

No. 10-41219

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NPR INVESTMENTS, L.L.C.,

Plaintiff – Appellee-Cross-Appellant

HAROLD W. NIX; CHARLES C. PATTERSON,

Intervenor Plaintiffs – Appellees

v.

UNITED STATES OF AMERICA,

Defendant – Appellant-Cross-Appellee

ON APPEAL FROM THE JUDGMENT OF
THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF TEXAS

RESPONSE AND REPLY BRIEF FOR THE UNITED STATES

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STATEMENT REGARDING ORAL ARGUMENT

The Government's statement regarding oral argument is set forth at page i of its opening brief.

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GLOSSARY

AAR – Administrative Adjustment Request

BLIPS – Bond Linked Issue Premium Structure

BOSS – Bond Option Sale Strategy

DGI – The Diversified Group Incorporated

FPAA – Notice of Final Partnership Administrative Adjustment

FX – foreign currency

I.R.C. – Internal Revenue Code of 1986 (26 U.S.C.)

IRM – Internal Revenue Manual

LLC – limited liability company

NSAR – Non-Docketed Service Advice Review

OPS – Option Partnership Strategy

PFN – Pre-Filing Notification

TEFRA – Tax Equity and Fiscal Responsibility Act of 1982

INTRODUCTION

This case is an action for judicial review of a notice of final partnership administrative adjustment (FPAA) issued by the Internal Revenue Service (IRS) with respect to the 2001 tax year of NPR Investments, LLC (the “Partnership”). The FPAA adjustments, which were premised on multiple grounds, had the effect of invalidating a tax shelter designed to generate \$65 million of artificial (*i.e.*, non-economic) tax losses for Harold Nix, Charles Patterson, and Nelson Roach (collectively, the “Partners”). The FPAA also determined that penalties relating to those adjustments were applicable.

The Partnership initially moved for summary judgment on the ground that the FPAA was procedurally invalid under I.R.C. § 6223(f). (R87-121.) After the District Court denied that motion (R484), the Partnership and the Partners conceded the adjustments on the merits. The Partnership then moved for partial summary judgment on the valuation misstatement penalties asserted in the FPAA (R715-733), and the Government moved to dismiss the Partners’ reasonable-cause defenses to all asserted penalties for lack of jurisdiction. (R1182-1240.)

The District Court granted the Partnership’s motion for partial summary judgment and denied the Government’s motion to dismiss.

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After a 3-day bench trial, the court issued a memorandum opinion and order holding that the FPAA was procedurally valid, but that neither of the remaining two penalties asserted in the FPAA – the negligence penalty and the substantial understatement penalty – was applicable. The court further held that, in any event, the Partners qualified for the reasonable-cause defense to those penalties.

The Government appealed the District Court’s rulings on the valuation misstatement penalties, the substantial understatement penalty, and the reasonable-cause defense, and the Partnership appealed the court’s ruling on the procedural validity of the FPAA.

BRIEF FOR THE UNITED STATES AS CROSS-APPELLEE

STATEMENT OF JURISDICTION

The Government agrees with the Partnership’s statement of jurisdiction.

STATEMENT OF THE ISSUE

Whether the District Court correctly held that the IRS validly issued the FPAA that is the subject of this case.

STATEMENT OF THE CASE

The Government's statement of the case is set forth in its opening brief. (GB:4-5.)¹

STATEMENT OF FACTS

The Government's principal statement of facts is set forth in its opening brief. (GB:5-30.) The following statement pertains to the facts that are particularly relevant to the Partnership's procedural argument.

A. The Partnership and its role in the tax shelter

The promoters of the tax shelter, The Diversified Group Incorporated ("DGI") and Alpha Consultants LLC ("Alpha"), formed the Partnership on August 28, 2001, and served as its co-managers.

(R2701.) The Partners acquired their interests in the Partnership on November 8, 2001, by contributing their respective wholly owned LLCs to the Partnership. (R2703.) About a week earlier, each LLC had purchased and sold two pairs of offsetting digital foreign currency options for a net cost of \$625,000, in the case of Nix and Patterson, and \$375,000, in the case of Roach. (R2703.)

¹ "GB" references are to the Government's opening brief. "PB" references are to the Partnership's opening brief.

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The Partnership closed out the option positions on December 12, 2001, and each Partner withdrew from the Partnership about a week later, receiving a combination of cash and foreign currency in liquidation of his interest therein. (R2704; D. Ex. 74 at 2230.)

B. The Partnership's 2001 tax return

The New York office of Grant Thornton LLP prepared the Partnership's 2001 tax return (the "return"). (R2706; P. Ex. 3.) On line 2 of Schedule B of the return, the question "Are any partners in this partnership also partnerships?" is answered by means of an "x" in the "Yes" column.² (P. Ex. 3 at 1443.) On line 4 of Schedule B, the question "Is this partnership subject to the coordinated audit procedures of sections 6221 through 6233?" is answered by means of an "x" in the "No" column. (*Id.*) Although line 4 instructs the filer to designate a tax matters partner only if it answered "Yes" to question 4, the return lists DGI as the tax matters partner. (*Id.*)

The Schedule K-1 pertaining to Alpha and attached to the return lists the partner's name as "Alpha Consultants LLC." (P. Ex. 3 at

² This "x" appears to be handwritten. (P. Ex. 3 at 1443.) The answers to the other ten questions in Schedule B are indicated by means of a uniformly typewritten "x". (*Id.*)

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1463.) In response to the question “What type of entity is this partner?”, the schedule identifies Alpha as a “Limited Liab Co.” (*Id.*)

C. Audit of the Partnership’s 2001 tax return

IRS Revenue Agent Paul Doerr commenced an audit of the Partnership’s 2001 return in January 2004. (P. Ex. 35 at 3031.) Doerr was also auditing Patterson in connection with his earlier participation in the BLIPS tax shelter. (R2707-08; P. Ex. 36; Tr. II, 124, 126.) *See* GB:6-7, 25-26. After Doerr’s initial review of the Partnership’s 2001 return, it was unclear to him whether the Partnership was subject to the TEFRA consolidated audit procedures. (P. Ex. 49 at 32-33.) Doerr and his manager determined that they would rely on the statement in the return indicating that the Partnership was not subject to those procedures. (*Id.* at 35.) Accordingly, in July 2004, Doerr prepared a standard audit letter for notifying non-TEFRA partnerships (and other types of filers) that their returns have been selected for examination. (*Id.* at 15, 49; R2707; P. Ex. 35 at 3033.)

Because it appeared that the Partnership was not subject to the TEFRA audit procedures, such that it would not be necessary to adjust any items of the Partnership before adjusting the returns of the

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Partners, Doerr terminated the audit by means of a standard non-TEFRA “no-change letter” dated March 25, 2005. (R2707, 2715; P. Ex. 49 at 35; P. Ex. 2.)

Around July 2005, Robert Gee, an IRS group manager who was supervising all of the BLIPS audits across the country, began reviewing a draft statutory notice of deficiency that Doerr had prepared with respect to Patterson that encompassed his participation in both the BLIPS shelter and the OPS shelter at issue in this case. (R2707-08; Tr. II, 124, 125-26.) *See* GB:7, 10, 26. In an e-mail dated July 17, 2005, Gee posed a series of questions to Doerr regarding the OPS shelter, including “Is [the Partnership] subject to TEFRA proceedings?” (P. Ex. 39, p.3.) By return e-mail dated July 21, 2005, Doerr replied “Non-Tefra.” (*Id.*) Gee then investigated further and determined that Alpha was treated as a partnership for tax purposes.³ (Tr. II, 126.) In an e-mail dated July 29, 2005, Gee set forth what he understood to be the salient facts regarding the transaction and asked Doerr to “review

³ Alpha could have elected to be treated as a corporation for tax purposes. *See* Treas. Reg. §§ 301.7701-2(a), 301.7701-3(a). Or, if there had been only one owner of Alpha, Alpha’s “default” status for tax purposes would have been that of a disregarded entity. *See* Treas. Reg. § 301.7701-3(b)(1)(ii).

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and make any changes.” (*Id.* at 127; P. Ex. 39, pp. 1-2.) Doerr responded by e-mail dated August 2, 2005. (P. Ex. 39, p.1.) In response to the statement “[The Partnership] is an entity subject to TEFRA procedures because one of its members, Alpha Consultants LLC, is a partnership,” Doerr responded “Correct.” (*Id.*) The IRS issued FPAAAs to the Partners on August 15, 2005. (R2708; P. Ex. 1.)

D. Proceedings below regarding the Partnership’s procedural argument

1. The parties’ arguments on summary judgment and the District Court’s denial of the Partnership’s motion

In its motion for summary judgment, the Partnership argued that the “no-change” letter issued by Doerr on March 25, 2005, constituted an FPAA, thereby rendering the August 15, 2005 FPAA invalid as a prohibited second FPAA with respect to the Partnership’s 2001 tax year. (R87-121.) *See* I.R.C. § 6223(f). In response, the Government argued that “[t]he no-change letter was not intended to be, did not purport to be, and statutorily did not qualify as, an FPAA.” (R137.) The Government noted, *inter alia*, that Doerr was not authorized to issue an FPAA. (R143-45.) The Government also argued that the August 2005 FPAA would be valid even if the no-change letter were considered to be an FPAA, as the limiting rule of § 6223(f) applies “in

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the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact,” I.R.C. § 6223(f), and “[h]ere, [the Partnership] misrepresented that it was not a partnership subject to the consolidated TEFRA audit procedures.” (R147.)

In its reply to the Government’s response, the Partnership argued that the no-change letter qualified as an FPAA “because it purports to be the final notice with respect to the IRS’s audit of [the Partnership] and the IRS delivered it to [DGI], which was the Tax Matters Partner of [the Partnership],” and “[n]othing else is required for a valid FPAA.” (R357.) The Partnership further argued that its erroneous representation on its 2001 return regarding the inapplicability of the TEFRA procedures was not a “misrepresentation of a material fact” within the meaning of I.R.C. § 6223(f). (R364.)

