

No. 10-41219

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IN THE UNITED STATES COURT OF APPEALS  
FOR THE FIFTH CIRCUIT

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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.

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

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**CROSS-APPELLANTS' REPLY BRIEF**

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## ARGUMENT

### I. Introduction

Section 6223(f) generally prohibits the Internal Revenue Service (“IRS”) from issuing more than one notice of final partnership administrative adjustment to a partnership with respect to any taxable year.<sup>1</sup> The IRS may, however, issue more than one notice if it shows “fraud, malfeasance, or misrepresentation of a material fact.” Section 6223(f). There is no allegation of fraud or malfeasance in this case. The only issue presented by the Partnership in its appeal is whether the district court erred in holding that an innocent mistake on the Partnership’s tax return constituted a “misrepresentation” that entitled the IRS to issue more than one notice of final partnership administrative adjustment to it.

As explained in our opening brief, the district court erred in defining “misrepresentation” for purposes of Section 6226(f) to include innocent mistakes. We further demonstrated that the district court also erred in refusing to define “misrepresentation” to include the element of reasonable reliance, notwithstanding that “misrepresentation” is elsewhere consistently defined to require a showing of reasonable reliance, and Section 6231(g) imposes that same requirement here. In

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<sup>1</sup> All references to “Section” or “Code” are to the Internal Revenue Code of 1986, as amended and in existence during the relevant time period.

its Response and Reply Brief, the government continues to insist that the district court accurately defined “misrepresentation.” The government alternatively argues, however, that even if the district court erred in how it defined “misrepresentation,” that its judgment should still be affirmed. According to the government, the district court also erred in holding that the March 25, 2005 notice was a notice of final partnership administrative adjustment, as that would make the August 15, 2005 notice the first and only notice of final partnership administrative adjustment (thus mooting the exception issue).

The government is wrong on both counts. The Court should affirm the judgment of the district court that the March 25 notice was a notice of final partnership administrative adjustment. The Court should also hold that the district court erred in defining “misrepresentation” to include innocent mistakes and, because the government failed to show that the mistake on the Partnership’s tax return was anything but innocent, the Court should hold the August 15 notice invalid under Section 6223(f)’s prohibition against sending multiple notices of final partnership administrative adjustments. The exception for misrepresentations also does not apply because the IRS did not reasonably rely on the mistake on the Partnership’s tax return, and the August 15 notice is invalid under Section 6223(f) for that alternative reason.

We recognize this is a reply brief, but we will conclude with a very brief response to a new argument that the government raised regarding penalties. We believe that a response is particularly important given that the government's argument directly implicates the jurisdiction of this Court.

## **II. The IRS Sent the Partnership a Valid Notice of Final Partnership Administrative Adjustment on March 25, 2005.**

The district court correctly held that the notice the IRS sent the Partnership on March 25, 2005, informing the Partnership that the IRS had completed its examination of the Partnership's return and that the notice was "the final notice [the Partnership] will receive regarding the examination" (R2707), met the statutory requirements for notices of final partnership administrative adjustments. (R2712 (citing Section 6223(a)).) TEFRA simply requires that the IRS give "notice of . . . the final partnership administrative adjustment resulting from any [partnership-level administrative proceeding]." Section 6223(a). "The standard for determining the validity of an FPAA is whether the FPAA provides adequate or minimal notice to the taxpayer that respondent has finally determined adjustments to the partnership return." *Triangle Investors LP v. Comm'r*, 95 T.C. 610, 613 (1990) (emphasis added); *see also Sealy Power, Ltd. v. Comm'r*, 46 F.3d 382, 386 (5th Cir. 1995) ("Both the FPAA and the notice of deficiency serve to notify affected taxpayers that the Commissioner has made a final administrative

determination of their liability for particular tax years.”) (emphasis added); *Selgas v. Comm’r*, 475 F.3d 697, 700 (5th Cir. 2007), *cert. denied*, 522 U.S. 824 (2007) (“[A] notice of deficiency is valid as long as it informs a taxpayer that the IRS has determined that a deficiency exists and specifies the amount of the deficiency.”); *Clovis I v. Comm’r*, 88 T.C. 980, 982 (1987) (stating that “no particular form is necessary,” but that notices of final partnership administrative adjustment “must minimally give notice to the taxpayer that respondent has FINALLY DETERMINED adjustments to the partnership return”) (emphasis in original); *Chomp Assocs. v. Comm’r*, 91 T.C. 1069, 1073-75 (1988) (following *Clovis I*).<sup>2</sup>

