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No. 12-562

In the Supreme Court of the United States

UNITED STATES OF AMERICA,
Petitioner,
v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.,
Respondents.

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

BRIEF FOR RESPONDENTS

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QUESTIONS PRESENTED

1. Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty.

2. Whether the substantial valuation misstatement penalty in 26 U.S.C. § 6662 applies when a transaction is disregarded because of a legal determination that the transaction lacks economic substance.

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INTRODUCTION

The government challenges the court of appeals' conclusion that the valuation misstatement penalty (26 U.S.C. § 6662(h)) does not apply where a tax underpayment is triggered by a legal determination that a transaction should be disregarded for lack of economic substance rather than a finding that the taxpayer inaccurately reported the price or cost of an item—*i.e.*, made a *valuation* misstatement. That challenge should be rejected. The text, history, and structure of the penalty establish that Congress intended to penalize "valuation misstatements." That is, what the government itself calls (at 41) the "run-of-the-mill case in which a taxpayer simply overstates the value or purchase price of an asset," an error that frequently impacts the cost, or basis, of tax items as well. Congress did not enact the quite different "basis-overstatement penalty" minted by the government in its brief, which the Internal Revenue Service (IRS) now seeks to use as an all-purpose hammer to stamp out the use of "non-economic substance transactions" that do not entail the misrepresentation of an asset's value or cost—*i.e.*, valuation misstatements. There is no reason for the Court to adopt that new penalty here, especially since Congress has already amended the statute to address the government's policy concerns.

But this Court also asked the parties to address a threshold issue that dooms the government's challenge from the outset: whether the district court had jurisdiction to determine the applicability of the penalty in this case at all. It did not. For the largely same reasons that the IRS lacked the authority to *impose* that penalty in this partnership-level proceeding, the district court lacked jurisdiction to

determine its applicability in this case. That conclusion follows from the Tax Equity and Fiscal Responsibility Act (or TEFRA), which separates partnership tax issues into one of two camps. One sort of issue may be resolved collectively for all partners, and so is addressed in a partnership-level proceeding. The other sort of issue tends to depend on each partner's individual circumstances, and so must be resolved in partner-by-partner proceedings. The government's theory of imposing the valuation misstatement penalty indisputably depends on the outcome a classic partner-by-partner determination: the partners' tax bases (or "outside basis") in their partnership interests. It is undisputed that the district court lacked jurisdiction to make that outside-basis determination. And the conclusion is no different when it comes to determining the applicability of a penalty based on outside basis.

Accordingly, this Court should dispose of the penalty issue on jurisdictional grounds. But if the Court does reach the merits, it should affirm.

STATEMENT OF THE CASE

I. STATUTORY BACKGROUND

A. Partnership Audits And Judicial Review

1. For federal income tax purposes, partnerships are neither fish nor fowl. Although partnerships can earn income and accrue deductions like individuals, they do not pay federal income tax. 26 U.S.C. § 701; *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493, 496 (1938). Instead, partnerships are tax conduits that allocate the tax consequences of their operations (including "tax items" such as income and deductions) among their partners. The partners in turn report and pay tax on their shares of those tax items. *United*

States v. Basye, 410 U.S. 441, 448 (1973). To facilitate that reporting, partnerships must track their own tax items and report them to the IRS on an information return including the partnership's gross income, deductions, and other items. 26 U.S.C. § 6031(a); *see also* IRS Form 1065 (partnership information return).

2. The jurisdictional issue before the Court turns on the procedures that Congress has enacted for reviewing alleged errors as to partnership information. Before 1982, the IRS lacked a centralized mechanism to correct errors reflected on a partnership return. Instead, the IRS addressed those errors at the partner level by issuing notices of deficiency to the partners whose own returns reflected those errors. The partners then could challenge the asserted deficiency either by filing a petition in the Tax Court, or by paying the deficiency and suing for a refund in district court or the Court of Federal Claims. H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 599 (1982). Congress revised those procedures in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and established a more unified process for determining partnership-level issues. *See* Pub. L. No. 97-248, § 402, 96 Stat. 648-68 (1982) (codified at 26 U.S.C. §§ 6221 *et seq.*).

The animating principle of TEFRA is that partnerships spawn two different kinds of tax disputes. The first class concerns matters better resolved once and for all partners, rather than seriatim for each partner. Congress called those matters "partnership item[s]," 26 U.S.C. § 6231(a)(3), and created a new proceeding "at the partnership level" to determine them, *id.* § 6221. The other class of disputes concerns "nonpartnership items," *id.* § 6231(a)(4), which are determined at the partner level (as was true before

TEFRA). Nonpartnership items may be entirely disconnected to the partnership (*e.g.*, wages from an unrelated employer), or may be "affected by a partnership item" in some way (*e.g.*, deductions based on an adjustment to a partnership item, *see* 26 C.F.R. § 301.6231(a)(5)-1(a)-(e)). The latter set of nonpartnership items are called "affected items." 26 U.S.C. § 6231(a)(5); *see* U.S. Br. 10 (recognizing that an "affected item" is a "non-partnership item").

TEFRA defines a "partnership item" as "any item required to be taken into account for the partnership's taxable year" for any income tax purpose, but only "to the extent regulations . . . provide that . . . such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. § 6231(a)(3); *see* 26 C.F.R. § 301.6231(a)(3)-1(a).[1] Partnership items include "[i]tems of income, gain, loss, deduction, or credit of the partnership" (including their allocation among the partners), as well as "the legal and factual determinations that underlie" the partnership items enumerated by regulation. 26 C.F.R. § 301.6231(a)(3)-1(a)(1)(i), (b). Partners generally must report partnership items on their individual tax return "consistent with the treatment of such partnership item on the partnership return." 26 U.S.C. § 6222(a).

The fundamental partnership tax concepts of "inside basis" and "outside basis" illustrate the difference between partnership items and nonpartnership items. Inside basis refers to the

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[1] Certain regulations cited herein had been promulgated as temporary regulations at the relevant times. But they are substantially identical to current regulations. Unified Partnership Audit Procedures, 66 Fed. Reg. 50,541, 50,543 (Oct. 4, 2001).

partnership's basis in its *own* property. Because a partnership must track its inside basis in partnership assets in order to accurately report depreciation deductions and other tax information, inside basis is a paradigmatic partnership item. *See* 26 C.F.R. § 301.6231(a)(3)-1(c)(2)(iv). By contrast, outside basis refers to a *partner's* basis in a partnership interest, and is generally an affected item—and, therefore, a nonpartnership item—because (except in circumstances not relevant here) a partnership need not track outside basis. *See id.* § 301.6231(a)(5)-1(b).

3. TEFRA segregates partnership items and nonpartnership items throughout the audit process and in providing for judicial review of the IRS's determinations. This arrangement "contemplates that adjustments to partnership items are made in one [audit] proceeding before assessments are made at the individual partner level." *AD Global Fund, LLC v. United States*, 481 F.3d 1351, 1355 (Fed. Cir. 2007). Following that partnership-level audit, the IRS issues a final partnership administrative adjustment (or FPAA) to the partnership. The partners may then challenge any partnership-item adjustments made in the FPAA in district court, or the Tax Court or Court of Federal Claims. 26 U.S.C. § 6226(a). TEFRA provides that courts "shall have jurisdiction [in such a suit] to determine all partnership items of the partnership for the partnership taxable year to which the notice of [FPAA] relates." *Id.* § 6226(f).

Following any judicial proceedings concerning such partnership-level matters, there is an abbreviated process for the IRS to assess and collect the so-called "computational adjustment"—the change in a partner's tax liability due to a partnership item adjustment (such

as an increase in partnership income). *Id.* §§ 6230(a)(1), 6231(a)(6). A partner may seek judicial review of an erroneous computational adjustment in a partner-level case. But to do so, the partner must pay the assessment first, request a refund from the IRS, and then sue for a refund. *Id.* § 6230(c). Those same abbreviated direct-assessment procedures apply to computational adjustments with respect to affected items if no "partner-level determinations" are necessary. 26 C.F.R. § 301.6231(a)(6)-1(a)(2). If affected-item adjustments do require partner-level determinations, then the IRS must give partners a chance to dispute any deficiency in Tax Court without paying the deficiency first. 26 U.S.C. § 6230(a)(1).

Because partnerships are tax conduits and not taxpayers, they are generally not liable for underpaid taxes or penalties. But adjustments to partnership items at the partnership level may make *partners* liable for penalties based on their share of those partnership-item adjustments Under those circumstances, penalties can be affected items, *see, e.g.*, 26 C.F.R. § 301.6231(a)(5)-1(e), and under the pre-1997 TEFRA rules, the IRS could not use the abbreviated direct-assessment procedure for penalties. H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 685 (1997).

4. In 1997, Congress modified the TEFRA procedures for certain penalties in the Taxpayer Relief Act (TRA). Congress recognized that the same efficiency benefits from determining all *partnership items* at the partnership level would apply if the applicability of penalties relating to those partnership items were determined at the partnership level as well. Pub. L. No. 105-34, § 1238, 111 Stat. 788, 1026-27 (1997). So Congress modified TEFRA's grant of jurisdiction in

§ 6226(f) to allow courts hearing partnership-level proceedings "to determine . . . the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a *partnership item*." 26 U.S.C. § 6226(f) (emphasis added).

In a break from past practice, Congress also provided that certain penalties—specifically, those that relate to adjustments to partnership items—can be immediately assessed. *Id.* § 6230(a)(1). Partners can still assert partner-level defenses, 26 C.F.R. § 301.6221-1(d), but they cannot assert them in ordinary partner-level deficiency proceedings. Instead, partners must file a claim in district court or the Court of Federal Claims "to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment" made after the partnership-level case. 26 U.S.C. § 6230(c)(4). Other than these changes, the TRA did not alter the basic TEFRA rule that nonpartnership items that require partner-level determinations must be determined in a partner-level proceeding and go through the ordinary deficiency procedures discussed above. *Id.* § 6230(a)(2)(A)(i).

B. The "Valuation Misstatement" Penalty

1. The other question before the Court concerns the scope of the valuation misstatement penalty enacted by Congress and now codified in 26 U.S.C. § 6662. The Internal Revenue Code (Code) imposes an array of penalties designed to encourage the proper reporting of tax matters and discourage taxpayers from violating the Code. One set of issues that proved to be especially problematic for the IRS concerned the "valuation of property." H.R. Rep. No. 201, 97th Cong., 1st Sess. 243 (1981) (H.R. Rep. No. 97-201); *see also*

H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 985 (1984) (H.R. Conf. Rep. No. 98-861). Property valuation issues arise in many tax contexts, such as in determining the fair market value of property deducted as a charitable contribution, or in determining the cost of property for purposes of calculating one's reportable tax gain or loss (since cost is a controlling factor for tax basis). Such valuation issues were creating havoc for the tax system.

The crux of the problem was the "difficult questions of fact" frequently presented by valuation issues, especially where "unique property is concerned." H.R. Rep. No. 97-201, at 243. These "valuation issues" created an enormous backlog of cases. As of 1981, there were "about 500,000 tax disputes outstanding which involve[d] valuation questions of more than routine significance." *Id.* Often these disputes were "resolved simply by 'dividing the difference' in the values asserted by the [IRS] and those claimed by the taxpayer," creating an incentive for taxpayers to "overvalue certain types of property" and thereby "delay the resolution of valuation issues." *Id.* In light of those problems and the huge backlog of valuation disputes totaling some $2.5 billion, Congress concluded that "a specific penalty is needed to deal with various problems related to valuation of property." *Id.*; *see also* H.R. Conf. Rep. No. 98-861, at 985.

In response, Congress enacted Section 6659 in 1981. Pub. L. No. 97-34, 95 Stat. 172, 341 (1981). The heading of Section 6659 stated, "ADDITION TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS FOR PURPOSES OF THE INCOME TAX," and Section 6659(a) imposed a graduated penalty for "an

underpayment ... attributable to a valuation overstatement." Section 6659(c) further provided:

> [T]here is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

Id. §6659(c), 95 Stat. at 342. Under this provision, "only significant overvaluations [were] penalized," thus "remov[ing] questions involving small differences from the ambit of this new penalty" and helping to clear the backlog of valuation disputes. Staff Joint Comm. on Taxation, 97th Cong., *General Explanation of the Economic Recovery Tax Act of 1981*, at 332 (Joint Comm. Print 1981) (*Blue Book*).