In denying the Partnership’s motion for summary judgment, the District Court found “unavailing” the Partnership’s argument that the no-change letter constituted an FPAA as a matter of law. (R484.) The court further noted that, even if the no-change letter were an FPAA, there would still be a genuine issue of material fact regarding whether the Partnership misrepresented a material fact, which would render

the general prohibition against second FPAA's in § 6223(f) inapplicable.

(*Id.*)

2. Trial proceedings and the District Court's opinion

The Partnership took Doerr's deposition in November 2009. (P. Ex. 49.) In its witness list filed with the joint final pre-trial order in February 2010, the Partnership designated portions of Doerr's deposition that it expected to present at trial. (R2200.) In its corresponding witness list, the Government listed Doerr and five others, including Gee, as witnesses that it "may call at trial." (R2202-03.) The Government also designated additional portions of Doerr's deposition to present at trial in the event it decided not to call him as a witness at trial. (R2204.) At the pre-trial conference, counsel for the Partnership indicated that they intended to establish any facts relevant to the § 6223(f) issue by means of Doerr's deposition. (R3488.) The Government did not call Doerr as a witness at trial; instead, it called Gee to testify regarding the § 6223(f) issue. (Tr. II, 115-137.)

The District Court ultimately ruled in favor of the Government on the validity of the August 2005 FPAA. (R2714-16.) As an initial matter, however, the court – relying on the same legal arguments it had previously rejected as "unavailing" (R484) – found that the March

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2005 no-change letter constituted an FPAA. (R2710-14.) Among other things, the court “reject[ed] the Government’s argument that because Doerr did not have express authority to issue an FPAA,” the no-change letter could not have been an FPAA. (R2713-14.) The court nonetheless found that the August 2005 FPAA was valid on the ground that the Partnership had misrepresented a material fact, within the meaning of I.R.C. § 6223(f), when it represented that it was not subject to TEFRA on its 2001 return. (R2714-16.) The court also found that I.R.C. § 6223(f) does not, as the Partnership claimed, impose a “justifiable reliance” requirement, and it added that, “to the extent that reliance is required, the Court finds that the IRS relied on [the Partnership’s] misrepresentation regarding its TEFRA classification when issuing the March 25, 2005 letter.” (*Id.* at 2716.) Having “f[ound] that the misrepresentation by [the Partnership] was a ‘material fact,’” the court concluded that the issuance of the August 2005 FPAA was permitted “[b]y the express language of Section 6223(f).” (*Id.*)

SUMMARY OF ARGUMENT

The District Court correctly held that the issuance of the August 2005 FPAA did not contravene I.R.C. § 6223(f). In that regard, the court correctly held that the Partnership’s erroneous representation on

its 2001 return that it was not subject to the TEFRA procedures constituted a misrepresentation of material fact within the meaning of § 6223(f). In any event, contrary to the court's ruling, the March 2005 no-change letter that the IRS issued to the Partnership was not an FPAA and therefore did not implicate § 6223(f) in the first place.

1. As the District Court explained, its determination that the term "misrepresentation" is broad enough to include negligent and innocent misstatements is supported by the leading legal dictionary, which contains separate sub-entries for the terms "fraudulent," "innocent," and "negligent" misrepresentation. The court also correctly pointed out that its interpretation of the term as including *all* false representations – whether intentional, negligent, or innocent – is supported by the disjunctive language of § 6223(f), which refers to "fraud, malfeasance, *or* misrepresentation of material fact." Finally, the court correctly found that § 6223(f) does not contain a "justifiable reliance" requirement and that, even if it did, the IRS relied on the Partnership's misstatement and acted reasonably in doing so.

2. In any event, the March 2005 no-change letter was not an FPAA and hence the provisions of § 6223(f) regarding the issuance of a second FPAA are not implicated in this case. The record shows that the

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no-change letter did not purport to be an FPAA and was not intended to be an FPAA, but, instead, was precipitated by the misrepresentation on the Partnership's return that it was not subject to the TEFRA provisions of the Internal Revenue Code. Moreover, that the IRS revenue agent who issued the no-change letter was not authorized to issue FPAA's further confirms that the letter was not intended to be an FPAA. In these circumstances, it was error for the District Court to deem the no-change letter to be an FPAA.

The District Court nevertheless correctly concluded that the August 2005 FPAA was procedurally valid, and its decision on this issue should be affirmed.

ARGUMENT

The District Court correctly held that the IRS validly issued the August 2005 FPAA

Standard of review

The District Court's interpretation of I.R.C. § 6223(f), and its determination of the requirements for a valid FPAA, present questions of law that are subject to *de novo* review. *See, e.g., Sealy Power, Ltd. v. Commissioner*, 46 F.3d 382, 385 (5th Cir. 1995). The court's factual findings regarding the IRS's issuance of the March 2005 no-change

letter are reviewed for clear error. *See, e.g., Duffie v. United States*, 600 F.3d 362, 364 (5th Cir. 2010).

I. Introduction

A. TEFRA overview

The central tenet of the TEFRA partnership provisions, I.R.C. §§ 6221-6234, is that “the tax treatment of any partnership item ... shall be determined at the partnership level.” I.R.C. § 6221. Under these provisions, the IRS may adjust partnership items only through the procedural mechanism of a single, partnership-level audit, rather than through separate audits of each partner. Such adjustments are effected through the issuance of a notice of final partnership administrative adjustment (FPAA). *See* I.R.C. § 6223(a)(2). With the exception of certain small partnerships and electing large partnerships, all partnerships that are required to file a return are subject to the TEFRA procedures. I.R.C. §§ 6231(a)(1), 6240(b)(1).

B. Procedural significance of an FPAA

In several respects, an FPAA is the functional equivalent of a statutory notice of deficiency, the means by which the IRS adjusts individual and corporate returns. *See* I.R.C. § 6212(a); *Sealy Power*, 46 F.3d at 386. One important respect in which an FPAA *differs* from a

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notice of deficiency pertains to its effect on a partner's right to request the IRS to make *taxpayer-favorable* adjustments to partnership items reported on the partnership return. Such a request, referred to as an administrative adjustment request (AAR), *see* I.R.C. § 6227, is somewhat analogous to an amended-return refund claim in the non-TEFRA context. However, whereas the issuance of a notice of deficiency (by itself) does not preclude the recipient from subsequently filing a refund claim with the IRS for the same taxable year, the mailing of an FPAA to the tax matters partner of a partnership precludes any partner from filing an AAR with respect to the same year. I.R.C. § 6227(a)(2). In that situation, a partner may seek taxpayer-favorable adjustments to the partnership return only as part of a timely initiated judicial proceeding in respect of the FPAA. *See Harbor Cove Marina Partners P'ship v. Commissioner*, 123 T.C. 64, 78 (2004); *see also* I.R.C. § 6226(f). If no partner files a petition for judicial review of the FPAA within 150 days of its issuance, *see* I.R.C. § 6226(a), (b)(1), then the right to seek taxpayer-favorable adjustments to the partnership return will be lost.

This preclusive effect of FPAAs has led the IRS to take the position (and courts have agreed) that the IRS may validly issue an

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FPAA at the close of a TEFRA audit even in the absence of any adjustments to partnership items. *See Univ. Heights at Hamilton Corp. v. Commissioner*, 97 T.C. 278, 282 (1991) (recognizing that the IRS “may choose to issue a ‘no change’ [FPAA] to prevent a [partner] from later filing an [AAR]”); *see also Russian Recovery Fund Ltd. v. United States*, 81 Fed. Cl. 793, 802 (2008); *but see Atl. Richfield Co. v. Dep’t of the Treasury*, 1996 WL 788366, at *3 (D.D.C. 1996) (not reported in F. Supp.). The preclusive effect of an FPAA cuts both ways, however, for the issuance of an FPAA also precludes the IRS from issuing a second FPAA for that partnership year “in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact.” I.R.C. § 6223(f).

As the foregoing discussion demonstrates, I.R.C. §§ 6227(a)(2) and 6223(f) place a premium on the determination whether a communication from the IRS in respect of a TEFRA partnership is an FPAA. In Part III of the Argument, *infra*, we demonstrate that the March 2005 no-change letter that the IRS issued to the Partnership was not an FPAA and therefore did not implicate § 6223(f). First, however, we turn to the ground on which the District Court sustained the validity of the August 2005 FPAA, *viz.*, its conclusion that the Partnership’s erroneous representation that it was not subject to the

TEFRA procedures constituted a misrepresentation of material fact within the meaning of § 6223(f).

II. The District Court correctly held that the Partnership misrepresented a material fact on its 2001 return within the meaning of I.R.C. § 6223(f), such that the IRS was not prohibited from issuing the August 2005 FPAA

A. The Partnership made a misrepresentation on its 2001 return

In determining that the Partnership's erroneous representation on its 2001 return regarding its TEFRA status constituted a misrepresentation for purposes of I.R.C. § 6223(f), the District Court correctly found (R2715) that the term "misrepresentation" is broad enough to include negligent and innocent statements. *See* Bryan A. Garner, *A Dictionary of Modern Legal Usage* 567 (2d ed. 1995). Although there are some legal contexts in which the term "misrepresentation" connotes some degree of scienter, *see Lane v. United States*, 286 F.3d 723, 731-32 (4th Cir. 2002), this is not one of them. In *Lane*, the court held that I.R.C. § 6532(b), which provides a 5-year statute of limitations for an erroneous refund suit where "it appears that any part of the refund was induced by fraud or misrepresentation of a material fact," does not require an intentional or knowing misrepresentation. *Id.* Noting the contrary authority of

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United States v. Northern Trust Co., 93 F. Supp. 2d 903, 908-910 (N.D. Ill. 2000), *rev'd*, 372 F.3d 886 (7th Cir. 2004), the court stated that the *Northern Trust* court improperly relied on cases involving statutory provisions addressing settlement agreements and closing agreements: “The meaning of the term “misrepresentation” in that setting in no way governs its meaning in the very different context of § 6532(b).” 286 F.3d at 732. The same is true with respect to the “very different context” (*id.*) of I.R.C. § 6223(f).

