

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’ PRINCIPAL AND RESPONSE BRIEF**

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Plaintiffs – Appellees Harold W. Nix and Charles C. Patterson  
(collectively referred to hereinafter as “Cross-Appellants”)*

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## CERTIFICATE OF INTERESTED PERSONS

(1) No. 10-41219: *NPR Investments, LLC, Plaintiff – Appellee-Cross-Appellant; Harold W. Nix, Charles C. Patterson, Intervenor Plaintiffs – Appellees v. United States of America, Defendant – Appellant-Cross Appellee.*

(2) The undersigned counsel of record certifies that the listed persons and entities as described in the fourth sentence of Rule 28.2.1 have an interest in the outcome of the case. These representations are made in order that the judges of this Court may evaluate possible disqualification or recusal.

- a. NPR Investments, LLC, Plaintiff – Appellee-Cross-Appellant;
- b. Harold W. Nix, Intervenor Plaintiff – Appellee;
- c. Charles C. Patterson, Intervenor Plaintiff – Appellee;
- d. Carol A. Nix, Spouse of Harold W. Nix;
- e. Mary L. Patterson, Spouse of Charles C. Patterson;
- f. Nelson J. Roach, Partner in NPR Investments, LLC;
- g. Sutherland Asbill & Brennan LLP, Counsel for Plaintiff – Appellee-Cross-Appellant and Intervenor Plaintiffs – Appellees (Kent L. Jones, Thomas A. Cullinan, and Kurt E. Lentz);
- h. United States of America, Defendant – Appellant-Cross-Appellee; and

i. Department of Justice, Counsel for Defendant – Appellant-Cross-Appellee (Richard Farber and Arthur T. Catterall).

s/ Thomas A Cullinan  
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**STATEMENT REGARDING ORAL ARGUMENT**

Cross-Appellants believe that oral argument would be beneficial to the Court given the large number of complex questions of law that are at issue in the cross-appeal.

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## STATEMENT OF JURISDICTION

Cross-Appellants agree with the government's Statement of Jurisdiction, but add that they filed their notice of cross-appeal on November 30, 2010. The cross-appeal is therefore timely. *See* FED. R. APP. P. 4(a)(3).

## STATEMENT OF THE ISSUES

In addition to responding to the issues raised in the government's appeal, this cross-appeal presents the following issue<sup>1</sup>:

Whether the district court erred in holding that the government was entitled to issue a second notice of final partnership administrative adjustment based on its finding that NPR Investments, LLC misrepresented a material fact on its tax return.

## STATEMENT OF FACTS

This federal tax case involves NPR Investments, LLC ("NPR"), a partnership "formed for various investment purposes in August 2001." (R2700.) Notwithstanding this clear finding of the district court, the government premises its entire argument on its refusal to acknowledge that Harold W. Nix, Charles C. Patterson, and Nelson J. Roach (the "Partners") invested in NPR with the hope and expectation of earning a profit. In the improper guise of a "statement of facts," the

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<sup>1</sup> In its Statement of the Issues the government alleges this case involves "a scheme designed to generate \$65 million of artificial (i.e., non-economic) tax losses for Harold Nix, Charles Patterson, and Nelson Roach." (Appellant's Br. at 2.) As explained more fully below in our Statement of Facts, however, the district court found that these individuals made the investments at issue for the express purpose of earning a profit.

government spends twenty-five pages of its brief rearguing its rejected theories that the Partners did not enter into these transactions to earn a profit, that the transactions could not have been profitable, and that the Partners' sole motivation for engaging in these transactions was to avoid taxes. (Appellant's Br. at 5-30.) The district court expressly rejected each of these arguments after a three-day trial, finding that the Partners "sought to make a profit from the investment plan when they entered the pertinent transactions" (R2719-2720), that the Partners "had a reasonable belief that they could make a profit with the transactions" (R2725), and that the "investment strategy could be profitable, excluding any advisement fees, in one of two ways." (R2702.) The district court based its findings of fact on the entire record. (R2700.) The government does not even allege, let alone attempt to show, any clear error in the findings. Nor could it, for there is plainly substantial evidence in the record to support these findings.<sup>2</sup>

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<sup>2</sup> In particular, the Partners' testimony regarding their investment motives requires credibility determinations that are the province of the trial court. As to whether the transactions could, in fact, have been profitable, the overwhelming evidence demonstrated that they could. (R2702.) While one of the government's experts (Dr. DeRosa) argued that the counterparty bank to these transactions could have avoided paying out profits essentially by acting in bad faith (R3267-3268), there is no evidence in the record to suggest that the bank would have acted in bad faith. Moreover, Dr. DeRosa lost all credibility when he proclaimed that the Partners, who have no background or training in finance, should have intuitively analyzed the potential profitability of these transactions using complicated financial modeling. (R3329-30; P. Ex. 52.) The government's other expert, Dr. Read, admitted that the transactions could have been profitable. (R3219-20.)

Similarly, the government argues without factual basis that NPR was formed as part of a tax shelter scheme, that the Partners' decision to withdraw from NPR was pre-planned, and that the Partners attempted to hide their tax reporting of these transactions from the IRS. (Appellant's Br. at 9-26.) The trial court explicitly found that "NPR was formed for various investment purposes in August 2001" (R2700), that the Partners "resigned from NPR based on Roach's decision to withdraw for personal reasons," (R2706), and that the Partners acted reasonably in relying on their long-time tax advisor, Sid Cohen, to prepare their tax returns. (R2725-26.) Other than the Partners' reason for withdrawing from NPR, the government does not even allege any clear error in these findings.<sup>3</sup>

The Partners adopt the district court's findings of fact, except for one inference that the trial court erroneously made in favor of the government regarding whether the IRS relied on a mistake on NPR's tax return (R2715-16), as discussed further below. The Partners briefly summarize some of the trial court's more important findings here for the convenience of the Court, supplemented as noted with certain references to the record.

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<sup>3</sup> The Partners' reason for withdrawing from NPR is the one factual finding for which the government alleges clear error. As discussed below, the district court did not clearly err by finding that the Partners withdrew from NPR based on Roach's decision to withdraw for personal reasons.

In late 2001, the Partners bought options on various foreign currencies and contributed them to NPR. (R2703.) The structural details of the investment and the contribution are described in the district court's Memorandum Opinion and Order. (R2700-2704.) As the district court expressly found, "[t]he [Partners] sought to make a profit from the investment plan when they entered the pertinent transactions." (R2719-2720.) The Partners reasonably believed that the transactions provided a chance to earn substantial profits. (R2725.) The Partners did not enter into the transactions for the purpose of avoiding taxes. (R2701, 2841-42, 3023, 3069.)

The Partners withdrew from NPR in December 2001 "based on Roach's decision to withdraw for personal reasons." (R2706). Upon withdrawing from NPR, they received foreign currencies in liquidation of their membership interests. (R2704.) The Partners contributed these foreign currencies to their law firm partnership, Nix, Patterson & Roach, LLP (the "law firm"). (R2704.) The law firm then sold certain of the currencies in 2001, 2002, and 2003, and claimed tax losses on the sales. (R2704.)

The losses that the law firm claimed on the sales of the foreign currencies were specially allocated to the Partners, as they were the partners who contributed the currencies to the law firm. (R2704.) Only a small amount of the foreign currencies were sold in 2001 and the resulting losses were allocated solely to

Roach (because only currencies contributed by him were sold), who reported the loss on his 2001 individual tax return. (R2873, 3041, 3075.) The bulk of the foreign currencies were sold in 2002 and 2003, with the resulting losses being allocated among the Partners. The Partners did not, however, claim the tax losses allocated to them from the sale of the foreign currencies in 2003 on their 2003 individual tax returns. (*See, e.g.*, R2884; *see also* P. Exs. 8, 10, 13.) Instead, as explained further below, the Partners were informed in 2002 that the IRS would likely challenge these losses, so the Partners caused Cohen to file multiple disclosure statements with the IRS that described the transactions with precise detail. (R2872-2874, 2949-2952, 3005, 3041-42, 3076-77.) The Partners were not then conceding that the IRS position was correct (R2874, 3041-42, 3076-77); rather, they filed the disclosures only to provide clear notice of the issue to the IRS.

Prior to filing any of their tax returns or the tax returns that were filed by NPR and the law firm, the Partners each obtained “a thorough, written opinion from Sidley Austin that detailed the proper tax treatment of their investments.” (R2706, 2725.) The Partners were familiar with Sidley Austin’s reputation as a premier tax firm and their tax advisor Cohen recognized R.J. Ruble – one of its partners – as an “acknowledged partnership tax expert.” (R2706.) The Partners reposed great trust in Sidley Austin, as evidenced by the fact that they also turned

to Sidley Austin for advice on how to restructure their law firm partnership – their most valuable asset. (R2954-55.)

The Partners did not blindly rely on the tax opinions they received from Sidley Austin. They reviewed the tax opinions with Cohen, their trusted tax advisor, who, after reviewing the opinions, concluded that Sidley Austin “had cited the important areas where there might be potential controversy and had adequately dealt with them to [his] satisfaction that [the Partners] would be okay.” (R2706). Cohen advised the Partners that “they could rely on the opinions because Sidley Austin was a ‘very well known firm’” and “because the opinions were ‘very, very well reasoned.’” (R2706.) At trial, the Partners’ expert Stuart Smith, who has over 40 years of experience as a tax lawyer, both as a Tax Assistant to the Solicitor General in the Department of Justice and in private practice, reached the same conclusion, opining that “the opinions provided ‘objectively reasonable tax advice’ because they ‘discussed all of the authorities in an even-handed balanced way, taking into account all possible challenges in a thorough and complete manner.’” (R2719.)

Not only did the Partners rely on the professional advice of their tax advisors in reporting the transactions but, contrary to the government’s unfounded allegations that the Partners tried to hide the transactions, the Partners went to great lengths to disclose the transactions on their returns. In this regard, on their 2002

tax returns, on which the vast majority of losses at issue were claimed, the Partners included disclosure statements that provided detailed descriptions of the transactions, informing the IRS that the “[p]rincipal tax benefits of the transaction[s]” were that the law firm “recognized foreign currency losses upon its disposition of nonfunctional foreign currency,” providing estimates of the “expected reduction of federal income tax liability” for each of the Partners, and identifying the entity that “promoted, solicited, or recommended” the investments. (R2705; P. Exs. 6, 7, 9, 12.) The Partners chose to make these disclosures even though they were advised that they were not technically required to do so. (R2874, 2950.)