The clause referring to the "adjusted basis of any property" was included in the original version of the penalty and squares with Congress's intention to target *valuation* misstatements. As the government itself recognizes, basis frequently boils down to the purchase price, or cost, of an item—triggering the same set of fact-based valuation issues. *See* U.S. Br. 24, 41, 49; *see also* 26 U.S.C. § 1012(a) ("The basis of property shall be the *cost* of such property, except as otherwise provided…. (emphasis added)).

2. In 1989, Congress—as part of a reorganization of the Code's penalty provisions—repealed the valuation misstatement penalty passed in 1981 and reenacted it as part of the consolidated accuracy-related penalty in Section 6662. Improved Penalty Administration and Compliance Tax (IMPACT) Act, Pub. L. No. 101-239, 103 Stat. 2388, 2399 (1989). The new section imposed a 20% penalty on "the portion of any underpayment

which is attributable to . . . [a]ny substantial valuation overstatement." 26 U.S.C. § 6662(b)(3).

The new penalty further provided:

> [T]here is a substantial valuation overstatement . . . if the value of any property (or the adjusted basis of any property) claimed on any [income tax return] is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

26 U.S.C. § 6662(e)(1) (1989). Of note, in the new penalty, Congress moved the reference to "adjusted basis" to a parenthetical clause. *See id.*

The new penalty escalated to 40% for a gross valuation misstatement, *i.e.*, when the overstated value or basis was 400% of the correct amount. *Id.* § 6662(h) (1989). A 1991 Treasury regulation stated that any valuation misstatement would qualify as a gross misstatement if the property had a correct value or basis of zero (which would otherwise render the misstatement percentage mathematically undefined). 26 C.F.R. § 1.6662-5(g). In 2006, the thresholds for both the substantial and gross valuation misstatement penalties were reduced to 150% and 200%, respectively. *See* Pension Protection Act of 2006, Pub L. No. 109-280, § 1219(a)(1)-(2), 120 Stat. 780, 1083.[2]

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[2] Congress substituted the term "valuation misstatement" for "valuation overstatement" in 1990 to account for changes not relevant here. Pub. L. No. 101-508, § 11312(a)-(b), 104 Stat. 1388, 1388-454 to -455 (1990); *see also* H.R. Rep. No. 881, 101st Cong., 2d Sess. 2314 (1990). This brief uses the current term "valuation misstatement," even when referring to earlier versions of the statute that used the term "valuation *overstatement*."

3. For the first two decades after its enactment, the IRS generally focused its application of the valuation misstatement penalty on cases, including tax shelters, involving property misvaluations. *See generally* David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, Tax Notes 1283, 1284-85 (June 10, 2013) ("[a]lmost all the cases" involving the penalty in effect during the 1980s "clearly involve issues of valuation, including basis that results from overvaluation") (discussing case law).

The cattle overvaluation tax shelter described in *Persson v. Commissioner*, 58 T.C.M. (CCH) 409 (1989), is typical. There, the taxpayers claimed deductions and credits for a bull that had purportedly been purchased for $400,000. The Tax Court, however, valued the bull at $175,000, and imposed valuation misstatement penalties. *See also, e.g.*, *Boyer v. Commissioner*, 64 T.C.M. (CCH) 1570 (1992) (Section 6659 penalty imposed where cattle had stated purchase price of over $25,000 but experts agreed cows were worth less than $4,000); *Brown v. Commissioner*, 64 T.C.M. (CCH) 20 (1992) (penalizing a tax shelter where prices paid by taxpayers "greatly exceeded the fair market value of the horses and rights they received"), *aff'd without op. sub nom. Konenkamp v. Commissioner*, 14 F.3d 47 (3d Cir. 1993). These schemes also directly impacted "basis," since the taxpayer's basis in the bulls was based on their cost (*i.e.*, their purchase price).

In other words, whether they involved alleged tax shelters (like the cattle cases) or simple factual misrepresentations about the value of property or cost (which could impact basis), the cases in which the IRS invoked the valuation misstatement penalty tended to involve *valuation* misstatements. In the 2000s,

however, the IRS faced a new problem: a wave of tax shelters involving schemes that it determined used transactions lacking in economic substance as a means of artificially inflating basis. In these cases, the IRS's basic complaint is not that taxpayers have inaccurately reported the value or cost of property; it is that, as a purely legal matter, transactions should not be deemed to exist at all for tax purposes. Yet, the IRS nevertheless turned to the valuation misstatement penalty as a way of attacking these schemes, spawning the penalty question presented by this case. *See* Shakow, *supra*, at 1287-88 & n.26 (discussing cases).

4. In 2010, Congress addressed the separate problem presented by taxpayers seeking to inflate basis through transactions deemed to lack economic substance by adding a new "noneconomic substance transaction" penalty tailored to *that* problem. Pub. L. No. 111-152, § 1409(b)(2), 124 Stat. 1029, 1069 (2010) (effective for transactions entered into after March 30, 2010). The new provision applies a 20% penalty "to the portion of any underpayment which is attributable to . . . [a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance." 26 U.S.C. § 6662(b)(6). In addition, Congress added a 40% penalty on any portion of an underpayment attributable to "nondisclosed noneconomic substance transactions." *Id.* § 6662(i); *see* I.R.S. Notice 2010-62, 2010-2 C.B. 411 (discussing disclosure requirements).

The "noneconomic substance transaction" penalty is in no way dependent on the presence of a "valuation misstatement." In addition, it was created and codified by Congress as an entirely separate and stand-alone penalty. *See* 26 U.S.C. § 6662(b)(3), (6).

II. FACTUAL AND PROCEDURAL HISTORY

A. Facts Relevant To This Litigation

Respondent Gary Woods was the primary representative in IRS matters (or tax matters partner) for two partnerships that the IRS later determined lacked economic substance. Agreed Findings of Fact ¶¶ 32(c), (d), *Woods v. United States*, (W.D. Tex. Aug. 30, 2010), ECF No. 40 (Agreed Facts). In 1999, both Woods and his business partner Billy "Red" McCombs became investors in those partnerships. *Id.* ¶¶ 1(a), 1(d), 1(e), 2(a). Before investing in the partnerships, Woods consulted extensively with legal and financial experts from nationally recognized firms. *Id.* ¶¶ 13-29.

The investments were made through the following series of transactions:

(1) Through their respective wholly owned limited liability companies (LLCs), Woods and McCombs purchased options on various foreign currencies.

(2) Around the same time, Woods and McCombs (through their respective LLCs) sold comparable foreign currency options.

(3) The LLCs contributed the purchased options (which were assets) and sold options (which were liabilities), as well as a smaller amount of cash, to two Texas general partnerships.

(4) The partnerships used the cash to purchase investment assets (either stock or foreign currency options).

(5) The LLCs transferred their respective interests in those partnerships to a pair of

S corporations jointly owned by Woods and McCombs, causing the partnerships to be treated as liquidated for tax purposes. *See* 26 C.F.R. § 301.7701-2(c)(2).

(6) The S corporations sold the investment assets.

Id. ¶¶ 31- 39.

The partnerships and S corporations (which are also treated as conduits for federal income tax purposes) timely filed information returns. *Id.* ¶ 43(f). The two S corporation returns reported the sales price, basis, and resulting losses from the sale of the investment assets. JA 200, 215. Because the basis of an asset received upon the liquidation of a partnership is equal to the partner's basis in the partnership interest (or "outside basis"), 26 U.S.C. § 732(b), the S corporations reported the basis of those assets as equal to the value of the purchased options originally contributed to the partnerships by the LLCs, *id.* § 722. In doing so, the parties to the transaction relied on professional advice that the liability associated with the sold options was too contingent to reduce outside basis. Trial Tr. 88:1-90:15 (W.D. Tex. Sept. 15, 2010) (Morning Sess.).

After conducting a partnership-level audit, the IRS issued FPAAs to Woods (as tax matters partner for the partnerships) and McCombs denying that the transactions involving the partnerships had any legal effect. In particular, the FPAAs (1) denied "the existence of" the partnerships, and (2) asserted that the partnership transactions "had no business purpose other than tax avoidance, lacked economic substance, and in fact and substance, constitute[] an economic sham for federal income tax purposes." JA 92, 146.

The FPAAs also imposed accuracy-related penalties, including 20% penalties for underpayments attributable to negligence and substantial understatements of income, and a 40% penalty for gross valuation misstatements. JA 96-97, 150-51.

B. Decisions Below

1. In 2005, Woods—as tax matters partner of both partnerships—brought this action on behalf of the partnerships in district court seeking review of the FPAAs, alleging that the tax consequences of the transactions described above were correctly reported and that, in any event, penalties were inappropriate. The petition for review asserted jurisdiction under TEFRA (26 U.S.C. § 6226(a)) and 28 U.S.C. § 1346(a)(1). JA 52. The district court found that the transactions lacked economic substance and held that the losses reported by the S corporations (and passed through to Woods and McCombs) "should be disregarded for tax purposes." Pet. App. 21a.

After additional briefing, the district court determined in light of the economic substance holding that the valuation misstatement penalty did not apply. The district court relied on *Heasley v. Commisioner*, in which the Fifth Circuit held that, "[w]henever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." 902 F.2d 380, 383 (5th Cir. 1990). Following *Heasley*, the district court held that the underpayment at issue here "is not attributable to a valuation overstatement; it is attributable to claiming an improper deduction." Pet. App. 6a. The district court upheld the other penalties imposed in the FPAAs for negligence and substantial understatements. *Id.* at 7a-12a.

2. The United States appealed the denial of the 40% penalty for a gross valuation misstatement. The government recognized that Woods accurately reported the basis of each purchased option underlying the transactions at issue, *i.e.*, that the actual cost of each purchased option (U.S. CA5 Br. 11-12) was equal to the reported basis for each purchased option (JA 169, 186). But the government argued that the valuation misstatement penalty nevertheless applies because the transactions that were deemed to lack economic substance had the effect of improperly inflating basis. The Fifth Circuit affirmed in an unpublished per curiam opinion citing *Heasley* and *Todd v. Commissioner*, 862 F.2d 540, 543 (5th Cir. 1988), which held that the valuation misstatement penalty does not apply where deductions are deemed "inappropriate altogether." *See* Pet. App. 2a.

Neither of the courts below—nor the parties—addressed or questioned the courts' jurisdiction under TEFRA to determine penalties.

SUMMARY OF ARGUMENT

I. The district court lacked jurisdiction to decide whether the valuation misstatement penalty applies in this partnership-level proceeding—for essentially the same reasons that the IRS lacked the authority to impose that penalty in the FPAAs to begin with. TEFRA reorganized the partnership tax world to pair partnership-level issues with partnership-level proceedings for both audit and judicial review, and vice versa for partner-level issues and proceedings. The linchpin of the government's theory that the valuation misstatement penalty applies in this case is that the partners overstated their outside basis. But, as the

government readily admits, that outside basis is not a *partnership* item under TEFRA. It follows that outside basis cannot be determined in a partnership-level proceeding. And because the district court lacked jurisdiction to determine the partners' outside basis, it lacked jurisdiction to determine penalties that depend on that forbidden outside-basis determination.

The grant of jurisdiction to determine—in a partnership-level proceeding—"the applicability of any penalty . . . which relates to an adjustment to a *partnership item*" (26 U.S.C. § 6226(f) (emphasis added)) does not change that outcome. The penalty at issue in this case undeniably relates to the adjustment of a nonpartnership item—outside basis—not to a partnership item. It is true that the outside-basis determination, in turn, relates to the adjustment of a partnership item—*i.e.*, the determination whether a partnership transaction should be "shammed" for lack of economic substance. But if it were enough for jurisdictional purposes that a penalty relate to a nonpartnership-item adjustment that, in turn, relates to a partnership-item adjustment, then the limitation to penalties "which relate[] to an adjustment to *partnership items*" would be rendered essentially meaningless and could readily be circumvented.