The district court found that the March 25, 2005 letter “provided notice, indicated that it was the final notice, and indicated that the IRS had determined not to adjust NPR’s partnership items.” (R2712.) The government does not, and cannot, dispute these findings as the March 25 notice is clear on its face. Nothing further is required under Section 6223(a) for a notice to qualify as a notice of final partnership administrative adjustment, and the district court’s holding on this issue should therefore be affirmed.

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<sup>2</sup> Because a notice of final partnership administrative adjustment is the functional equivalent of a notice of deficiency, cases addressing the requirements for notices of deficiency are relevant to determining the requirements for notices of final partnership administrative adjustments. *See, e.g., Sealy Power*, 46 F.3d at 385-86.

The government wrongly argues, however, that the March 25 notice nevertheless did not constitute a valid notice under section 6223(a) because the government allegedly did not intend it to be such a notice and because Agent Doerr allegedly lacked authority to issue it.

A. The March 25 Notice Shows that the IRS Intended it to be the Final Notice to the Partnership.

The government argues that the March 25 letter was not a valid notice under Section 6223(a) because the IRS and Agent Doerr did not intend for it to be such a notice. (Appellant’s Resp. and Reply Br. (“Resp. Br.”) at 31-38.) That is flatly wrong. The March 25 notice could not be more clear – it expressly states that the IRS has completed its audit of the Partnership (subject to certain exceptions not relevant here) and provides in two different places that it is the final notice that the Partnership will receive. The March 25, 2005 notice stated:

We’ve completed the examination of your tax return for the year(s) shown above. We made no changes to your reported tax.

\* \* \*

This letter is the final notice you’ll receive regarding your examination unless you are a shareholder in a subchapter S corporation, a beneficiary of a trust, or a partner in a partnership. We may examine the tax return of a subchapter S corporation, trust, or partnership in which you are involved later and find that we have to make changes to the return. Otherwise, this is the final notice you will receive regarding the examination.

(P. Ex. 2 (emphasis added).) The March 25, 2005, notice meets all elements of the term “notice of final partnership administrative adjustment.” It is a notice, it

indicated that it was the final notice, and it indicated that the IRS had determined not to adjust the Partnership's partnership items. That is all that is required for it to be a valid notice of final partnership administrative adjustment. *See Sealy Power*, 46 F.3d at 386; *Triangle Investors*, 95 T.C. at 613.

Moreover, Revenue Agent Paul Doerr, the IRS employee responsible for the audit of the Partnership, testified at his deposition that he intended this March 25, 2005, notice to be the “final notice to NPR Investments, LLC regarding [his] examination of NPR Investments, LLC.” (P. Ex. 49 at 62.) Agent Doerr also intended the March 25, 2005, notice to advise the Partnership that he had completed his examination and that he was making no changes to the return. (*Id.* at 61.) It is therefore undisputed that Agent Doerr intended the March 25 notice to be the final notice of administrative adjustment that the IRS would send to the Partnership.

The government spends several pages of its brief citing cases for the unremarkable proposition that a document can only be a notice of deficiency if the Commissioner intends it to be such a notice. The government studiously avoids discussing how that intent is to be determined, however, for in all of those cases the courts determined what the Commissioner intended from the language of the document itself. *See, e.g., Estate of Schmalstig v. Comm’r*, 43 B.T.A. 433, 438 (1941) (“But the sufficiency of the notice must be determined from the language

used. It is idle to speculate that the Commissioner must have intended to give petitioners a notice of deficiency before the bar of the statute had fallen.”); *Lerer v. Comm’r*, 52 T.C. 358, 365 (1969) (“[T]he sufficiency of the notice must be determined from the language used.”); *Barnes v. Comm’r*, 130 T.C. 248, 254 (2008) (judging the government’s intent by the language used in the notice); *Bourekis v. Comm’r*, 110 T.C. 20, 26 (1998) (judging whether the government “intended” a notice of deficiency to serve as such by looking to the language of the relevant documents).