Ultimately, NPR’s return was examined by Paul Doerr, an Internal Revenue Service Revenue Agent. (R2707.) Doerr initially determined not to adjust any items on NPR’s return. Instead, Doerr determined the IRS should deny the losses related to the Partners’ participation in NPR by issuing notices of deficiency directly to NPR’s partners under the non-TEFRA audit procedures. He determined to do this apparently because the tax losses at issue were not claimed on NPR’s tax return. (R2707.) On March 25, 2005, Doerr issued a letter to NPR indicating that the IRS had finished its audit of NPR and that no changes would be made to its return. (R2707.) Subsequently, a different IRS agent, Robert Gee, concluded from the same information available to Doerr that NPR was subject to the TEFRA audit

procedures and that the adjustments should be made at the partnership level by issuing a notice of final partnership administrative adjustment to NPR. (R2708.) As a result, the IRS sent what purported to be a second notice of final partnership administrative adjustment on August 15, 2005. (R2707-2708; P. Ex. 1.)

Roach responded to the August 15, 2005, notice of final partnership administrative adjustment by filing a petition in the Eastern District of Texas, contesting the adjustments proposed by the IRS. (R26-R55.) The other Partners subsequently intervened in the case. (R492-501.) On August 10, 2009, the Partners amended their petition to concede the underlying merits of the dispute on the ground that NPR “did not enter ‘into the option(s) positions or purchase the foreign currency or stock with a profit motive’” – one of the grounds asserted in the August 15, 2005, notice to support disallowance of the tax losses. (R580; P. Ex. 1.) The Partners did not concede the correctness of any of the alternative grounds set forth in the August 15, 2005, notice. (R580-581.) The Partners conceded the single ground described above to avoid the “hazards and significant litigation costs associated with litigating all of the grounds on which [the Government] based its adjustments to [NPR’s] tax return.” (R610.) The Partners reached their decision to concede after considering recent precedent, including the district court’s and this Court’s decisions in *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); (R610). Specifically, the Partners recognized the difficulties

they would face in proving that NPR's original, professional managers – individuals who would not be available to testify at trial – had a profit motive based on this Court's finding in *Klamath* that the profit motive of the professional managers at the time the transaction was entered into would be relevant in determining whether the transaction had economic substance. *See Klamath*, 568 F.3d at 545.

### **SUMMARY OF ARGUMENT**

1. The district court correctly held that the March 25, 2005, notice was a valid notice of final partnership administrative adjustment. The Court erred, however, in holding that the government was entitled to issue a second notice of final partnership administrative adjustment based on its finding that NPR misrepresented a material fact on its 2001 partnership tax return.

2. The district court correctly held that the accuracy-related penalties under 26 U.S.C. § 6662<sup>4</sup> did not apply.

a. The district court correctly determined that the valuation misstatement penalties were inapplicable as a matter of law under this Court's decisions in *Heasley v. Commissioner*, 902

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<sup>4</sup> References to sections are to sections of 26 U.S.C., the Internal Revenue Code of 1986, as amended.

F.2d 380 (5th Cir. 1990) and *Weiner v. United States*, 389 F.3d 152 (5th Cir. 2004).

b. The district court correctly held that the Partners had “substantial authority” for the position taken on the law firm’s and their individual tax returns and that the substantial understatement and negligence penalties did not apply.

3. The district court had jurisdiction to consider the Partners’ reasonable cause defenses in the proceeding below.

4. The district court correctly held that the Partners acted reasonably and in good faith when relying on the tax opinion letters they received from Sidley Austin.

## ARGUMENT

### **I. The District Court Erred in Holding that the Government had Authority to Issue the Second Notice of Final Partnership Administrative Adjustment.**

#### **A. Standard of review.**

Questions of statutory interpretation are questions of law subject to de novo review. *United States v. Clayton*, 613 F.3d 592, 595 (5th Cir. 2010).

#### **B. The district court erred in holding that an innocent mistake may constitute fraud, malfeasance, or misrepresentation of a material fact.**

Pursuant to the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), the tax treatment of “partnership items” is to be determined at the

partnership level. 26 U.S.C. § 6221. When the IRS seeks to adjust partnership items in a partnership-level administrative proceeding, TEFRA requires that the IRS give “notice of . . . the final partnership administrative adjustment resulting from such proceeding.” 26 U.S.C. § 6223(a). The district court correctly determined that the March 25, 2005, letter issued by the IRS with respect to NPR’s 2001 tax return was a valid notice of final partnership administrative adjustment resulting from the IRS audit of NPR. (R2712.)

The district court erred, however, in finding that the IRS was permitted to issue a second notice of final partnership administrative adjustment on August 15, 2005. In TEFRA, Congress specifically limited the IRS to the issuance of only one notice of final partnership administrative adjustment to a partnership for any taxable year. Section 6223(f) of the Internal Revenue Code expressly states:

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.

26 U.S.C. § 6223(f). The district court erroneously held that the IRS was entitled to rely on the “fraud, malfeasance, or misrepresentation of a material fact” exception (the “exception”) to issue the second notice of final partnership administrative adjustment. (R2714.)

The district court found that the IRS was entitled to invoke the exception because “the tax return filed by NPR erroneously failed to check a box that indicated that NPR was subject to the TEFRA provisions.” (R2715-2716). In so holding, the district court found absolutely “no evidence” that this incorrect answer was “intentional or fraudulent.” (R2715.) The district court nevertheless held the exception applied based on its conclusion that the exception encompasses even “innocent” misstatements of a material fact. (R2716.)

The district court erred in holding that the exception allows the IRS to issue a second notice of final partnership administrative adjustment whenever a partnership innocently misstates a material fact on its tax return. The district court’s interpretation of the term “misrepresentation of a material fact” to include innocent mistakes directly contradicts Congress’ prohibition against *second* notices, for it would allow the IRS to issue a second notice *whenever* there is a material mistake on a partnership’s return (which, obviously, is the only reason why the IRS would want to issue a second notice of final partnership administrative adjustment). The standard adopted by the district court would preclude the IRS from issuing a second notice only when any mistakes on a partnership return are *immaterial* and always allow second notices where the mistakes are material. That is a nonsensical construction of the statute and it cannot stand.

The district court should have given “misrepresentation” its ordinary meaning – “the act of making a false or misleading assertion about something, *usually with the intent to deceive.*” (R2714) (quoting BLACK’S LAW DICTIONARY 1091 (9th ed. 2009) (emphasis added).) The district court’s only basis for departing from the term’s ordinary meaning was that “Black’s Law Dictionary additionally provides definitions for the terms ‘fraudulent misrepresentation,’ ‘innocent misrepresentation,’ ‘material misrepresentation,’ and ‘negligent misrepresentation,’ implying that a ‘misrepresentation,’ by itself, necessarily need not be fraudulent or intentional.” (R2714-2715.) That Black’s Law Dictionary offers a separate definition for the more specific term “innocent misrepresentation” is absolutely no basis for defining the general term “misrepresentation” to include “innocent mistake.”

To the contrary, defining “misrepresentation” to include innocent mistakes would render meaningless the terms “fraud” and “malfeasance” in the exception, in violation of well-settled principles of statutory construction. If an innocent mistake is sufficient to make the exception applicable, the terms “fraud” and “malfeasance” become mere surplusage. *See United States v. Rayo-Valdez*, 302 F.3d 314, 319 (5th Cir. 2002) (“[W]hen interpreting a statute, it is necessary to give meaning to all its words and to render none superfluous.”); *Kelly v. Boeing Petroleum Servs., Inc.*, 61 F.3d 350, 362 (5th Cir. 1995) (interpreting a statute in a

manner so as to avoid rendering any of its language to be “mere surplusage”). Certainly, defining “misrepresentation” to include innocent mistakes is inconsistent with Congress’ use of the terms “fraud” and “malfeasance” in the same exception, as the latter terms both connote intentional wrongdoing. *See Nero v. Indus. Molding Corp.*, 167 F.3d 921, 930 (5th Cir. 1999) (holding that the doctrine of *noscitur a sociis* applies “to avoid ascribing to one word a meaning so broad that is inconsistent with its accompanying words”) (quoting *Gustafson v. Alloyd Co.*, 513 U.S. 561, 575 (1995)). The district court should have avoided defining “misrepresentation” in a manner that is inconsistent with Congress’ use of the terms “fraud” and “malfeasance” in the same statute. *Id.*

Of course, this Court need not resort to principles of statutory construction to resolve this issue. That the district court erred is patently obvious. In effect, the district court converted Congress’ restriction on the IRS that requires it to show “fraud, malfeasance, or misrepresentation of a material fact” to now only require the IRS to show “fraud, malfeasance, or innocent misstatement of a material fact.” That reading of the statute cannot stand.

Other courts have properly construed language identical to the term “misrepresentation of a material fact” in Section 6223(f) to require that a showing of deliberative intent be made. For example, Section 7121 precludes the IRS from setting aside a settlement agreement in the absence of “a showing of fraud or

malfeasance, or misrepresentation of a material fact” – the exact same language as is found in Section 6223(f). For purposes of Section 7121, “a misrepresentation is not synonymous with a mistake: It denotes something more deliberate or more conscious than mere error or mistake.” *See Halpern v. Comm’r*, 79 T.C.M. (CCH) 1976, 1979 (2000). Similarly, courts have defined “misrepresentation” in Section 6532 to require a showing of “gross negligence” or “recklessness.” *See, e.g., Lane v. United States*, 286 F.3d 723, 732 (4th Cir. 2002). For any of these statutory provisions, had Congress intended the term “misrepresentation of a material fact” to include innocent mistakes, it could easily have used the term “misstatement” instead of “misrepresentation.” *Id.*

The district court’s error makes it unnecessary for this Court to rule on any of the other issues appealed by either party in this proceeding. The district court erred in holding that the IRS was entitled to invoke the exception to the general prohibition against second notices of final partnership administrative adjustment, and the second notice is therefore invalid. As a result, all of the IRS’ adjustments in the second notice are invalid. Since the other issues presented by the parties’ cross-appeals concern only those invalid adjustments, this Court need not further consider the other issues raised by the parties.

**C. The district court alternatively erred in finding that the IRS was entitled to rely on any misrepresentation.**

The district court also erred in holding that the IRS was entitled to rely on the mistake on NPR's tax return to issue a second notice of final partnership administrative adjustment. For a misrepresentation of material fact to be recognized, "[n]ot only must there be reliance but the reliance must be justifiable under the circumstances." W. Page Keeton, *PROSSER AND KEETON ON THE LAW OF TORTS* § 108 (5th ed. 1984) (citing *Restatement (Second) of Torts* § 537). A person cannot "blindly rel[y] upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation." *Lewis v. Bank of Am. NA*, 343 F.3d 540, 546-47 (5th Cir. 2003). Put otherwise, "a person may not justifiably rely on a representation if 'there are 'red flags' indicating such reliance is unwarranted.'" *Id.* (quoting *In re Mercer*, 246 F.3d 391, 418 (5th Cir. 2001)).

