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.

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

BRIEF FOR THE UNITED STATES

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QUESTIONS PRESENTED

Section 6226 of the Internal Revenue Code confers jurisdiction on a district court to review the Internal Revenue Service's audit of a partnership's return and "to determine * * * the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Section 6662 of the Code imposes a penalty for an underpayment of federal income tax that is "attributable to" a "substantial valuation misstatement," and the term "substantial valuation misstatement" is defined to include a substantial overstatement of adjusted basis in property. See 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1). The questions presented are as follows:

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 overstatement penalty applies to an underpayment of tax resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property.

PARTIES TO THE PROCEEDINGS

Petitioner is the United States of America.

Respondent is Gary Woods, as Tax Matters Partner of Tesoro Drive Partners and SA Tesoro Investment Partners.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-2a) is not published in the *Federal Reporter* but is reprinted in 471 Fed. Appx. 320. The opinions of the district court (Pet. App. 3a-14a, 15a-22a) are reported at 794 F. Supp. 2d 714 and 794 F. Supp. 2d 710.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 2012. A petition for rehearing was denied on August 8, 2012 (Pet. App. 23a-24a). The petition for a writ of certiorari was filed on November 6, 2012. The petition was granted on March 25, 2013. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The pertinent statutory and regulatory provisions are reproduced in the appendix to this brief. App., *infra*, 1a-64a.

STATEMENT

This case concerns a penalty that the Internal Revenue Service (IRS) assesses when a taxpayer overstates his basis in property on an income-tax return in a way that results in an underpayment of tax. 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1). The overstatement in this case arose from an abusive tax shelter in which two taxpayers used sham partnerships to create the illusion that they had very high bases in certain assets. They then used the high basis figures to claim tax deductions of tens of millions of dollars.

The IRS concluded, under the "economic substance" doctrine, that the partnerships and the transactions must be disregarded for tax purposes. It further found that the taxpayers were subject to the overstatement penalty for any underpayments of tax resulting from the scheme. On judicial review, the district court agreed that the transactions lacked economic substance, but held that the overstatement penalty was inapplicable as a matter of law, and the court of appeals affirmed. Pet. App. 1a-22a.

I. STATUTORY BACKGROUND

A. Section 6662's Basis-Overstatement Penalty

1. The Internal Revenue Code, "relying as it does upon self-assessment and reporting," *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 815 (1984), requires taxpayers to file returns indicating the amount of income tax they owe. 26 U.S.C. 6011(a), 6012(a). If the

IRS determines that an individual's return understates his tax liability, it generally must send a notice of deficiency to the taxpayer indicating the amount owed. 26 U.S.C. 6211-6212. The taxpayer may challenge the deficiency determination in the United States Tax Court before the IRS may assess the deficiency. 26 U.S.C. 6213(a).

In reviewing returns, the IRS also determines the applicability of any penalties set forth in Section 6662 for certain inaccuracies on a return that result in the underpayment of tax, such as when a taxpayer substantially understates the amount of income tax owed or negligently fails to comply with provisions of the Code. See 26 U.S.C. 6662.[1] As relevant here, Section 6662 imposes a penalty if a taxpayer overstates her basis in property on a return in a way that results in an underpayment of tax. 26 U.S.C. 6662(a), (b)(3) and (e). The term "basis" refers to "a taxpayer's capital stake in an asset for tax purposes," *Washington Mut. Inc.* v. *United States*, 636 F.3d 1207, 1217 (9th Cir. 2011), and in practice it is often equal to the price the taxpayer paid for the asset (*e.g.*, stock). As a general matter, a taxpayer determines her gain or loss on the sale of an asset by subtracting the basis from the sale price; a positive figure is a gain while a negative figure is a loss. See 26 U.S.C. 1001(a). Thus, a taxpayer who overstates her basis in a sold asset on a return will understate the gain

[1] Unless otherwise indicated, all citations to 26 U.S.C. 6662 are to that provision as it appears in the 2000 edition of the United States Code. A number of the regulations cited in this brief replaced temporary regulations that were in effect until October 2001. Because the regulations are materially identical, this brief cites the more readily accessible current regulations.

(or overstate the loss) from the sale, which often results in an underpayment of income tax.

To deter such basis overstatements, Section 6662 provides that, when a taxpayer is determined to have underpaid her tax, "there shall be added to the [income] tax [owed] an amount equal to 20 percent of the portion of the underpayment * * * which is attributable to * * * [a]ny substantial valuation misstatement." 26 U.S.C. 6662(a) and (b)(3). A taxpayer commits a "substantial valuation misstatement" if, *inter alia*, "the 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 * * * adjusted basis." 26 U.S.C. 6662(e)(1)(A). No penalty is imposed, however, unless the underpayment exceeds $5000. 26 U.S.C. 6662(e)(2).