Many other cases not cited by the government make it abundantly clear that the Commissioner’s intent is to be judged from the face of the document. *See Musso v. Comm’r*, 531 F.2d 772, 774 (5th Cir. 1976) (taxpayer conceded that the notice was not a notice of deficiency, and the court agreed from a review of the notice); *Guaba v. Comm’r*, 80 T.C.M. (CCH) 201, 203 (2000) (evaluating the language of a letter to determine it was not intended to be a notice of deficiency); *Kane v. Comm’r*, 57 T.C.M. (CCH) 648, 650 (1989) (“[I]t is clear from the letters that they were not intended as notices of deficiency.”).<sup>3</sup>

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<sup>3</sup> In *Hubbard v. Commissioner*, 89 T.C. 792 (1987), the Tax Court did state 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,” but it did so in determining the reasonableness of the government’s position after the government

To do otherwise would violate the well settled principle that courts “do not ‘look behind the notice of deficiency to determine or examine the evidence used, or the propriety of the Commissioner’s motives in making the deficiency determinations.’” *Vaksman v. Comm’r*, 54 F. App’x 592, at \*2 (5th Cir. 2002) (quoting *Pasternak v. Comm’r*, 990 F.2d 893, 898 (6th Cir. 1993)); *see also Henry v. United States*, 277 F. App’x 429, 434 (5th Cir. 2008) (“Section 7422 does not empower the district court to look behind the deficiency notice and to accept or reject it based on the IRS’s means or motives.”); *Sealy Power*, 46 F.3d at 386 n.9 (“[C]ourts have reaffirmed their reluctance to look behind the notice of deficiency to determine whether the Commissioner’s determination is arbitrary.”); *Greenberg’s Express, Inc. v. Comm’r*, 62 T.C. 324, 327 (1974).

The government offers no compelling reason for the Court to disregard the established law to “look behind” the March 25 notice to determine what the Commissioner intended. Indeed, to allow such an inquiry would obviously open the door to the very “tax protesters” mentioned in the government’s brief to challenge future notices by making claims about the Commissioner’s intent and

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had conceded that it did not intend the letter it sent to the taxpayer to be a notice of deficiency. 89 T.C. at 801-03 (emphasis added). Thus, even in *Hubbard*, the court did not look beyond the language of the notice of deficiency.

demanding discovery to prove those claims. Courts have until now refused to allow precisely that type of discovery. *See, e.g., Karlin v. Comm'r*, 60 T.C.M. (CCH) 795, 796 (1990) (refusing to allow a taxpayer to take discovery into the Commissioner's reasons for issuing a notice and the procedures followed, so the taxpayer could challenge its validity). In any event, even if the Court were inclined to "look behind" the March 25 notice, all it would find would be Agent Doerr's deposition testimony that he intended that notice to be the final notice to the Partnership indicating that no adjustment would be made to its return. That is all that is required under the statute and case law for it to be a notice of final partnership administrative adjustment.

B. Whether Doerr Lacked Authority Under Internal IRS Delegation Orders to Issue the March 2005 Notice of Final Partnership Administrative Adjustment is Immaterial.

The government suggests that the March 25 notice could not be a notice of final partnership administrative adjustment because Agent Doerr allegedly did not have the authority to issue such a document. (Resp. Br. at 38-39.) That claim must fail for any of three different reasons.

First, the March 25, 2005, notice is an official act of the agency that is entitled to a presumption of regularity. "The presumption of regularity supports the official acts of public officers, and, in the absence of clear evidence to the contrary, courts presume that they have properly discharged their official duties."

*United States v. Chemical Found., Inc.*, 272 U.S. 1, 14-15 (1926); *see also F.C.C. v. Schreiber*, 381 U.S. 279, 296 (1965) (recognizing the presumption that administrative agencies “will act properly and according to law”); *Webster v. Estelle*, 505 F.2d 926, 929-30 (5th Cir. 1974) (“Official records are entitled to a presumption of regularity.”).