TEFRA adopts this general rule, for it expressly requires the IRS to show that any reliance on NPR's mistake was reasonable. Section 6231(g)(2) provides that if "on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter does not apply to such partnership for such year but such determination is erroneous, then the provisions of this subchapter shall not apply to such partnership (and its items) for such taxable year or to partners of such partnerships." 26 U.S.C. § 6231(g) (emphasis added). In

other words, 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.

The district court therefore plainly erred when it refused to consider whether the IRS' reliance was reasonable. This Court need not remand the case, however, because the record overwhelmingly demonstrates that the IRS' reliance was *unreasonable*. *See Will v. Cain*, 348 F.App'x 35, 2009 WL 3241504, at \*5 (5th Cir. Oct. 9, 2009) ("If the district court's finding was clearly erroneous, we need not remand for the district court to make factual findings in light of our decision."), *cert. denied*, 130 S. Ct. 2372 (2010).

NPR's 2001 tax return was prepared by the major national accounting firm of Grant Thornton LLP ("Grant Thornton") and filed with the IRS on or about April 1, 2002. (R2706; P. Ex. 3.) On line 2 of Schedule B, the return indicates that one of NPR's partners was a partnership (R2706). Since one of its partners was a partnership, NPR was automatically subject to the TEFRA provisions. *See* 26 U.S.C. § 6231(a)(1); Treas. Reg. § 301.6231(a)(1)-1(a)(2). Line 4 of Schedule B then redundantly asks, however, whether the partnership is subject to the TEFRA provisions. (R2706.) Grant Thornton mistakenly answered "no" to the question on line 4. (R2706.) Grant Thornton completed Schedule B, however, as though it had answered "yes" to the question on line 4, because the balance of line 4 instructs taxpayers to designate a "tax matters partner" only if they respond "yes"

to the question. (*See* P. Ex. 3 at 1.) The tax return designates a tax matters partner as though the question on line 4 had been answered “yes.” (*Id.*)

Since NPR’s tax return indicates that one of its partners was also a partnership (P. Ex. 3 at Sch. B, line 2), it was obvious to the IRS that NPR was subject to the TEFRA partnership provisions. Any partnership that has a partner that is itself a partnership is automatically subject to the TEFRA provisions. *See* 26 U.S.C. § 6231(a)(1); Treas. Reg. § 301.6231(a)(1)-1(a)(2). Paul Doerr, the IRS agent auditing NPR’s return, was aware of this rule of law at the time he was conducting the audit of NPR. (*See* P. Ex. 49 at 34-35 (Doerr acknowledging that he knew in 2004 and 2005 that if a partnership has a partner as one of its partners, then the TEFRA provisions are “automatically” applicable), 73.) Indeed, when Doerr prepared the March 25 notice informing NPR that he had completed his examination of its 2001 tax return and determined that no adjustments should be made, Doerr knew that one of NPR’s partners was a partnership. (*See* P. Exs. 37, 49 at 54-55, 72.) In notes that Doerr prepared prior to, or at the time, he prepared the March 25, 2005, notice (P. Ex. 49 at 72), he wrote: “Note this entity was not interviewed since the entity is located in New York and *the entities partners are*

*also partnerships. The partnerships that are the partners in this entity are being audited by the promoter teams.”* (P. Ex. 37 at 2 (emphasis added).)<sup>5</sup>

Doerr was an experienced revenue agent who had conducted roughly 50 audits of TEFRA partnerships and taken continuing education classes regarding the audit of TEFRA partnerships. (P. Ex. 49 at 9, 37.) Even a cursory examination of the return revealed that NPR was subject to the TEFRA provisions. Indeed, Doerr *conceded* that, looking at NPR’s 2001 tax return as a whole, it was his opinion that NPR was subject to the TEFRA provisions because it had a partnership as a partner. (P. Ex. 49 at 34-35, 79.)<sup>6</sup>

The IRS’s own administrative guidance is also instructive on this point. In 2002 IRS NSAR 20236, 2002 WL 32167931 (June 12, 2002), the IRS considered a situation where a partnership had checked “Yes” in response to the question posed

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<sup>5</sup> The district court also committed clear error by finding that the government relied on NPR’s mistake. Although Doerr (who was outside the subpoena range and refused to attend trial) testified at his deposition that he relied on NPR’s mistake, he also testified that he knew that one of NPR’s partners was a partnership which automatically made NPR subject to the TEFRA rules. (P. Ex. 49 at 34-35, 44, 54-55, 72.) The trial court should have drawn an adverse inference against the government on the reliance point, as the government refused to make Doerr available at trial. *See, e.g., United States v. Wilson*, 322 F.3d 353, 363 (5th Cir. 2003) (“[T]his circuit has long recognized that a party’s failure to call available witnesses or produce evidence that would clarify or explain disputed factual issues can give rise to a presumption that the evidence, if produced, would be unfavorable to that party.”).

<sup>6</sup> It is apparent that Doerr determined that no changes were necessary to NPR’s tax return because the tax losses at issue were not claimed on NPR’s tax return, but were instead claimed on the tax returns filed by the law firm. (P. Ex. 49 at 36, 55.)

in Schedule B at line 4, indicating that it was a TEFRA partnership, but where the rest of the return indicated it was *not* subject to TEFRA. The IRS rightfully concluded that it could not reasonably rely on the partnership's obviously incorrect answer to line 4 to treat it as though it were a TEFRA partnership and that the IRS was therefore required to use non-TEFRA procedures to audit the partnership. The same logic applies in this case: the IRS could not reasonably rely on an obviously incorrect response to line 4 to treat NPR as a non-TEFRA partnership when the rest of NPR's return made clear that it was a TEFRA partnership.

It is therefore no surprise that the government opted not to bring Doerr to trial. It would obviously have been impossible for him to claim that he was reasonable in relying on the mistake on NPR's tax return to treat it as though it were not subject to the TEFRA procedures when he instead testified during his deposition that the rest of NPR's tax return indicated that it was subject to those procedures. There is not the slightest fig leaf of evidence in the record to even suggest that the IRS was reasonably relying on the innocent mistaken answer to the question on line 4 to conclude that NPR was not subject to the TEFRA provisions. To the contrary, the Schedule B upon which the IRS claims it relied raises the "red flags" that made any such reliance unwarranted.<sup>7</sup>

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<sup>7</sup> In fact, two red flags were raised on the exact same page that contained the innocently mistaken response: (1) the indication that one of NPR's partners was a

In short, the IRS did not reasonably rely on the innocent mistake on NPR's tax return, so it may not invoke the exception to the general prohibition against second notices of final partnership administrative adjustment. The Court should hold that the second notice is invalid, and it therefore need not consider the remaining issues raised in these cross-appeals for the reasons stated above.

**II. The District Court Correctly Held That The Accuracy-Related Penalties were Inapplicable as a Matter of Law.**

**A. The valuation misstatement penalties do not apply to underpayments of tax that are attributable to grounds unrelated to valuation or basis.**

Even assuming that the IRS was permitted to issue a second notice of final partnership administrative adjustment, the district court correctly concluded that all of the penalties asserted in that second notice were inapplicable. The government's first argument is that the district court wrongly held that the valuation misstatement penalties could not apply. (Appellant's Br. at 34-43.)

The valuation misstatement penalties, however, only apply to underpayments of tax that are "attributable to" either a gross or substantial valuation misstatement. 26 U.S.C. § 6662(a), (e), (h). There is a substantial "valuation misstatement" if "the value of any property (or the adjusted basis of any

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partnership; and (2) the designation of a tax matters partner. (P. Ex. 3.) Another red flag was raised by the Schedule K-1s that were attached to NPR's 2001 partnership return, which clearly identified Alpha Consultants, LLC (a pass-through entity) as one of its partners. (*Id.*)

property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).” 26 U.S.C. § 6662(e). The statute defines a “gross valuation misstatement” the same way except that “400 percent” is substituted for “200 percent.” 26 U.S.C. § 6662(h). Thus, there must be a misstatement of the value or basis of property in order for the valuation misstatement penalties to potentially be applicable.

The government’s appeal must fail for the simple reason that NPR did not overstate the value or basis of any property on its return. To the contrary, the Partners conceded that NPR “did not enter ‘into the option(s) positions or purchase the foreign currency or stock with a profit motive” – a ground unrelated to value or basis. The government and the district court accepted the Partners’ concession, and the district court never made any finding that NPR had overstated the value or basis of any property on its return.

The government attempts to manufacture a valuation misstatement out of thin air by baldly asserting that, based on the Partners’ concession, “there is no question that there were gross valuation misstatements in this case.” (Appellant’s Br. at 35.) The government does not even attempt to support this statement, which is the central premise of its entire argument, except to: (a) bluntly allege that any underpayment of tax here “is directly attributable to . . . participation in a tax

shelter that was specifically designed to generate huge artificial losses by means of grossly overstating the taxpayer's basis in his partnership interest," (Appellant's Br. at 43); and (b) incoherently argue that the deductions could not have been conceded on grounds unrelated to value or basis because NPR "was created for the sole purpose of implementing the basis shifting scheme" which "presupposes that it lacked a profit motive." (Appellant's Br. at 43 n.20.) The government, however, does not cite to any findings of the district court to support these statements. Instead, the government cites an IRS Notice that reflects the *agency's* litigating position and a case involving a *different* taxpayer. In *this* case, however, the district court found that the Partners "sought to make a profit from the investment plan when they entered the pertinent transactions" and that NPR was "formed for various investment purposes in August 2001." (R2700, 2719-2720.) The government has not recognized the existence of these findings, much less made any assertion that these findings were clearly erroneous. There is therefore no basis for the government's naked allegation that NPR overstated the value or basis of any property on its return.<sup>8</sup>

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<sup>8</sup> As discussed later in this brief, the government does not even *contend* that there was any misstatement of value or basis on *NPR's* tax return. Rather, the alleged misstatement occurred on the returns filed by the *law firm* when it sold the foreign currencies.

The Fifth Circuit described the relevant legal principles in *Todd v. Commissioner*, 862 F.2d 540, 542 (5th Cir. 1988). In *Todd*, the IRS disallowed deductions and credits claimed by the taxpayers relating to food storage units on the ground that the units had not been placed in service, or, alternatively, on the ground that the taxpayers had overstated the value of the units. 862 F.2d at 541. The Tax Court, without ruling on whether the taxpayers overstated the value of the units, determined that the deductions and credits were improper because the units had not been placed in service. The IRS then assessed a valuation misstatement penalty against the Todds under Section 6659. The taxpayers appealed the IRS' assessment to the Tax Court, which held that the penalties were inapplicable because the IRS had disallowed the taxpayers' deductions and credits on the alternative ground unrelated to valuation or basis.