II. On the merits, the court of appeals correctly concluded that the valuation misstatement penalty does not apply in the situation presented here. The text, history, and structure of the penalty confirm that it was intended to cover "valuation misstatements"—*i.e.*, factual misrepresentations concerning an asset's worth or cost. That is perfectly consistent with the penalty's parenthetical reference to "adjusted basis" because—as the government admits (at 24)—it is

"commonplace" for "basis errors" to arise "from the taxpayers' factual misrepresentation about a particular purchase price or value." Accurately reporting a transaction that is later deemed not to exist at all as a legal matter under the economic substance doctrine does not present a "valuation misstatement." And Congress confirmed as much when it enacted a new, and separate, "non-economic substance transaction" to address that different situation in 2010. The all-encompassing "basis-overstatement penalty" that the government erroneously says Congress adopted in 1981 would render the 2010 "non-economic substance transaction penalty" essentially superfluous.

The valuation misstatement penalty is also inapplicable in this case because the tax underpayment is not "attributable to" any valuation misstatement (26 U.S.C. § 6662(b)(3)), as the Fifth Circuit held below. To be "attributable to" a valuation misstatement, an underpayment must *result from* that misstatement. But when the IRS "shams" a transaction on legal grounds, and thus disallows all tax benefits following from that transaction because it is deemed not to exist, the underpayment results from the fact that the resulting tax benefits have been wiped out along with the transaction (and not from any valuation misstatement in connection with the underlying transaction that has been "shammed"). Any valuation misstatement underlying the "shammed" transaction is completely irrelevant to the underpayment, because the whole point of "shamming" the transaction is to deem it non-existent for tax purposes.

If there were any doubt about the applicability of the valuation misstatement penalty to the situation presented by this case, the canon that tax laws—and

tax penalties—must be strictly construed would require resolving that doubt in favor of the taxpayers. Whatever else is true, it cannot be said that Congress plainly intended the penalty to apply when the underpayment results from a legal determination that a transaction lacks economic substance. And while the government frequently enjoys the benefit of the doubt under administrative deference principles, the citizens enjoy that benefit when, as here, the government is training its fearsome tax power on them.

III. The government's policy plea to adopt its proposed "basis-overstatement penalty" not only misconceives the appropriate function of this Court in a statutory interpretation case, but overlooks that Congress has already answered that plea. In 2010, Congress amended the Code to add a new, stand-alone "non-economic substance transaction penalty" that directly addresses the situation here. The fact that Congress declined to make that penalty retroactive provides no reason for this Court to rewrite the valuation misstatement penalty in a way that would render Congress's recent action largely superfluous. The IRS has all the tools its needs today to address the problems that it complains about here. This Court need not subvert the *valuation* misstatement penalty to achieve the IRS's policy objectives.

ARGUMENT

The United States asks this Court to decide whether the valuation misstatement penalty applies when a transaction is disregarded for legal purposes under the economic substance doctrine. As explained in Part II below, the court of appeals correctly held that the penalty does not apply in that situation,

though there is an even more fundamental reason for why that is so than the one given by the Fifth Circuit: there simply is no *valuation* misstatement in that context. In granting certiorari, this Court instructed the parties to also address whether the district court had jurisdiction to consider the applicability of this penalty in this partnership-level proceeding. As explained in Part I below, having considered that issue in light of this Court's direction, respondents believe that the answer is no. Accordingly, although the Fifth Circuit correctly held that the penalty does not apply, this case should be disposed of on jurisdictional grounds and the applicability of the penalty will have to be reserved for a future partner-level case.

I. THE DISTRICT COURT LACKED JURISDICTION TO CONSIDER THE VALUATION MISSTATEMENT PENALTY

This case was brought as a challenge to FPAAs issued after a partnership-level audit, which assert that the valuation misstatement penalty applies based on a conclusion that the partners' misstated their outside basis in partnership items. JA 94-97, 148-51. The jurisdictional question raised by this Court boils down to whether this partnership-level proceeding is the right way to determine the applicability of this penalty, or whether it should be determined in a later partner-level proceeding. TEFRA strictly, but sensibly, pairs partnership-level issues with partnership-level proceedings on audit and judicial review—and vice versa for partner-level issues. As explained below, however, there is a fundamental mismatch between this partnership-level proceeding and the partner-level issue at the heart of the penalty at issue. The Court

accordingly must conclude that the district court lacked jurisdiction to determine that penalty.

A. The Valuation Misstatement Penalty Hinges On A Partner-Level Determination That TEFRA Explicitly Makes Off-Limits In A Partnership-Level Proceeding

The cornerstone of the government's position that the valuation misstatement penalty applies in this case is that respondents overreported their outside basis in a partnership—because the IRS legally deemed that partnership to be a sham. In order to determine whether outside basis was overstated, the district court would necessarily have to determine what outside basis actually was—which the government itself concedes is a *partner*-level question. U.S. Br. 33. By its terms, TEFRA does not grant a district court jurisdiction to make that partner-level determination in a partnership-level proceeding like this.

1. The government's theory for applying the asserted penalty proceeds in three steps: (1) the partnership transactions lacked economic substance and constituted a sham; (2) a partner's outside basis in a sham partnership is zero; and (3) claiming any outside basis greater than zero results in an underpayment of tax. U.S. Br. 41. The government candidly admits that "any overstatement penalty ultimately imposed on the taxpayers in this case will be premised on misstatements of outside basis." *Id.* at 33.

But to reach that conclusion, there must be jurisdiction to determine that the partners actually misrepresented their outside basis. That premise cannot be assumed—the practice of "'assuming' jurisdiction for the purpose of deciding the merits . . .

offends fundamental principles of separation of powers." *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83, 94 (1998). This Court has accordingly quashed the "'doctrine of hypothetical jurisdiction,'" *id.* (citation omitted), and reaffirmed that "[w]ithout jurisdiction the court cannot proceed at all in any cause,'" *id.* (quoting *Ex parte McCardle*, 74 U.S. (7 Wall.) 506, 514 (1869)). That is particularly true here, where Congress has crafted a jurisdictional regime that carefully assigns the responsibility for certain questions only to certain proceedings. Jurisdiction to decide that the partners misstated outside basis is essential here.

2. The district court lacked jurisdiction to decide that question—just as the IRS lacked authority to impose the penalty in a partnership-level audit in the first place. As discussed, under TEFRA's division of responsibility between partner-level and partnership-level proceedings, the universe of tax items is divided between partnership items (including their allocation among the partners and penalties relating to adjustments to those partnership items) and nonpartnership items (including so-called "affected items" that are merely "affected by a partnership item"). 26 U.S.C. § 6231(a)(4)-(5). Nonpartnership items (other than penalties relating to adjustments to partnership items) must be determined in partner-level proceedings, not in the partnership-level affair.

As the government has conceded, outside basis is a nonpartnership item under this scheme. *See* U.S. Br. 32 & n.7; *see also* U.S. Br. 32-33 & n.15, *Logan Trust v. Commissioner*, No. 12-1148 (D.C. Cir. Oct. 25, 2012) ("We agree that outside basis is an affected item, not a partnership item . . . ."). To qualify as a partnership item, an item must be (1) "required to be taken into

account for the partnership's taxable year," and (2) "more appropriately determined at the partnership level than at the partner level," as determined by regulation. 26 U.S.C. § 6231(a)(3). Outside basis is neither. As relevant here, "outside basis is not an 'item required to be taken into account for the partnership's taxable year.'" U.S. Br. 33 n.15, *Logan Trust v. Commissioner*, No. 12-1148 (D.C. Cir.); *see also* U.S. Br. 32 & n.7. And Treasury regulations provide that "[t]he basis of a partner's partnership interest [*i.e.*, outside basis] is an affected item to the extent it is not a partnership item." 26 C.F.R. § 301.6231(a)(5)-1(b).

Since outside basis flunks both of the "partnership item" tests, outside-basis adjustments could only be determined in a partner-level proceeding *after* the partnership-level proceeding has concluded. *See* 26 U.S.C. § 6230(a)(2)(A)(i); Chief Counsel Notice 2009-11 at 3 (Mar. 11, 2009) ("The partner's basis in the partnership interest or the distributed asset and the resulting loss is an affected item that requires further determinations at the partner level . . . ."). That is true not only for the district court's authority to determine the applicability of the penalty in this proceeding, but for the IRS's authority to impose it in the FPAAs at issue, which are based on the partnership-level audit.

3. The government argues that the district court had jurisdiction to determine that a penalty applies based on alleged misstatements of outside basis *before* any court has determined that such basis was actually misrepresented. That argument has an Alice-in-Wonderland feel to it. *See Tigers Eye Trading, LLC v. Commissioner*, 138 T.C. 67, 189 (2012) (Holmes, J., dissenting) (observing that "it's usually only in Wonderland, or in the more unpleasant judicial

systems around the world, that 'penalty first—verdict afterwards' is the rule") (quoting Lewis Carroll, *Alice's Adventures in Wonderland* 109 (Oxford Univ. Press 2009)). And it has been rejected by the District of Columbia and Federal Circuits. As Judge Sentelle explained, "since the [court] lacked jurisdiction to determine outside basis, it also lacks jurisdiction to determine that penalties apply with respect to outside basis." *Petaluma FX Partners LLC v. Commissioner*, 591 F.3d 649, 655 (D.C. Cir. 2010); *accord Jade Trading, LLC v. United States*, 598 F.3d 1372, 1379-80 (Fed. Cir. 2010). That logic is unassailable.

The government has argued in other cases that even though outside basis is not a partnership item, the conclusion that the outside basis of a *sham* partnership is zero is so "obvious" as to eliminate the need for a partner-level determination of outside basis. *See, e.g.*, U.S. Br. 52, *Petaluma*, No. 08-1356 (D.C. Cir.). But the District of Columbia and Federal Circuits have correctly rejected that argument as well: "The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. In other words, it does not matter how low the fruit hangs when one is forbidden to pick it." *Petaluma*, 591 F.3d at 655; *accord Jade Trading*, 598 F.3d at 1380. Under TEFRA, the partner-level determination of outside basis must be made at the partner level, no matter how obvious the government claims that determination will be.

B. The Court Should Reject The Government's Attempt To Engage In An End-Run Around TEFRA's Jurisdictional Limits

Because it is clear that the outside-basis determination necessary to the imposition of the penalty must be made in a partner-level proceeding, the government focuses its jurisdictional argument on the fact that the TRA created a limited exception that allows the IRS and courts to determine—in a partnership-level proceeding—"the applicability of . . . any penalty . . . which relates to an adjustment to a partnership item." 26 U.S.C. §§ 6221, 6226(f). But that provision cannot bear the weight that the government places on it in trying to create jurisdiction here.

1. The parties agree about the driving force behind the IRS's case: "Any overstatement penalty assessed in this case will be assessed because the partners claimed a basis higher than zero in those assets." U.S. Br. 32. The same was true in the substantially identical cases considered by the District of Columbia and Federal Circuits, where the valuation misstatement penalty "was imposed on the underpayment of income tax due to the [asserted] gross valuation misstatement of the partners' outside basis in the partnership." *Jade Trading*, 598 F.3d at 1380; *accord Petaluma*, 591 F.3d at 655. Under a straightforward application of Section 6226(f), the valuation misstatement penalty "relates to" such an adjustment to outside basis.

But as the District of Columbia and Federal Circuits concluded, that is not enough to establish jurisdiction in a partnership-level proceeding. Because "outside basis is an affected item, not a partnership item," the asserted penalty "relates to an adjustment of an affected item, not a partnership item." *Jade*

Trading, 598 F.3d at 1380. But Section 6226(f) creates penalty jurisdiction only when the penalty relates to a *partnership* item—not an affected item, which is, by definition, a *nonpartnership* item. *See Petaluma*, 591 F.3d at 655 (finding no "jurisdiction to determine that penalties apply with respect to outside basis because those penalties do not relate to an adjustment to a *partnership* item.") (emphasis added); U.S. Br. 9-10.

In order to avoid that straightforward application of Section 6226(f), the government asks the Court to look beyond the outside-basis adjustment on which its theory for imposing the penalty rests to see if any partnership item "'has a connection with or reference to' th[at] adjustment." *Id.* at 31-32 (citation omitted). In other words, according to the government, the adjusted item that triggers the penalty does not have to be a partnership item, so long as a partnership item is connected to that adjusted item *in some way*. Here, the government argues that that "connection" exists between the district court's sham determination and outside basis, and so concludes that the valuation misstatement penalty "relate[s] to" the sham determination (which is an adjustment to a partnership item). *Id.* at 32. Translation: "Ignore the outside basis and just look at the sham determination," even though the whole point of making the sham determination is to upset the taxpayers' outside basis.