Nothing in the record provides any basis for rebutting the presumption of regularity that attaches to the March 25, 2005, notice. Agent Doerr testified that “[e]very case requires a manager’s approval to close” and that, although he did not personally place the March 25, 2005, notice in the mail, his typical practice was to prepare the notice and for it thereafter to be mailed by someone else, such as his manager or a processing unit. (P. Ex. 49 at 51, 53.) The government elected not to call Agent Doerr as a witness in this case; the government also failed to put on any evidence indicating that the March 25, 2005, notice was not properly issued in the manner that Agent Doerr described. Absent any clear evidence to the contrary, the presumption of regularity plainly applies and it should, therefore, be presumed that the March 25, 2005 notice was issued “properly and according to law.”

Indeed, there is no testimony from Agent Doerr on this topic because the government failed to bring him to trial, and the government failed to present any admissible evidence, let alone prove, as it claims, that he was not authorized to issue such a notice. Instead of bring Agent Doerr to trial, the government elected

to bring Agent Robert Gee. (R3170.) Agent Gee, however, was not Doerr's supervisor with respect to the audit of the Partnership (R3177), and he had no personal knowledge of the circumstances surrounding the issuance of the March 2005 letter, other than what Agent Doerr told him in person and through e-mail exchanges (R3176). The district court made abundantly clear, however, that what Agent Doerr told Agent Gee was inadmissible hearsay: "I'm not going to listen – I'm not going to permit this. That's just pure hearsay that you're trying to get around bringing somebody here that has personal knowledge of something that's at issue in this court, and y'all – y'all are trying to end run me. . . . I'm sustaining the objection as to anything that Mr. Doerr told you." (R3167, 3175-77.) Thus, there is no basis for the government's claim that Agent Doerr was not authorized to issue the March 25, 2005, notice.

Second, this Court has already rejected the very argument that the government makes here: that a notice is invalid if it is signed by an official who lacked authority to issue it. (Resp. Br. at 39 n.9.) In *Selgas*, this Court held that whether an IRS agent lacks authority to issue a notice of deficiency is "irrelevant" to determining the validity of the notice of deficiency, since the relevant statute does not prescribe "any particular form of notice or specify any content it must include." *Selgas*, 475 F.3d at 700. The Fifth Circuit further explained that "[t]he existence of a signature or the identity of any IRS official who provides one, is

superfluous” to determining the validity of a notice. *Id.* See also *Israel v. Comm’r*, 86 T.C.M. (CCH) 694, 696 (2003) (“[P]etitioner’s argument that the person who sent the notices of deficiency did not have the delegated authority to send them has been deemed by this Court to be frivolous.”).<sup>4</sup> Thus, the precedent of this Court forecloses the very argument that the government seeks to make here.

Third, “delegation orders do not affect the rights and obligations of citizens. They are not substantive or legislative-type rules of law, but rather rules of internal agency/management procedure.” *Stamos v. Comm’r*, 95 T.C. 624, 631 (1990), *aff’d*, 956 F.2d 1168 (9th Cir. 1992), *cert. denied*, 506 U.S. 873 (1992); see also *Selgas*, 475 F.3d at 699 (“IRS internal operating procedures confer no rights on individual taxpayers[.]”), *Cullen v. Comm’r*, 64 T.C.M. (CCH) 673, 674 (1992) (same). Accordingly, even if Agent Doerr had not been authorized to issue the March 25 notice, and even if that somehow still matters after *Selgas*, the

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<sup>4</sup> The cases the government relies on in support of its argument do not require the Court to disregard its precedent in *Selgas* or the Tax Court’s precedent in *Israel*. In *Craig v. Commissioner*, 119 T.C. 252 (2002), the court did not hold that authority to issue a notice was a necessary condition for a notice to be valid. And the discussion in *Kellogg v. Commissioner*, 88 T.C. 167, 172 (1987), that the government relies upon is mere dicta and inconsistent with the familiar rule stated in that very case that the “sufficiency of the notice must be determined from the language used.”

Partnership was permitted to waive that defect. *See Donohue v. Comm'r*, 37 T.C.M. (CCH) 954, 956 (1978).

**III. The District Court Erred in Holding that NPR's Innocent Mistake on its 2001 Partnership Tax Return was a Misrepresentation of a Material Fact Under Section 6223(f).**

A. A Misrepresentation of a Material Fact Under Section 6223(f) Requires Wrongful Culpability that at Least Rises to Gross Negligence or Recklessness.