In affirming the Tax Court's decision, this Court stated the applicable formula for determining whether an underpayment is "attributable to" a valuation overstatement:

*The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two*

amounts will be the underpayment that is attributable to the valuation overstatement.

*Id.* at 542-43 (quoting STAFF OF JT. COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 (Comm. Print 1981)) (emphasis in original). Under this formula, if a taxpayer concedes the IRS's adjustments on grounds unrelated to valuation or basis, as the Partners did in this case, any underpayment by the taxpayer will not be "attributable to" a valuation overstatement, and, therefore, the valuation misstatement penalties of Section 6662 will not apply. The valuation misstatement penalties therefore do not apply in this case by their own terms.

The Fifth Circuit's decision in *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), also reflects this precise point. In *Heasley*, prior to trial the taxpayers conceded that they were not entitled to the deductions and credits challenged by the IRS, electing only to challenge the IRS' assessment of various penalties including valuation overstatement penalties under Section 6659(a)—the predecessor to Section 6662. At trial, the Tax Court upheld the IRS's assessment of the valuation overstatement penalties. On appeal, this Court reversed the Tax Court's decision, holding that the valuation overstatement penalty did not apply because the taxpayers' underpayment was "attributable to" the IRS' total disallowance of the claimed deductions and credits rather than to a valuation overstatement. The Court explained:

Whenever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit. In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit. In this case, the [taxpayers'] actual tax liability does not differ one cent from their tax liability with the valuation overstatement included. In other words, the [taxpayers'] valuation overstatement does not change the amount of tax actually owed.

*Id.* at 383.

More recently, the Fifth Circuit reiterated its rulings in *Todd* and *Heasley* in *Weiner v. United States*, 389 F.3d 152 (5th Cir. 2004). In *Weiner*, the taxpayer settled his case with the IRS without specifying the grounds on which he was settling. 389 F.3d at 159-60. Despite the taxpayer's settlement, the IRS assessed an interest penalty under Section 6621,<sup>9</sup> which contained the same type of "attributable to" language as is found in the valuation misstatement penalties, claiming that the taxpayer's underpayment was "attributable to" a "tax motivated transaction." *Id.* As in *Heasley*, the taxpayer argued that the increased interest penalty was inapplicable because the IRS proffered several alternative bases for disallowing his deductions and his settlement agreement did not establish that his

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<sup>9</sup> The Section 6621 interest penalty and the Section 6662 valuation misstatement penalties use almost identical language for determining when the two different penalties apply, and courts have relied on legislative history and judicial interpretations of Section 6621 in interpreting the valuation misstatement penalties. *See Weiner*, 389 F.3d at 160-62 (collecting cases).

underpayment was “attributable to” a tax motivated transaction. *Id.* And, just as in *Heasley*, this Court held that the taxpayer’s underpayment was not “attributable to” a tax motivated transaction, since it was impossible to tell from the taxpayer’s settlement agreement the precise grounds on which he conceded. *Id.* The court reasoned:

There is no way, given the multiple reasons provided for the disallowance in the FPAAs, to determine whether the underpayments are “attributable to” a tax motivated transaction. . . . Because, under the circumstances of these cases, the taxpayers’ underpayments are not “attributable to” a tax motivated transaction as a matter of law, the IRS may not assess the additional interest against them.

*Weiner* at 162-63. (emphasis added). *See also McCrary v. Comm’r*, 92 T.C. 827, 851-55 (1989) (reaching the same conclusion in a fully reviewed Tax Court decision).

*Heasley*, *Weiner*, and *Todd* make clear that, under this Court’s jurisprudence, when a taxpayer concedes on grounds unrelated to valuation or basis (as the Partners have done here), any underpayment by the taxpayer is not “attributable to” a valuation overstatement and that the Section 6662 valuation misstatement penalties therefore cannot apply as a matter of law.<sup>10</sup>

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<sup>10</sup> These decisions implement policy goals Congress sought to achieve in enacting the valuation penalties. Congress enacted the valuation misstatement penalties primarily to discourage taxpayers from taking extreme positions on the valuation of property for tax purposes. *See* GENERAL EXPLANATION OF THE ECONOMIC

**B. The government’s effort to distinguish the “total disallowance rule” is misplaced.**

The district court also rejected the valuation misstatement penalties under what the government calls the “total disallowance” rule adopted by the Fifth Circuit in *Heasley*: “Whenever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit.” *Heasley*, 902 F.2d at 383. The government spends several pages in its brief arguing that this rule has been superseded by regulation or at least undermined by *Weiner*. (Appellant’s Br. at 39-43.) The government is wrong, but it is important to note that the Court need not even address this alternative basis for the district court’s holding because, as explained above, the district court did not find that NPR misstated the value or basis of any property on its return so that the valuation misstatement penalties could not apply in any event.

The government first argues that the rule announced in *Heasley* has been superseded by a twenty-year old regulation. (Appellant’s Br. at 39-40.) The regulation provides that, in situations in which basis or value is determined to be

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RECOVERY TAX ACT OF 1981 at 334. Litigation of valuation issues requires significant use of resources by the government and the courts, and applying a steep penalty for extreme valuation positions taken by taxpayers encourages settlements and concessions of valuation issues, as the Partners have done here. *See Todd*, 862 F.2d at 544. This Court has recognized that forcing parties to litigate questions of valuation or basis solely to impose penalties undermines the rationale behind valuation penalties, and it has refused to allow such litigation when the taxpayer concedes the underlying adjustment. *See Weiner*, 389 F.3d at 162-63.

zero, (i) the valuation misstatement percentage test is deemed met even though it is mathematically impossible to calculate a percentage change where the correct amount is zero and (ii) the deemed valuation misstatement is deemed to be a “gross” valuation misstatement instead of only a “substantial” valuation misstatement. Treas. Reg. § 1.6662-5(d)(ex. 3) and (g).

The government’s argument that this regulation somehow overruled *Heasley* is overreaching at its worst. The parts of the regulation the government cites state how to determine the *amount* of a misstatement in certain cases. But they do not determine *when* a penalty applies. The first section of the regulation, however, which the government carefully avoids discussing, expressly states that a valuation misstatement penalty is applicable only “[i]f any portion of an underpayment ... is *attributable to a substantial [or gross] valuation misstatement.*” Treas. Reg. § 1.6662-5(a) (emphasis added). The government never *mentions* this section of the regulation even though, as the district court observed, that language was the express basis of *Heasley’s* rejection of such penalties. *Heasley*, 902 F.2d at 383.

The language the government now cites was instead designed to solve a basic mathematical problem. A gross valuation misstatement exists “if the ... adjusted basis of any property claimed on a return ... is 400 percent or more of the correct amount.” Treas. Reg. § 1.6662-5(e)(2). If an asset’s correct basis is zero, the formula requires division by zero, a mathematical impossibility. The

regulation sensibly addresses this problem by providing that, in zero-basis cases, the “gross” valuation misstatement penalty applies – but *only if* the underpayment is otherwise attributable to a valuation misstatement. Treas. Reg. § 1.6662-5(a).<sup>11</sup> Importantly, the regulation does not purport to overrule (and the preamble to the regulation does not even discuss) the mathematical test first adopted by this Court in *Todd*.<sup>12</sup>

Moreover, in *Weiner* a decision entered after the promulgation of this regulation in 1991, this Court reaffirmed and followed its decisions in *Todd* and *Heasley*. 389 F.3d 152, 159-63. Other courts also continue to follow *Todd* and *Heasley*. See, e.g., *Derby v. Comm’r*, 95 T.C.M. (CCH) 1177 (2008); *Alpha I, L.P. v. United States*, 84 Fed. Cl. 622, 626-32 (2008).

Finally, the government’s argument that *Weiner* somehow undermined *Heasley* is misguided. (Appellant’s Br. at 41-43.) Nothing 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

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<sup>11</sup> The government has not shown that the Partners’ bases in the foreign currencies were zero, as that is an “affected item” the final calculation of which will be resolved if necessary in subsequent proceedings. See Treas. Reg. §§ 301.6231(a)(3)-1(c), 301.6231(a)(5)-1.

<sup>12</sup> The government’s interpretation of Treas. Reg. § 1.6662-5(g) is not due any deference because its interpretation completely ignores the “attributable to” language in Section 6662. See *Auer v. Robbins*, 519 U.S. 452, 461-62 (1997) (finding deference does not apply if the government’s interpretation is “inconsistent with the regulation”).

Circuit in *Irom v. Commissioner*, 866 F.2d 545, 547 (2d Cir. 1989). The government's strained reading of *Weiner* can also be rejected for the simple reason that *Weiner* could not have overruled *Heasley*, as one panel of this Court cannot overrule a prior decision of the Court in the absence of an en banc consideration or a superseding Supreme Court decision. *See United States v. Lipscomb*, 299 F.3d 303, 313 n.34 (5th Cir. 2002).

**C. The district court correctly determined that the substantial understatement penalty did not apply.**

The substantial understatement penalty is inapplicable if there is substantial authority for the position challenged, and there was substantial authority for the position the Partners took on their returns – namely, that the short option positions contributed to NPR did not constitute liabilities within the meaning of Section 752. Indeed, the case law existing at the time the Partners filed their returns amply supported this position. Most notably, in *Helmer v. Commissioner*, the government successfully argued that contingent obligations, such as the short option positions contributed by the Partners to NPR, are not liabilities within the meaning of Section 752. 34 T.C.M. (CCH) 727 (1975). The government also successfully argued that contingent obligations are not liabilities within the meaning of Section 752 on several subsequent occasions. *See, e.g., Long v. Comm'r*, 71 T.C. 1, 7-8 (1978), *motion for reconsideration*, 71 T.C. 724 (1979), *aff'd and remanded*, 660 F.2d 416 (10th Cir. 1981) (stating that “contingent or contested liabilities . . . are

not ‘liabilities’ for partnership basis purposes at least until they have become fixed or liquidated.”); *LaRue v. Comm’r*, 90 T.C. 465 (1988) (holding that obligations that are fixed in the sense that it is known that some amount will be paid, but that remain contingent in amount, do not constitute “liabilities” for purposes of Section 752); *see also Gibson Prods. Co. v. United States*, 637 F.2d 1041 (5th Cir. 1981).

Moreover, the government’s own administrative guidance reveals that the short option positions the Partners contributed to NPR were not liabilities within the meaning of Section 752. In a foundational Revenue Ruling, the IRS determined that the term “liability” in Section 752 did not include “unrealized receivables.” Rev. Rul. 73-301, 1973-2 C.B. 215. Instead, “[t]he liabilities referred to in section 752 . . . are those liabilities which arise from a debtor-creditor relationship with a *sum certain* due to a *fixed or determinable* date of maturity.” I.R.S. Gen. Couns. Mem. 33,948 (Oct. 22, 1968) (emphasis added).