As the District Court pointed out (R2714-15), that the term “misrepresentation” does not, by itself, imply knowledge or intent (or even negligence) is made plain by the leading legal dictionary. *See* Black’s Law Dictionary 1091-92 (9th ed. 2009) (providing sub-entries for, *inter alia*, “fraudulent,” “innocent,” and “negligent” misrepresentation.) And the edition that is contemporaneous with the 1982 enactment of TEFRA – an edition that does not contain sub-entries for the term “misrepresentation” – even more clearly demonstrates that the term does not connote any particular state of mind or degree of culpability:

Any manifestation by words or other conduct by one person to another that, under the circumstances, amounts to an assertion not in accordance with the facts. An untrue statement of fact. An incorrect or false representation.

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That which, if accepted, leads the mind to an apprehension of a condition other and different from that which exists. ...

Black's Law Dictionary 903 (5th ed. 1979) (adding that only "[c]olloquially" is the term "understood to mean a statement made to deceive or mislead"). The second paragraph of this edition's definition also comports with the *Lane* court's recognition that cases construing the term in the context of contracts are inapposite in other contexts:

In a limited sense, an intentional false statement respecting a matter of fact, made by one of the parties to a contract, which is material to the contract and influential in producing it. A "misrepresentation," *which justifies the rescission of a contract*, is a false statement of a substantive fact ... material to proper understanding of the matter in hand, made with intent to deceive or mislead. [*Id.* (emphasis added).]

The District Court further noted (R2715) that its interpretation of § 6223(f) as including *all* false representations of material facts is consistent with the disjunctive language of the statute ("fraud, malfeasance, *or* misrepresentation of a material fact"). The Supreme Court employed similar reasoning in holding that the term "misrepresentation" in 28 U.S.C. § 2680(h), which provides that the United States is not liable in tort for claims arising out of, *inter alia*, "misrepresentation [or] deceit," does not imply willfulness. *See United States v. Neustadt*, 366 U.S. 696, 702 (1961) ("[A]s 'deceit' means

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fraudulent misrepresentation, ‘misrepresentation’ must have been meant to include negligent misrepresentation, since otherwise the word ‘misrepresentation’ would be duplicative.”) (internal quotation marks omitted); *see also United States v. Northern Trust Co.*, 372 F.3d 886, 888 (7th Cir. 2004) (“‘Misrepresentation’ differs from ‘fraud;’ otherwise § 6532(b) would be redundant.”). As the Fourth Circuit explained more fully in *Lane*:

The five-year statute of limitations [under I.R.C. § 6532(b)] applies under circumstances of either “fraud or misrepresentation.” And by definition, fraud requires an intentional or knowing misrepresentation. Thus, to construe the word “misrepresentation” as limited to intentional or knowing misrepresentations would render that statutory term superfluous. This would ignore the basic principle of statutory interpretation instructing courts to “avoid a reading which renders some words altogether redundant.” ...

286 F.3d at 731 (quoting *Gustafson v. Alloyd Co.*, 513 U.S. 561, 574 (1995)) (additional citation omitted). Construing “misrepresentation” in § 6223(f) as requiring intent or knowledge would likewise render the term superfluous.

Finally, although the misrepresentation on the Partnership’s 2001 return surely implicates some degree of culpable behavior – whether

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negligence, gross negligence, or recklessness⁴ – the District Court correctly found that the exception in § 6223(f) does not require a showing of this kind of culpability, either; rather, all that is required for the exception to apply is the “submi[ssion of] a material fact that was false.” (R2715.) This interpretation is bolstered by the presence of the word “malfeasance” in § 6223(f). “Malfeasance” is defined in relevant part as “[a] wrongful or unlawful act.” Black’s Law Dictionary 1042 (9th ed. 2009). “Wrongful conduct,” in turn, is defined as “[a]n act taken in violation of a legal duty.” *Id.* at 337. The term “legal duty,” of course, encompasses the “duty of care” underlying the law of negligence. *See id.* at 580-82; *see also* Black’s Law Dictionary 1446 (5th ed. 1979) (stating that the term “wrongful act” “is occasionally equated to [the] term “negligent”). Accordingly, construing “misrepresentation” in § 6223(f) as requiring some degree of culpability short of willfulness (such as negligence) would – as is the case with an interpretation

⁴ This is particularly so in light of the apparently handwritten correction to the answer to the question “Are any partners in this partnership also partnerships?” on line 2 of Schedule B of the return. *See supra* note 2 and accompanying text. Somebody consciously changed this answer, and his or her failure to make a corresponding change to the question regarding the applicability of TEFRA is at least negligent.

requiring willfulness – render the term “misrepresentation” superfluous.⁵

- B. The fact misrepresented by the Partnership was material

The District Court correctly found that the Partnership’s misrepresentation on its 2001 return was material, as it “related directly to the proper audit procedures that should have been originally applied to the tax return.” (R2715.) The Partnership does not contest the court’s finding of materiality in its opening brief, nor could it have, as it did not contest the issue below. Accordingly, materiality is not at issue on appeal.

- C. The Partnership’s arguments on appeal are meritless
 - 1. The Partnership’s attempts to read a willfulness requirement into § 6223(f) are unavailing

The Partnership begins by erroneously asserting that the District Court’s interpretation of § 6223(f) “to include innocent mistakes ... would allow the IRS to issue a second notice *whenever* there is a

⁵ In *Lane*, 286 F.3d at 732, the Fourth Circuit rejected, in *dicta*, the Government’s argument that the term “misrepresentation” in I.R.C. § 6532(b) includes innocent misrepresentations. Although the Government respectfully disagrees with this *dicta*, we note that § 6532(b), unlike § 6223(f), does not contain the word “malfeasance” (*i.e.*, it is limited to “fraud or misrepresentation of a material fact.”)

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material mistake on a partnership's return (which, obviously, is the only reason why the IRS would want to issue a second [FPAA])." PB:12 (emphasis in original). In other words, the Partnership appears to be arguing that, under the District Court's interpretation of § 6223(f), the IRS can issue a second FPAA whenever it discovers what it deems to be an erroneous position on the return that it failed to catch before it issued the first FPAA. What the Partnership overlooks is that the exception in § 6223(f) only applies to misrepresentations of material *facts* (not disputed *tax positions*). Accordingly, the Partnership's stated concern that the District Court's decision will somehow open the floodgates to multiple FPAA's is unfounded.

The Partnership's next assertion – that the District Court “depart[ed] from” the “ordinary meaning” of the term “misrepresentation” based solely on the appearance of multiple sub-entries for the term in Black's Law Dictionary (PB:13) – is doubly wrong. First, the word “misrepresentation” – a term of art, as evidenced by its inclusion in Black's Law Dictionary – does not have an “ordinary” meaning from which the court could have departed, much

less the ordinary meaning the Partnership ascribes to it.⁶ Second, the court did not rely solely on Black's Law Dictionary; rather, it also relied on the disjunctive language of the statute, *see Neustadt*, 366 U.S. at 702, and it reasoned that the Partnership's interpretation "would prevent the IRS from relying upon submitted information in tax returns in preparing notices and would place an impermissible burden on the IRS to verify the accuracy of the submitted information and the intent with which it was submitted." (R2715).

The Partnership's invocation of principles of statutory construction (PB:13-14) is equally misguided. The Partnership's first contention – that if an innocent misrepresentation "is sufficient to make the exception applicable, the terms 'fraud' and 'malfeasance' become mere surplusage" (PB:13) – is directly contrary to *Neustadt*, 366 U.S. at 702, *Northern Trust*, 372 F.3d at 888, and *Lane*, 286 F.3d at 731, all of which stand for the proposition that reading a willfulness

⁶ Moreover, that the definition of the term in the latest edition of Black's Law Dictionary includes the clause "usually with the intent to deceive" – a fact that was not lost on the District Court (R2714) – does not, as the Partnership suggests (PB:13), imply that, all other things being equal, the legal term should be construed as connoting willfulness. *See* Black's Law Dictionary 903 (5th ed. 1979) ("*Colloquially* it is understood to mean a statement made to deceive or mislead") (emphasis added).

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requirement into the term “misrepresentation” in these circumstances would render *that* term superfluous. *See supra* pp. 18-19. And the Partnership’s additional claim that the District Court’s interpretation “is inconsistent with Congress’s use of the terms “fraud” and “malfeasance” in the same exception,” PB:14, is based on the false premise that those terms “both connote intentional wrongdoing,” *id.* As explained *supra* at pp. 19-21, the term “malfeasance” is broad enough to include negligence. Accordingly, under the District Court’s correct interpretation of § 6223(f), each of the terms “fraud,” “malfeasance,” and “misrepresentation of a material fact” has independent significance.

The Partnership’s remaining arguments on this issue fare no better. In claiming that “[i]n effect, the district court *converted* Congress’s restriction on the IRS ... to now only require the IRS to show ‘fraud, malfeasance, or innocent misstatement of a material fact,’” PB:14 (emphasis added), the Partnership simply assumes the answer to the question decided by the court. In relying on a case interpreting the term “misrepresentation” in the context of I.R.C. § 7121 (closing agreements), PB:14-15, the Partnership ignores the Fourth Circuit’s conclusion in *Lane*, 286 F.3d at 732, that cases

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construing the term in the context of contracts are inapposite in other contexts. *See supra* pp. 16-17, 18. And in referring to the *dicta* in *Lane* to the effect that the term “misrepresentation” in I.R.C. § 6532(b) should not be construed to include innocent misrepresentations, PB:15, the Partnership ignores the fact that § 6532(b), unlike § 6223(f), does not contain the word “malfeasance” (*i.e.*, it is limited to “fraud or misrepresentation of a material fact.”) *See supra* pp. 19-21 & note 5.

2. The District Court correctly found that there is no reliance requirement in § 6223(f) and that even if there were, the IRS was entitled to rely on the Partnership’s misrepresentation
 - a. Section 6223(f) does not contain a reliance requirement

The Partnership’s attempt to read a reliance requirement into § 6223(f), like its attempt to read a willfulness requirement into that provision, is unavailing. The authorities cited by the Partnership in this regard (PB:16) are wholly inapposite, as they deal with common law tort principles in general and the common law tort of fraudulent misrepresentation in particular.⁷ And its claim that “TEFRA adopts

⁷ In quoting *Lewis v. Bank of Am. NA*, 343 F.3d 540, 546-47 (5th Cir. 2003), and *In re Mercer*, 246 F.3d 391, 418 (5th Cir. 2001), the Partnership conveniently excises any reference to fraud. *See Lewis*, 343 F.3d at 546 (stating that “a *fraud plaintiff*” cannot “blindly rel[y]

(continued...)