The government's argument that the term "misrepresentation" in Section 6223(f) should be defined to include innocent mistakes must fail for the simple reason that it would have the exception swallow the rule. Section 6223(f) prohibits the IRS from issuing more than one notice of final partnership administrative adjustment to a partnership unless there has been "a showing of fraud, malfeasance, or misrepresentation of a material fact." The IRS, of course, would only be incentivized to issue a second notice when the partnership has misreported a fact on its tax return. Thus, defining "misrepresentation" to include innocent mistakes would gut the prohibition in Section 6223(f) against the IRS issuing more than one notice. The government has no answer for this except to say that the exception "only applies to misrepresentations of material *facts* (not disputed tax *positions*)" which purportedly keeps the "floodgates" closed. (Resp. Br. at 22 (emphasis in original).) That is completely nonsensical, of course, as all tax *positions* are based on *facts*. It is plainly obvious that to allow the IRS to send a

second notice of adjustment whenever it learns that a partnership has made a material mistake of “fact” on its tax return would eviscerate the prohibition against second notices in Section 6223(f).

The government discusses a number of cases interpreting Section 6532(b) in its brief, but these cases offer no support for its position. Section 6532(b) (as presently written) generally extends the time that the IRS has to pursue recovery of an erroneous refund made to a taxpayer from two years to five years “if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact.” The cases cited by the government do not define “misrepresentation” even in this context to include innocent mistakes; they expressly require at least a showing of recklessness or gross negligence. *Lane v. United States*, 286 F.3d 723, 732 (4th Cir. 2002); *United States v. Northern Trust Co.*, 93 F. Supp. 2d 903, 909 (N.D. Ill. 2000), *rev’d on other grounds*, 372 F.3d 886 (7th Cir. 2004).<sup>5</sup>

Indeed, the government recognizes there are “some legal contexts in which the term ‘misrepresentation’ connotes some degree of scienter,” yet the

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<sup>5</sup> Indeed, there is good reason to define “misrepresentation” more narrowly under Section 6223(f) than the definition given that term by the courts for purposes of Section 6532(b), since the government has traditionally been granted broad power to bring legal action to recover refunds of money belonging to the treasury that was erroneously paid. *See Black Prince Distillery, Inc. v. United States*, 586 F.Supp. 1169, 1174 (D.N.J. 1984); *United States v. Wurts*, 303 U.S. 414, 416 (1937).

government never gives any reason for its claim that Section 6223(f) “is not one of them.” (Resp. Br. at 16.) To the contrary, the “legal context” of Section 6223(f) requires “misrepresentation” to mean something more than an innocent mistake of fact, for to read it otherwise would vitiate the main purpose of the statute: to prohibit the IRS from issuing more than one notice of final partnership administrative adjustment to a partnership in any given year.

The government asserts, however, that because Section 6223(f) also uses the term “malfeasance,” “misrepresentation” must mean “innocent mistake” in order to give independent meaning to all three terms: fraud, malfeasance, and misrepresentation. Essentially, the government argues that “malfeasance” means negligence, and “fraud” means intentional wrongdoing, so “misrepresentation” must mean “innocent mistake.” That is easily disproven, however, for the simple reason that “malfeasance” does not mean “negligence.” Misfeasance and nonfeasance include elements of negligence, while malfeasance does not. See BLACK'S LAW DICTIONARY 1090, 1153 (9th ed. 2009) (misfeasance and nonfeasance); see also *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 65 (Tex. 1997).

All three terms can be defined however, such that they all do have independent meaning. The term “fraud” is defined as a “knowing misrepresentation of the truth or concealment of a material fact to induce another

to act to his or her detriment.” BLACK'S LAW DICTIONARY 731 (9th ed. 2009) (fraud). “Malfeasance” is defined more broadly than “fraud” as a “wrongful or unlawful act,” which may or may not be fraud but is still willful. BLACK'S LAW DICTIONARY 1042 (9th ed. 2009) (malfeasance). Neither fraud nor malfeasance include a culpability of gross negligence or negligence. Accordingly, defining “misrepresentation” to require at least negligence would provide independent meaning to each of the terms in the statute.

