial concluded June 27, 2011) ($360 million basis misstatement). If the rule adopted by those circuits is allowed to stand, 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.

b. In 2010, Congress added to Section 6662 a new subsection that imposes a 40% penalty on any underpayment of tax that is attributable to a "nondisclosed noneconomic substance transaction" entered into after March 30, 2010. 26 U.S.C. 6662(i) (Supp. V 2011). Although this provision may eventually lessen the impact of the Fifth and Ninth Circuit's flawed interpretation of the overstatement penalty, it has no application to the thousands of taxpayers who engaged in abusive, basis-inflating tax shelters before the provision's effective date—and the millions of dollars in penalties they owe to the federal treasury. Section 6662(i) will have no effect, moreover, on cases where value- or basis-related deductions are disallowed in full on a ground other than lack of economic substance. See, *e.g.*, *Derby* v. *Commissioner*, 95 T.C.M. (CCH) 1177, 1194 (2008).

2. Without further review by this Court, the interpretation of Section 6662's overstatement penalty adopted by the Fifth and Ninth Circuits will continue to foster "inequalities in the administration of the revenue laws." *Commissioner* v. *Sunnen*, 333 U.S. 591, 599 (1948). Taxpayers who participated in basis-inflating tax shelters and who reside in the Fifth or Ninth Circuit are currently exempt from the overstatement penalty, but taxpayers elsewhere who participated in the same tax shelters are not. See, *e.g.*, *Murfam Farms, LLC* v. *United States*, 94 Fed. Cl. 235 (2010) (upholding the overstatement penalty in a case involving COBRA). Such arbitrary differences in treatment threaten the government's ability to enforce the Internal Revenue Code in an even-handed manner.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 2012

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 11-50487

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, A TEXAS GENERAL PARTNERSHIP, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Filed: June 6, 2012

Appeal from the United States District Court
for the Western District of Texas
USDC No. 5:05-cv-00216

Before: JONES, Chief Judge, and WIENER and GRAVES, Circuit Judges.

PER CURIAM:*

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* Pursuant to 5TH CIR. R. 47.5, the court has determined that this opinion should not be published and is not precedent except under the limited circumstances set forth in 5TH CIR. R. 47.5.4.

This Court has considered this appeal on the basis of the briefs and the record on appeal. Having done so, we are convinced that this issue is well settled and that the district court should be affirmed. *See Bemont Invs., L.L.C. v. United States,* No. 10-41132, 679 F.3d 339 (5th Cir. Apr. 26, 2012); *Heasley v. Comm'r of Internal Revenue*, 902 F.2d 380 (5th Cir. 1990); *Todd v. Comm'r of Internal Revenue*, 862 F.2d 540 (5th Cir. 1988).

AFFIRMED.

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS

Nos. SA-05-CA-216, SA-05-CA-217

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

GARY WOODS, AS TAX MATTERS PARTNER OF SA TESORO INVESTMENT PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

Mar. 21, 2011

ORDER REGARDING OBJECTIONS TO ACCURACY-RELATED PENALTIES

HARRY LEE HUDSPETH, Senior District Judge.

Plaintiff Gary Woods, in his capacity as Tax Matters Partner for two general partnerships[1] filed these petitions for judicial review of final partnership administrative adjustments made by the Internal Revenue Service with respect to the partnership returns for taxable year 1999. As the principal place of business of each partnership was located in San Antonio, Texas, this Court has jurisdiction under 26 U.S.C. § 6226(a)(2). Following a bench trial in September 2010, the Court entered an order granting the Defendant's motion for judgment as a matter of law. In doing so, the Court held that the ordinary and capital losses claimed in the partnership tax returns were properly disallowed by the Commissioner, because the complicated series of transactions which generated the purported paper losses lacked economic substance. Accordingly, the Court held that the Defendant was entitled to judgment in its favor with respect to the administrative adjustments to the partnership returns of Tesoro Drive Partners and SA Tesoro Investment Partners. Left unresolved was the question whether the imposition of accuracy-related penalties was justified. The Court invited the parties to submit briefs on that question, and those briefs were filed. The issue is now ripe for decision.

As noted in the Order Granting Defendant's Motion for Judgment as a Matter of Law, the partnership tax

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[1] The partnerships in question were Tesoro Drive Partners (Cause No. SA-05-CA-216) and SA Tesoro Investment Partners (Cause No. SA-05-CA-217).

items at the center of this dispute resulted from the November 1999 decision of Plaintiff Woods to participate, on his own behalf and on behalf of his associate, Billy Joe "Red" McCombs, in a tax shelter known as COBRA.[2] This tax avoidance strategy was dreamed up by the law firm of Jenkins & Gilchrist, marketed by the accounting firm of Ernst & Young, and assisted in its implementation by another law firm, Brown & Wood, A few selected high net worth individuals were invited in the year 1999 to participate in COBRA, which even its proponents described as an "aggressive" strategy. Its purpose, in common with other forms of tax shelters, was to generate large paper losses to be set off against large amounts of income which a participant expected to receive in that particular year.