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this general [justifiable reliance] rule, for it expressly requires the IRS to show that any reliance on [the Partnership's] mistake was reasonable," *id.*, is simply wrong. I.R.C. § 6231(g)(2) does not, as the Partnership asserts, provide that "the IRS may only rely on a partnership's tax return to conclude that the TEFRA provisions do not apply if its reliance is reasonable." PB:17 (emphasis in original). Rather, § 6231(g)(2) provides that, if on the basis of a partnership return, the IRS reasonably (but erroneously) concludes that the partnership is not subject to the TEFRA provisions, then those provisions shall not apply for such year. In other words, an erroneous determination by the IRS that the TEFRA provisions are inapplicable is given effect where the mistake was reasonable. Section 6231(g)(2), however, is irrelevant in this case inasmuch as the IRS is *not* claiming that the TEFRA partnership provisions are *not* applicable to the Partnership (*i.e.*, because it erroneously, but reasonably, made such a determination); on the contrary, it maintains that those provisions *are* applicable here.

⁷ (...continued)
upon a misrepresentation ...") (emphasis added); *Mercer*, 246 F.3d at 418 (stating that "*the recipient of a fraudulent misrepresentation*" may not justifiably rely on it if "there are 'red flags' indicating such reliance is unwarranted") (emphasis added).

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Nothing in § 6231(g) suggests that, where a partnership return contains a misrepresentation of a material fact, the IRS must have reasonably relied on that misrepresentation in order to qualify for relief from the procedural rule of § 6223(f). Indeed, such a requirement would make no sense in the circumstances presented here; if the IRS were required to demonstrate reasonable reliance on the misrepresentation contained in the Partnership's return in order to qualify for the exception in § 6223(f), then the need to qualify for that exception would vanish, since the TEFRA provisions would be altogether inapplicable pursuant to § 6231(g)(2). Moreover, the inclusion of reasonable-reliance language in § 6231(g) indicates that if Congress had intended to incorporate a reasonable-reliance requirement in § 6223(f), it would have expressly done so.

- b. In any event, the IRS was entitled to rely on the Partnership's misrepresentation

Even if a showing of reasonable reliance were required under § 6223(f), the District Court expressly found that "the IRS relied on [the Partnership's] misrepresentation regarding its TEFRA classification when issuing the March 25, 2005 [no-change] letter" (R2716), and it expressly "reject[ed] [the Partnership's] arguments that it was unreasonable for the IRS to treat [the Partnership] as a non-TEFRA

partnership” (*id.*). These findings are supported by the deposition testimony of Paul Doerr, the IRS Revenue Agent who issued the no-change letter, and the live testimony of Robert Gee, an IRS group manager who has extensive experience dealing with the TEFRA procedures.

At his deposition, Doerr was questioned by the Partnership’s counsel about “Plaintiff’s Exhibit 16,” which Doerr identified as a declaration he had signed. (P. Ex. 49 at 32.) Counsel for the Partnership read portions of the declaration into the record, including the following statements (*id.* at 33, 35.):

After my initial review of the [Partnership’s] 2001 partnership return, Form 1065, it was unclear whether the partnership was subject to the TEFRA consolidated audit procedures.

...

It was determined that we would rely on the statement on [the Partnership’s] return that [it] was not subject to the TEFRA consolidated audit procedures.

...

Additionally, because it appeared that [the Partnership] was not subject to the TEFRA consolidated audit procedures, I believe[d] it would not be necessary to adjust any items in that partnership return before adjusting the foreign currency losses claimed on its partners’ tax returns, by issuing statutory notices of deficiency under section 6212 to those partners.

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And when counsel for the Government questioned Doerr regarding the conflicting responses to the questions on lines 2 and 4 of Schedule B of the Partnership's 2001 return (*id.* at 70-71), he testified that revenue agents normally focus on question 4, "[bec]ause that's where they're indicating whether they're subject to TEFRA." (*Id.* at 72.)

In light of the foregoing, the Partnership's claim (PB:19 n.5) that the District Court "committed clear error by finding that the government relied on [the Partnership's] mistake" is unfounded. Indeed, the only argument the Partnership makes in this regard (*id.*) is that the court "should have drawn an adverse inference against the government on the reliance point, as the government refused to make Doerr available at trial." The insinuation that the Government somehow underhandedly denied access to Doerr, however, rings hollow for two reasons. First, the Government had listed Doerr (along with five others, including Gee) as a witness that it "*may* call at trial" (R2202-03 [emphasis added]), and counsel for the Partnership represented to the court at the pre-trial conference that they intended to establish any facts relevant to their § 6223(f) argument by means of Doerr's deposition. (R3488.) Second, the very fact that the Partnership had unfettered access to Doerr through pre-trial discovery belies any

claim of prejudice that would warrant an adverse inference against the Government.⁸

The Partnership devotes most of its energy (PB:17-21) to attacking the District Court's finding that the IRS acted reasonably, but here again it overstates its case. On a general level, suffice it to say that it is somewhat disingenuous to characterize an IRS Revenue Agent's failure to catch the inconsistency in Schedule B of the Partnership's 2001 return as wholly unreasonable while claiming that the failure of "the major national accounting firm of Grant Thornton LLP" (PB:17) to catch the same mistake was wholly innocent. On a more specific level, the Partnership's reliance on a Non-Docketed Service Advice Review (NSAR) in the context of I.R.C. § 6231(g) (*id.* at 19-20) is misplaced. The issue in the NSAR was not whether the

⁸ That is precisely why this Court has shunned the invocation of the "uncalled-witness rule" in the context of district court civil trials conducted under federal rules. *See Herbert v. Wal-Mart Stores, Inc.*, 911 F.2d 1044, 1049 (5th Cir. 1990) (*per curiam*) (bringing the rule's "archaism to the attention of the court for possible consideration en banc"), *reh'g en banc denied*, 917 F.2d 559 (5th Cir. 1990) (table); *Verdin v. Sea-Land Serv., Inc.*, 8 F.3d 21, 1993 WL 455645, at *4 (5th Cir. 1993) (not reported in F.3d) ("the disfavor with which we greet the uncalled-witness presumption renders it an improper argument [in civil cases] in most circumstances"); *cf. Streber v. Commissioner*, 138 F.3d 216, 221-22 (5th Cir. 1998) (Tax Court case, where the more limited Tax Court Rules then in place (R2656-61) prohibited depositions of non-consenting, nonparty witnesses without a court order).

examining agent there acted reasonably when he commenced TEFRA procedures in reliance on the partnership's misrepresentation that it was subject to TEFRA, but rather whether the return provided a reasonable basis for the IRS to take the legal position going forward that the TEFRA provisions applied to the partnership pursuant to § 6231(g)(1). Moreover, the Partnership misleadingly implies (*id.* at 20 n.7) that the Schedule K-1 for Alpha that was attached to the Partnership's 2001 return identified Alpha as a pass-through entity. The schedule K-1 identified Alpha as a limited liability company, and LLCs are not necessarily treated as partnerships for tax purposes. *See* Treas. Reg. §§ 301.7701-2(a), 301.7701-3(a), (b)(1)(ii).

- III. In any event, the March 2005 no-change letter was not an FPAA and therefore did not implicate § 6223(f)
 - A. The District Court's analysis omits the crucial element of intent

In *Sealy Power*, 46 F.3d at 385-86, this Court recognized that "an FPAA is the functional equivalent of a notice of deficiency" and therefore should be analyzed "the same way that we would analyze a notice of deficiency." As notices of deficiency are within the exclusive province of the Tax Court, that court's decades-old jurisprudence regarding the requirements for a valid notice of deficiency is of

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particular import in determining the requirements for a valid FPAA. A review of that jurisprudence reveals that, even if a written communication from the IRS meets the minimal notice standards that a notice of deficiency must satisfy, it will not be treated as a notice of deficiency if it is clear that the communication was not intended to constitute a notice of deficiency.

In *Estate of Schmalstig v. Commissioner*, 43 B.T.A. 433 (1941), the Board of Tax Appeals (the Tax Court's predecessor) was faced with a letter that not only denied a refund claim, but also stated that "[a]n examination of the evidence at hand shows a deficiency of \$4,034.76" and included a detailed computation of the deficiency. *Id.* at 434. Referring to the "well established rules applicable to a statutory notice of deficiency," *id.* at 437, the Board acknowledged that "[t]he form of the notice is immaterial" and that "it is sufficient if it fairly advises the taxpayer that there is a deficiency in respect of the tax." *Id.* at 437-38. But the Board recognized that this minimal notice requirement is only a floor: "Nothing *short of such a notice*, sent by registered mail, gives a taxpayer the right to petition this Board for a redetermination of the deficiency." *Id.* at 438 (emphasis added, citations omitted). The Board found that the letter at issue, however, was not intended by the Commissioner to be, nor was it, a notice of deficiency. *Id.* Although the

Board relied primarily on the language of the letter in determining that “the disallowance of [the refund] claim – no more and no less – was its object,” *id.* at 438, it also considered the mode of delivery, concluding that the use of registered mail did not support an inference that the Commissioner intended the letter to be a notice of deficiency. *Id.* at 439.

In *Lerer v. Commissioner*, 52 T.C. 358 (1969), the Tax Court considered a “Form 7900” letter advising a trustee in bankruptcy that the IRS was assessing taxes of the bankrupt. *Id.* at 361; *see* I.R.C. § 6871. The letter stated in part that “the determination of the income tax liabilities of [the bankrupt] discloses deficiencies ... in the aggregate amount of \$55,512.28” and included a computation of the deficiencies. 52 T.C. at 361. The taxpayer argued that “even though [the Commissioner] did not intend the notice as a notice of deficiency, the fact that it ‘determines’ deficiencies for the years 1963, 1964, and 1965 makes it as a matter of law a notice of deficiency.” *Id.* at 364. In other words, “It is petitioner’s contention that respondent cannot send any letter in which he advises a taxpayer of a determination of an income tax deficiency without having that letter be a statutory notice of deficiency.” *Id.* Citing and discussing *Estate of Schmalstig*, the court rejected the taxpayer’s argument “that the mere statement of the

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determination of a deficiency per se makes the notice a notice of deficiency.” *Id.* As was the case in *Estate of Schmalstig*, the court looked primarily to the language of the letter in ascertaining the Commissioner’s intent, but it also found that “the fact that assessment was made within a few days after the mailing of the letter is further indication that the notice was not intended as a notice of deficiency and in fact was not a notice of deficiency.” *Id.* at 366.