In recognition of the well-settled and substantial authority that contingent obligations are not liabilities, the government promulgated regulations in 2003 – two years after the Partners entered into the transactions at issue – in an effort to *retroactively change* the regulatory definition of a liability to include contingent obligations. *See* Treas. Reg. § 1.752-1(a)(4)(ii) (expanding the definition of liability to include “any . . . contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the

Internal Revenue Code”). The preamble to the 2003 regulations specifically acknowledges that the revised concept of “liability” set out in the regulations *does not* follow the rule that the IRS advocated, and obtained, in *Helmer* and related cases. *See* Assumption of Partner Liabilities, 68 Fed. Reg. 37434, 37436 (June 24, 2003).

Notes made by Richard Starke, an attorney in the office of IRS Chief Counsel in 1995, and a memorandum to high-ranking IRS officials drafted by Mary Berman, also an attorney in the office of IRS Chief Counsel in 1995, confirm that the IRS itself had for years been well aware that the position it had taken on the definition of a “liability” for purposes of Section 752 could result in taxpayers obtaining tax benefits. Starke was charged with drafting IRS Revenue Ruling 95-45, which addressed whether a short sale is a liability in the corporate context. As reflected in his notes, Starke attended numerous meetings with IRS officials where the definition of “liability” for purposes of Section 752 was discussed. (P. Ex. 41.) Starke reports that the IRS understood that the manner in which “liability” had been defined could be advantageous or disadvantageous to the IRS, depending on the situation, and that the underlying issue involved “mismatch between inside and outside basis.” (*Id.*) He then reports that “if [the IRS] had to choose one poison or another, [Stuart Brown, then Chief Counsel of the Internal Revenue Service] tended [to] agree with *Helmer* (a position IRS perhaps needs, lesser of two evils.)”

(*Id.*) IRS Chief Counsel Brown suggested writing a regulation to cover these issues. In debating the correct path, the Treasury Department advocated using Section 752 to equate inside and outside basis, but understood such use of Section 752 would be “cram[ming] through [a] result” and “not an entirely clean way of doing it.” (*Id.*) The IRS did not issue or propose the regulations under Section 752 as discussed in Starke’s notes. Instead, the IRS waited until 2003 (eight years later) to promulgate such regulations, and then made them retroactive.

Berman’s memorandum is in accord with Starke’s assessment of whether options created liabilities for purposes of Section 752. Berman wrote: “While *we agree that existing authority prevents treating options as creating liabilities* in the proposed revenue ruling, further consideration of the appropriateness of expanding the definition of liability is recommended.” (P. Ex. 43 (emphasis added).) It is both disingenuous and legally unsupportable for the government to assert that the Partners lacked substantial authority for their return position, when that return position was, at the time, in accord with the government’s own longstanding interpretation of Section 752.

It is the case law and administrative guidance discussed above that formed the basis of the advice Sidley Austin and Pollans & Cohen gave the Partners. The existing case law and administrative guidance provided “substantial authority” for, and strongly supported, the Partners’ tax return positions. (R2725.) The district

court did not “confuse” the substantial authority defense with reliance on a legal opinion to conclude that the Partners had substantial authority for their tax return positions as the government contends. (Appellant’s Br. at 47-49.) Rather, the district court found that the Sidley Austin opinions “relied on the relevant authority at the time,” as confirmed by Cohen’s and Smith’s later review of the authorities cited in the opinions. (R2719.) While the district court also concluded that the Partners reasonably relied on the opinions and advice they received from Sidley Austin and Cohen (R2719), that conclusion rests in large part on the fact that the opinions captured the then-existing law, which supported the Partners’ tax return positions.

**1. The Partners’ concession does not preclude a finding of substantial authority.**

The government’s argument that the Partners’ concession that the original, professional managers of NPR lacked a profit motive is tantamount to a concession that there was not substantial authority for their tax positions is long on rhetoric, but short on reason. (Appellant’s Br. at 46-47.) It ignores the expressly, limited scope of the Partners’ concession – that the NPR entity entered into the transactions without a profit motive – but that the individual Partners believed, even in the face of this concession, “that the manner in which they reported the transactions at issue in this case for tax purposes was correct.” (R610-11.) The Partners’ concession that NPR’s former managers lacked a profit motive in

operating NPR has no bearing on whether there was substantial authority for the tax positions taken by the law firm and the Partners.

Essentially, the government's argument is that if any reason arises to invalidate a transaction, then there cannot be substantial authority for a taxpayer's position. This reasoning fails in the face of the plain language of Section 6662, which allows taxpayers to avail themselves of the substantial authority defense even in the case of tax shelters, which are defined as an entity or plan or arrangement "if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax." 26 U.S.C. § 6662(d)(2)(C)(i)(II). Even if, under the decision in *Klamath*, partnerships formed by managing members who lack a profit motive would fall within the definition of a tax shelter, the statute expressly contemplates that substantial authority may nonetheless still exist. *See infra* pp. 43-44.

The government's position also directly conflicts with the relevant Treasury regulations which explain that there is substantial authority for the tax treatment of an item if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(iii). "All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists." Treas. Reg. § 1.6662-4(d)(3)(i).

The government's effort to use a single ground as a litmus test is thus misguided, for the district court correctly is to consider *all* of the relevant authorities to find that there was substantial authority. (R2717-2720.)

Moreover, as explained in far greater detail below in our discussion of whether the district court had jurisdiction to consider the reasonable cause defense, the losses that were at issue in this case were not even claimed on the tax return filed by NPR. Instead, under applicable partnership taxation principles, the losses were reported only on the tax returns filed by the law firm and the Partners. The motives of NPR's former managing members are therefore plainly irrelevant in determining whether there was substantial authority for the tax positions taken by the law firm and the Partners.<sup>13</sup>

**2. The district court did not find that the transactions at issue lacked economic substance.**

As discussed above, the *Helmer* line of cases, which provide that contingent obligations are not liabilities within the meaning of Section 752, provided substantial authority for the positions the Partners took on their tax returns. And

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<sup>13</sup> This case is notably different from *Klamath*, 568 F.3d 537 (5th Cir. 2009), in that respect. In *Klamath*, the district court found that the transactions lacked economic substance because the former managing member's lack of profit motive caused it to take actions that made it impossible for the underlying transactions to be profitable. *Klamath*, 568 F.3d at 545. In this case, however, the motives of the former managing members of NPR have no bearing on whether the foreign currency options could in fact have been profitable, and, indeed, the district court found that the foreign currency options could have been profitable. (R2702.)

the opinions the Partners received from Sidley Austin “relied on the relevant authority at the time,” *i.e.*, the *Helmer* line of cases. (R2719.) The government nevertheless argues that the *Helmer* line of cases could not provide substantial authority because the transaction at issue lacked economic substance. (Appellant’s Br. at 50.) The cases the government relies on in support of its argument are inapposite, however, for in each of those cases, the trial court first determined that the transaction at issue lacked economic substance. Here, the district court made no such finding. In fact, the district court found that NPR was formed for “various investment purposes,” and the Partners “sought to make a profit.” (R2700, 2719-2720.)

Even if the district court had reached the issue of whether the transactions had economic substance and concluded that they did not, the Partners *still* would have had substantial authority under this Court’s precedent. *See Streber v. Comm’r*, 138 F.3d 216 (5th Cir. 1998). Under *Streber*, “there is substantial authority from a factual standpoint for the taxpayer’s position” so long as there is “evidence going both ways.” 138 F.3d at 223 (quoting *Osteen v. Comm’r*, 62 F.3d 356, 359 (11th Cir. 1995)). “Only if there was a record upon which the Government could obtain a reversal under the clearly erroneous standard could it be argued that from an evidentiary standpoint, there was not substantial authority.” *Id.* (quoting *Osteen*, 62 F.3d at 359). Here, the record could have supported a

finding that the transactions at issue had economic substance: NPR was formed for investment purposes (R2700); the Partners entered into the transactions at issue seeking a profit (R2719-2720); and the transactions “could be profitable, excluding any advisement fees, in one of two ways.” (R2702.) Under these facts, it would not have been clearly erroneous for the district court to hold that the transactions at issue had economic substance, so the government cannot claim that the Partners lacked substantial authority for their return positions on the speculative, unproven ground that the transactions lacked economic substance. *See Streber*, 138 F.3d at 223.

The government also questions the district court’s observation that the tax opinions provided to the partners “relied on the relevant authority at the time” suggesting that the court took a “myopic” view by not considering cases decided long after the transactions at issue were completed. (Appellant’s Br. at 49-50.) The government apparently overlooked its own Treasury regulation, however, which instructs that the determination of whether substantial authority exists is to be made “at the time the return containing the item was filed” or “on the last day of the taxable year to which the return relates.” Treas. Reg. § 1.6662-4(d)(iv)(C).

Finally, the government argues that “beginning in August 2000, there was *direct authority* – in the form of Notice 2000-44 – contrary to the claimed tax treatment of the offsetting-option shelter,” so “[g]iven the lack of any other

authority at the time (pro or con) addressing the efficacy of this shelter, it follows that the claimed tax treatment of the offsetting-option transaction at issue here could not have satisfied the substantial authority standard.” (Appellant’s Br. at 50 (emphasis added).) Notice 2000-44, however, is not *direct authority* that overturns or modifies the *Helmer* line of cases. Rather, it is nothing more than a statement of the government’s litigating position; it is not authoritative. *Guilzon v. Comm’r*, 985 F.2d 819, 822 (5th Cir. 1993) (noting that, while revenue rulings are “to some degree authoritative, . . . [n]otices are not”). Notice 2000-44 plainly did not, and could not, overrule the *Helmer* line of cases, and the Partners are entitled to challenge the government’s litigating position as stated in Notice 2000-44.

### **III. The District Court Had Jurisdiction to Consider the Partners’ Reasonable Cause and Good Faith Defenses in the Proceedings Below.**

As discussed in the preceding section, the district court correctly determined that the valuation misstatement penalties and the substantial understatement penalty do not apply by their own terms.<sup>14</sup> There is no dispute that these holdings were within the jurisdiction of the district court. The district court also found, however, that even if any of the accuracy-related penalties could apply, none of them would be applicable in this case because the Partners acted reasonably and in good faith. While the government argues that the district court exceeded its

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<sup>14</sup> The government did not appeal the district court’s holding that the negligence penalty was not applicable.

jurisdiction in so holding, (Appellant's Br. at 51-57), this Court need not resolve the jurisdictional issue, or even consider the reasonable cause defense, if it affirms the judgment of the district court that the penalties are not applicable in the first instance.