Section 6662 imposes a greater penalty for a "gross valuation misstatement[ ]," defined to include an overstatement of the adjusted basis of property that is 400% or more of the correct amount. 26 U.S.C. 6662(h)(2)(A)(i).[2] "To the extent that a portion of the underpayment [of income tax] is attributable to one or more gross valuation misstatements," a penalty equal to 40% of that portion of the underpayment is imposed on the taxpayer. 26 U.S.C. 6662(h)(1). Even if a single underpayment might otherwise trigger multiple penalties, the largest penalty amount that can be imposed is 40% of the underpayment. See 26 U.S.C. 6662(b); 26 C.F.R. 1.6662-2(c).

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[2] Section 6662 was amended in 2006 to lower the threshold for a substantial valuation misstatement to 150% (26 U.S.C. 6662(e)(1)(A)) and the threshold for a gross valuation misstatement to 200% (26 U.S.C. 6662(h)(2)(A)(i)). See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1) and (2), 120 Stat. 1083.

2. Under Section 6662, cases may arise in which part of a taxpayer's underpayment of tax is "attributable to" an overstatement of basis, while the remainder of the underpayment is attributable to other errors (for example, failing to include all taxable income or taking an inapplicable deduction). In those circumstances, it is necessary to identify the "portion" of the underpayment of tax that is "attributable to" the basis overstatement.

After the passage of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, which added the predecessor to the overstatement penalty of Section 6662,[3] the staff of Congress's Joint Committee on Taxation produced a summary of the legislation known as the *Blue Book*. See Staff of the Joint Comm. on Taxation, 97th Cong., *General Explanation of the Economic Recovery Tax Act of 1981* (Comm. Print 1981) (*Blue Book*). The *Blue Book* stated that "[t]he portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability." *Id.* at 333. It

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[3] The predecessor to the overstatement penalty was located at 26 U.S.C. 6659 and provided a schedule of penalties for "an underpayment of [income tax] for the taxable year which is attributable to a valuation overstatement." 26 U.S.C. 6659(a) (1988). A "valuation overstatement" was in turn defined to exist "if * * * 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 * * * adjusted basis." 26 U.S.C. 6659(c) (1988). Section 6662 was enacted in 1989 to replace Section 6659 (and other penalty provisions). See Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, § 7721(a) and (c)(2), 103 Stat. 2395, 2399. The principal purpose of the change was to "improve the fairness, comprehensibility, and administrability of the[ ] penalties" by consolidating a number of penalty provisions in one section. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1388 (1989).

then set forth a formula to calculate the appropriate portion:

> [T]he underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

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

To illustrate the application of this formula, the *Blue Book* included the following example:

> Assume that in 1982 an individual files a joint return showing taxable income of $40,000 and tax liability of $9,195. Assume, further, that a $30,000 deduction which was claimed by the taxpayer as the result of a valuation overstatement is adjusted down to $10,000, and that another deduction of $20,000 is disallowed totally for reasons apart from the valuation overstatement. These adjustments result in correct taxable income of $80,000 and correct tax liability of $27,505. Accordingly, the underpayment due to the valuation overstatement is the difference between the tax on $80,000 ($27,505) and the tax on $60,000 ($17,505) (i.e., actual tax liability reduced by taking into account the deductions disallowed because of the valuation overstatement), or $9,800.

Id. at 333 n.2.[4]

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

B. Procedures For Auditing Partnership Returns And Imposing Penalties

1. As "pass through" entities, partnerships do not pay federal income tax. 26 U.S.C. 701. Rather, tax on a partnership's income is paid by individual partners, who must account on their own tax returns for their distributive shares of the partnership's income and losses. 26 U.S.C. 701, 702(a); see *United States* v. *Basye*, 410 U.S. 441, 448 (1973). A partnership, however, must file an information return every year "stating specifically the items of its gross income and [any allowable] deductions," and identifying the "individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual." 26 U.S.C. 6031(a).

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

Before 1982, if the IRS believed that a partnership's return was inaccurate, it was required to issue separate notices of deficiency to all partners, each of whom could independently challenge his notice in the Tax Court. That approach often resulted in duplicative proceedings and inconsistent treatment of partnership income among different partners, and it required the IRS to enter into separate settlements with each partner. See *Callaway* v. *Commissioner*, 231 F.3d 106, 107-108 (2d Cir. 2000). To remedy those problems, Section 402 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, established unified procedures through which the IRS determines partnership-level tax issues for all partners at once and courts then review the IRS's conclusions. See § 402, 96 Stat. 648-667; 26 U.S.C. 6221-6234.