At the time that Woods elected to participate in COBRA in November 1999, barely enough time remained to complete all the steps required by the COBRA scenario before December 31st of that year. However, the two Tesoro partnerships, under the guidance of Woods, did complete the process in time to transfer all their remaining assets to two Sub-chapter S corporations,[3] effectively liquidating both partnerships. Those two Sub-chapter S entities then sold the assets, which the tax returns claimed resulted in an ordinary loss of $13,353,162 and a short-term capital

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[2] The initials COBRA stands for "Current Options Bring Reward Alternatives."

[3] Those corporations were Tesoro Drive Investors, Inc. and SA Tesoro Investors, Inc.

loss of $32,297,786. In the final partnership administrative adjustments, these losses were disallowed.

The Defendant contends that in addition to disallowing the losses claimed on the partnership returns, the Commissioner was justified in imposing three categories of accuracy-related penalties: (1) a penalty for gross or substantial misstatement of valuation; (2) a penalty for negligence or disregard of rules and regulations; and (3) a penalty for substantial understatement of income tax. 26 U.S.C. § 6662. The Court will discuss each category in turn.

With respect to the first penalty, the statute defines "valuation misstatement" as including misstatements relating either to value or to basis, 26 U.S.C. § 6662(e)(1)(A). In this Circuit, however, it is clearly established that whenever the Internal Revenue Service totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction. In such a case, the underpayment is not attributable to a valuation overstatement; it is attributable to claiming an improper deduction. *Heasley v. Commissioner of Internal Revenue,* 902 F.2d 380, 383 (5th Cir. 1990). Counsel for the Defendant contends that because of the passage of time and intervening events, *Heasley* is no longer good law. However, until and unless *Heasley* is overruled by the Court of Appeals or the Supreme Court, this Court is bound by its holding.[4] The Court must respectfully

[4] The Court of Appeals for the Fifth Circuit has been invited to revisit *Heasley* in a case styled *Southgate Master Fund v. United*

decline the invitation by defense counsel to overrule the Court of Appeals.

The Commissioner next imposed a penalty on the alleged underpayment of tax based on a finding of negligence or disregard of rules and regulations on the part of the taxpayer, pursuant to 26 U.S.C. §§ 6662(a) and (b)(1). The statute defines "negligence" to include any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code, and "disregard" to include reckless or intentional, as well as careless, conduct. § 6662(c).

The inquiry into a taxpayer's negligence has been described as "highly individualized," *Merino v. Commissioner,* 196 F.3d 147, 154 (3rd Cir. 1999), but the Court should begin that inquiry by matching the taxpayer's conduct against that of a reasonably prudent person. *Heasley,* 902 F.2d at 383; *Marcello v. Commissioner,* 380 F.2d 499, 506 (5th Cir. 1967). Negligence may be indicated by a taxpayer's failure to question a deduction which seems "too good to be true." *Hansen v. Commissioner*, 471 F.3d 1021, 1029 (9th Cir. 2006). The justification for the imposition of a penalty may be even more clearly defined if the circumstances indicate reckless or intentional disregard, not just a failure to exercise ordinary-care. *Marcello*, 380 F.2d at 506.

Where, as here, the Commissioner's finding of negligence and/or disregard is challenged, it is appropri-

States, Appeal No. 09-11166. At this writing, the Court of Appeals has held oral argument in that appeal, but has not ruled.

ate for the Court to consider the level of knowledge and sophistication of the individual taxpayer. *Merino*, 196 F.3d at 154. In this case, Plaintiff Woods' knowledge of business in general and accounting in particular was both broad and deep. He earned a Bachelor's degree in business administration from Southwest Texas State (now Texas State) University, and his formal education continued with a Master's degree from Southern Methodist University and course work toward a Ph.D. at the University of North Texas. He is a Certified Public Accountant, licensed in the State of Texas. His practical experience and business acumen are also impressive. He occupied a key management role in McCombs Enterprises, which invested in everything from car dealerships to professional sports teams in the National Basketball Association and the National Football League. Although Plaintiff Woods may not have qualified as a "tax specialist," he was a far cry from a man who had just fallen off a turnip truck. His wealth of knowledge and experience should have alerted him to the fact that the COBRA scheme was simply "too good to be true." Specifically, he was aware from the start that the complicated, rapid-fire, series of transactions called for by the COBRA plan were for the sole purpose of generating a large paper loss for tax purposes, and he also knew, or should have known, that these transactions did not possess "economic substance compelled by business or regulatory realities." *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009). By Woods' own admission, he was aware that tax shelter entities are required to have a business purpose, and to possess economic substance. Under all the circumstances, his tax treatment of the "losses" generated by the COBRA transactions on the Tesoro partnership returns was at best negligent, and at worst, reckless or intentional disregard of established regulations. Accordingly, the Commissioner was justified in imposing the penalty for negligence or disregard of rules and regulations.