The government made basically the same "pay no attention to that man behind the curtain" argument before the District of Columbia Circuit in *Petaluma*. *See* U.S. Br. 60, *Petaluma*, No. 08-1356 (D.C. Cir.) (Because "the partnership was a sham, the claimed contributions of property to the purported partnership necessarily were overstated. Thus, the penalties do

'relate' to partnership items . . . ."); *see also id.* at 57-58 ("[T]he words 'relates to' in §§ 6221 and 6226(f) . . . include penalties that indirectly relate to partnership items."). But that court recognized the argument for what it was—an end-around attempt to circumvent the jurisdictional limits of Section 6226(f). A penalty based on outside basis requires a partner-level determination whether or not the penalty has a connection to a partnership item. But that partner-level inquiry is forbidden at the partnership-level. *See Petaluma*, 591 F.3d at 655; *see also Jade Trading*, 598 F.3d at 1380.

2. Even if such an expansive reading of "relates to" would be appropriate in other contexts, the government itself recognizes here that "the language of Section 6226(f)" must be read in light of its "larger statutory context." U.S. Br. 34-35. In that larger context, the government's interpretation falls flat. Section 6226(f) specifically authorizes jurisdiction to determine the applicability of penalties that "relate[] to an adjustment to a partnership item." For example, the district court could have considered the valuation misstatement penalty if the *partnership itself* had donated a flea market painting to charity but reported the valuation of a Renoir. The charitable deduction would be a partnership item, and the valuation misstatement penalty relating to *that* partnership item adjustment could be adjudicated at the partnership level. 26 C.F.R. § 301.6231(a)(3)-1(a)(1)(i).

By contrast, Section 6226(f) does not confer jurisdiction over penalties that relate to adjustments to *affected items*—which, indisputably, are not partnership items. Given the specific jurisdictional grant over penalties relating to partnership-item adjustments, Congress sensibly left jurisdiction over

penalties relating to nonpartnership-item adjustments where it was before: at the partner level. *See*, *e.g.*, 26 C.F.R. § 301.6221-1(c) ("Assessment of any penalty . . . that relates to an adjustment to a partnership item shall be made based on partnership-level determinations."). The government's interpretation of "relates to" would rewrite Section 6226(f) to create precisely the jurisdiction that Congress withheld.

That would not be mere tinkering with the statute. To the contrary, it would upset TEFRA's jurisdictional scheme. If the government wishes to impose a penalty based on an affected-item adjustment (as it does here), it will always be able to find a correlative adjustment to a partnership item. That follows from the statutory definition of "affected item," which includes "any item *to the extent such item is affected by a partnership item*." 26 U.S.C. § 6231(a)(5) (emphasis added). Here, to reiterate the point, outside basis is an affected item because it is affected by the sham determination (a partnership item). So a penalty that directly "relates to" an affected item adjustment will always indirectly "relate[] to" a partnership item adjustment. *See* U.S. Br. 33. If that indirect relationship satisfies the requirement of Section 6226(f), then Congress's omission of penalty jurisdiction over adjustments to nonpartnership items will be effectively undone.

TEFRA separately defines "partnership item" (Section 6231(a)(3)), "nonpartnership item" (Section 6231(a)(4)), and "affected item" (Section 6231(a)(5)), and it is undisputed that an "affected item" is a nonpartnership item (U.S. Br. 10). Accordingly, Congress's use of "partnership item" in Section 6226(f) is significant, and should be given effect. Congress granted jurisdiction to determine the applicability of a

penalty that "relates to an adjustment to a *partnership item*." It did not confer jurisdiction to determine the applicability of a penalty that "relates to an adjustment to an *affected item*." And it did not confer jurisdiction to determine the applicability of a penalty that "relates to an adjustment to a nonpartnership item (like outside basis) that, in turn, relates to a partnership item" (which is another way of saying an affected item). The government's interpretation would render Congress's use of "partnership item" largely meaningless.[3]

3. The government attempts to reframe its argument by claiming that the valuation misstatement penalty relates to the determination that the *contributions to* and *distributions from* the partnership were shams (rather than that the partnership transaction itself was a sham). *See* U.S. Br. 31, 33-34. But here again, the government runs into the problem that it is hard to "think about a thing inextricably attached to something else without thinking of the thing which it is attached to." Thomas Reed Powell, *quoted in* Thurman W. Arnold, *The Symbols of Government* 101 (1935). However the issue is framed, "any overstatement penalty ultimately imposed on the taxpayers in this case will be premised on misstatements of outside basis" (U.S. Br. 33)—a

[3] The government argues that its interpretation does not "render the 'relates to' limitation superfluous" because "a penalty might be imposed . . . for misstating affected items if liability for such penalties does not turn on adjustments to partnership items." U.S. Br. 34. That is a head scratcher. If an item does not turn on adjustments to a "partnership item," it is not an "affected item." 26 U.S.C. § 6231(a)(5). And, in any event, whether the government's interpretation renders "relates to" superfluous or not, the government is urging the Court to rewrite the statute.

premise that was beyond the jurisdiction of the district court to determine in this partnership-level case.

To be clear, the district court undeniably had jurisdiction over other aspects of this case, such as respondents' challenge to the IRS's decision to sham the partnership transactions (a partnership item). The only question here is the court's jurisdiction over penalties, and that jurisdiction was lacking.

C. For Essentially The Same Reasons That The District Court Lacked Jurisdiction, The IRS Lacked Authority To Impose The Penalty In The FPAAs To Begin With

For largely the same reasons that the district court lacked jurisdiction to determine the applicability of the valuation misstatement penalty in this partnership-level proceeding, the IRS lacked the authority to impose that penalty at all in the FPAAs that were the result of the partnership-level audit (JA 95-97, 149-51). Just as TEFRA limits the jurisdiction of a district court to partnership-level matters in a partnership-level proceeding (in § 6226(f)), the statute bifurcates and limits the authority of the IRS in the same fashion (in § 6221(a)). Which is to say, partnership-level proceedings may not be used to make partner-level determinations—and may not be used to determine penalties that depend on future partner-level determinations. *See supra* at 21-24. Accordingly, if the IRS wishes to penalize partners for their treatment of affected items (like outside basis), the government must use the partner-level audit and review procedures specified by TEFRA. *Supra* at 5-6.

Respondents here were left with essentially no choice but to challenge the IRS's determination of penalties in this case because the penalties were

(erroneously) imposed in the FPAAs. Indeed, if respondents had not challenged the penalties, the government likely would have argued that respondents waived the right to challenge their imposition against the partners individually. *Cf.* U.S. Br. 10 (citing 26 U.S.C. § 6230(c)(4)). To prevent putting taxpayers between the same rock and a hard place in the future, the Court should make clear that the IRS lacks authority under TEFRA to impose partner-level penalties (or any penalties, like the one at issue here, that depend on a partner-level determination) in an FPAA issued as the result of a partnership-level audit. Under TEFRA, such penalties may only be imposed by the IRS, if at all, in a partner-level proceeding in which all necessary determinations, such as outside basis for the penalty at issue here, are made, and in which partners may challenge those penalties.[4]

II. THE VALUATION MISSTATEMENT PENALTY DOES NOT APPLY

On the merits, the courts of appeals properly held that the valuation misstatement penalty does not apply where, as here, a transaction is accurately reported, but is simply deemed not to exist as a legal matter under the economic substance doctrine. The Fifth

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[4] For the same reasons that the district court lacked jurisdiction to determine the valuation misstatement penalty, it lacked jurisdiction to consider the other accuracy-related penalties. Pet. App. 7a-14a. Thus, if this Court vacates the district court's penalty judgment, it should do so in its entirety. *See Petaluma*, 591 F.3d at 655-56; *Jade Trading*, 598 F.3d at 1380. In addition, the Court should remand the case to the district court so that it may consider whether any other action is necessary or appropriate in light of this Court's decision, including return of any jurisdictional deposit (26 U.S.C. § 6226(e)(1)) tied to penalties.

Circuit has reasoned that the valuation misstatement penalty is inapplicable in that situation on the ground that, where a deduction or loss is disallowed altogether, an underpayment is not "attributable to" any valuation misstatement, since any valuation misstatement "play[s] no part in calculating the tax . . . actually owed." *Todd*, 862 F.2d at 541-42. But this Court need not even reach that argument, because there is an even more fundamental reason that the penalty is inapplicable: there was no "valuation misstatement" to begin with. Without a valuation misstatement, the *valuation misstatement* penalty cannot apply.

A. The "Valuation Misstatement" Penalty Is Not Triggered By Transactions That Are Accurately Reported But Deemed Not To Exist Based On A Legal Conclusion That They Lack Economic Substance

Fundamentally, the penalty question in this case concerns the problem that Congress meant to address when it enacted the "valuation misstatement" penalty. To its credit, the government recognizes the crux of the issue: Consistent with the valuation problems that Congress set out to address when it enacted the penalty, the "run-of-the-mill case" in which the penalty has been applied is where "a taxpayer simply overstates the value or purchase price of an asset." U.S. Br. 41; *see id.* at 49 (the "more prosaic" situation in which the penalty has been applied is "where a taxpayer overstates his basis in sold property by misrepresenting the relevant facts"). Yet, as the government concedes (*id.* at 41), here the alleged overstatements "arise not from the taxpayers' factual misrepresentation about a particular purchase price or

value," but rather because of a legal determination that the property should be deemed not to exist under the economic substance doctrine. *Id.* at 24.

The government argues (at 41) that this distinction is "immaterial," but the text, history, and structure of the statute point to the opposite conclusion. And Congress underscored that conclusion when, in 2010, it adopted a new, "non-economic substance transaction" penalty explicitly addressing the issue here. What the government asks the Court to do here is not to enforce the valuation misstatement penalty, but rather to *create* a "basis-overstatement penalty"—a term that the government mints in its brief and uses no fewer than 28 times throughout its brief—that does not depend on the existence of a *valuation* error at all. As explained below, the standard tools of statutory construction compel the conclusion that Congress did not enact the government's "basis-overstatement penalty," and that the valuation misstatement penalty that it *did* adopt is inapplicable here.[5]

1. The Text And History Of § 6662 Make Clear That The "Valuation Misstatement" Penalty Does Not Cover The Different Situation Here

a. This Court of course starts with the text of the provision, and here the most important textual clue is Congress's use of "valuation." The ordinary meaning of "valuation" is a fact-based assessment of the monetary

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[5] Because of the "clearly established" (Pet. App. 6a) circuit precedent holding that the penalty does not apply for the reasons discussed in Part II.B, *supra*, there was no need for respondents to make this threshold argument in the courts below in justifying their over-arching position that the penalty does not apply.

worth (or value) of something.[6] Consistent with that meaning, Section 6662(e)(1)(A) explains that there is a valuation misstatement with respect to value when "the value of any property (or adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation." 26 U.S.C. § 6662(e)(1)(A). The reference to "correct amount" reinforces that Congress had the ordinary meaning of "valuation" in mind. Moreover, Congress did not just use the word "valuation" in explaining how the penalty operates, it called the penalty a "valuation misstatement" penalty and used that phrase in the headings of Sections 6662(e) and -(h). Congress's use of "valuation misstatement[s]" in the penalty's headings underscores that its reference to "valuation" is significant. *See Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 47 (2008).

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[6] Dictionaries published around the time of the penalty's enactment (1981) agree on the ordinary meaning of "valuation" and confirm that it is inherently fact-based. *See, e.g.*, *Webster's Third New Int'l Dictionary* 2530 (1981) ("1 : the act or process of valuing or of estimating value or worth: as **a** : the act or process of setting or determining the price of something : APPRAISAL . . . 2 : the value or price set upon something as its estimated or determined market value"); *Webster's New Collegiate Dictionary* 1283 (1981) ("1: the act or process of valuing; *specif*: appraisal of property 2: the estimate or determined market value of a thing"); *Random House Dictionary of the English Language* 2103 (2d ed. 1987) ("1. the act of estimating or setting the value of something; appraisal. 2. An estimated value or worth."); *American Heritage Dictionary of the English Language* (1981) ("1. The act or process of assessing the value or price of something: an appraisal. 2. The assessed value or price of something.").