In any event, this Court need not decide whether “misrepresentation” as it is used in Section 6223(f) requires intentional wrongdoing, gross negligence, recklessness, or even negligence, because the government failed to prove any of these. Indeed, the government never even deposed anyone from the accounting firm that prepared the Partnership’s tax return or made any attempt to bring the return preparer to trial. There is thus not even a scintilla of evidence in the record to support a finding that the return was negligently prepared and, of course, the district court made no such finding. It is therefore no surprise that the government suggests – for the first time in this appeal – that negligence exists here because “somebody” handwrote the answer to question 2 on Schedule B to the return. (Resp. Br. at 20 n.4.) That new claim must fail for the simple reason that it was not raised below, *see Wiley v. State Farm Fire & Cas. Co.*, 585 F.3d 206, 214 n. 21 (5th Cir. 2009), and, in any event, it obviously falls far short of satisfying the

government's burden of showing a misrepresentation, even if that burden would be satisfied by showing mere negligence.

B. A Misrepresentation of a Material Fact Under Section 6223(f) Requires that the IRS Show it Reasonably Relied Upon the Misrepresentation.

The government's claim of misrepresentation must fail for the alternative reason that the IRS was not reasonable in relying on the mistake on the Partnership's tax return. For this purpose, the Court need not determine whether "misrepresentation" means "fraudulent misrepresentation," "negligent misrepresentation" or "innocent misrepresentation," because each requires reasonable reliance upon the misrepresentation. *See Hunter v. Pricekubeka, PLLC*, 339 S.W.3d 795 (Tex. App. 2011) (fraudulent misrepresentation requires reliance); Restatement (Second) of Torts § 525 (2011) (fraudulent misrepresentation requires justifiable reliance); *Fed. Land Bank Ass'n v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991) (negligent misrepresentation requires reasonable reliance); Restatement (Second) of Torts § 552A (2011). Even the definition of "misrepresentation" advocated by the government — "innocent misrepresentation" — requires a showing of reasonable reliance on a material misrepresentation. *See Sheldon Co. Profit Sharing Plan and Trust v. Smith*, 858 F.Supp. 663, 670 (W.D. Mich. 1994).

The government dismisses these cases as being “inapposite, as they deal with common law tort principles.” (Resp. Br. at 25.) Notably, the government also dismisses cases involving contract disputes as being inapposite. (Resp. Br. at 24-25.) The government fails to explain, however, how any of the terms “fraud, malfeasance, or misrepresentation of a material fact” should be defined for purposes of Section 6223(f) if not by reference to their usage in the common law in tort or contract. Certainly the government did exactly that in its repeated citation to Black’s Law Dictionary which is nothing more than a dictionary of legal terms as they are used in the common law

Moreover, Section 6231(g)(2) confirms what is already inherent in the term “misrepresentation,” that the IRS must reasonably determine whether TEFRA is applicable when relying on statements in a partnership tax return. The government claims that Section 6231(g) does not apply in this case by attempting to mislead the Court into focusing on the second notice of final partnership administrative adjustment that was issued on August 15, 2005. (Resp. Br. at 26.) The issue is not, as the government suggests, whether the IRS was reasonable when it issued the August 2005 notice. Rather, the issue is whether the IRS was reasonable in believing that the Partnership was not subject to the TEFRA rules when it issued the March 2005 notice. Indeed, the government claims that the mistake on the Partnership’s tax return misled the IRS to treat the Partnership as though it were

not subject to TEFRA and to issue the March 2005 notice. Section 6231(g) governs this precise situation: it provides that the TEFRA procedures will not apply if the IRS “reasonably determines” on the basis of the partnership return that TEFRA should not apply. That is precisely what the government claims occurred in this case, and the reasonableness requirement in Section 6231(g) is controlling.

The government does not even claim that the IRS’ reliance on the mistake on the Partnership’s tax return was reasonable. To the contrary, the government concedes that it was “unclear” to Agent Doerr after his review of the Partnership’s tax return whether it was subject to TEFRA. (Resp. Br. at 5.) He then discussed it with his manager and they “determined that they would rely on the statement in the return indicating that the Partnership was not subject to those procedures.” (*Id.*) While that may establish – as the district court found – that the IRS relied on the Partnership’s return, it falls far short of demonstrating that such reliance was reasonable. Notably, the government does not point to any evidence in the record to suggest that Agent Doerr acted reasonably, for there is none. There is absolutely no evidence that even suggests, for example, that Agent Doerr or his manager conducted any investigation into the discrepancies on the Partnership’s return. Nor does the government even attempt to explain how the IRS was able to determine that the Partnership was subject to the TEFRA procedures only a few months later based on the same information that was available in March.