Moreover, the district court did not err in considering the Partners' reasonable cause and good faith defense. The district court had jurisdiction in the TEFRA proceeding below to "determine all partnership items . . . *and the applicability of any penalty* . . . which relates to an adjustment to a partnership item." *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 548 (5th Cir. 2009) (citing 26 U.S.C. § 6226(f)) (emphasis in original). Under TEFRA, "the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level." 26 U.S.C. § 6221. A "partnership item" generally includes items that are "*more appropriately* determined at the partnership level than at the partner level." 26 U.S.C. § 6231(a)(3) (emphasis added).

It is undisputed that the penalties asserted by the IRS in the August 15, 2005, notice directly relate to the adjustments to partnership items that the IRS made in that same notice. Those "partnership items" expressly include the actions taken by the Partners. Indeed, but for the actions of the Partners, there could not possibly be

*any* penalty, for the losses at issue in this case were not claimed on NPR's tax return, but were instead first claimed on the tax returns filed by the law firm when it sold the foreign currencies that it had received from the Partners. (R2704). The penalties relate to that specific conduct, which indisputably was at issue in this proceeding, and the district court therefore had jurisdiction to consider whether a penalty would apply to that conduct, which necessarily entailed an evaluation as to whether that conduct was reasonable.

Indeed, the August 15, 2005, notice explicitly put at issue whether the Partners had acted reasonably and in good faith, for it stated that “[t]here has been no showing by the partnership *or any of its partners* that there was reasonable cause for any of the resulting underpayments, that the partnership *or any of its partners* acted in good faith, or that any other exceptions to the penalty apply.” (P. Ex. 1.) Not only did the government place the Partners’ reasonable cause and good faith defense at issue, it also conducted extensive discovery into the defenses raised by the Partners. (*See* P. Ex. 49 at 15; R1953-2008, R2010-13.) Thus, the imposition of the accuracy-related penalties against the Partners constitutes “any penalty . . . which relates to an adjustment to a partnership item,” *see* 26 U.S.C. § 6226(f), and the district court had jurisdiction to consider the applicability of the accuracy-related penalties to the Partners, as well as the Partners’ reasonable cause and good faith defenses to those penalties.

The government relies on Temp. Treas. Reg. § 301.6221-1T(d) to argue that “partner-level defenses” must be asserted in a separate proceeding after the conclusion of the partnership-level proceeding. (Appellant’s Br. at 53-54.) That may be true, but it simply is not relevant here, because the same regulation defines “partner-level defenses” as being “limited to those that are personal to the partner or are dependant upon the partner’s separate return.” In this case, however, the reasonable cause defense is not personal to Patterson, Nix or Roach and it certainly is not dependant upon their separate individual tax returns. To the contrary, the losses that the IRS disallowed in the August 15 notice involved the Partners’ contribution of their option positions to NPR, NPR’s distribution of foreign currencies to the Partners, the Partners’ contribution of the foreign currencies to their law firm, and the sale of those currencies by the law firm. None of this is “personal” to any of the Partners. Indeed, it would be impossible to divorce the determination of whether the penalties are applicable from the reasonableness of the Partners’ actions since both determinations depend on the same conduct.

Moreover, this Court expressly held in *Klamath* that partners may present a reasonable cause defense on behalf of the partnership in a partnership-level proceeding. *Klamath*, 568 F.3d at 548 (holding that since “reasonable cause and good faith were asserted on behalf of Klamath and Kinabalu, by the current managing partners, . . . the district court did not err in considering the defenses”).

As in *Klamath*, reasonable cause and good faith are being asserted by NPR's current managing partner on behalf of NPR. Thus, this case falls squarely within the type of case in which this Court recognizes the jurisdiction of the district courts to consider a partner's defenses to penalties in a partnership-level proceeding.

Nevertheless, the government argues that this case does not fall within *Klamath* because, according to the government, the Partners have not asserted the reasonable cause and good faith and defense on behalf of NPR, and, indeed the government argues that, because of the Partners' concession, the Partners' could not have asserted the defense on behalf of NPR. (*See* Appellant's Br. at 55-58.) These arguments ignore the factual realities of this case. This case was brought by NPR, by and through the Partners, including its current managing partner, Patterson. Thus, NPR's members are naturally acting on its behalf in this litigation to challenge all of the adjustments made by the government in the August 15, 2005, notice of final partnership administrative adjustment, including the penalties. Those penalties are predicated on tax positions taken on the Partners' and their law firm's tax returns, not NPR's tax returns. Therefore, the Partners' reasonable cause and good faith defense is one and the same with NPR's with respect to the penalties that the government has asserted. Patterson, as NPR's current managing member, was able to assert that defense in the action below pursuant to this Court's decision in *Klamath*.

The Partners' concession that NPR lacked a profit motive when it entered into the transactions, based on perceived difficulties of proving that NPR's original managing members had a profit motive, does not preclude the Partners from asserting a reasonable cause and good faith defense on behalf of NPR. To the contrary, this Court found in *Klamath* that Nix and Patterson could raise the reasonable cause and good faith defense on behalf of their partnerships at issue in that case, even though it had found that "[t]he evidence clearly shows [that the original managing partners] designed the loan transactions and the investment strategy so that no reasonable possibility of profit existed and so that the funding amount would create massive tax benefits but would never actually be at risk." *Klamath*, 568 F.3d at 545. Thus, *Klamath* makes clear that the original managing partners' lack of profit motive does not preclude subsequent managing partners from raising the reasonable cause and good faith defense on behalf of the partnership. Indeed, that the Partners conceded that NPR lacked a profit motive is irrelevant to the penalty determination in this case since the losses at issue were not even claimed on NPR's tax return.

Finally, no appellate court has ever accepted the government's invitation to divorce the initial determination of the penalty from the reasonable cause defense when the penalty depends on the conduct of specific partners. To the contrary, some appellate courts have stricken the penalty from the TEFRA proceeding when

it is entirely dependant on partner-level conduct. *See Petaluma FX Partners, LLC v. Comm’r*, 591 F.3d 649, 655-56 (D.C. Cir. 2010) (holding that the trial court lacked jurisdiction over accuracy-related penalties relating to an affected item, the taxpayer’s outside basis in the partnership); *Jade Trading, LLC v. United States*, No. 03-2164T, 2011 WL 1632378 (Fed. Cl. Apr. 29, 2011) (holding that the court lacked jurisdiction to consider the accuracy-related penalties, since they could not have been applied without reference to the taxpayers’ outside bases). In this case, however, penalties depend on both the actions of NPR and the Partners, as was the case in *Klamath*, and it was entirely appropriate to fully determine the applicability of the penalty in the district court proceeding.

**IV. The District Court Correctly Held That the Partners Acted Reasonably and in Good Faith When Relying on the Tax Opinion Letters They Received From Sidley Austin.**

The district court correctly held after a three-day trial that the Partners could not be liable for any accuracy-related penalty because they acted reasonably and in good faith. (R2725-2726.) Despite the inherently factual nature of this determination, the government offers three reasons for this court to now reverse that judgment: 1) the district court should have found that the Partners’ belief that Sidley Austin did not have a conflict of interest was unreasonable (Appellant’s Br. at 61-63); 2) the Partners were not entitled to rely on the opinions authored by Sidley Austin because certain representations that they made to obtain those

opinions were allegedly untrue (Appellant's Br. at 63-66); and 3) the Partners did not act in good faith because they allegedly tried to conceal the transactions from the IRS. (Appellant's Br. at 66-68.) There is no merit to any of these arguments. Before responding to these specific arguments, however, it is necessary to explain the circumstances of the Partners' investment in more detail because the district court based its holding on the entire record, (R2700), and the government alleges that the district court clearly erred in finding that the Partners' withdrawal from NPR was not pre-planned. (Appellant's Br. at 64-65.)

**A. The Partners acted reasonably and in good faith.**

There is ample evidence in the record to support the trial court's factual finding that the Partners acted reasonably and in good faith. Nix, Patterson, and Roach are not tax lawyers, and they have no expertise in tax matters. (R2725.) Instead, they rely on qualified, professional advisors for tax advice. (R2827-28, 3013-14, 3064-65.) The Partners initially relied on the advice of Sid Cohen, their personal CPA at Pollans & Cohen. (R2725.) Cohen had nearly 40 years of experience, much of which was spent at Arthur Andersen in Chicago doing audits, tax work, special consulting, cost studies, and construction audits. (R2927.) After leaving Arthur Andersen in 1982, Cohen moved to Beaumont, Texas where, along with his friend and colleague Al Pollans, he formed the accounting firm Pollans & Cohen. In addition to providing clients with audit and tax work, Pollans & Cohen

also evaluated investment opportunities for clients. (R2928.) In evaluating investment opportunities, Cohen would assist clients in “seeing if a particular investment strategy fit their goals and objectives and risk tolerances.” (R2928.)

In 2001, the Partners expressed to Cohen an interest in investing in foreign currencies because, though investing in foreign currencies required them to put a considerable amount of money at risk, investments in foreign currency carried the possibility of returns not achievable in traditional investments, such as stocks and bonds. (R2700-2701, 2929.) When the Partners expressed their interest in investing in foreign currencies to Cohen, there was no discussion of tax benefits. (R2701, 2929.) Cohen introduced the Partners to Diversified Group, Inc. (“DGI”) in the summer of 2001 because DGI was offering an investment involving options in foreign currencies. (R2703, 2931.) Cohen described the foreign currency option investment being offered by DGI as “risky,” but also pointed out to the Partners that they had the “potential to make a lot of money on it.” (R2701.) At the Partners’ direction, Cohen set up a meeting with DGI and R.J. Ruble of Sidley Austin in New York in October of 2001. (R2701.) The meeting in New York was attended by Cohen, Patterson, James Haber, and R.J. Ruble.<sup>15</sup> (R2701.) The meeting consisted of two sessions: a morning session; and an afternoon session.

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<sup>15</sup> Nix and Roach did not attend the meeting in New York, but Patterson attended the meeting on their behalf and reported to them on what he learned at the meeting.

At the morning session, Haber explained how an investment in paired foreign currency options could be profitable. DGI's investment strategy could be profitable in one of two ways.<sup>16</sup> (R2701-2702.) First, if the reference price for the foreign currency options on the options' expiration date fell between the strike prices on the long and short option positions, the investor would make a substantial profit. (R2702.) Under this scenario, the investor would receive a payment under the long option without having to pay out under the short option. (R2702.) This was coined the "sweet spot" by DGI, and Patterson was told by DGI that other of its customers had attained the "sweet spot. (R2843.) As the district court put it, "[t]he 'sweet spot' is the range where the long option pays and the short option does not pay, in other words, a 'home run.'" (R2702 n. 5.) Second, if the reference price on the expiration date was greater than both strike prices, then the investor would receive a payment under the long position, but would also have to pay out under the short position, resulting in a net profit that would be substantially less than if the reference price had settled between the strike prices. (R2702.)