As the plain meaning of "valuation" reflects (*see* note 6, *supra*), valuation is inherently a factual—rather than legal—concept. That meaning is confirmed by the practice of the Tax Court, whose valuation docket spurred the adoption of the valuation misstatement penalty in the first place. The Tax Court has a longstanding practice of treating valuation issues as matters of *fact*, rather than questions of law. *See, e.g.*, *Newcomb v. Commissioner*, 23 T.C. 954, 962 (1955) ("[V]aluation . . . presents a question of fact peculiar to each individual case."); *Estate of Mellinger v. Commissioner*, 112 T.C. 26, 38 (1999) ("Valuation is a question of fact, so the tax court must weigh all relevant evidence to draw the appropriate inferences."). Congress is presumed to be aware of that pratice when it enacted the penalty. *See Goodyear Atomic Corp. v. Miller*, 486 U.S. 174, 184-85 (1988).

b. The legislative history overwhelmingly confirms that the valuation misstatement penalty was intended to address situations presenting "valuation" issues. Congress created the penalty based on the judgment that "a specific penalty is needed to deal with various problems related to valuation of property." H.R. Rep. 97-201, at 243. Specifically, Congress was concerned with "difficult questions of fact" that property valuation issues presented, "especially where unique property is concerned," which had created an enormous backlog of tax disputes. *Id.* Thus, in 1981, Congress enacted a valuation overstatement penalty to apply "if a taxpayer makes a large error in placing *too high a value on property* which results in an understatement of tax." 128 Cong. Rec. 8965 (1982) (statement of Rep. Roskenkowski) (emphasis added).

In 1989, when Congress reenacted the valuation misstatement penalty, Congress yet again reaffirmed its understanding that valuation is a fact-based inquiry—affecting such areas as "charitable contributions of property, depreciation or amortization of acquired assets, the basis of inherited property and so forth"—and that valuation "is often, in fact, usually a matter of widely varying opinions even among *experts*," and not a legal determination to be made by jurists. *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings on H.R. 2528 Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 101st Cong. 114 (1989) (emphasis added). Indeed, Congress observed that "[d]ifferences in estimates of value by equally qualified appraisers often differ by more than 50 percent" based on "failure to apply sound valuation principles or reliance on unqualified appraisers." *Id.* at 121.

Although not all members of this Court attach significance to such legislative history, for those who do this is compelling additional evidence that Congress meant the penalty to address misstatements about *valuation*—an inherently factual concept concerning the worth or cost of property. *See, e.g.*, *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1361 (2013); *Hertz Corp. v. Friend*, 559 U.S. 77, 95 (2010); *Samantar v. Yousuf*, 130 S. Ct. 2278, 2289 n.12 (2010).

2. Congress Did Not Adopt The Open-Ended "Basis-Overstatement Penalty" Conceived By The Government

Relying on Congress's inclusion of the clause "(or adjusted basis of any property)," the government asserts that Congress actually adopted a "basis-overstatement penalty." *E.g.*, U.S. Br. 2, 21, 23. To be

sure, the "valuation misstatement" penalty that Congress enacted can apply to misstatements of basis too, but only when basis is incorrectly reported due to a factual misrepresentation of property's worth or cost—that is, a *valuation* misstatement. The government asks this Court to take the reference to "adjusted basis" and conclude that Congress enacted an entirely different penalty, which could be invoked any time a taxpayer's basis has been overstated—regardless of whether there is any valuation misstatement at all. The Court should reject that interpretation.

a. To begin with, Congress's reference to "adjusted basis" is perfectly consistent with its enactment of a *valuation* misstatement penalty—and by no means compels the conclusion that Congress meant to adopt an omnibus "basis-overstatement penalty." Indeed, the government admits that the "run-of-the-mill case" in which the penalty applies is "where a taxpayer overstates his basis in sold property *by misrepresenting the relevant facts*." U.S. Br. 41, 49 (emphasis added); *see id.* at 24 ("more commonplace basis errors" arise "from the taxpayers' factual misrepresentation about a particular purchase price or value"). And, by definition, basis often turns on the purchase price, or cost, of an item—triggering a classic valuation issues. 26 U.S.C. § 1012(a). The reference to "adjusted basis" therefore hardly compels the interpretation advanced by the government.

b. Moreover, as is true of all "statutory language," Congress's reference to "adjusted basis" here "must be read in context and . . . 'gathers meaning from the words around it.'" *Jones v. United States*, 373 U.S. 373, 389 (1999) (quoting *Jarecki v. G.D. Searle & Co.*, 367 U. S. 303, 307 (1961)); *accord Whitman v. American*

Trucking Ass'ns, Inc., 531 U.S. 457, 466 (2001). In context, the reference to "adjusted basis" simply clarifies that factually inaccurate assertions of "adjusted basis" (which arise from misrepresentations about price or cost) count as valuation misstatements.

That conclusion is reinforced by the grammatical structure of § 6662(e)(1)(A), which refers to "adjusted basis" in a parenthetical clause: "the value of any property (or the adjusted basis of any property)." 26 U.S.C. § 6662(e)(1)(A). In the 1981 version of the penalty, the reference to "adjusted basis" was including in a clause set off by commas. When Congress repealed and reenacted the penalty in 1989, it replaced the commas with parentheses. *Supra* at 8-10. Those parentheses—like all punctuation used by Congress—must be given effect in construing the statute. *See* Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 161 (2012) ("No intelligent construction of a text can ignore its punctuation.").

This parenthetical construction signals that the item inside the parentheses is meant to illustrate or explain what is outside the parentheses—not *change* it. *See, e.g.*, *Novacor Chems., Inc. v. United States*, 171 F.3d 1376, 1381 (Fed. Cir. 1999) ("the parenthetical is merely an illustrative example"). In particular, courts have recognized that parenthetical phrases such as the one used in Section 6662(e)(1)(A) do not have "broad and independent meaning." *Disabled in Action of Pa. v. Southeastern Pa. Transp. Auth.*, 539 F.3d 199, 212 (3d Cir. 2008). Instead, such parenthetical clauses ordinarily are "related to, or dependent upon" their non-parenthetical antecedents for meaning. *Id.* This is not news to the Solicitor General. *See, e.g.*, U.S. Br. 21,

Logan v. United States, No. 06-6911 (2007) (arguing that the conclusion that Congress intended certain language to clarify rather than *change* the meaning of a provision is "strengthened by Congress's use of a parenthetical phrase (a parenthetical, after all, being where one expects clarifying language).").

The fact that Congress replaced the commas that surrounded "or the adjusted basis of any property" in § 6659 (enacted in 1981) with parentheses in § 6662 only increases the significance of the parentheses. *See, e.g.*, *Peters v. Ashcroft*, 383 F.3d 302, 309 (5th Cir. 2004) ("Congress in fact reduced the grammatical import of" items inside the parentheses "when it replaced commas cordoning off . . . the predecessor provision with the parentheses that now appear."). And this Court has similarly interpreted parenthetical phrases as "emphasiz[ing] the fact that that which is within is meant simply to be illustrative," *Chickasaw Nation v. United States*, 534 U.S. 84, 89 (2001), and to "partake of the nature" of items outside the parentheticals. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 469-70 (1933). Here, the reference to "adjusted basis" simply illustrates a type of valuation misstatement, *i.e.*, a factual misrepresentation of the cost or value of an item. It does not change the ordinary meaning of valuation misstatement.

This construction makes perfect sense. While in the abstract, "adjusted basis" could be portrayed as a more expansive concept, in context it refers to fact-based basis errors. After all, basis originates in the "cost" of property, 26 U.S.C. § 1012(a), a concept that also depends on valuation. And the government itself acknowledges that the the "more commonplace basis errors" involve "factual misrepresentations about a

particular purchase price or value." U.S. Br. 24. For example, a homeowner takes an initial basis equal to the valuation determined by the purchase price in a bona fide arm's-length transaction. And the homeowner's adjusted basis may change in light of other transactions that depend on valuations, such as adding a bathroom or replacing the roof. *See, e.g.*, *Ettig v. Commissioner*, 55 T.C.M. (CCH) 720 (1988).

Congress's use of "or" in "(or the adjusted basis of any property)" is consistent with the illustrative function of the parenthetical. In addition to the use that connotes difference, "or" also frequently introduces a term with similar meaning (or a synonym). Scalia & Garner, *Reading Law* 122. Courts have accordingly recognized that "or" can introduce an illustrative or merely explanatory phrase. *See, e.g.*, *Mizrahi v. Gonzales*, 492 F.3d 156, 166 (2d Cir. 2007) ("[T]he disjunctive parenthetical here at issue need not be assigned a different meaning from the preceding language to avoid being surplusage; it can reasonably be construed to illustrate or explain the broader proposition.") This use of "or" dovetails with the use of parentheses in § 6662(e)(1)(A) to set off the clause.

Respondents' reading of the penalty gives effect to both Congress's pointed use of "valuation" *and* its parenthetical reference to "adjusted basis." The government's interpretation asks this Court to take the dependent reference to "adjusted basis" and transform the penalty from a "valuation misstatement" penalty into a "basis-overstatement" penalty that is in no way dependent on a *valuation* error—essentially blowing it

up and transforming it into a penalty scarcely recognizable to the one Congress intended.[7]

c. The structure and context of the valuation misstatement penalty confirm that it applies only to valuation errors—and not legal errors—that affect adjusted basis. When penalties can apply to *legal* errors, Congress and Treasury have typically provided defenses specifically for *legal* close calls. For example, the substantial understatement penalty in § 6662(b)(2) does not apply to the extent that there "was substantial authority" for tax treatment of items resulting in an understatement, which includes legal errors. 26 U.S.C. § 6662(d)(2)(B)(i); *see also* 26 C.F.R. § 1.6662-4(d)(2) ("substantial authority standard" involves "an analysis of the law"). In addition to the "substantial authority" defense, the Code provides a "reasonable basis" defense with respect to legal errors when the "relevant facts affecting the item's tax treatment" are disclosed. 26 U.S.C. § 6662(d)(2)(B)(ii); *see also* 26 C.F.R. § 1.6662-3(b)(3). Other penalties that cover legal errors provide similar defenses, including the penalty for negligence (26 U.S.C. § 6662(b)(1)). Consistent with the fact that Congress did not intend to reach legal errors with the valuation misstatement penalty, there is no specifically legal defense.[8]

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[7] The reference to "adjusted basis" at the end of § 6662(e)(1)(A) must be read in light of the preceding parenthetical, and thus does not support the government's reading either. It is noteworthy, though, that Congress used "correct amount"—a valuation concept—to refer to both "valuation or adjusted basis" at the end of the provision.

[8] While there is a "reasonable cause" defense available to most of the § 6662 penalties, 26 U.S.C. § 6664(c)(1)-(2), that defense is not *specific* to legal mistakes, *see* 26 C.F.R. § 1.6664-

The absence of specifically legal defense is particularly striking given that the government's interpretation would subject a broad swath of legal mistakes to the penalty. If this Court adopts the government's "basis-overstatement penalty," the IRS may seek to impose penalties on myriad other legal errors affecting adjusted basis that have nothing to do with valuation misstatements, such as failing to take allowable depreciation, associating liabilities with unassociated assets, or failing to account for the effect of certain distributions that reduce basis. *See* Shakow, *supra*, at 1285 (listing examples). Indeed, the government admits that it could apply the penalty (under its theory) in other novel contexts involving no "factual error" but only the "misapplication of basis-computation rules," such as those in the consolidated return regulations. U.S. Br. 42.

Application of the valuation misstatement penalty to legal errors in the computation of basis is also inconsistent with the penalty's graduated structure. The penalty has always been calibrated to become more severe as the numerical degree of value or basis overstatement increases. *See* 26 U.S.C. § 6662(h)(2)(A) (20% penalty for 150% overstatement; 40% for 200% overstatement); *see also id.* § 6659 (1981) (10% penalty for 150% overstatement; 20% for 200% overstatement; 30% for 250% overstatement). But when transactions are "shammed" under the economic substance doctrine (or basis is invalidated based on other legal errors) the penalty operates like an on/off switch, because the

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4(b)(1), and there is no reason to conclude that Congress intended to put taxpayers whose legal mistakes lead to misstatements of basis at a disadvantage compared to taxpayers whose legal errors give rise to other penalties with specifically legal defenses.

basis is reduced to "zero" in this situation, which makes it mathematically impossible to apply the penalty's graduated scale. Thus, under the government's theory, the maximum 40% penalty will apply in *every case* that presents such a legal dispute—effectively eliminating the penalty's carefully structured, graduated scheme.