In *Abrams v. Commissioner*, 84 T.C. 1308 (1985), *aff’d sub nom. Donley v. Commissioner*, 791 F.2d 383 (5th Cir. 1986), the court held that pre-filing notification (PFN) letters issued to tax shelter investors did not constitute notices of deficiency. The court noted, *inter alia*, that the PFN letters “do not state that they are notices of deficiencies” and, citing *Lerer*, further noted that “as respondent has pointed out, the letters were not *intended* to be notices of deficiencies.” *Id.* at 1310 (emphasis in original) (fn. ref. omitted). *Abrams* involved 111 petitioners and was affirmed by eight other Courts of Appeals in addition to this Court. *See Neal v. Commissioner*, 1986 U.S. App. LEXIS 28562 (2d Cir. 1986) (unpublished order); *Abrams v. Commissioner*, 787 F.2d 939 (4th Cir. 1986); *Benzvi v. Commissioner*, 787 F.2d 1541 (11th Cir. 1986); *Spector v. Commissioner*, 790 F.2d 51 (8th Cir. 1986); *Becker v. Commissioner*, 799 F.2d 753 (7th Cir. 1986)

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(table); *Alford v. Commissioner*, 800 F.2d 987 (10th Cir. 1986); *Gaska v. Commissioner*, 800 F.2d 633 (6th Cir. 1986); *Abrams v. Commissioner*, 814 F.2d 1356 (9th Cir. 1987).

Hubbard v. Commissioner, 89 T.C. 792 (1987), illustrates that the issue of intent cuts both ways. In *Hubbard*, the issue was whether the May 1986 mailing of a copy of a November 1985 notice of deficiency – the issuance of which in November 1985 had been rendered invalid for failure to use the taxpayer’s last known address, see I.R.C. § 6212(b)(1) – constituted the issuance of a notice of deficiency in May 1986. In a pre-hearing order, the court cited *Abrams* and “advised respondent that he should be prepared to *present evidence concerning his intentions with respect to*” the May 1986 mailing. 89 T.C. at 796 (emphasis added). The Commissioner subsequently conceded the jurisdictional issue, “acknowledg[ing] that he did not intend the May 27, 1986 mailing of the November 13, 1985 notice of deficiency to constitute the issuance of a notice of deficiency on May 27, 1986.” *Id.* at 801. In awarding attorneys’ fees to the taxpayer under I.R.C. § 7430, the court, citing *Abrams* and *Lerer*, noted that “this Court has held ... that it has no jurisdiction over a case based upon a letter from respondent to a taxpayer which was not *intended* to constitute a notice of deficiency.” *Id.* at 801-02 (emphasis in original).

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It is now “well established that the [Tax] Court lacks jurisdiction over a petition that is filed with respect to a letter from the Commissioner to the taxpayer that was not intended to constitute a notice of deficiency.” *Bourekis v. Commissioner*, 110 T.C. 20, 26 (1998) (applying this principle to a purported notice of determination not to abate interest under I.R.C. § 6404(g)); *see also Barnes v. Commissioner*, 130 T.C. 248, 254 (2008) (applying this principle to a purported final notice of determination regarding innocent-spouse relief under I.R.C. § 6015; “in analyzing whether the Commissioner’s letter to a taxpayer constituted a statutory notice of deficiency, this Court has looked to whether the letter purported to be a deficiency notice and whether the Commissioner intended it as such”). Significantly, in determining that the letter at issue in *Barnes* – Letter 3657C – “d[id] not purport to be a final notice of determination under section 6015 ... and was not intended as such,” 130 T.C. at 254, the court noted that “[p]ursuant to the Internal Revenue Manual (IRM), Letter 3657C is the form to be used to explain that a section 6015 claim for relief has been previously disallowed,” *i.e.*, not as a final notice of determination, and that “[t]he character of the Letter 3657C sent to petitioner is consistent with this provision.” *Id.* at 255 (citation to IRM omitted). In a footnote, the court stated that “[a]lthough ... the Internal Revenue Manual (IRM) does not

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have the force of law, *we look to these provisions as indications of respondent's intent with respect to the issuance to petitioner of Letter 3657C.*" *Id.* n.8 (emphasis added).

It is undisputed that the IRS – and Revenue Agent Doerr in particular – did not intend the March 2005 no-change letter to constitute an FPAA. Thus, Doerr did *not* conduct a TEFRA examination of the Partnership and then issue a no-change letter because he had determined that no adjustments to partnership items were necessary. On the contrary, the District Court expressly found that “Doerr mistakenly took actions as though [the Partnership] was a non-TEFRA partnership, applied the normal deficiency procedures set forth in Sections 6211 through 6216, and issued a standard non-TEFRA closing letter.” (R2715.) The court added that “Doerr was under the mistaken impression that [the Partnership] was not subject to the TEFRA audit procedures at the time he issued the March 25, 2005 no-change letter” and, therefore, “that there was no need to adjust any of the items on [the Partnership’s] return.” (*Id.*) Finally, the court stated that it was probable that the IRS would not have issued the no-change letter had it not been misled into believing that the Partnership was not subject to the TEFRA provisions. (R2716.) Under these

circumstances, and in light of the foregoing authorities, the March 2005 no-change letter did not constitute an FPAA.

- B. Doerr's lack of authority to issue an FPAA is further evidence that the no-change letter he sent to the Partnership was not intended to be an FPAA

In rejecting the Government's argument that Doerr's lack of authority to issue an FPAA precluded the March 2005 no-change letter from being a valid FPAA, the District Court cited *Israel v. Commissioner*, 86 T.C.M. (CCH) 694, 696 (2003), as determining that a taxpayer's argument to that effect was frivolous. (R2714.) Although it is a frequent tactic of tax protesters to challenge the authority of IRS officials to take various actions, it does not follow that the authority of a particular IRS official to take a particular action is never of any moment. *See, e.g., Craig v. Commissioner*, 119 T.C. 252, 263 (2002) (providing a detailed analysis of the delegation-of-authority issue in the context of a final notice of intent to levy, the issuance of which is a prerequisite for a valid levy under I.R.C. § 6330(a)(1)).

Indeed, the Tax Court has specifically held that a letter that neither purported to be, nor was intended to be, a notice of deficiency "can not be considered a statutory notice of deficiency within the meaning of section 6212" where the IRS revenue officer who issued the letter "did not possess the delegated authority to issue a notice

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pursuant to section 6212.” *Kellogg v. Commissioner*, 88 T.C. 167, 174 (1987). That is precisely the situation here: the March 2005 no-change letter did not purport to be an FPAA, was not intended to be an FPAA, and was issued by someone who was not authorized to issue FPAAAs. If Doerr’s lack of authority to issue FPAAAs is not dispositive of the issue, then at the very least it is additional evidence (if any is needed) that neither he nor any of his superiors intended the no-change letter to be an FPAA. *See Barnes*, 130 T.C. at 255 & n.8.⁹ As demonstrated above, that lack of intent precludes a finding that the no-change letter was an FPAA.

CONCLUSION

For the reasons discussed above, the District Court correctly held that the IRS validly issued the August 2005 FPAA, and that aspect of its judgment should be affirmed.

⁹ In *Selgas v. Commissioner*, 475 F.3d 697 (5th Cir. 2007), this Court rejected the taxpayer’s argument that the notice of deficiency issued to him was invalid because it was signed by an official who lacked the authority to issue such notices. In so doing, the Court pointed out that there was no requirement that a deficiency notice be signed in the first place. We would add that, under I.R.C. § 6212, it is sufficient if the Secretary or his delegate has *authorized* the issuance of the notice of deficiency. Evidence establishing that a written communication purporting to be a notice of deficiency was issued without authorization by the Secretary or his delegate unquestionably would invalidate the notice.

REPLY BRIEF FOR THE UNITED STATES AS APPELLANT

- I. The valuation misstatement penalties under I.R.C. § 6662(e) and (h) are applicable in this case
 - A. The Partnership erroneously claims that this case does not involve any valuation misstatements

The Partnership starts off on the wrong foot (PB:22) by claiming that the Government’s valuation-misstatement argument “must fail for the simple reason that [the Partnership] did not overstate the value or basis of any property on its return.” The Partnership misapprehends the issue to be determined in a partnership-level proceeding in which a valuation misstatement penalty is asserted by the IRS. The penalty applies to the extent a taxpayer’s underpayment of income tax is attributable to a substantial (or gross) valuation or basis misstatement. I.R.C. § 6662(b)(3), (e), (h). Because partnerships are not subject to the income tax, the “taxpayers” in this context are the partnership’s partners. A court in a partnership-level proceeding, however, has jurisdiction to determine the applicability of any penalty which relates to the adjustment of a partnership item. I.R.C. § 6226(f). Accordingly, the issue is not whether the partnership “overstate[d] the value or basis of any property on its return,” as the Partnership claims (PB:22); rather, the issue is the propriety of the IRS partnership-item

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adjustments that result in the asserted valuation misstatement, regardless whether that misstatement appears on the face of the partnership return or on the individual return of a partner.

Indeed, under the Partnership's position, the IRS would be altogether precluded from asserting valuation misstatement penalties in the context of Son-of-BOSS shelters like this one (*i.e.*, where the basis overstatement shows up on the partner's return). On one hand, the IRS would be unable (according to the Partnership) to assert the penalty in the partnership proceeding; on the other hand, the IRS would be precluded from asserting the penalty in subsequent partner-level proceedings, since the penalty in this context clearly "relates to an adjustment to a partnership item" (be it a sham determination or otherwise), I.R.C. § 6221, such that its "applicability" must "be determined at the partnership level," *id.* See *Krause v. United States*, 398 F. App'x 35, 36, 38 (5th Cir. 2010) (*per curiam*) (valuation misstatement penalties in Son-of-BOSS case were "related to" partnership items).¹⁰ Such a "Catch-22" result clearly would be improper.