The government offered expert testimony in an effort to support the notion that the Partners could not profit from these transactions on the theory that the

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(R3021.)

<sup>16</sup> DGI's investment strategy involved entering into a long and short option position in the same currency, but with different strike prices.

reference price would never land in the “sweet spot.” While that testimony proved not to be credible (R3219-20 (Read acknowledged that the reference price could land in the “sweet spot”); R3303 (DeRosa acknowledged that, if the reference price had settled in the “sweet spot,” the Partners would have received a substantial payment under the long option without having to make a payment on the short option )), whether the “sweet spot” would or would not in fact be achieved is irrelevant. What matters is that the Partners had a valid basis from the information they possessed to believe that it could be achieved and that they could profit thereby.

At an afternoon session, Ruble of Sidley Austin discussed the tax aspects of the investment. (R2702-2703, 2931.) Specifically, Ruble explained how the investment proposed by DGI would be treated under the Internal Revenue Code and result in potential tax benefits, depending on whether the Partners made a profit or loss from the investment. (R2702-2703, 2934.) At the time of the meeting, Patterson recognized Sidley Austin as one of the largest law firms in the United States with a “tremendous reputation in several fields, including tax” and, therefore, believed that Sidley Austin was “absolutely” qualified to provide him with advice on tax issues. (R2846.) Cohen also recognized Ruble as a tax expert on partnership matters, and he was familiar with the law firm Sidley Austin from his time at Arthur Andersen in Chicago. (R2933.) That the Partners believed they

could reasonably rely on the advice of Sidley Austin is further demonstrated by the fact that they sought Sidley Austin's advice in connection with the restructuring of the law firm. (*See generally* R2955, 3026.)

During his first meeting with Ruble, Patterson inquired whether any conflict of interest existed based on Ruble's and Sidley Austin's representation of DGI. (R2725, 2846-47.) In order to determine whether a conflict of interest existed, Patterson asked Ruble "a series of questions about his allegiance to [DGI] and was there anything in [Ruble's] mind as to what he had done for [DGI] that would in any way impair his ability to be loyal to [the Partners] – and give [them] an independent tax opinion." (R2725, 2846-47.) Ruble assured him that there was not. (R2725, 2846-47) Given the Partners' occupation as plaintiffs' lawyers, Patterson believed that Ruble was being honest with him, because of the obvious consequences if he were dishonest. (R2846-47.)

After addressing Patterson's concern of a potential conflict of interest, Ruble discussed the tax aspects of DGI's investment strategy under different scenarios, including the tax treatment of the investment transactions if the reference price settled in the "sweet spot" and the tax losses that could occur if the investment transactions did not land in the "sweet spot." (R2701-2703, 2848.) Ruble also explained the analysis and conclusions contained in a generic tax opinion relating to the transaction at the meeting. (R2702, 2849.)

Following the meetings in New York, Patterson returned to Texas and discussed the substance of those conversations with Nix and Roach. *See generally* R2704.) In those discussions, Patterson described how DGI's investment strategy worked and relayed the possibility of earning substantial profits if the investments landed in the "sweet spot." (R2702-03, 2850.)

The Partners also turned to Cohen for advice in evaluating DGI's investment strategy. Cohen evaluated the transaction from both an economic and a tax standpoint. (R2704, 2934.) With respect to the economics of the transaction, Cohen looked at the types of options and the foreign currencies being considered and reviewed historical data regarding the movement of the foreign currencies. (R2935.) Cohen also reviewed outlines of the proposed transactions provided by DGI with the Partners and communicated with DGI regarding the Partners' requested changes to the outlines. (R2935-37, P. Ex. 47, 48.) Finally, Cohen met with the Partners on several occasions in Daingerfield, Texas to discuss the economics of the transaction. At those meetings, Cohen told the Partners that the investment in foreign currency options "fit their goals and objectives with what they were trying to accomplish." (R2939.) With respect to the tax aspects of the transaction, Cohen "reviewed the tax opinion that Mr. Ruble had proposed and checked out the citations and the . . . reasoning to see that it made sense to [him]." (R2706, 2934.)

Based in large part on the advice of Cohen, the Partners ultimately decided to invest in the foreign currency options. (R2719, 2725.) An important reason for each of the Partners to invest in the foreign currency options was the possibility of hitting the “sweet spot.” (R2842, 3023, 3069.) This possibility enhanced the economics of the transaction by providing a real, but narrow opportunity for a large profit. (R2837, 3023-24, 3030-32, 3331, 3406.) After the Partners decided to go forward, Cohen assisted them with the documentation and monitored the investments by reviewing daily pricing sheets indicating where each of the foreign currency options stood. (R2940; P. Ex. 26 at PC06339.)

When the Partners resigned from NPR based on Roach’s decision to withdraw for personal reasons, the Partners each obtained a thorough, written opinion from Sidley Austin that detailed the proper tax treatment of their investments. (R2706.) In drafting those opinions, Sidley Austin relied on representations made by each of the Partners. (R2706 (citing P. Exs. 17, 18, 19).), only one of which the government challenges in its appeal. Significantly, each Partner made the following representation:

There existed no understanding, agreement, obligation, or arrangement pursuant to which any of the parties described herein committed to undertake all or any of the transactions described herein upon the happening of any other transactions, except to the extent that Investor/SMLLC (and Fund as transferee of Investor) and Bank were contractually obligated to perform under the Options in accordance with their stated terms.

(*See, e.g.*, P. Ex. 17 at ¶ 11.) Each of the Partners believed this representation to be true at the time it was made, and continued to believe it to be true at the time of trial. (R2706.)

Not learned in the area of tax law, the Partners reviewed the Sidley Austin opinions with Cohen. (R2706.) After reviewing the Sidley Austin opinions, Cohen concluded that the opinions “had cited the important areas where there might be potential controversy and had adequately dealt with them to [his] satisfaction that [the Partners] would be okay.” (R2706.) Accordingly, he advised the Partners that they could rely on the opinions because Sidley Austin was a “very well known firm,” because the opinions were “very, very well reasoned,” and because R.J. Ruble was an “acknowledged partnership tax expert.” (R2706.)

Cohen’s conclusion is reinforced by the expert opinion of Stuart Smith, who was engaged by the Partners to testify at trial concerning his evaluation of the Sidley Austin opinions. Smith has practiced tax law for four decades and has spent approximately half of that time representing the United States on tax issues in the Supreme Court and in the courts of appeals. (R3105-06.) He reviewed the Sidley Austin opinions and concluded that they provided “objectively reasonable tax advice” because they “discussed all of the authorities in an even-handed balanced way, taking into account all possible challenges in a thorough and complete manner.” (R2719, 3122.) He further concluded that the Sidley Austin opinions

were of the quality and character upon which a taxpayer could reasonably rely in good faith. (R2719, 3122.) Smith explained that the detailed opinions met not only the common law standard of objective reasonableness but also the higher standard that applies in proceedings before the Treasury under Circular 230. (R2726, 3119; P. Ex. 44 at 6.) Smith's expert testimony was un rebutted at trial.

Cohen prepared the Partners' individual returns and their law firm's partnership return in accordance with the Sidley Austin opinions and he recommended to the Partners before signing and filing their returns that they should report the sales of the foreign currencies they received when they resigned from NPR on the basis recommended by the Sidley Austin opinions. (R2952.) The Partners relied on this advice in good faith. (R2726, 2952.) Cohen decided independently to report the tax losses the Partners were allocated from the law firm's sale of the foreign currencies they received in liquidation of their interest in NPR under the law firm's "Business Risk Division." (R2948 (Cohen testifying that he did not discuss with, or seek the input of, the Partners the treatment of the foreign currencies on the law firm's partnership return).) Cohen placed the foreign currency losses on the "Business Risk Division" statement as a way of "separating the currency from the law practice so the partners could see what was going on in the law practice, and it wouldn't get all mixed together." (R2948.)

The Partners' good faith is exemplified by the disclosure statements that were filed with their 2002 individual returns, on which the vast majority of the foreign currency losses at issue were claimed, and the law firm's 2002 and 2003 tax returns. (P. Exs. 5, 6, 7, 9, 12.) These disclosure statements provided a complete recitation of the major features of the investments, leaving nothing hidden from the IRS, even though the Partners were advised that they were not technically required to file the disclosure statements. (R2949-52 (Cohen testifying that "we did not believe that [the Partners] were subject to the provisions that required this to be filed, but they filed it anyway"); P. Exs. 5, 7, 9, and 12.) The disclosure statements evidence the Partners' reasonable and good faith belief based on the advice of their highly qualified, professional advisors that their tax treatment of their investments in NPR was proper. (R2726.)

In short, the Partners acted reasonably and in good faith in relying on their tax advisors' advice with respect to their investment in NPR. As aptly stated by Nix: "[A]t every step, we followed the advice of people we relied on, people who were supposed to have known what they were doing and did know what they were doing." (R2726.) As Nix stated, in noting that taxpayers who are not experts on tax law have no real alternative: "[W]hat else could we have done except follow their advice?" (R2726.)

Just as the government declined to bring Doerr to testify at trial, it declined to offer any expert evidence of its own, or any other rebuttal of the uniform legal conclusion of the Partners' advisors who opined, after their thorough review of the transactions at issue, that the tax treatment of the transactions, as reported by the Partners, was appropriate. Thus, even if the August 15, 2005 notice were valid, the accuracy-related penalties assessed by the government in that notice are manifestly inapplicable in this case.

**B. Sidley Austin did not have a conflict of interest.**

The government argues that the district court failed to consider whether Ruble had a conflict of interest. (Appellant's Br. at 61). That argument is easily refuted by the district court's opinion, in which the court framed the parties' argument below as follows: on the one hand, "the Government . . . argues that the Taxpayers had full knowledge of their advisors' conflicts of interest"; and, on the other, "[t]he [Partners] argue . . . that they reasonably relied upon their advisors" and "that any potential conflicts of interest did not make their reliance unreasonable." (R2724-25.) Ultimately, the district court found that the Partners' reliance on their advisors' advice, including Sidley Austin's, "was reasonable and that the [Partners] relied upon this advice in good faith," explicitly "reject[ing] the Government's arguments to the contrary." (R2726.) The district court, thus, did consider whether there was a conflict of interest and did not err in the legal

standard it applied in determining whether the Partners' acted reasonably and in good faith.