3. The Legal Question Whether To "Sham" An Accurately Reported Transaction For Lack Of Economic Substance Is Unrelated To Valuation Misstatements

The economic substance doctrine has nothing to do with the valuation misstatement that triggers the penalty. Before its codification in 2010, courts applied the economic substance doctrine as judge-made law to disregard transactions for tax purposes even when they complied with the literal terms of the Code. *See, e.g.*, *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353-54 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007). The determination whether a transaction lacks economic substance is a question of law. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978); *accord* U.S. Br. at 9-10, *Sala v. United States*, 132 S. Ct. 91 (2011) (No. 10-1047), 2011 WL 2159626. The doctrine thus does not turn at all on the sort of fact-based *valuation* problems that the valuation misstatement penalty was intended to address.

This case illustrates the difference. The options purchased by Woods and McCombs (and subsequently contributed to the partnerships) were the only partnership items actually subject to a valuation exercise. But the government has conceded that the cost or value of those purchase options was precisely equal to their reported basis. *See supra* at 16. In other words, the government has conceded that respondents

did not make any "factual misrepresentations about a particular purchase price or value." U.S. Br. 24. The only ground that the government and the district court have identified for disregarding the tax consequences of the transactions is that they lacked economic substance, *see id.*; Pet. App. 19a-20a, and the application of the penalty to that purely legal error is the only merits question presented, U.S. Br. i.

The government contends that because there was no economic substance, the taxpayers must have overstated their outside basis. U.S. Br. 41. But this syllogism simply assumes that any basis overstatement is a valuation misstatement and, thus, fails to account for the ordinary meaning of *valuation*. *Supra* at 34. No valuation is necessary to determine whether "'a transaction lacks economic substance compelled by business or regulatory realities.'" Pet. App. 19a-20a (quoting *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009)). The government recognizes (at 41) the critical difference between basis overstatements based on valuation misstatements and on legal errors, but never addresses why the economic substance doctrine actually results in a *valuation misstatement*. That failure is fatal.

4. Congress's Subsequent Action Confirms That The Valuation Misstatement Penalty Was Not Intended To Address The Situation Presented Here

Congress's recent actions remove any doubt that the valuation misstatement penalty was not intended to apply to basis overstatements caused by a legal determination that a transaction lacks economic substance. As discussed, in 2010, Congress specifically addressed this distinct issue by creating a separate

"noneconomic substance transaction" penalty. 26 U.S.C. § 6662(b)(6), (i) (2010); *see supra* at 12. Moreover, although Congress adopted a graduated scheme for that penalty, the trigger for the greater penalty is whether the transaction was properly disclosed—as opposed to valuation concepts that are mathematically meaningless when a transaction is "shammed" for lack of economic substance.

The addition of the "non-economic substance transaction penalty" in 2010 as a stand-alone provision "sheds light upon the meaning of" the earlier valuation misstatement penalty. *See Branch v. Smith*, 538 U.S. 254, 280-81 (2003) (plurality opinion); *see also United States v. Freeman*, 44 U.S. (3 How.) 556, 564-65 (1845) ("[I]f it can be gathered from a subsequent statute *in pari materia*, what meaning the [later] legislature attached to the words of a former statute, they will amount to a legislative declaration of its meaning, and will govern the construction of the first statute."); Scalia & Garner, *Reading Law* 254-55 ("[T]he meaning of an ambiguous provision may change in light of a subsequent enactment."). If Congress had adopted the broad-based "basis-overstatement penalty" advanced by the government, there would have been no need for Congress to adopt this new penalty.

The manner in which Congress acted is also telling. Rather than amending the valuation misstatement penalty to make clear that it is triggered by basis adjustments resulting from the legal invalidation of "non-economic substance transactions," Congress enacted an entirely new and different penalty. Section 6662 continues to set forth the valuation misstatement penalty in one silo (§ 6662(b)(3), (e), (h)), and the new "non-economic substance transaction" penalty in

another (§ 6662(b)(6), (i)). The new penalty in no way refers to "valuation" or any other language reminiscent of the substantial valuation misstatement penalty. Of course, that is perfectly consistent with the fact that the valuation misstatement penalty was never designed, or intended, to cover the situation at issue here. And Congress's action in 2010—which, remarkably, never sees the light of day in the government's brief—utterly belies the government's position that basis overstatements resulting from legally "shammed" transactions have been covered all along by the valuation misstatement penalty.

B. An Underpayment Stemming From A Legal Determination That A Transaction Lacks Economic Substance Is Not "Attributable To" Any Valuation Misstatement

The valuation misstatement penalty is inapplicable in this case for another reason: it only applies to "the portion of any underpayment which is *attributable to* . . . [a] substantial valuation misstatement." 26 U.S.C. § 6662(b)(3) (emphasis added). When an independent legal ground (such as the "shamming" of a transaction under the economic substance doctrine) renders a deduction *of any size* improper, a valuation misstatement is irrelevant to a taxpayer's liability for taxes. The underpayment in such a case—as the court of appeals has correctly held—simply is *not* "attributable to" any valuation misstatement.

1. The government correctly recognizes (at 39-40) that an underpayment is only "attributable to" a valuation misstatement if that misstatement caused the underpayment. Yet without defining what sort of causation satisfies the statutory requirement, the

government assumes (at 40-41) that there is a sufficient causal link in this case. That is incorrect.

The ordinary meaning of "attributable to" is "resulting from" or "caused by." *See Webster's Third New Int'l Dictionary* 141-42 (1981) (defining "attribute" as "to explain as caused or brought about by"); *American Heritage Dictionary of the English Language* 85 (1981) ("[t]o regard or assign as . . . resulting from someone or something"). An underpayment triggered by a legal determination that a transaction should be disregarded under the economic substance doctrine does not "result from"—and is not "caused by"—a valuation misstatement, when the reason that the underlying deduction or loss is disallowed is that the transaction was "shammed" (and any attendant gains or losses are thus erased).

The IRS's or a court's determination that a deduction or loss resulting in the underpayment is legally inapplicable altogether as a result of the "shamming" a transaction under the economic substance doctrine cuts off any causal relationship between any valuation misstatement and the underpayment. *See Bemont Invs., L.L.C. v. United States*, 679 F.3d 339, 347-48 (5th Cir. 2012) ("Because the IRS treated the transactions as a sham, and disallowed all tax attributes flowing from the transactions in full, any valuation misstatement was irrelevant to the calculation of the tax . . . .").

Stretching "attributable to" any further would conflict with the aim of the statute. In cases where there *is* a genuine valuation dispute, the government's interpretation of "attributable to" would "force" a court to decide valuation issues for the sole purpose of imposing a valuation misstatement penalty, *Todd v.*

Commissioner, 862 F.2d at 543-45 & n.14—even when the court knows that the deduction or loss is disallowed altogether under the economic substance doctrine. *See also Keller v. Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009) ("When a depreciation deduction is disallowed in total, any overvaluation is subsumed in that disallowance, and an associated tax underpayment is 'attributable to' the invalid deduction, not the overvaluation of the asset."). Forcing courts or the IRS to resolve disputes over the value of property when they are unnecessary to determine tax liability would be thoroughly inconsistent with Congress's goal of easing—rather than cluttering—the Tax Court's docket of such valuation disputes.[9]

2. This interpretation is strongly supported by the guidance prepared by the staff of the Joint Committee on Taxation in its *General Explanation of the Economic Recovery Tax Act of 1981* (*Blue Book*). This Court has stated that the Blue Book "provides a compelling contemporary indication" of the meaning of the statute. *Federal Power Comm'n v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 472 (1973). And—despite questioning its probative value here (at 46)—the government has itself relied on the Blue Book as evidence of Congress's intent, since "it contains the views of the committee staff which participated in

[9] The conception of causation appropriate for any particular statutory provision or scheme must be interpreted in light of the context and purposes of that statute. *See, e.g.*, *Holmes v. Securities Investor Prot. Corp.*, 503 U.S. 258, 266 (1992); *Blue Shield of Va. v. McCready*, 457 U.S. 465, 476-77 (1982).

every step of the legislative process."[10] The Blue Book states that "[t]he portion of a tax underpayment that is attributable to a valuation misstatement will be determined *after taking into account any other proper adjustments to tax liability*." *Blue Book* at 333 (emphasis added). Accordingly, there is no underpayment attributable to a valuation misstatement (and hence no valuation misstatement penalty) if a tax rule—like the economic substance doctrine—requires an adjustment to tax liability that, by itself, results in the disallowance of the claimed tax benefits. *See Todd*, 862 F.3d at 542-43.

The economic substance doctrine here operates as precisely the sort of "other proper adjustment to tax liability" that the Blue Book refers to—that is, an independent legal ground for disallowing a deduction aside from a valuation misstatement. The district court treated the operation of the economic substance doctrine as fatal *in and of itself* to the reported losses, rather than as one link in a chain of causation that eventually led to a valuation misstatement: "[The transaction] was totally lacking in economic substance and was for the sole purpose of creating a tax benefit. Therefore, both the ordinary loss and the capital loss claimed by the respective partnerships should be disregarded for tax purposes." Pet. App. 21a. The court did not endorse the government's own "'Tinker to Evers to Chance' routine" that reconstructed the

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[10] U.S. Br. 24, *Allbritton v. Commissioner*, 37 F.3d 183 (5th Cir. 1994) (No. 94-40277), 1994 WL 16510112; *see, e.g.*, U.S. Br. 5 n.7, 27 n.19, *United States v. Carlton*, 512 U.S. 26 (1994) (No. 92-1941), 1993 WL 638225 (Nov. 15, 1993); Pet. for Writ of Certiorari 28, *Commissioner v. Soliman*, 506 U.S. 168 (1993) (No. 91-998).

transaction in a way that caused a valuation misstatement, which in turn caused the reported losses—it simply disallowed the losses outright. *Id.*; *see also* U.S. Br. 47-48. Therefore, just as in *Todd*, there is no reason to require an otherwise unnecessary valuation because an independent legal ground resolves the dispute over tax liability on its own.

3. The government claims that Treasury regulations should resolve any dispute over which underpayments are "attributable to" valuation misstatements. U.S. Br. 42-43. But those regulations are entirely silent on the central question: *whether* an underpayment is "attributable to" a valuation misstatement in the situation presented here.

26 C.F.R. § 1.6662-5(g) states that the "value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount" and therefore "[t]here is a gross valuation misstatement with respect to such property." The regulation's only function is to "help[] determine whether a valuation misstatement is a gross misstatement" when "true basis is determined to be zero" and the misstatement percentage would otherwise be mathematically undefined. *Bemont Invs.*, 679 F.3d at 348 n.5. It does not address whether or when an underpayment is "attributable to" a valuation misstatement, and it "does not purport to negate" cases finding underpayments *not* attributable to valuation misstatements. *Id.* The regulation provides no hook on which the government can hang its claim to *Chevron* deference.

More generally, the Treasury regulations at most parrot the statute in relevant respects. *See* 26 C.F.R. § 1.6662-5. No deference to an administrative

interpretation is due "when, instead of using its expertise and experience to formulate a regulation, it has elected merely to paraphrase the statutory language." *Gonzales v. Oregon*, 546 U.S. 243, 257 (2006). And because "'Congress has delegated to the administrative official and not to appellate counsel the responsibility for elaborating and enforcing statutory commands,'" no deference is due to the government's litigating position that the valuation misstatement penalty applies here. *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988) (citation omitted).

C. Any Doubt As To Whether The Valuation Misstatement Penalty Applies Here Must Be Resolved In Favor Of The Taxpayers

Although they do not help the government here, the government frequently has a significant advantage in litigation against its citizens in the form of doctrines according deference to its interpretations or resolving ambiguities in its favor. The government is not shy about invoking those rules, and often rests on them. In this context, however, the shoe is on the other foot.