¹⁰ The Partnership expressly concedes elsewhere in its brief (PB:41) that "the penalties asserted by the IRS in the August 15, 2005 [FPAA] directly relate to the adjustments to partnership items that the IRS made in the same notice."

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Similarly, the Partnership's strategic concession of the merits on a ground that it claims is unrelated to value or basis does not make the IRS's other partnership-item adjustments – and the basis overstatements on the Partners' returns resulting therefrom – disappear. As this Court recognized in *Sealy Power*, 46 F.3d at 387, an FPAA is presumed to be correct, and the partnership bears the burden of proving that it is incorrect. In the absence of a settlement agreement or an adjudication in respect of an FPAA adjustment, the FPAA adjustment is conclusive. *See* I.R.C. § 6230(c)(4) (for purposes of partner-level refund proceedings, “the treatment of partnership items on the partnership return, under the settlement, under the [FPAA], or under the decision of the court (whichever is appropriate) shall be conclusive.”); *Keener v. United States*, 551 F.3d 1358, 1367 (Fed. Cir. 2009) (sham-transaction determination in FPAA was conclusive as to settling partners, as that finding was not altered by the settlement agreement), *cert. denied*, 130 S. Ct. 153 (2009).

Moreover, that the other FPAA adjustments in this case may have been alternative means to the same result – the disallowance of the Partners' claimed loss deductions – does not make them any less conclusive. *Schell v. United States*, 589 F.3d 1378, 1384 (Fed. Cir. 2009), *cert. denied*, 131 S. Ct. 346 (2010); *see Krause v. United States*,

2010 WL 1718072, at *4 (W.D. Tex. 2010) (not reported in F. Supp. 2d) (partner barred from challenging applicability of valuation misstatement penalty asserted in an uncontested FPAA that included “14 different bases on which ... to disallow a loss deduction” in a Son-of-BOSS transaction; “[b]y definition, all of these issues were conclusively determined when the FPAA was finalized”), *aff’d per curiam*, 398 F. App’x 35 (5th Cir. 2010).

B. *Heasley* does not preclude application of the valuation misstatement penalties in this case

1. Treas. Reg. § 1.6662-5 supersedes *Heasley*

Under *Heasley*, an underpayment of tax resulting from the total disallowance of a deduction cannot be “attributable to” any valuation overstatement that may have been included in that deduction. *Heasley v. Commissioner*, 902 F.2d 380, 383 (5th Cir. 1990). As we indicated in our opening brief, however, Treas. Reg. § 1.6662-5(d), ex. 3, illustrates the superseding principle that an underpayment of tax resulting from the total disallowance of a deduction *can* be attributable to a valuation overstatement. *See* GB:39. Tellingly, the Partnership makes no attempt to reconcile *Heasley* with the principle illustrated in the cited example.

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A closer look reveals that any such attempted reconciliation by the Partnership would have been futile. Under *Heasley*, if (1) a taxpayer claims a depreciation deduction, (2) the IRS disallows that deduction in full, and (3) there is a basis overstatement included in that deduction, then any underpayment resulting from the disallowance of the deduction is not “attributable to” the basis overstatement but, instead, is attributable to claiming an improper deduction. 902 F.2d at 383. The reasoning is that, regardless whether the taxpayer had overstated his basis by \$100,000 or \$1 million, his depreciation deduction would have been disallowed in full. *See id.* In contrast, under Treas. Reg. § 1.6662-5(d), ex. 3, although (1) a taxpayer claims a depreciation deduction, (2) the IRS disallows that deduction in full, and (3) there is a basis overstatement included in that deduction, the underpayment resulting from the disallowance of the deduction is nonetheless “attributable to” the basis overstatement. In other words, under the regulation, regardless whether the taxpayer had overstated his basis by \$100,000 or \$1 million, the underpayment would have been attributable to the basis overstatement. This agency construction of § 6662 directly contradicts both the result and the reasoning of *Heasley* and, for the reasons stated in our opening brief (GB:39-40), is

controlling. *See Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982 (2005).

2. The Partnership provides only a cursory (and misleading) response to the Government's analysis of *Weiner* and its effect on the parameters of the "total disallowance" rule

In our opening brief (GB:41-43), we demonstrated that this Court's opinion in *Weiner v. United States*, 389 F.3d 152 (5th Cir. 2004), casts doubt on the continuing viability of the "total disallowance" rule as expressed in *Heasley*. The Partnership's response (PB:30-31) – that "[n]othing in *Weiner* indicates that the Fifth Circuit was distancing itself from its own precedent in *Heasley* to adopt the broader 'capable of being attributed to' standard adopted by the Second Circuit in *Irom v. Commissioner*, 866 F.2d 545, 547 (2d Cir. 1989)" – is not only conclusory, but also misstates the Government's argument. The Government has never suggested that *Weiner* supports adoption of the "capable of being attributed to" standard, which would contravene *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1989). Rather, the Government contends that the fact that the *Weiner* court reserved judgment on *Irom's* "separability" test – the means by which the *Irom* court distinguished *Todd*, and a test that is contrary to what the *Weiner* court referred to as *Heasley's* "exten[sion] [of] the *Todd* rule,"

389 F.3d at 161 – indicates that the *Weiner* court was open to a middle ground between the “capable of being attributed to” standard and the “total disallowance” rule.

Nor does the Government contend, as the Partnership erroneously suggests (PB:31), that *Weiner* overruled *Heasley*. *Weiner* does, however, suggest ambivalence towards the much-maligned “total disallowance” rule, just as *Herbert v. Wal-Mart Stores, Inc.*, 911 F.2d 1044 (5th Cir. 1990) (*per curiam*), indicates ambivalence towards the “uncalled-witness rule” in the context of district court civil trials conducted under federal rules. *See supra* note 8; *see also Keller v. Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009) (acknowledging 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,” and remarking 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,” but recognizing that it was constrained by *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990)), *reh’g en banc denied by unpublished order*, No. 06-75441 (9th Cir. May 20, 2009).

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- II. The “substantial authority” exception to the substantial understatement penalty does not apply in this case
 - A. The Partnership’s profit-motive concession precludes a finding of substantial authority as a matter of law

In light of the Partnership’s concession that DGI and Alpha lacked a profit motive in operating the Partnership, the relevant inquiry under the substantial-authority standard is whether there was substantial authority for the Partnership’s position that the *Helmer* principle – viz., that the obligation to perform under an option is not a liability for purposes of I.R.C. § 752¹¹ – applied to its dealings with the Partners notwithstanding the Partnership’s lack of a profit motive. *See* GB:46-47. Inasmuch as the Partners have conceded that the Partnership’s concession precludes them from deducting any of the losses purportedly engendered by their dealings with the Partnership (R580), they can hardly argue now that there was substantial authority for the Partnership’s position as so circumscribed by its concession. Instead, the Partnership offers two flawed arguments in support of its assertion that its concession has no effect on the position to be evaluated for substantial authority.

¹¹ *See Helmer v. Commissioner*, 34 T.C.M. (CCH) 727, 730-31 (1975).

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First, the Partnership erroneously argues that, because the losses at issue were claimed by the law firm and the Partners rather than the Partnership, PB:37, it is “the tax positions taken by the law firm and the Partners” that are to be evaluated for substantial authority, and the Partnership’s concession “has no bearing on” that determination. *Id.* at 35-36. In so arguing, the Partnership repeats the mistake it made in the context of the valuation misstatement penalties. Just as the fact that the massive basis overstatements resulting from the FPAA adjustments did not appear on the Partnership’s return has no bearing on the applicability of the valuation misstatement penalties in this case, *see supra* pp. 40-41, the fact that the massive artificial losses resulting from the basis overstatements did not appear on the Partnership’s return has no bearing on the applicability of the substantial-authority exception. The position to be evaluated for substantial authority in this partnership proceeding is not, as the Partnership apparently believes, whether there was substantial authority for the law firm’s (and the Partners’) claimed loss deductions; rather, the issue is whether there was substantial authority for the

Partnership's treatment of the partnership items that engendered those deductions.¹²

The Partnership's next argument – that, under the Government's position, “if any reason arises to invalidate a transaction, then there cannot be substantial authority for a taxpayer's position” (PB:36 [emphasis in original]) – is similarly misguided. Although not entirely clear, it appears that the Partnership is arguing that under the Government's position, any issue contested by, and adjudicated against, a taxpayer must be taken into account in identifying the position to be evaluated for substantial authority. But that is not the Government's position. Rather, the Government's position is that the Partnership, having *conceded* that it lacked a profit motive at the time it entered into the transactions and that such concession resulted in substantial understatements of tax, cannot seek to immunize the Partners from the substantial understatement penalty by claiming that those underpayments, rather than being attributable to its conceded lack of a profit motive, are instead attributable to its pre-concession reliance on *Helmer*.

¹² Moreover, what the “Partners believed” regarding the correct tax treatment of the transactions, PB:35, is not relevant to the substantial-authority analysis. See Treas. Reg. § 1.6662-4(d)(3)(i); GB:47 n.23.

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- B. In any event, the *Helmer* principle does not provide substantial authority for claiming tax benefits based on the application of that principle to a transaction that is not bona fide

Given the Partnership's concession that it lacked a profit motive, the parties' dispute regarding the proper application of the substantial-authority standard in the context of an offsetting-option shelter that a court has held lacked economic substance is largely academic. As demonstrated in our opening brief, however, the Partnership could not have satisfied the substantial-authority standard even if the shelter had been invalidated by a court rather than by the Partnership's own concession. *See* GB:49-50. That is because numerous courts have rejected the argument that the *Helmer* principle, in and of itself, provided substantial authority for the claimed tax treatment of offsetting-option shelters. *Id.* (citing cases); *see also Woods v. United States*, 2011 WL 2620990, at *3 (W.D. Tex. Mar. 31, 2011), *appeal docketed* (5th Cir. No. 11-50487).