TEFRA requires the IRS to determine "the tax treatment of any partnership item" in a proceeding "at the partnership level"—*i.e.*, through an audit of the partnership's return. 26 U.S.C. 6221. TEFRA further requires that each partner, on his own tax return, must "treat a partnership item in a manner which is consistent with the treatment of such partnership item on the partnership return," 26 U.S.C. 6222(a), or else notify the IRS of any inconsistency between the two returns, 26 U.S.C. 6222(b)(1). The statute defines a "partnership item" as "any item required to be taken into account for the partnership's taxable year under any [income tax] provision" that, as provided in regulations, "is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. 6231(a)(3). In accordance with the statute, the Treasury has defined the term "partnership item" by regulation to include "[t]he partnership aggregate and each partner's share of * * *

[i]tems of income, gain, loss, deduction, or credit of the partnership," as well as certain "[i]tems relating to * * * [c]ontributions to the partnership" and "[d]istributions from the partnership." 26 C.F.R. 301.6231(a)(3)-1(a)(1)(i), (a)(4)(i) and (ii). The regulation further provides that "[t]he 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." 26 C.F.R. 301.6231(a)(3)-1(b).

Under TEFRA, the IRS may initiate an administrative proceeding to audit a partnership's information return by sending notice to certain specified partners. 26 U.S.C. 6223(a). Any partner may participate in that proceeding. 26 U.S.C. 6224(a). If the IRS concludes that adjustments to partnership items are necessary, it must issue a Notice of Final Partnership Administrative Adjustment (FPAA) setting forth the changes. See 26 U.S.C. 6223(a)(2), 6225(a).

The partners then may challenge the FPAA in court. TEFRA authorizes certain partners to file a petition for readjustment in the Tax Court, the Court of Federal Claims, or a federal district court. 26 U.S.C. 6226(a) and (b), 6231(a)(7), (8) and (11). All partners with an interest in the outcome are parties to the action and may participate in the proceedings. 26 U.S.C. 6226(c) and (d). The partnership as an entity, however, is not a party to the suit; rather, "[t]he partnership proceeding contemplated by Congress is simply a conglomeration or aggregation of the[] affected partners." *Chef's Choice Produce, Ltd.* v. *Commissioner*, 95 T.C. 388, 395 (1990). The reviewing court in a TEFRA action has "jurisdiction to determine all partnership items of the partnership for the partner-

ship taxable year to which the [FPAA] relates." 26 U.S.C. 6226(f).

After the conclusion of administrative and judicial proceedings, the IRS computes the effect of the partnership-item adjustments on the tax liability of each partner. This change in tax liability is called a "computational adjustment." 26 U.S.C. 6230(c)(1)(A), 6231(a)(6); 26 C.F.R. 301.6231(a)(6)-1. As a general matter, a computational adjustment is immediately assessable against a partner without a notice of deficiency. See 26 U.S.C. 6230(a). For example, if an adjustment to the partnership's income requires a change to the distributive share of that income claimed on a partner's return, the IRS may immediately assess the additional tax liability. In that circumstance, an individual partner may file an administrative refund claim (and then may file suit if the claim is denied) if he believes that the IRS has committed an error in making the computational adjustment. 26 U.S.C. 6230(c)(1)(A) and (3). In a refund proceeding, however, "the treatment of partnership items * * * under the [FPAA], or under the decision of the court [in a partnership-level proceeding] (whichever is appropriate) [is] conclusive." 26 U.S.C. 6230(c)(4).

If the IRS makes a computational adjustment attributable to an "affected item"—*i.e.*, a non-partnership item that is affected by a partnership item, such as a deduction that varies with a partner's adjusted gross income—that adjustment is immediately assessable if it necessarily follows from the partnership-item adjustment, as in the case of a purely mathematical change to the partner's return. 26 U.S.C. 6230(a)(1) and (2)(A)(i), 6231(a)(5). If, however, the necessary changes require substantive "partner level determinations," the IRS

generally must follow the ordinary deficiency procedures. 26 U.S.C. 6230(a)(2)(A)(i); see *Duffie* v. *United States*, 600 F.3d 362, 385 (5th Cir.), cert. denied, 131 S. Ct. 355 (2010).

In addition to genuine partnerships, the TEFRA procedures apply to an entity that files a partnership return but is determined, for tax purposes, not to have been a partnership or not to have existed during the relevant tax year. 26 U.S.C. 6233; see 26 C.F.R. 301.6233-1.