The Commissioner imposed yet another accuracy related penalty on the portion of underpayment of tax which he concluded was attributable to a substantial understatement of income tax. Although such a penalty is authorized by § 6662(b)(2), the statute further provides that the amount of any such understatement would be reduced, if (1) the tax treatment of the item in question was based on "substantial authority," or (2) the relevant facts affecting the tax treatment of the item are disclosed in the return itself or an attached statement, and there is a reasonable basis for the treatment chosen by the taxpayer. § 6662(d)(2)(B), However, where, as here, a tax shelter is involved, the "disclosure prong" (§ 6662(d)(2)(B)(ii)) does *not* apply, and a heightened standard is applied to the "substantial authority" prong. § 6662(d)(2)(C). In the tax shelter context, the taxpayer must go beyond demonstrating the existence of substantial authority, and demonstrate his own reasonable belief that his treatment of the item in question was "more likely than not" the proper treatment of the item.

§ 6662(d)(2)(C)(i)(II).[5] It is beyond dispute that the cobra plan was a tax shelter, and that the Tesoro partnerships were organized for the specific purpose of executing the COBRA tax avoidance strategy. Therefore, the heightened standard applies.

Was there "substantial authority" for Woods' treatment of the COBRA induced tax loss? The short answer is, there was not. It was obvious to Woods, as it would have been to anyone with his background and experience, that the COBRA transactions did not possess economic substance, and were being undertaken for the sole purpose of establishing a large paper tax loss. To put it another way, COBRA was marketed to everyone, including Woods, as a tax shelter, and a tax shelter it was. Furthermore, the tax opinions rendered by the law firms of Jenkins & Gilchrist and Brown & Wood do not qualify as "substantial authority." Not only were those opinions tainted by the involvement of their authors in the COBRA scheme (of which more later), but the authorities on which those authors purport to rely cannot justify the deduction of paper losses generated by transactions lacking economic substance and executed for the sole purpose of creating a tax benefit.

Assuming *arguendo* the existence of substantial authority, Woods must further show that he "reasonably believed" that his tax treatment of the COBRA

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[5] The statute has been amended since these events occurred. Today, none of the exceptions contained in § 6662(d)(2)(B) are applicable to items attributable to a tax shelter.

losses was "more likely than not" the proper treatment of those items. § 6662(d)(2)(c)(i)(II). The reasonable belief requirement overlaps substantially with the "reasonable cause and good faith" defense found in 26 U.S.C. § 6664(c), and the two will be considered together.

The statutory "reasonable cause" exception to the penalty for underpayment of tax provides that no penalty will be imposed as to any portion of an underpayment with respect to which the taxpayer acted with reasonable cause and good faith. § 6664(c)(1). The taxpayer has the burden of establishing this defense. *Klamath,* 568 F.3d at 548, which has been described as a "narrow" defense. *Stobie Creek Investments LLC v. United States,* 608 F.3d 1366, 1381 (Fed. Cir. 2010). The existence or non-existence of reasonable cause is a question of fact decided on a case-by-case basis. Treas. Reg. § 1.6664-4(b)(1). As in most cases, Woods attempts to show reasonable cause by contending that he relied upon the advice of competent and independent professional advisers. *United States v. Boyle,* 469 U.S. 241, 251, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985); *Stobie Creek,* 608 F.3d at 1381.

Plaintiff Woods contends that he reasonably relied on the advice of an accounting firm, Ernst & Young, and two law firms, Jenkins & Gilchrist and Brown & Wood. However, he cannot sustain his burden of showing that his reliance on their advice was objectively reasonable. First, each of the three had an inherent conflict of interest which was too obvious to be ignored. *Chamberlain v. Commissioner,* 66 F.3d 729, 732 (5th Cir. 1995); *Stobie Creek,* 608 F.3d at 1382. The firm of Jenkins & Gilchrist was the inventor and promoter of the COBRA strategy, and Ernest & Young and Brown & Wood were, at the very least, agents of the promoter. From the moment he was first introduced to COBRA in November 1999, Woods had actual knowledge of the role of Jenkins & Gilchrist in developing, and Ernst & Young in marketing, the COBRA strategy. He also knew that the fees charged by each of those firms would be based on a percentage of the "desired loss"! Although the involvement of Brown & Wood was not known until later, Woods was told up front that a second opinion would be obtained for the purpose of making the tax deduction "penalty proof." The firm of Brown & Wood was not selected by Plaintiff Woods, but by Jenkins & Gilchrist, and its fee was not extra, hut was "carved out" of the fee paid to Jenkins & Gilchrist. In short, Brown & Wood was not an "independent" professional adviser in any common ordinary English language dictionary meaning of that word.