This might have been resolved had the government brought Agent Doerr to trial. The government argues at length that the Court should not draw an adverse inference against it for its failure to produce Agent Doerr, but that is really beside the point. As noted above, it was incumbent on the government to show that it reasonably relied on the mistake on the Partnership's return and it failed to meet that burden.

While it is not necessary for the Court to draw the adverse inference requested by the Partnership, since the government has failed to satisfy its burden, the adverse inference should have been given. At the pre-trial conference in this case the government took the position that the district court's order on the Partnership's motion for summary judgment resolved the "second notice" issue against the Partnership as a matter of law. That position was inexplicable, however, as the government had not cross-moved for partial summary judgment. Thus, the district court made clear that this was an issue for trial. (R3499 ("Well, let me make it clear . . . . We'll try the issue.")) At trial, the Partnership asked the Court to draw an adverse inference from the government's failure to bring Agent Doerr to trial. In response, the government claimed that, notwithstanding the discussion that had taken place at the pre-trial conference, it did not know the second notice issue was going to be an issue for trial. The district court found that position to be wholly unreasonable: "Well, yes, you did know, and to suggest that

the order was that unclear strains your credibility considerably with the Court.” (R3362-63.)

The government exhibits the same indifference here, feigning disbelief that the district court found the March 2005 notice to be a notice of final partnership administrative adjustment “on the same legal arguments it had previously rejected as ‘unavailing.’” (Resp. Br. at 9.) The government’s characterization of the district court’s about-face with respect to the validity of the March 2005 notice is, obviously, less than accurate. While the district court did decide the issue based on the same legal standards, the factual record was not the same, since at trial and in its post-trial briefing the Partnership was able to point to Agent Doerr’s deposition testimony that he intended the March 2005 notice to be the “final notice” to the Partnership. (P. Ex. 49 at 61-62.)

The government also argues, in the same vein, that the Partnership was not prejudiced by its failure to bring Agent Doerr to trial because: 1) he was identified as a witness that it may call, 2) counsel for the Partnership represented that it would use Agent Doerr’s deposition testimony to establish any facts relevant to the validity of the March 2005 notice, and 3) the Partnership had the opportunity to depose Agent Doerr. (Resp. Br. at 29.)

The assertion that counsel for the Partnership represented that it would rely solely on Agent Doerr’s deposition testimony is patently false (R3498), and the

government's decision to call Agent Gee, who could not offer any meaningful or relevant testimony on Agent Doerr's intent or authorization vis-à-vis the March 2005 notice, as a witness rather than Agent Doerr deprived the Partnership and the district court of the opportunity to explore admitted inconsistencies in Agent Doerr's testimony. (R3361.) Indeed, at trial, the government described Agent Doerr's testimony to the court: "Mr. Doerr's deposition, when you read it, you're going to find that he was confused. Did he know? Should he have known?" (*Id.*) That being the case, the Partnership and the Court were prejudiced by the government's decision not to call Agent Doerr. The government's failure to call Agent Doerr, therefore, should result in an adverse inference being drawn against the government that the IRS was not reasonable in relying on the mistake on the Partnership's tax return.

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The Court should reverse the judgment of the district court that the IRS was permitted to issue a second notice of final partnership administrative adjustment on August 15, 2005. The second notice was prohibited by Section 6223(f) and the exception to that rule for misrepresentations of material fact did not apply.

**IV. The District Court Properly Considered the Partners' Good Faith and Reasonable Cause Defenses Contemporaneously With the Accuracy-Related Penalties in the Proceedings Below.**

The government raised a new argument in the reply portion of its brief regarding its penalty claims that we will briefly address here. The government argues that it is simply irrelevant that the losses that could potentially give rise to a penalty in this partnership-level proceeding were not claimed on the partnership return, and that the penalties at issue are all appropriately determined in this proceeding because the adjustments made in the August 15 notice of final partnership administrative adjustment are conclusive. (Resp. Br. at 40-42.)