The Partnership's response to this argument (PB:39) – that the cases cited by the Government were “decided long after the transactions at issue were completed” – is frivolous. The Government, of course, did not cite these cases as being indicative of the substantive law at the time of the transactions, *i.e.*, as authorities to be weighed in

determining whether there was substantial authority for the Partnership's position. Rather, the Government cited these cases for the proposition that, in applying the substantial-authority standard to an offsetting-option shelter undertaken on the basis of *Helmer*, courts should not consider the *Helmer* principle to the exclusion of longstanding judicial doctrines that deny tax benefits flowing from meaningless transactions, even when those transactions comply with the literal wording of the statute (here, I.R.C. § 752, as interpreted by *Helmer*). The Partnership has no answer to that argument.

The Partnership also erroneously claims (PB:38) that the cases cited by the Government are inapposite because, in each of the cases, “the trial court first determined that the transaction at issue lacked economic substance,” and that “[h]ere, the district court made no such finding.” As discussed *supra* at pp. 42-43, however, the Partnership's strategic concession of the profit-motive issue does not make the other FPAA adjustments – including the determination that the transactions lacked economic substance – any less conclusive. In any event, the lack of a profit motive at the partnership level underlies this Court's holding that the BLIPS shelter purchased by Patterson and Nix the year before they bought this shelter had no reasonable possibility of profit and therefore lacked economic substance. *See Klamath Strategic Inv. Fund,*

LLC v. United States, 568 F.3d 537, 545 (5th Cir. 2009). Accordingly, for purposes of the substantial-authority analysis, there is no material distinction between this offsetting-option case and the offsetting-option cases cited by the Government.

The Partnership's reliance on *Streber v. Commissioner*, 138 F.3d 216 (5th Cir. 1998), in support of the proposition that it would have had substantial authority for its position even if it had tried the economic-substance issue and lost, PB:38, is misplaced. In *Streber*, a divided panel of this Court concluded that, inasmuch as the case before it "turned on one factual issue," *id.* at 223, the relevant inquiry under the substantial-authority exception was whether there was substantial authority for the taxpayer's position from a *factual* standpoint. Putting aside the propriety of this aspect of *Streber*, *see id.* at 227-28 (King, J., dissenting), as well as its precedential value, *see id.* at 228-29, the adjudication of the economic-substance issue in the instant case would not have turned on one factual issue.

More importantly, although the determination whether there was substantial *legal* authority – as contemplated in Treas. Reg. § 1.6662-4(d)(3)(iii) – for the position that a given transaction had economic substance may often be difficult due to the fact-specific nature of the economic-substance inquiry, that is not the case here. As explained in

our opening brief (GB:50), there was direct legal authority – in the form of Notice 2000-44, 2000-2 C.B. 255 – contrary to the position that the offsetting-option shelter would be respected for tax purposes. In that regard, the Partnership’s rejoinder that Notice 2000-44 “is nothing more than a statement of the government’s litigating position; it is not authoritative,” PB:40, completely ignores Treas. Reg. § 1.6662-4(d)(3)(iii), which expressly provides that published IRS Notices are “authority” for purposes of the substantial-authority inquiry. The Partnership is absolutely correct in asserting (*id.*) that taxpayers are entitled to challenge the Government’s position as stated in Notice 2000-44, but such taxpayers plainly are not immunized from the substantial understatement penalty if their challenge is unsuccessful.

III. The District Court did not have jurisdiction to consider the Partners’ reasonable-cause defenses in this partnership-level proceeding

A. The District Court’s jurisdictional ruling is directly contrary to *Klamath*

In *Klamath*, 568 F.3d at 548, this Court held that “a reasonable cause and good faith defense may be considered during partnership-level proceedings if the defense is presented on behalf of the partnership.” In our opening brief (GB:55-58), we demonstrated that the District Court’s denial – without analysis (R2494) – of the

Government's motion to dismiss the Partners' reasonable-cause defenses for lack of jurisdiction was directly contrary to *Klamath* because the Partners did not assert – and could not have asserted – a reasonable-cause defense on behalf of the Partnership. Although the Partnership insists in response (PB:44) that “reasonable cause and good faith are being asserted by [Patterson] on behalf of [the Partnership],” its argument on appeal is squarely at odds with the reasonable-cause defense asserted below, as the District Court's opinion on this issue makes clear. (R2724-26.) *See* GB:55-58. Because the issue raised by the Partners – and ruled on by the District Court – was “whether [each] [P]artner has met the criteria of” the reasonable-cause exception, Temp. Treas. Reg. § 301.6221-1T(d) (1999), the defenses are, by definition, individual, partner-level defenses.¹³ And, as the *Klamath* court recognized, “[t]he TEFRA structure enacted by Congress does not permit a partner to raise an individual defense during a partnership-level proceeding.” 568 F.3d at 548.

Undeterred, the Partnership argues incoherently (PB:44) that “the Partners' reasonable cause and good faith defense is one and the

¹³ The *Klamath* court quoted this definitional aspect of Temp. Treas. Reg. § 301.6221-1T(d) in its discussion of the jurisdictional issue. *See Klamath*, 568 F.3d 547-48.

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same with [the Partnership's]." As explained in our opening brief (GB:55 n.24), that argument directly contradicts the *Klamath* court's distinction between "individual," partner-level defenses, which "TEFRA ... does not permit ... to [be] raise[d] ... during a partnership-level proceeding," 568 F.3d at 548, and those "presented on behalf of the partnership," which "may be considered during partnership-level proceedings," *id.* In short, *Klamath* precludes a finding that the District Court had jurisdiction to consider the Partners' reasonable-cause defenses.

B. The Partnership's remaining arguments on this issue are meritless

In suggesting that two recent cases declined to "divorce the initial determination of the penalty from the reasonable cause defense" where "the penalty from the TEFRA proceeding ... is entirely dependent on partner-level conduct," PB:45-46, the Partnership plainly mischaracterizes those cases. *See Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649, 655-56 (D.C. Cir. 2010), *on remand*, 135 T.C. 581 (2010), *appeal pending* (D.C. Cir. No. 11-1084); *Jade Trading, LLC v. United States*, 98 Fed. Cl. 453 (2011); *see also Jade Trading, LLC v. United States*, 598 F.3d 1372, 1378-80 (Fed. Cir. 2010). The courts in *Petaluma* and *Jade* held that the trial courts in those Son-of-

BOSS cases did not have jurisdiction to determine the threshold applicability of accuracy-related penalties where the underpayments resulted from overstatements of basis on the partners' returns. The courts reasoned (erroneously, in the Government's view) that the penalty did not "relate to" the partnership-item adjustment that gave rise to the basis overstatements – *viz.*, the finding that either the partnership or its transactions were economic shams – as required by I.R.C. § 6226(f).¹⁴

Nothing in the *Petaluma* and *Jade* cases suggests that the courts were adopting the Partnership's argument herein (PB:45) that "the initial determination of the penalty" should not be "divorce[d] ... from the reasonable cause defense when the penalty depends on the conduct of specific partners." In any event, adoption of the Partnership's argument in this regard effectively would nullify the distinction drawn by this Court in *Klamath* between an individual reasonable-cause defense asserted by a specific partner on his own behalf, and the assertion of a reasonable-cause defense by a managing partner on behalf of his partnership. *Klamath*, 568 F.3d at 548.

¹⁴ The Partnership concedes that the penalties here *do* relate to the partnership-item adjustments in the FPAA. *See supra* note 10.

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Moreover, the Partnership's suggestion that the reason the District Court in this case – but not the trial courts in *Petaluma* and *Jade* – had jurisdiction to make “the initial determination of the penalty” (*id.*) is that, unlike *Petaluma* and *Jade*, the “penalties depend on both the actions of [the Partnership] and the Partners,” *id.* at 46, is spurious. *Petaluma* and *Jade* involved the same contribution of option positions to the partnership and the same liquidating distribution of a non-cash asset from the partnership that are involved in this case. *See Petaluma*, 591 F.3d at 650; *Jade*, 598 F.3d at 1374-75.

Finally, the Partnership's suggestion that the Partners' reasonable-cause defenses were “put at issue” (PB:42) by the FPAA and by the Government's conduct of pre-trial discovery is a red herring. The Partnership cites no authority for this novel “open the door” jurisdictional theory, nor is there any to be found. To the contrary, there is no such thing as subject-matter jurisdiction by consent. *See, e.g., Commodities Futures Trading Comm'n v. Schor*, 478 U.S. 833, 851 (1986); *Raymon v. Alvord Indep. Sch. Dist.*, 639 F.2d 257, 258 (5th Cir. 1981).

IV. Even if this Court concludes that the District Court had jurisdiction to consider the Partners' reasonable-cause defenses, the District Court clearly erred in sustaining those defenses

Because the District Court lacked jurisdiction to consider the Partners' reasonable-cause defenses in this partnership-level proceeding, this Court need not determine whether the District Court properly sustained those defenses on the merits. In the event the Court disagrees with the Government on the jurisdictional issue, however, it should overturn the District Court's ruling on the merits, and it may do so based on both legal error and clearly erroneous factual findings.

A. The Partners did not act in good faith

The Partnership's narrative in support of the District Court's finding that the Partners acted reasonably and in good faith (PB:47-57) is notable for what it does not say. For instance, no mention is made of the fact that this is the *second* go-around for two of the Partners (Nix and Patterson) as purchasers of abusive, Son-of-BOSS tax shelters. (R2707-08 & n.7.) *See Klamath*, 568 F.3d at 543-45; GB:6-7. Nor is any mention made of the fact that Nix and Patterson similarly withdrew from their BLIPS shelter after about 60 days and received liquidating distributions that included euros worth \$63,726 for which each claimed a tax basis of \$25 million. *See* GB:7. And the Partnership does not

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deny that Patterson and Nix reported the artificial tax losses from their BLIPS shelter as though they had been recognized through a partnership (which was not the case), effectively hiding those losses. *Id.* This evidence bears directly on the credibility of Patterson and Nix's self-serving testimony in this case.