History proves all too well that "the power to tax involves the power to destroy." *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819) (Marshall, C.J.). This Court therefore has long taken special care to ensure that the tax laws are not abused. And one way of doing so is insisting that the tax laws should "'be intelligible to those who are expected to obey them.'" *White v. Aronson*, 302 U.S. 16, 20-21 (1937) (citation omitted). Accordingly, this Court has repeatedly held that, "if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer." *Hassett v. Welch*,

303 U.S. 303, 314 (1938); *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552, 561 (1932) ("If there were doubt as to connotation of the term, and another meaning might be adopted, the fact of its use in a tax statute would incline the scale to the construction most favorable to the taxpayer."); *see also United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 839 (2001) (Thomas, J., concurring) ("'When the tax gatherer puts his finger on the citizen, he must also put his finger on the law permitting it'" (citation omitted)).

Application of that canon is especially important when it comes to the government's efforts to impose *penalties* on its citizens for failure to obey the tax laws. As Chief Justice Marshall observed, "penal laws are to be construed strictly" because "the power of punishment is vested in the legislative, not in the judicial department." *United States v. Wiltberger*, 18 U.S. (5 Wheat.) 76, 95 (1820). This Court has accordingly held that tax penalties are "to be strictly construed," *Ivan Allen Co. v. United States*, 422 U.S. 617, 627 (1975), and admonished that no taxpayer is "'to be subjected to a penalty unless the words of the statute plainly impose it.'" *Commissioner v. Acker*, 361 U.S. 87, 91 (1959) (citations omitted).

At a minimum, the valuation misstatement penalty does not "plainly impose" the all-encompassing "basis-overstatement penalty" that the government asks this Court to adopt in this case. That is reason enough to reject the government's interpretation. When the government is wielding the "power to destroy," the *citizen* gets the benefit of the doubt.

III. CONGRESS HAS ALREADY ADDRESSED THE GOVERNMENT'S POLICY CONCERNS

In the end, the government makes what amounts to a policy plea to this Court to adopt the all-encompassing "basis-overstatement penalty" that the government has devised to reach what the government views as "far more egregious conduct" (at 26) than the sort of factual misrepresentations of property or price that Congress clearly had in mind when it enacted the "valuation misstatement penalty." U.S. Br. 26, 49. But this Court's duty is of course to interpret the law that Congress has enacted, not the law that the IRS—with the benefit of hindsight—*wishes* Congress had enacted. Especially in view of the strict-construction canon discussed above, such policy arguments could never provide a basis for disregarding—or expanding—the penalty that Congress actually enacted. And that is especially true here, where Congress has already acted to address the government's policy concerns.

The transaction targeted by the IRS here would fall cleanly within the "noneconomic substance transaction" penalty added by Congress in 2010. 26 U.S.C. § 6662(b)(6), (i). Because the losses at issue were disallowed "by reason of a transaction lacking economic substance," the 20% accuracy-related penalty would apply. *Id.* § 6662(b)(6). And because the taxpayers did not disclose the facts relevant to the tax treatment of the transaction on the mandatory form, the 40% penalty would kick in too. *Id.* § 6662(i)(1)-(2). Today, there is no question that the IRS has the statutory authority to penalize that transaction.

True, Congress declined to make this new penalty retroactive. It only applies to transactions entered into *after* the date of the enactment of the Act, and so does

not apply to the transactions at issue here. But Congress was certainly free to adopt this new penalty only on a prospective basis. There is no reason for this Court to transform the "valuation misstatement penalty" that Congress adopted decades earlier into the government's "basis-overstatement penalty" just so the government can mop up whatever enforcement issues might exist with respect to transactions that took place before the effective date of the 2010 Act for which the three-year statute of limitations in 26 U.S.C. § 6501(a) has not already run in 2013.

Moreover, even before Congress gave the IRS the power to penalize noneconomic substance transactions, the IRS had a potent tool for addressing situations like this. For taxable years after 2004, the "reportable transaction understatement penalty" imposed a 20% penalty on any understatement of taxes attributable to certain kinds of tax avoidance transactions known as "listed transactions" or "reportable transactions." American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 812, 118 Stat. 1418, 1577 (codified at 26 U.S.C. § 6662A). The transaction at issue in this case became a "listed transactions" in 2000. I.R.S. Notice 2000-44, 2000-2 C.B. 255, 256. In addition, there is the possibility of the 20% negligence penalty, which the IRS has determined applies in this case. JA 96, 150.

If this transaction took place today, the IRS has taken the position that it may impose a 20% reportable transaction understatement penalty *on top of* certain other 20% accuracy-related penalties properly determined in partner-level proceedings, such as the penalty for negligence. *See* I.R.S. Chief Counsel Mem. at 4 (PMTA 2010-55) (Aug. 24, 2010), *available at* http://www.irs.gov/pub/lanoa/pmta_2010-55.pdf

(concluding that § 6662A penalty applies in addition to § 6662 penalties not explicitly referenced in § 6662A(e). That would allow the IRS to seek the same aggregate 40% penalty sought in this case. On top of that, Congress has also given the IRS the power to penalize taxpayers for failing to file a disclosure statement notifying the IRS that they have participated in a listed transaction. *See* 26 U.S.C. § 6707A.

In short, Congress has given the IRS ample weapons to attack, and prevent, transactions deemed to lack economic substance. Accordingly, in deciding this case, this Court may give effect to the "valuation misstatement" penalty that Congress actually enacted secure in the knowledge that Congress has served its coordinate role as well by updating the penalties to address the different issue presented here.[11]

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[11] Nor is there any reason for this Court to rewrite the valuation misstatement penalty to address the government's Orwellian sense of taxpayer fairness, under which the "fairest" tax penalty apparently is the one that can be imposed on the *most* taxpayers. U.S. Br. 26, 49. There is nothing "unfair" or "anomal[ous]" (*id.* at 48-49) about Congress taking an incremental approach to penalties, or to crafting different penalties to address different issues (as it ultimately did here).

CONCLUSION

The judgment of the court of appeals on the applicability of the valuation misstatement penalty should be vacated for lack of jurisdiction and the case remanded so that the district court may consider whether any other action is necessary or appropriate. In the alternative, the judgment should be affirmed.

Respectfully submitted,

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26 U.S.C. § 6221

§ 6221. Tax treatment determined at partnership level

Except as otherwise provided in this subchapter, 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. § 6226

§ 6226. Judicial review of final partnership administrative adjustments

(a) Petition by tax matters partner

Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

(3) the Court of Federal Claims.

* * *

(f) Scope of judicial review.

A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

* * *

26 U.S.C. § 6230

§ 6230. Additional administrative provisions

(a) Coordination with deficiency proceedings.

(1) In general.

Except as provided in paragraph (2) or (3), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) Deficiency proceedings to apply in certain cases.

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or

(ii) items which have become nonpartnership items (other than by reason of section 6231(b)(1)(C)) and are described in section 6231(e)(1)(B).

(B) Subchapter B shall be applied separately with respect to each deficiency described in subparagraph (A) attributable to each partnership.

(C) Notwithstanding any other law or rule of law, any notice or proceeding under subchapter B with respect to a deficiency described in this paragraph shall not preclude or be precluded by any other notice, proceeding, or determination with respect to a partner's tax liability for a taxable year.

(3) Special rule in case of assertion by partner's spouse of innocent spouse relief.

(A) Notwithstanding section 6404(b), if the spouse of a partner asserts that section 6015 applies with respect to a liability that is attributable to any adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment), then such spouse may file with the Secretary within 60 days after the notice of computational adjustment is mailed to the spouse a request for abatement of the assessment specified in such notice. Upon receipt of such request, the Secretary shall abate the assessment. Any reassessment of the tax with respect to which an abatement is made under this subparagraph shall be subject to the deficiency procedures prescribed by subchapter B. The period for making any such reassessment shall not expire before the expiration of 60 days after the date of such abatement.

(B) If the spouse files a petition with the Tax Court pursuant to section 6213 with respect to the request for abatement described in subparagraph (A), the Tax Court shall only have jurisdiction pursuant to this section to determine whether the requirements of section 6015 have been satisfied. For purposes of such determination, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

(C) Rules similar to the rules contained in subparagraphs (B) and (C) of paragraph (2) shall apply for purposes of this paragraph.

(b) Mathematical and clerical errors appearing on partnership return

(1) In general

Section 6225 shall not apply to any adjustment necessary to correct a mathematical or clerical error (as defined in section 6213(g)(2)) appearing on the partnership return.

(2) Exception

Paragraph (1) shall not apply to a partner if, within 60 days after the day on which notice of the correction of the error is mailed to the partner, such partner files with the Secretary a request that the correction not be made.

(c) Claims arising out of erroneous computations, etc.

(1) In general

A partner may file a claim for refund on the grounds that—

(A) the Secretary erroneously computed any computational adjustment necessary—

(i) to make the partnership items on the partner's return consistent with the treatment of the partnership items on the partnership return, or

(ii) to apply to the partner a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a),

(B) the Secretary failed to allow a credit or to make a refund to the partner in the amount of

the overpayment attributable to the application to the partner of a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a), or

(C) the Secretary erroneously imposed any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

(2) Time for filing claim

(A) Under paragraph (1)(A) or (C)

Any claim under subparagraph (A) or (C) of paragraph (1) shall be filed within 6 months after the day on which the Secretary mails the notice of computational adjustment to the partner.

(B) Under paragraph (1)(B)

Any claim under paragraph (1)(B) shall be filed within 2 years after whichever of the following days is appropriate:

(i) the day on which the settlement is entered into,

(ii) the day on which the period during which an action may be brought under section 6226 with respect to the final partnership administrative adjustment expires, or

(iii) the day on which the decision of the court becomes final.

(3) Suit if claim not allowed.

If any portion of a claim under paragraph (1) is not allowed, the partner may bring suit with respect to such portion within the period specified in subsection (a) of section 6532 (relating to periods of limitations on refund suits).

(4) No review of substantive issues

For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.

(5) Rules for seeking innocent spouse relief

(A) In general

The spouse of a partner may file a claim for refund on the ground that the Secretary failed to relieve the spouse under section 6015 from a liability that is attributable to an adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment).

(B) Time for filing claim

Any claim under subparagraph (A) shall be filed within 6 months after the day on which the Secretary mails to the spouse the notice of computational adjustment referred to in subsection (a)(3)(A).

(C) Suit if claim not allowed

If the claim under subparagraph (B) is not allowed, the spouse may bring suit with respect to the claim within the period specified in paragraph (3).

(D) Prior determinations are binding

For purposes of any claim or suit under this paragraph, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

* * *

26 U.S.C. § 6231

§ 6231. Definitions and special rules

(a) Definitions

For purposes of this subchapter—

(1) Partnership

(A) In general.

Except as provided in subparagraph (B), the term "partnership" means any partnership required to file a return under section 6031(a).

(B) Exception for small partnerships

(i) In general

The term "partnership" shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a non-resident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.

(ii) Election to have subchapter apply.

A partnership (within the meaning of subparagraph (A)) may for any taxable year elect to have clause (i) not apply. Such election shall apply for such taxable year and all subsequent taxable years unless revoked with the consent of the Secretary.

(2) Partner.

The term "partner" means—

(A) a partner in the partnership, and

(B) any other person whose income tax liability under subtitle A is determined in whole or in part

by taking into account directly or indirectly partnership items of the partnership.

(3) Partnership item.

The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

(4) Nonpartnership item.

The term "nonpartnership item" means an item which is (or is treated as) not a partnership item.

(5) Affected item.

The term "affected item" means any item to the extent such item is affected by a partnership item.

(6) Computational adjustment.

The term "computational adjustment" means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership under this subchapter to an indirect partner shall be treated as computational adjustments.

(7) Tax matters partner.

The tax matters partner of any partnership is—

(A) the general partner designated as the tax matters partner as provided in regulations, or

(B) if there is no general partner who has been so designated, the general partner having

the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than 1 such partner, the 1 of such partners whose name would appear first in an alphabetical listing).

If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner. The Secretary shall, within 30 days of selecting a tax matters partner under the preceding sentence, notify all partners required to receive notice under section 6223(a) of the name and address of the person selected.

* * *

26 U.S.C. § 6659
(Pub. L. No. 97-34, tit. VII, § 722, 95 Stat. 172, 341)

SEC. 722. ADDITIONS TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS, INCREASE IN NEGLIGENCE PENALTY.

(a) Valuation Overstatements.—,

(1) In general.—Subchapter A of chapter 68 (relating to additions to tax) is amended by redesignating section 6659 as section 6660 and by inserting after section 6658 the following new section:

"SEC. 6659. ADDITION TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS FOR PURPOSES OF THE INCOME TAX.