Second, Woods' claim of reliance on professional advice is not objectively reasonable because he knew or should have known that the COBRA tax benefit was "too good to be true" in light of all the circumstances, including his own education, business experience, sophistication, and his purpose in carrying out the COBRA transactions. Treas. Reg. § 1.6664-4(c); *Hansen,* 471 F.3d at 1032; *Stobie Creek,* 608 F.3d at 1382.

Third, any claim of reasonable reliance which might have been arguable prior to December 1999 dissolved when the Internal Revenue Service issued, and when Ernst & Young and Woods became aware of, IRS Notice 99-59. That Notice unequivocally warned taxpayers that artificial losses of the COBRA kind were not properly allowable for federal income tax purposes. Ernst & Young personnel immediately grasped the significance of the IRS warning as it related specifically to COBRA, and just as quickly (1) discontinued marketing the strategy, and (2) notified its clients, including Plaintiff Woods. December 1999 was, of course, before the filing of the Tesoro partnership returns. If all the alerts previously discussed in this opinion could be termed "red flags," IRS Notice 99-59 was more like a dagger to the heart of any claim of reasonable reliance on advice received from the likes of Ernst & Young, Jenkins & Gilchrist, or Brown & Wood.

In summary, the Court finds that Plaintiff Woods has failed to sustain his burden of proving that when the partnership returns in this case were filed, he reasonably believed that his tax treatment of the purported losses was "more likely than not" the proper treatment of these items, or that he acted with reasonable cause or good faith, as case law has defined those terms. The Commissioner's imposition of a penalty on that portion of the underpayment attributable to the substantial understatement of income tax should be affirmed.

In light of the foregoing discussion, the Court finds that the following orders should be entered.

IT IS ORDERED that the Commissioner's imposition of a penalty for misstatement of valuation be, and it is hereby, REVERSED.

IT IS FURTHER ORDERED that, in all other respects, judgment be, and it is hereby, entered in favor of the Defendant United States of America, and that the rulings of the Commissioner of Internal Revenue be, and they are hereby, AFFIRMED.

APPENDIX C

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS

Nos. SA-05-CA-216-H, SA-05-CA-217-H
GARY WOODS, AS TAX MATTERS PARTNER OF
TESORO DRIVE PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

GARY WOODS, AS TAX MATTERS PARTNER OF
SA TESORO INVESTMENT PARTNERS, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

Sept. 21, 2010

ORDER GRANTING DEFENDANT'S MOTION FOR JUDGMENT AS A MATTER OF LAW

HARRY LEE HUDSPETH, Senior District Judge.

These two consolidated cases are petitions for judicial review of final partnership administrative adjustments, with jurisdiction in this Court founded upon 26 U.S.C. § 6226(a)(2). In cause number SA-05-CA-216, Plaintiff Gary Woods is requesting the Court to order the readjustment of certain items in the partnership return of Tesoro Drive Partners, a Texas general partnership, for the calendar year 1999. In cause number SA-05-CA-217, the same Plaintiff, Gary Woods, is requesting the Court to order the readjustment of items in the partnership return of SA Tesoro Investment Partners, a Texas general partnership, for the same calendar year. The two cases were consolidated for trial, and beginning September 13, 2010, were tried to the Court without the intervention of a jury. On September 16, 2010, the Plaintiff rested his case-in-chief, and the Defendant moved for judgment in its favor as a matter of law. The Court, having considered the motion, found that it should be granted.

This is a hard case, but not a difficult one. Billy Joe "Red" McCombs is a successful and famous Texas entrepreneur, civic leader, and philanthropist. He is also well known outside the State of Texas, partly because of his former ownership of national sports franchises, including the San Antonio Spurs professional basketball team and the Minnesota Vikings professional football team. His numerous and diversified business interests and investments are gathered under the umbrella of McCombs Enterprises, a sole proprietorship headquartered in San Antonio, Texas. For more than 30 years, his "right-hand man" has been Gary Woods, the Plaintiff in this case, who holds the title of President of McCombs Enterprises. A high degree of trust and confidence exists between McCombs and Woods. In fact, on December 15, 1993, McCombs executed a universal power of attorney in favor of Woods, which generally authorizes the latter to take any action on behalf of McCombs which could be taken by McCombs himself. In November 1999, Plaintiff Woods, on his own behalf and on behalf of McCombs, agreed to participate in a tax shelter known as COBRA. The evidence shows that COBRA was dreamed up by the law firm of Jenkens & Gilchrist and was being marketed by the accounting firm of Ernst & Young to a few selected high net-worth individuals.