The Partnership's narrative is also notable for what it glosses over. As we argued in our opening brief, "[t]he most obvious indication of the Partners' lack of good faith is that ... they blatantly tried to hide the claimed tax benefits ... by improperly netting the losses against their law partnership's gross receipts." GB:66-67; *see id.* at 21-24. The Partnership's cursory response – that "Cohen decided independently to report the tax losses ... from the law firm's sale of the foreign currencies ... under the law firm's 'Business Risk Division'" (PB:55) – is the "head in the sand" defense at its worst. *See Klamath*, 568 F.3d at 545. And the Partnership's suggestion that the Partners somehow cured this chicanery by belatedly disclosing the shelter on their 2002 returns (as required by regulation), PB:56, is cynicism at its worst. As explained in our opening brief (GB:25-26), by the time the Partners filed their 2002 returns in October 2003, the jig was up; the IRS had uncovered Nix and Patterson's participation in the BLIPS shelter, and

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it had begun seeking information from them regarding any other listed transactions in which they had participated.

B. Ruble was tainted by a conflict of interest

In our opening brief, we argued that the District Court erred as a matter of law in failing to consider whether the Partners' alleged belief that Ruble did not have a conflict of interest was reasonable, GB:61, and that, in any event, any such belief would have been unreasonable, *id.* at 61-63. In response to the first argument, the Partnership simply misstates the argument, claiming that "[t]he government argues that the district court failed to consider *whether Ruble had a conflict of interest.*" PB:57 (emphasis added). Nowhere does the Partnership assert that, in finding that the Partners reasonably relied on Ruble's tax opinion, the court considered whether their alleged belief that Ruble was conflict-free was reasonable. Moreover, the court did not, as the Partnership suggests (*id.*), implicitly find that Ruble was conflict-free; rather, the court clearly was satisfied that Patterson *believed* that Ruble did not have a conflict. (R2725.) Again, the court's failure to consider whether that alleged belief was reasonable constitutes legal error. *See* GB:61.

If the Court reaches the merits of the Partners' reasonable-cause defenses and agrees with the Government that the District Court erred

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as a matter of law in its analysis of the conflict-of-interest issue, it need not remand for further consideration of that issue, as the record overwhelmingly demonstrates that the Partners should have known that Ruble had a conflict of interest. *See* GB:61-63; *see also Woods, supra*, at *4. The Partnership's argument to the contrary begins with the remarkable assertion that, although Ruble was hired by the promoter and received his fee out of the promoter's fee, "there is not any evidence in the record to support the notion that [Ruble] *did* have a conflict of interest." PB:58 (emphasis in original). But its next assertion is even more spurious; according to the Partnership, that Ruble's "fee was dependent on the Partners' decision to enter into the transactions" proves nothing, since "[t]hat, of course, is true for every professional services firm in the country." We doubt that, if the Partners had sought an opinion from an independent law firm regarding the advisability (from a tax standpoint) of entering into these transactions, that firm would have agreed to waive its fee if the Partners decided not to enter into the transactions.

In any event, the issue is not, as the Partnership claims (PB:59), whether there was "reason for the Partners to believe that [Ruble's] positive advice was contingent on them entering the transactions." Rather, the issue is whether there was reason for the Partners to

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believe that Ruble's positive advice was influenced by the fact that he had been hired by the promoter and by the fact that, since his fee was payable out of the promoter's fee (which the Partners knew, Tr. II, 16), he would not be paid unless the Partners entered into the transactions. The proper resolution of that issue is self-evident, particularly in light of the Partners' "experience, knowledge, and education." Treas. Reg. § 1.6664-4(b)(1); *see* GB:59, 61-62.

Finally, the Partnership's reliance on *Heasley* for the proposition that "[t]he mere fact that DGI referred the Partners to [Ruble] does not create a conflict of interest," PB:59, is wholly misplaced. The *Heasley* court expressly stated that "nothing in the record supports a finding that [the CPA to whom the promoter had referred the Heasleys for preparation of their return] did not independently assess the Heasleys' tax liability or that [the promoter] influenced [the CPA's] calculations," 902 F.2d at 384 n.9; indeed, the court stated that "nothing else in the record connects the two." *Id.* at 385. The same obviously cannot be said of DGI and Ruble. Moreover, the *Heasley* court was concerned that "[i]f we require moderate-income investors to independently investigate their investments, the start-up investigation costs may prevent them from investing at all." *Id.* at 383-84. The Partners, of course, were not so hamstrung.

C. The Partners' reliance on the Ruble opinion does not meet the minimum regulatory requirements

In our opening brief (GB:63-66), we demonstrated that the Partners' reliance on the Ruble opinion does not meet the minimum regulatory requirements for two reasons. First, the Partners failed to disclose to Ruble a highly relevant fact: that they had intended from the outset to withdraw from the Partnership before year-end. *Id.* at 63-64; *see* Treas. Reg. § 1.6664-4(c)(1)(i). We then listed six examples of how the record reveals that the District Court's "accept[ance] [of] the Partners' self-serving testimony that the timing of their withdrawal was unplanned and 'based on Roach's decision to withdraw for personal reasons' (R2706)," GB:64, is clearly erroneous. *See id.* at 64-65. The Partnership's response is largely non-responsive; for instance, at one point it asserts (PB:63-64) that evidence of a pre-planned withdrawal that tends to refute the Partners' testimony is contrary to "unrefuted testimony from trial."

Although this Court normally "defers to [a] district court's credibility determinations," it may disturb such determinations if "a review of the evidence leaves [it] with the definite and firm conviction that a mistake has been made." *Sealed Appellant v. Sealed Appellee*, 394 F.3d 338, 345 (5th Cir. 2004) (internal quotation marks omitted).

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In order *not* to be left with the definite and firm conviction that the District Court erred in finding that the Partners' premature withdrawal from the Partnership was not pre-planned, this Court must believe that all of the following facts are mere coincidences: (1) Nix and Patterson prematurely withdrew from their BLIPS partnerships in *Klamath*; (2) each of Cohen's clients that participated in DGI's OPS shelter in 2000 withdrew from his partnership prior to the end of that year;¹⁵ (3) Cohen's October 22, 2001 memo indicates that the Partners would "close the option positions," withdraw from the Partnership, and then "determine[] the amount of loss to be recognized ... in year 1" (*i.e.*, 2001) and beyond;¹⁶ and (4) Tan's October 24, 2001 e-mail to Haber at DGI indicates that "[e]ach partner will be redeemed out in FX, and

¹⁵ The Partnership erroneously claims (PB:63) that "the Partners were not even aware that other clients of Cohen's had invested in these types of transactions." Patterson testified that, at the time of the meeting in New York with DGI and Ruble, he knew that Cohen had referred several other clients of his to DGI for transactions. (Tr. I, 109.)

¹⁶ The Partnership's suggestion that Cohen contemplated that the Partners would close the positions and withdraw only "if there is a profit," PB:62, ignores the language in the memo immediately preceding that clause. That language conveys that it would be preferable for the Partner to withdraw at a time when his contributed option positions were worth more than what he paid for them, *i.e.*, so that he could premise his withdrawal on a decision to capture a profit. See R1771 ("Since the potential of making a profit is one of the most important reasons for investing, Mr. X monitors the value of the options and if there is a profit ..."); see *also* D. Ex. 143.

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each will contribute such FX to their law partnership” prior to year-end, with Roach “convert[ing] some FX in 2001” and Nix and Patterson “banking the FX” for conversion in later years, *which is exactly what transpired*. See GB:7, 64-65.

The Partners’ reliance on the Ruble opinion also fails the minimum regulatory requirements because they knew or should have known that at least one of their factual representations to Ruble – as relevant here, that there was no understanding that DGI would include a non-cash asset (*i.e.*, foreign currency) in the liquidating distributions upon the Partners’ withdrawal from the Partnership – was unlikely to be true. See GB:14-15, 65-66; see Treas. Reg. § 1.6664-4(c)(1)(ii). As we explained in our opening brief (GB:66), “[i]nasmuch as the entire scheme hinged on the inclusion of foreign currency in the liquidating distributions, it cannot seriously be argued that” there was no understanding that such a part-cash, part-FX distribution was forthcoming. The Partnership’s only response (PB:65) – unsupported by any citation to the record – is that the District Court “expressly found that no such ‘scheme’ existed.” Inasmuch as the District Court did not even address the merits of the shelter due to the Partnership’s profit-motive concession, this assertion, like so many others proffered by the Partnership, does not hold up.

CONCLUSION

For the reasons set forth above, the District Court erred in (1) granting the Partnership summary judgment on the applicability of the valuation misstatement penalties, (2) holding that the substantial understatement penalty was inapplicable, (3) denying the Government's motion to dismiss the Partners' reasonable-cause defenses for lack of jurisdiction, and (4) sustaining the Partners' reasonable-cause defenses (if it had jurisdiction to do so). Those aspects of the court's judgment should be reversed. The District Court correctly held that the IRS validly issued the August 2005 FPAA, and that aspect of its judgment should be affirmed.

Respectfully submitted,

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JULY 2011

ADDENDUM

Internal Revenue Code (26 U.S.C.):

Sec. 6223. Notice to Partners of Proceedings.

* * * * *

(f) Only One Notice of Final Partnership Administrative Adjustment. – If the Secretary mails a notice of final partnership administrative adjustment for a partnership taxable year with respect to a partner, the Secretary may not mail another such notice to such partner with respect to the same taxable year of the same partnership in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact.

* * * * *

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CERTIFICATE OF SERVICE

I hereby certify that on July 29, 2011, I mailed by First Class Mail seven copies of the foregoing brief to the Clerk of the Court and electronically filed the foregoing brief with the Clerk of the Court using the CM/ECF system, which will send notice of such filing to the following registered CM/ECF users:

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ECF CERTIFICATIONS

Pursuant to Fifth Circuit Rule 25.2.1, I hereby certify that (i) any required privacy redactions have been made, (ii) the electronic submission is an exact copy of the paper document, and (iii) the document has been scanned for viruses with the most recent version of a commercial virus scanning program and is free of viruses.

Dated: July 29, 2011

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USDC No. 5:05-CV-219

The following pertains to your cross appellee's brief electronically filed on July 29, 2011.

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Sincerely,

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