The government also argues that the Partners were unreasonable in believing that Sidley Austin did not have a conflict of interest. The government's argument must fail for several reasons. First, there is not any evidence in the record to support the notion that Sidley Austin *did* have a conflict of interest. The government does nothing more than allege that Sidley Austin had a conflict of interest because its fee was dependant on the Partners' decision to enter into the transactions. That, of course, is true for every professional services firm in the country and certainly does not amount to a conflict of interest.

Second, the government misquotes the record in its desperate effort to negate the trial court's findings of fact. For instance, the government alleges that Sidley Austin's services were provided by DGI "as part of a package deal." (Appellant's Br. at 62.) The cited portions of the record, however, establish that the Partners understood that DGI had retained Sidley Austin and R.J. Ruble to discuss the tax aspects of the transaction and that the Partners first met R.J. Ruble at DGI's offices, not that Sidley Austin's services were part of a package deal. (R2932, 2963.) Similarly, the government asserts that "the Partners were not going to commit to the transaction without a favorable tax opinion." (Appellant's Br. at 62.) The cited portion of the record shows, however, that the Partners reviewed

drafts of Sidley Austin's opinions prior to entering into the transactions and that they understood they would receive final tax opinions from Sidley Austin if they entered into the transactions. (R3025-26.) There was obviously no reason for the Partners to believe that Sidley Austin's positive advice was contingent on them entering the transactions; to the contrary, Sidley Austin explained what its advice would be if they entered the transactions before they finally decided to undertake them. The rest of the cited portions of the record demonstrate that the Partners believed Sidley Austin was qualified to render the opinions, that the Partners were familiar with Sidley Austin, both from being adverse to Sidley Austin in their law practice and from their retention of Sidley Austin to restructure their law firm partnership, and that they discussed the Sidley Austin opinions with their longtime tax advisor Sid Cohen. (R3025-26.) None of this establishes that the partners were not going to commit to the transaction without a favorable tax opinion.

The government places undue emphasis on the fact that the Partners were referred to Sidley Austin by DGI and did not independently choose Sidley Austin to opine on the transactions. (Appellant's Br. at 62.) The mere fact that DGI referred the Partners to Sidley Austin does not create a conflict of interest. *See Heasley v. Comm'r*, 902 F.2d 380, 384 n.9 (5th Cir. 1990) (holding that the referral of a taxpayer to a tax professional by the tax shelter promoter does not support a finding that the professional was not objective, and holding that the taxpayers

could reasonably rely on the tax professional's advice). The Partners reasonably believed that Sidley Austin did not have a conflict of interest based on Patterson's questioning of Ruble. (Tr. I, 60-61.)

In any event, Sidley Austin was just one of the professional advisors the Partners relied on in determining whether to enter the transaction and how to treat the transaction for tax purposes. The Partners also relied on their longtime tax advisor, Sid Cohen. (R2719.) Based in large part on Cohen's advice, the Partners decided to enter into the transaction and believed that they could make a profit in the transactions. (R2719-20, 2725.) When the Partners withdraw from NPR, they received the tax opinions from Sidley Austin, which they reviewed with Cohen. (R2706.) After his review of the opinions, Cohen concluded that the opinions "had cited the important areas where there might be potential controversy and had adequately dealt with them to [his] satisfaction." (R2706.) The district court found that "[t]he advice given to the Taxpayers by Sidley Austin and Cohen relied on the existing case law and strongly supported NPR's position that the Taxpayers' tax position was 'more likely than not' correct." (R2725.) At trial, Stuart Smith, the Partners' expert witness, confirmed that the Sidley Austin tax opinions "complied with standards common to the profession and with administrative standards established by Treasury Circular 230" and concluded that the opinions "reached objectively reasonable conclusions." (R2725-26.) It was the totality of

these facts and circumstances, considered together with the government's asserted conflict of interest, that led the district court to its conclusion that the Partners' belief that their tax treatment of the transactions was correct, was reasonable, and that the Partners relied on their advisors' advice in good faith. (R2726.)

**C. Sidley Austin's opinions met the regulatory requirements.**

The government next argues that the Partners could not rely on the Sidley Austin opinions because they failed to inform Sidley Austin that they had allegedly pre-planned to withdraw from NPR during 2001 to ensure that they could claim the tax losses. (Appellant's Br. at 63-64.) The government fails to explain, however, why it would be necessary for the Partners to withdraw from NPR in 2001 to claim tax losses the vast majority of which they did not claim until 2002. The Partners could just as easily have withdrawn from NPR in those later years to claim the losses then. The government's suggestion that there was a pressing need to withdraw from NPR in 2001 for tax purposes simply lacks any foundation and is not supported by the record.

Indeed, the record clearly reflects that the Partners did not intend to withdraw from NPR at the time they entered into the transaction. The government's argument that the Partners planned to withdraw is predicated on two documents: (1) an October 22, 2001 outline prepared by Cohen; and (2) an October 24, 2001 e-mail from Mox Tan to Haber. As discussed below, the

evidence at trial established that neither the outline nor the e-mail reflect the Partners' understanding of the transaction. (R2942, 3364-65.) The October 22, 2001, outline – on which the government premises its argument that the Partners had a preconceived plan to withdraw from NPR – bears special attention. Contrary to the government's statement that “[t]he outline further provides that the partnership *will* ‘close the option positions’ (*i.e.*, before their expiration),” (Appellant's Br. at 14 (emphasis added)), the outline states, in black and white, that “Mr. X monitors the value of the options and *if* there is a profit, he instructs the investment advisors to close the options positions.” (R1771 (emphasis added).) Thus, far from evidencing a preconceived plan on the part of the Partners to withdraw from NPR early, the outline merely reflects Cohen's analysis of a possible outcome of the transaction. As further evidence that the outline does not reflect a preconceived plan of the Partners to withdraw early, Cohen testified that none of the Partners told him they planned to withdraw early from NPR. (R2942.)

The district court correctly found, based on the evidence at trial, including the credibility of the witnesses, that the Partners withdrew from NPR “based on Roach's decision to withdraw for personal reasons.” (R2706.) Since the district court's finding turns on the credibility of the witnesses, “the burden of showing that the findings of the district court are clearly erroneous is heavier,” as the Court must give “due regard to the district court's credibility evaluations.” *French v.*

*Allstate Indem. Co.*, No. 09-30209, 2011 WL 1228281, at \*3 (5th Cir. Apr. 4, 2011) (quoting *Canal Bridge Co., Inc. v. Torco Oil Co.*, 220 F.3d 370, 375 (5th Cir. 2000)). None of the contrary “evidence” that the government cites in bullet points, including the October 22, 2001 outline, establishes that the district court committed clear error, and certainly does not carry the heavier burden the government is required to here. (*See* Appellant’s Br. at 64-65). To respond point-by-point:

- That Cohen’s other clients who invested with DGI in 2000 may have withdrawn prior to that year is irrelevant to the Partners’ intentions and does not provide evidence that the Partners intended to withdraw early from NPR. Indeed, the Partners were not even aware that other clients of Cohen’s had invested in these types of transactions. (R3000 (Cohen testifying that he did not tell any of the Partners about his other clients’ transactions));
- The government did not establish at trial that Cohen based the comments in his October 22, 2001, memo outlining the Partners’ proposed transaction on any statements from the Partners. In fact, Cohen testified that none of the Partners told him they planned to withdraw from NPR early. (R2942);
- The government did not provide any evidence that Tan’s comments to Haber in the October 24, 2011, e-mail were based on any statements made, or beliefs held, by the Partners. Rather, the government introduced Defendant’s Ex. 162 under a business records declaration from Alpha Consultants, one of NPR’s original partners, but did nothing further to lay a foundation for the e-mail. (R3135, 3153-56.) Again, Roach testified that the e-mail did not reflect his understanding of the transaction, that he never had a conversation with Tan, who was relaying the comments to Haber, and that “when [he] got into this transaction, it was [his] intent to see it through.” (R3364-65.) Quite simply, Roach never told either Tan or Haber that he intended to convert any foreign currency in 2001;
- Cohen’s December 7, 2001, e-mail to Tan does not say anything about the Partners’ state of mind when they entered into the transaction, and the

implication the government attempts to draw from it is contrary to the unrefuted testimony from trial. (R2842, 3023, 3069);

- Cohen's testimony at trial regarding why the Partners withdrew from NPR is not inconsistent with the Partners' stated reasons for withdrawing from the partnership, and the government was unable at trial to refute their testimony. Importantly, Cohen testified that prior to the Partners telling him in December 2001 that they were withdrawing from NPR, none of the Partners had told them they had planned to terminate their investment in 2001. (R2942); and
- Roach's acknowledgement on cross-examination that he knew his divorce settlement payment would come due before the end of the year and that he could have liquidated other investments does not speak to Roach's intention to stay in NPR when he entered into the transaction. To the contrary, Roach testified that he hoped and expected the options to payoff. (R3023-24.)

The government's attempt to cobble together a story in support of its theory that the Partners intended to withdraw from NPR at the time they entered into the transactions from sources that do not reflect any of the beliefs held by the Partners is insufficient to establish that the district court committed clear error.

Finally, the government contends that the Partners knew or should have known that the following representation that they made to Sidley Austin was false:

There existed no understanding, agreement, obligation, or arrangement pursuant to which any of the parties described herein committed to undertake all or any of the transactions described herein upon the happening of any other transactions, except to the extent that Investor/SMLLC (and Fund as transferee of Investor) and Bank were contractually obligated to perform under the Options in accordance with their stated terms.

(See P. Exs. 14-16 at 4.) Once again, the government has failed to cite any evidence in the record to support its claim that the representation *was* false.

Instead, the government once again relies on a mistaken construction of tax law, asserting that, since “the entire scheme hinged on the inclusion of foreign currency in the liquidating distributions, it cannot seriously be argued that there was no understanding between DGI and the Partners that DGI would cause the Partnership to include the necessary foreign currency in those distributions upon the Partners’ withdrawal.” (Appellant’s Br. at 62.) The district court, however, expressly found that no such “scheme” existed. Once again, the government asks this Court to draw inferences that the district court refused to draw. The district court held that “[e]ach of the Taxpayers believed [the representations made to Sidley Austin] to be true at the time they were made, and continued to believe them to be true at the time of trial.” (R2706 (citing Tr. I at 77-78, 252-53; Tr. II at 29).) The government has not shown that finding to be clearly erroneous.

### **CONCLUSION**

For the reasons described above, the government’s appeal of the decision below should be rejected, the cross-appeal of the Partners should be upheld and judgment entered in their favor, or, alternatively, the case should be remanded for entry of an order consistent with the Court’s decision in this case.

Dated: May 17, 2011

s/ Thomas A. Cullinan

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## CERTIFICATE OF SERVICE

I hereby certify that on May 17, 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 May 17, 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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