For purposes of this order, it is unnecessary to discuss the details of the COBRA tax avoidance scheme or plan. Suffice it to say that it involved a series of specific steps which, in order to execute the plan, had to be completed by December 31, 1999.

Woods decided to participate in COBRA, on his own behalf and on behalf of McCombs. The steps required by the COBRA plan are described in great detail in the evidence in this case, and there is no need to repeat those details here. Suffice it to say that on November 12, 1999, Woods began the implementation of COBRA plans for himself and McCombs by forming three sets of business entities: two limited liability companies,[6] two general partnerships,[7] and two Sub-

[6] The names of the LLCs were GW Tesoro Investments, LLC (for Gary Woods) and BJM Tesoro Drive Investments, LLC (for Billy Joe McCombs).

[7] The two partnerships were named Tesoro Drive Partners and

chapter S corporations. Soon after these entities were formed, Woods contributed $791,000.00 to his LLC, and McCombs contributed $2,429,000.00 to his LLC. The very next day, the LLCs invested $2,300,000.00 in thirty-day foreign currency options. Each "long" option on a currency was paired with a "short" option on a different currency.[8] On November 23, 1999, the LLCs transferred the options to the partnerships. The cash remaining in the LLCs was also transferred to the partnerships. Within the next 30 days, each partnership used this cash to purchase shares in Sun Microsystems. On December 15, 1999, one of the partnerships (Tesoro Drive Partners) sold its shares in Sun Micro, resulting in a short-term capital gain of approximately $5,000.00. Tesoro Drive Partners then used its cash to buy Canadian Dollars.

The thirty-day currency options were due to expire on December 20, 1999. However, on December 17, 1999, Deutsche Bank offered Woods $3,000,000.00 for the early termination of the currency option spreads. Woods accepted the offer, resulting in a profit to the partnerships of $700,000.00.[9]

As the year 1999 was coming to a close, both part-

SA Tesoro Investment Partners, and Woods and McCombs were the only partners in both.

[8] Four foreign currencies were utilized: the Australian Dollar, the Japanese Yen, the German Deutsche Mark, and the Swiss Franc.

[9] The specific profit breakdown was Tesoro Drive Partners $650,000.00; SA Tesoro Investment Partners $50,000.00.

nerships transferred all their remaining assets to the two Subchapter S corporations, effectively resulting in the liquidation of the partnerships. One of those Subchapter S corporations, Tesoro Drive Investors, Inc., received the Canadian Dollars, while the other, SA Tesoro Investors, Inc., received the remaining shares in Sun Microsystems. What these entities did next was the whole point of the COBRA strategy. Tesoro Drive Investors, Inc. sold the Canadian Dollars, which Woods and McCombs claimed resulted in an ordinary loss for tax purposes of $13,353,162.00. SA Tesoro Investors, Inc. sold the remaining shares of Sun Microsystems stock, which, according to Woods and McCombs, resulted in a short-term capital loss for tax purposes in the amount of $32,297,786. This treatment was based on the central theory of COBRA, which was that the basis of each partnership's property was the cost of the "long" currency options, while the "short" options could be disregarded for tax purposes.

In the Fifth Circuit, whether a transaction is honored as legitimate for tax purposes requires the Court to determine whether the transaction possesses "economic substance." *Klamath Strategic Investment Fund v. United States,* 568 F.3d 537, 544 (5th Cir. 2009). As the Court of Appeals recently framed the issue in *Klamath,*

> "Thus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the tax-

> payers profess a genuine business purpose without tax avoidance motivations."

Id. It is also clear that the "transaction" which must have economic substance is the transaction that generates the tax benefit, not collateral transactions that do not produce tax benefits. *Klamath,* 568 F.3d at 545; *Coltec Industries, Inc. v. United States,* 454 F.3d 1340, 1356 (Fed. Cir. 2006); *Nicole Rose Corporation v. Commissioner,* 320 F.3d 282, 284 (2nd Cir. 2003). In seeking to detect the presence or the absence of economic substance in the instant case, therefore, the Court cannot focus on those transactions which the taxpayer claims confer economic substance, i.e., profitable trades in currency options and Sun Microsystems stock. These were collateral transactions, which not only did not produce the tax benefit at issue in this case, but did the opposite—they resulted in taxable income to the partnerships. Instead, the "transaction" that is relevant in this case is the Plaintiff's use of two partnerships with a six-week life span to conduct that trading for the sole purpose of generating a paper loss. *See Merryman v. Commissioner,* 873 F.2d 879, 881 (5th Cir. 1989). The "Tinker to Evers to Chance"[10] routine utilized by the taxpayers in this case (the transfer of assets from individuals to LLCs to partnerships to Subchapter S corporations) was not "compelled or encouraged by business or regulatory realities," nor was it "imbued with tax independ-