Essentially, the government now argues with respect to the valuation misstatement penalties that the “issue is not whether the partnership overstated the value or basis of any property on its return,” but is instead “the propriety of the IRS partnership-item adjustments that result in the asserted valuation misstatement.” (*Id.* at 40-41.) Similarly, regarding the substantial understatement penalty, the government asserts that the issue is not whether there was substantial authority for the actual losses claimed, but again that “the issue is whether there was substantial authority for the Partnership’s treatment of the partnership items that engendered those deductions.” (Resp. Br. at 48-49.) The obvious net effect of this is that the government is seeking to extend the jurisdiction of the district court to impose a penalty in the partnership proceeding based on “partnership items” that presumably

involve the conduct of the partners (the government has not identified what adjusted “partnership item” would cause a penalty). At the same time, the government claims that the district court lacked jurisdiction to consider whether the partners engaged in that same conduct reasonably and in good faith.

The government’s position is nonsensical. The penalty statute, Section 6662, is very clear. There can only be a valuation misstatement penalty if there is an overstatement of “the value of any property (or the adjusted basis of any property) on a return.” *See* Section 6662(e)(1)(A). Even if all of the adjustments made by the IRS in the notice of final partnership administrative adjustment had been sustained, none of those adjustments, which were all adjustments to the Partnership’s return, result in the overstatement of the value or basis of any property on the partnership return that would be sufficient to invoke the penalty.<sup>6</sup> The penalty could only apply, if at all, if the government had proven that the law firm overstated basis in the foreign currencies that it sold.

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<sup>6</sup> The government also claims for the first time that all of the adjustments made in the notice of final partnership administrative adjustment are deemed to be “conclusive.” (Resp. Br. at 42.) Of course, as even recognized by the government, that rule does not apply when the IRS’ adjustments are contested and the court issues a contrary decision, which is precisely what occurred in this case when the district court declined to uphold the penalties.

Similarly, the “substantial authority” exception to the substantial understatement penalty works by reducing the amount of the understatement that would be subject to a penalty for any position for which there is substantial authority. Section 6662(d). It is nonsensical, then, to apply the exception to the penalty at the partnership-level (by determining, as the government claims, “whether there was substantial authority for the Partnership’s treatment of the partnership items that engendered those deductions”), when the penalty itself could only apply based on deductions claimed at the partner-level.

The rules are clear: if the penalty relates to an adjustment to a partnership item, it is to be determined in the partnership proceeding. *See* Section 6221. If the penalty relates to an adjustment to an affected item, it is to be determined in the partner-level proceeding. *See Jade Trading, LLC v. United States*, 98 Fed. Cl. 453 (2011); *Petaluma FX Partners, LLC v. Comm’r*, 591 F.3d 649 (D.C. Cir. 2010). There is no “Catch-22” as the government claims. The government wants the penalty to be determined in this partnership-level proceeding, but carefully avoids identifying the partnership item that could support its penalty claims. That is because, as explained in our prior brief, the only conduct that could support these penalties is the partners’ contributions of the options to the Partnership, the partners withdrawal from the Partnership and receipt of the foreign currencies, the partners’ contribution of those currencies to the law firm, and the law firm’s sale of

those currencies for claimed tax losses. We, and apparently the government, believe this conduct is a partnership item that the district court properly considered in this proceeding. The district court therefore also appropriately considered in this proceeding whether that conduct was undertaken reasonably and in good faith.

### CONCLUSION

The judgment of the district court that the IRS was permitted to issue a second notice of final partnership administrative adjustment in this case should be reversed. The Court should accordingly declare that the notice issued by the IRS on August 15, 2005 was not valid.

Dated: August 15, 2011

s/ Thomas A. Cullinan \_\_\_\_\_

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**CERTIFICATE OF SERVICE**

I hereby certify that on August 15, 2011, I electronically filed the foregoing brief with the Clerk of the Court using the CM/ECF system. Participants in the case who are registered CM/ECF users will be served by the CM/ECF system.

I further certify that on August 15, 2011, I mailed by First Class Mail two (2) copies of the foregoing brief to the following participant who is not registered to receive electronic CM/ECF notices:

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