"(a) Addition to the Tax.—If—,

"(1) an individual, or

"(2) a closely held corporation or a personal service corporation,

has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

"(b) Applicable Percentage Defined.—For purposes of subsection (a), the applicable percentage shall be determined under the following table:

"If the valuation claimed is the following percent of the correct valuation—	The applicable percentage is
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

"(c) Valuation Overstatement Defined.—,

"(1) In general.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return exceeds 150 percent of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

"(2) Property must have been acquired within last 5 years.—This section shall not apply to any property which, as of the close of the taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than 5 years.

"(d) Underpayment Must Be at Least $1,000.—This section shall not apply if the underpayment for the taxable year attributable to the valuation overstatement is less than $1,000.

"(e) Authority To Waive.—The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that such claim was made in good faith.

"(f) Other Definitions.—For purposes of this section—,

"(1) Underpayment.—The term 'underpayment' has the meaning given to such term by section 6653(c)(1).

"(2) Closely held corporation.—The term 'closely held corporation' means any corporation described in section 465(a)(1)(C).

"(3) Personal service corporation.—The term 'personal service corporation' means any corporation which is a service organization (within the meaning of section 414(m)(3))."

* * *

26 U.S.C. § 6662 (2000)

§ 6662. Imposition of accuracy-related penalty on underpayments

(a) Imposition of penalty.

If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies.

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

* * *

(e) Substantial valuation misstatement under chapter 1

(1) In general

For purposes of this section, there is a substantial valuation misstatement under chapter 1 if—

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

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

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

(2) Limitation.

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

* * *

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

(1) In general

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

(2) Gross valuation misstatements

The term "gross valuation misstatements" means—

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

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

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

(iii) in paragraph (1)(B)(ii)—

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

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

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

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "25 percent" for "50 percent".

26 U.S.C. § 6662 (current)

§ 6662. Imposition of accuracy-related penalty on underpayments

(a) Imposition of penalty.

If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies.

This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement.

(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

(7) Any undisclosed foreign financial asset understatement.

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

* * *

(e) Substantial valuation misstatement under chapter 1

(1) In general

For purposes of this section, there is a substantial valuation misstatement under chapter 1 if—

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

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

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

(2) Limitation

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

* * *

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

(1) In general

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

(2) Gross valuation misstatements

The term "gross valuation misstatements" means—

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

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

(ii) in paragraph (1)(B)(i)—

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

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

(iii) in paragraph (1)(B)(ii)—

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

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

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

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

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

(1) In general.

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

(2) Nondisclosed noneconomic substance transactions.

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

(3) Special rule for amended returns.

In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or

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

* * *

26 C.F.R. § 1.6662-5(g)

* * *

(g) Property with a value or adjusted basis of zero. The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent

* * *

26 C.F.R. § 301.6231(a)(3)-1

§ 301.6231(a)(3)–1 Partnership items.

(a) In general. For purposes of subtitle F of the Internal Revenue Code of 1954, the following items which are required to be taken into account for the taxable year of a partnership under subtitle A of the Code are more appropriately determined at the partnership level than at the partner level and, therefore, are partnership items:

(1) The partnership aggregate and each partner's share of each of the following:

(i) Items of income, gain, loss, deduction, or credit of the partnership;

(ii) Expenditures by the partnership not deductible in computing its taxable income (for example, charitable contributions);

(iii) Items of the partnership which may be tax preference items under section 57(a) for any partner;

(iv) Income of the partnership exempt from tax;

(v) Partnership liabilities (including determinations with respect to the amount of the liabilities, whether the liabilities are nonrecourse, and changes from the preceding taxable year); and

(vi) Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine—

(A) The investment credit determined under section 46(a);

(B) Recapture under section 47 of the investment credit;

(C) Amounts at risk in any activity to which section 465 applies;

(D) The depletion allowance under section 613A with respect to oil and gas wells; and

(E) The application of section 751 (a) and (b);

(2) Guaranteed payments;

(3) Optional adjustments to the basis of partnership property pursuant to an election under section 754 (including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest); and

(4) Items relating to the following transactions, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner:

(i) Contributions to the partnership;

(ii) Distributions from the partnership; and

(iii) Transactions to which section 707(a) applies (including the application of section 707(b)).

(b) Factors that affect the determination of partnership items. The term "partnership item" includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc. Examples of these determinations are: The partnership's method of accounting, taxable year, and inventory method; whether an election was made by the partnership;

whether partnership property is a capital asset, section 1231 property, or inventory; whether an item is currently deductible or must be capitalized; whether partnership activities have been engaged in with the intent to make a profit for purposes of section 183; and whether the partnership qualifies for the research and development credit under section 30.

(c) Illustrations—(1) In general. This paragraph (c) illustrates the provisions of paragraph (a)(4) of this section. The determinations illustrated in this paragraph (c) that the partnership is required to make are not exhaustive; there may be additional determinations that the partnership is required to make which relate to a transaction listed in paragraph (a)(4) of this section. The critical element is that the partnership needs to make a determination with respect to a matter for the purposes stated; failure by the partnership actually to make a determination (for example, because it does not maintain proper books and records) does not prevent an item from being a partnership item.

(2) Contributions. For purposes of its books and records, or for purposes of furnishing information to a partner, the partnership needs to determine:

(i) The character of the amount received from a partner (for example, whether it is a contribution, a loan, or a repayment of a loan);

(ii) The amount of money contributed by a partner;

(iii) The applicability of the investment company rules of section 721(b) with respect to a contribution; and

(iv) The basis to the partnership of contributed property (including necessary preliminary

determinations, such as the partner's basis in the contributed property).

To the extent that a determination of an item relating to a contribution can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item. For example, it may be necessary to determine whether contribution of the property causes recapture by the contributing partner of the investment credit under section 47 in certain circumstances in which that determination is irrelevant to the partnership.

(3) Distributions. For purposes of its books and records, or for purposes of furnishing information to a partner, the partnership needs to determine:

(i) The character of the amount transferred to a partner (for example, whether it is a distribution, a loan, or a repayment of a loan);

(ii) The amount of money distributed to a partner;

(iii) The adjusted basis to the partnership of distributed property; and

(iv) The character of partnership property (for example, whether an item is inventory or a capital asset).

To the extent that a determination of an item relating to a distribution can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that item is not a partnership item. Such other information would include those factors used in determining the partner's basis for the partnership interest that are not themselves

partnership items, such as the amount that the partner paid to acquire the partnership interest from a transferor partner if that transfer was not covered by an election under section 754.

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26 C.F.R. § 301.6231(a)(5)-1

§ 301.6231(a)(5)–1 Definition of affected item.

(a) In general. The term affected item means any item to the extent such item is affected by a partnership item. It includes items unrelated to the items reflected on the partnership return (for example, an item, such as the threshold for the medical expense deduction under section 213, that varies if there is a change in an individual partner's adjusted gross income).

(b) Basis in a partner's partnership interest. The basis of a partner's partnership interest is an affected item to the extent it is not a partnership item.

(c) At-risk limitation. The application of the at-risk limitation under section 465 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.

(d) Passive losses. The application of the passive loss rules under section 469 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.

(e) Penalty, addition to tax, or additional amount—(1) In general. The term affected item includes any penalty, addition to tax, or additional amount provided by subchapter A of chapter 68 of the Internal Revenue Code of 1986 to the extent provided in this paragraph (e).

(2) Penalty, addition to tax, or additional amount without floor. If a penalty, addition to tax, or additional amount that does not contain a floor (that is, a threshold amount of underpayment or understatement necessary before the imposition of the penalty, addition to tax, or additional amount) is

imposed on a partner as the result of an adjustment to a partnership item, the term affected item shall include the penalty, addition to tax, or additional amount computed with reference to the portion of the underpayment that is attributable to the partnership item adjustment(s) to which the penalty, addition to tax, or additional amount applies.

(3) Penalty, addition to tax, or additional amount containing floor—(i) Floor exceeded prior to adjustment. If a partner would have been subject to a penalty, addition to tax, or additional amount that contains a floor in the absence of an adjustment to a partnership item (that is, the partner's understatement or underpayment exceeded the floor even without an adjustment to a partnership item) the term affected item shall include only the portion of the penalty, addition to tax, or additional amount computed with reference to the partnership item (or affected item) adjustments.

(ii) Floor not exceeded prior to adjustment. In the case of a penalty, addition to tax, or additional amount that contains a floor, if the taxpayer's understatement or underpayment does not exceed the floor prior to an adjustment to a partnership item but does so after such adjustment, the term affected item shall include the penalty, addition to tax, or additional amount computed with reference to the entire underpayment or understatement to which the penalty, addition to tax, or additional amount applies.

(4) Examples. The provisions of this paragraph (e) may be illustrated by the following examples:

Example 1. A, a partner of P, had an aggregate underpayment of $1,000 of which $100 is attributable to an adjustment to partnership items. A is negligent in

reporting the partnership items. The accuracy-related penalty under section 6662 for negligence computed with reference to the $100 underpayment attributable to the partnership item adjustments is an affected item.

Example 2. B, a partner of P, understated B's income tax liability attributable to nonpartnership items by $6,000. An adjustment to a partnership item resulting from a partnership proceeding increased B's income tax by an additional $2,000. Prior to the adjustment, B would have been subject to the accuracy-related penalty under section 6662 for a substantial understatement of income tax with respect to the $6,000 understatement attributable to nonpartnership items. The portion of the accuracy-related penalty under section 6662 computed with reference to the $2,000 understatement attributable to partnership items to which the accuracy-related penalty applies is an affected item. The portion of the accuracy-related penalty under section 6662 computed with reference to the $6,000 pre-existing understatement is not an affected item.

Example 3. C, a partner in partnership P, understated C's income tax liability attributable to nonpartnership items by $4,000. As a result of an adjustment to partnership items, that understatement is increased to $10,000. Prior to the adjustment, C would not have been subject to the accuracy-related penalty under section 6662 for a substantial understatement of income tax. The accuracy-related penalty under section 6662 computed with reference to

the entire $10,000 understatement to which the accuracy-related penalty applies is an affected item.

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26 C.F.R. § 301.6231(a)(6)-1

§ 301.6231(a)(6)–1 Computational adjustments.

(a) Changes in a partner's tax liability—(1) In general. A change in the tax liability of a partner to properly reflect the treatment of a partnership item under subchapter C of chapter 63 of the Internal Revenue Code is made through a computational adjustment. A computational adjustment includes a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item, or any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item. However, if a change in a partner's tax liability cannot be made without making one or more partner-level determinations, that portion of the change in tax liability attributable to the partner-level determinations shall be made under the deficiency procedures (as described in subchapter B of chapter 63 of the Internal Revenue Code), except for any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item.

(2) Affected items that do not require partner-level determinations. Changes in a partner's tax liability with respect to affected items that do not require partner-level determinations (such as the threshold amount of medical deductions under section 213 that changes as the result of determinations made at the partnership level) are computational adjustments that are directly assessed. When making computational adjustments, the Internal Revenue Service may assume that amounts the partner reported on the partner's individual return include all amounts

reported to the partner by the partnership (on the Schedule K–1s attached to the partnership's original return), absent contrary notice to the Internal Revenue Service (for example, a "Notice of Inconsistent Treatment" pursuant to § 301.6222(a)–2(c)). Such an assumption by the Internal Revenue Service does not constitute a partner-level determination. Moreover, substituting redetermined partnership items for the partner's previously reported partnership items (including partnership items included in carryover amounts) does not constitute a partner-level determination where the Internal Revenue Service otherwise accepts, for the sole purpose of determining the computational adjustment, all nonpartnership items (including, for example, nonpartnership item components of carryover amounts) as reported.

(3) Affected items that require partner-level determinations. Changes in a partner's tax liability with respect to affected items that require partner-level determinations (such as a partner's at-risk amount to the extent it depends upon the source from which the partner obtained the funds that the partner contributed to the partnership) are computational adjustments that are subject to the deficiency procedures. Notwithstanding the preceding sentence, any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item is not subject to the deficiency procedures, but rather may be directly assessed as part of the computational adjustment that is made following the partnership proceeding, based on determinations in that

proceeding, regardless of whether any partner-level determinations may be required.

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