[10] The record does not reveal whether the Plaintiff's economic expert, Dr. Don Chance, is related in anyway to first-baseman Chance.

ent considerations." *Frank Lyon Company v. United States,* 435 U.S. 561, 583-84, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978). It was totally lacking in economic substance and was for the sole purpose of creating a tax benefit. Therefore, both the ordinary loss and the capital loss claimed by the respective partnerships should be disregarded for tax purposes. The Defendant is entitled to judgment in its favor with respect to the Plaintiff's petition for review of those particular adjustments to the partnership returns.

Still unresolved is the question whether the Internal Revenue Service was justified in imposing certain penalties in addition to the income taxes due and owing as a result of the adjustments. In this connection, the Plaintiff contends that no penalties are justified, relying in part on the defense of reasonable cause and good faith. The Court instructed the Plaintiff to file a brief in support of his position no later than September 27, 2010, and allowed the Defendant until October 7, 2010 to respond. Upon reviewing those briefs, the Court will determine whether additional evidence from either party will be required in connection with the issue of penalties.

It is therefore ORDERED that the Defendant's motion for judgment as a matter of law with respect to the disallowance of the ordinary and capital losses claimed on the partnership returns in this case be, and it is hereby, GRANTED.

It is further ORDERED that Plaintiff Gary Woods file his brief with respect to the issue of penalties no later than September 27, 2010.

It is further ORDERED that the Defendant respond to the Plaintiff's brief no later than October 7, 2010. After reviewing the briefs filed by the parties, the Court will determine whether additional testimony should be taken with respect to this issue.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 11-50487

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, A TEXAS GENERAL PARTNERSHIP, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

[Filed: Aug. 8, 2012]

ON PETITION FOR REHEARING EN BANC

(Opinion: June 6, 2012, 5 Cir., ____, ____, F.3d ____)

Before: JONES, Chief Judge, and WIENER and GRAVES, Circuit Judges.

PER CURIAM:

(✓) Treating the Petition for Rehearing En Banc as a Petition for Panel Rehearing, the Petition for Panel Rehearing is DENIED. No member of the panel nor judge in regular active service of the court having requested that the court be polled on Rehearing En Banc (FED. R. APP. P.

and 5TH CIR. R. 35), the Petition for Rehearing En Banc is DENIED.

( ) Treating the Petition for Rehearing En Banc as a Petition for Panel Rehearing, the Petition for Panel Rehearing is DENIED. The court having been polled at the request of one of the members of the court and a majority of the judges who are in regular active service and not disqualified not having voted in favor (FED. R. APP. P. and 5TH CIR. R. 35), the Petition for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ JAMES E. GRAVES, JR.
JAMES E. GRAVES, JR.
United States Circuit Judge

APPENDIX E

1. 26 U.S.C. 6662 (2000) provides:

Imposition of accuracy-related penalty

(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.

(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), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

(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)).

(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) Special rules in cases involving tax shelters

(i) In general

In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter—

(I) subparagraph (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) Subparagraph (B) not to apply to corporations

Subparagraph (B) shall not apply to any item of a corporation which is attributable to a tax shelter.

(iii) Tax shelter

For purposes of this subparagraph, 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.

(D) Secretarial list

The Secretary shall prescribe (and revise not less frequently than annually) a list of positions—

(i) for which the Secretary believes there is not substantial authority, and

(ii) which affect a significant number of taxpayers.

Such list (and any revision thereof) shall be published in the Federal Register.

(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 200 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 50 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) "400 percent" for "200 percent" each place it appears,

(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 "25 percent" for "50 percent".

2. 26 C.F.R. 1.6662-5 provides:

Substantial and gross valuation misstatements under chapter 1.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and §1.6664-2, of any income tax imposed under chapter 1 of subtitle A of the Code that is required to be shown on a return is attributable to a substantial valuation misstatement under chapter 1 ("substantial valuation misstatement"), there is added to the tax an amount equal to 20 percent of such portion. Section 6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement under chapter 1 ("gross valuation misstatement"). No penalty under section 6662(b)(3) is imposed, however, on a portion of an underpayment that is attributable to a substantial or gross valuation misstatement unless the aggregate of all portions of the underpayment attributable to substantial or gross valuation misstatements exceeds the applicable dollar limitation ($5,000 or $10,000), as provided in section 6662(e)(2) and paragraphs (b) and (f)(2) of this section. This penalty also does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664-4 applies. There is no disclosure exception to this penalty.

(b) *Dollar limitation.* No penalty may be imposed under section 6662(b)(3) for a taxable year unless the portion of the underpayment for that year that is attributable to substantial or gross valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)). This limitation is applied separately to each taxable year for which there is a substantial or gross valuation misstatement.

(c) *Special rules in the case of carrybacks and carryovers*—(1) *In general.* The penalty for a substantial or gross valuation misstatement applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried that is attributable to a substantial or gross valuation misstatement for the year in which the carryback or carryover of the loss, deduction or credit arises (the "loss or credit year"), provided that the applicable dollar limitation set forth in section 6662(e)(2) is satisfied in the carryback or carryover year.

(2) *Transition rule for carrybacks to pre-1990 years.* The penalty under section 6662(b)(3) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to a substantial or gross valuation misstatement for a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

The preceding sentence applies only if the underpayment for the carryback year exceeds the applicable dollar limitation ($5,000, or $10,000 for most corporations). See *Example 3* in paragraph (d) of this section.

(d) *Examples*. The following examples illustrate the provisions of paragraphs (b) and (c) of this section. These examples do not take into account the reasonable cause exception under §1.6664-4.

Example 1. Corporation Q is a C corporation. In 1990, the first year of its existence, Q had taxable income of $200,000 without considering depreciation of a particular asset. On its calendar year 1990 return, Q overstated its basis in this asset by an amount that caused a substantial valuation misstatement. The overstated basis resulted in depreciation claimed of $350,000, which was $250,000 more than the $100,000 allowable. Thus, on its 1990 return, Q showed a loss of $150,000. In 1991, Q had taxable income of $450,000 before application of the loss carryover, and Q claimed a carryover loss deduction under section 172 of $150,000, resulting in taxable income of $300,000 for 1991. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $250,000. For 1990, the underpayment resulting from the $100,000 taxable income (-$150,000+$250,000) is attributable to the valuation misstatement. Assuming the underpayment resulting from the $100,000 taxable income exceeds the $10,000 limitation, the penalty will be imposed in 1990. For 1991, the elimination of the loss carryover results in additional taxable income of $150,000. The underpayment for 1991 resulting from that adjustment is also attributable to the substantial valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $150,000 additional taxable income for 1991 exceeds the $10,000 limitation, the substantial valuation misstatement penalty also will be imposed for that year.

Example 2. (i) Corporation T is a C corporation. In 1990, the first year of its existence, T had a loss of $3,000,000 without considering depreciation of its major asset. On its calendar year 1990 return, T overstated its basis in this asset in an amount that caused a substantial valuation misstatement. This overstatement resulted in depreciation claimed of $3,500,000, which was $2,500,000 more than the $1,000,000 allowable. Thus, on its 1990 return, T showed a loss of $6,500,000. In 1991, T had taxable income of $4,500,000 before application of the carryover loss, but claimed a carryover loss deduction under section 172 in the amount of $4,500,000, resulting in taxable income of zero for that year and leaving a $2,000,000 carryover available. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $2,500,000.

(ii) For 1990, the underpayment is still zero (-$6,500,000+$2,500,000=-$4,000,000). Thus, the penalty does not apply in 1990. The loss for 1990 is reduced to $4,000,000.

(iii) For 1991, there is additional taxable income of $500,000 as a result of the reduction of the carryover loss ($4,500,000 reported income before carryover loss minus corrected carryover loss of $4,000,000= $500,000). The underpayment for 1991 resulting from reduction of the carryover loss is attributable to the valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $500,000 additional taxable income exceeds the $10,000 limitation, the substantial valuation misstatement penalty will be imposed in 1991.

Example 3. Corporation V is a C corporation. In 1990, V had a loss of $100,000 without considering depreciation of a particular asset which it had fully depreciated in earlier years. V had a depreciable basis in the asset of zero, but on its 1990 calendar year return erroneously claimed a basis in the asset of $1,250,000 and depreciation of $250,000. V reported a $350,000 loss for the year 1990, and carried back the loss to the 1987 and 1988 tax years. V had reported taxable income of $300,000 in 1987 and $200,000 in 1988, before application of the carryback. The $350,000 carryback eliminated all taxable income for 1987, and $50,000 of the taxable income for 1988. After disallowance of the $250,000 depreciation deduction for 1990, V still had a loss of $100,000. Because there is no underpayment for 1990, no valuation misstatement penalty is imposed for 1990. However, as a result of the 1990 depreciation adjustment, the carryback to 1987 is reduced from $350,000 to $100,000. After absorption of the $100,000 carryback, V has taxable income of $200,000 for 1987. This adjustment results in an underpayment for 1987 that is attributable to the valuation misstatement on the 1990 return. The valuation misstatement for 1990 is a gross valuation misstatement because the correct adjusted basis of the depreciated asset was zero. (See paragraph (e)(2) of this section.) Therefore, the 40 percent penalty rate applies to the 1987 underpayment attributable to the 1990 misstatement, provided that this underpayment exceeds $10,000. The adjustment also results in the elimination of any loss carryback to 1988 resulting in an increase in taxable income for 1988 of $50,000. Assuming the underpayment resulting from this additional $50,000 of income exceeds $10,000, the gross valuation misstatement penalty is imposed on the underpayment for 1988.

(e) *Definitions*—(1) *Substantial valuation misstatement.* There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 200 percent or more of the correct amount.

(2) *Gross valuation misstatement.* There is a gross valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 400 percent or more of the correct amount.

(3) *Property.* For purposes of this section, the term "property" refers to both tangible and intangible property. Tangible property includes property such

as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action.

(f) *Multiple valuation misstatements on a return*—(1) *Determination of whether valuation misstatements are substantial or gross.* The determination of whether there is a substantial or gross valuation misstatement on a return is made on a property-by-property basis. Assume, for example, that property A has a value of 60 but a taxpayer claims a value of 110, and that property B has a value of 40 but the taxpayer claims a value of 100. Because the claimed and correct values are compared on a property-by-property basis, there is a substantial valuation misstatement with respect to property B, but not with respect to property A, even though the claimed values (210) are 200 percent or more of the correct values (100) when compared on an aggregate basis.

(2) *Application of dollar limitation.* For purposes of applying the dollar limitation set forth in section 6662(e)(2), the determination of the portion of an underpayment that is attributable to a substantial or gross valuation misstatement is made by aggregating all portions of the underpayment attributable to substantial or gross valuation misstatements. Assume, for example, that the value claimed for property C on a return is 250 percent of the correct value, and that the value claimed for property D on the return is 400 percent of the correct value. Because the portions of an underpayment that are attributable to a substantial or

gross valuation misstatement on a return are aggregated in applying the dollar limitation, the dollar limitation is satisfied if the portion of the underpayment that is attributable to the misstatement of the value of property C, when aggregated with the portion of the underpayment that is attributable to the misstatement of the value of property D, exceeds $5,000 ($10,000 in the case of most corporations).

(g) *Property with a value or adjusted basis of zero.* 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.

(h) *Pass-through entities*—(1) *In general.* The determination of whether there is a substantial or gross valuation misstatement in the case of a return of a pass-through entity (as defined in §1.6662-4(f)(5)) is made at the entity level. However, the dollar limitation ($5,000 or $10,000, as the case may be) is applied at the taxpayer level *(i.e.,* with respect to the return of the shareholder, partner, beneficiary, or holder of a residual interest in a REMIC).

(2) *Example.* The rules of paragraph (h)(1) of this section may be illustrated by the following example.

Example. Partnership P has two partners, individuals A and B. P claims a $40,000 basis in a depreciable asset which, in fact, has a basis of $15,000. The determination that there is a substantial valuation misstatement is made solely with reference to P by comparing the $40,000 basis claimed by P with P's correct basis of $15,000. However, the determination of whether the $5,000 threshold for application of the penalty has been reached is made separately for each partner. With respect to partner A, the penalty will apply if the portion of A's underpayment attributable to the pass-through of the depreciation deduction, when aggregated with any other portions of A's underpayment also attributable to substantial or gross valuation misstatements, exceeds $5,000 (assuming there is not reasonable cause for the misstatements (*see* §1.6664-4(c)).

(i) [Reserved]

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* [Reserved]

(k) *Returns affected.* Except in the case of rules relating to transactions between persons described in section 482 and net sections 482 transfer price adjustments, the provisions of section 6662(b)(3) apply to returns due (without regard to extensions of time to file) after December 31, 1989, notwithstanding that the original substantial or gross valuation misstatement occurred on a return that was due (without regard to extensions) before January 1, 1990. Assume, for example, that a calendar year corporation claimed a deduction on its 1990 return for depreciation of an asset with a basis of X. Also assume that it had reported the same basis for computing depreciation on its returns for the preceding 5 years and that the basis shown on the return each year was 200 percent or more of the correct basis. The corporation may be subject to a penalty for substantial valuation misstatements on its 1989 and 1990 returns, even though the original misstatement occurred prior to the effective date of sections 6662(b)(3) and (e).