2. Because partnerships do not pay tax, they are not subject to penalties for underpayment. Errors on a partnership return, however, may lead to the imposition of penalties against an individual partner if the partner prepares his own return in a manner consistent with the (inaccurate) partnership return and underpays his own taxes as a result. Penalties are not partnership items under TEFRA, but they can be affected items if they are imposed on a partner as the result of an adjustment to a partnership item. See 26 C.F.R. 301.6231(a)(5)-1(e); see also 26 U.S.C. 6230(a)(2)(A)(i). Penalties virtually always require further partner-level determinations. For that reason, under TEFRA as originally enacted, penalties could "only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding." H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 685 (1997) (1997 Conference Report); see *Tigers Eye Trading, LLC* v. *Commissioner*, 138 T.C. 67, 89 (2012).

In 1997, Congress recognized that "applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the

Tax Court's inventory." H.R. Rep. No. 148, 105th Cong., 1st Sess. 594 (1997) (1997 House Report). Accordingly, in Section 1238 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 1026-1027, Congress added provisions ensuring "that the partnership-level proceeding [would] include a determination of the applicability of penalties at the partnership level," while still "allow[ing] partners to raise any partner-level defenses in a refund forum." 1997 Conference Report 685.

The Taxpayer Relief Act provides that "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item[] shall be determined at the partnership level." 26 U.S.C. 6221. It likewise expands TEFRA's judicial-review provision to authorize a court 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). Thus, with respect both to partnership items themselves, and to any penalties related to adjustments to partnership items, Section 6226(f)'s delineation of a court's jurisdiction in partnership-level proceedings closely tracks the language of 26 U.S.C. 6221, which describes the determinations the IRS must make at the partnership level.

Since payment of taxes on partnership income is the responsibility of individual partners rather than of the partnership itself, neither the IRS nor a court can definitively resolve in partnership-level proceedings whether or on whom a penalty will ultimately be imposed. Rather, those determinations require a review of the returns of individual partners. If a particular partner did not owe any tax in a given year, for example, he would not be subject to Section 6662's accuracy-related penalties even if the partnership improperly claimed a loss on

its return. For that reason, in the partnership-level proceedings, the IRS and the court can make only the threshold determination that an adjustment to a partnership item corrects the sort of error that, if reflected in partners' individual returns, could trigger a penalty. See *Tigers Eye*, 138 T.C. at 142.

Once partnership-level proceedings conclude, the IRS evaluates partners' individual returns in light of the partnership-level adjustments. Unlike with other affected items requiring "partner level determinations," the IRS may assess penalties against individual partners immediately through computational adjustments without issuing a notice of deficiency. See 26 U.S.C. 6230(a)(2). A partner may then file a refund claim "to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment." 26 U.S.C. 6230(c)(4). Again, however, any determination by the FPAA or by a court in a partnership-level proceeding regarding the applicability of the penalty is "conclusive" in the refund proceeding. *Ibid.*

Under Treasury regulations implementing the Taxpayer Relief Act, "[p]artner-level defenses are limited to those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level," such as "determinations as to whether any applicable threshold underpayment of tax has been met with respect to the partner" (*e.g.*, whether the taxpayer's individual return understated the tax owed by at least $5000). 26 C.F.R. 301.6221-1(d); see 26 U.S.C. 6662(e)(2). Such defenses do not include the "the legal and factual determinations that underlie the determination of any penalty * * * other than [those that underlie] partner-level defenses." 26 C.F.R. 301.6221-1(c).

II. FACTUAL BACKGROUND AND PROCEEDINGS BELOW

A. Execution Of The COBRA Tax Shelter

In November 1999, respondent Woods and another individual, Billy Joe ("Red") McCombs, participated in an abusive tax shelter called Current Options Bring Reward Alternatives, or COBRA. Pet. App. 4a-5a & n.2. The purpose of COBRA was to generate a large paper loss that could offset real gains that the taxpayer realized in a given tax year. *Id.* at 5a. McCombs, at one time the owner of the NBA's San Antonio Spurs and the NFL's Minnesota Vikings, expected to realize significant income in 1999 from the expansion of the NFL to include the resurrected Cleveland Browns franchise. *Id.* at 16a; 9/15/2010 Trial Tr. (Afternoon Sess.) 76-77. Woods was a long-time business associate of McCombs. Pet. App. 16a.

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

To execute COBRA, a taxpayer would purchase and sell largely offsetting short-term options on a foreign currency. See generally *RA Invs. I, LLC* v. *Deutsche Bank AG*, No. 3:04-cv-1565, 2005 WL 1356446, at *1 (N.D. Tex. June 6, 2005) (describing COBRA). For example, a taxpayer might purchase a 30-day option on a foreign currency valued at $100 million while selling a 30-day option on the same currency worth $95 million—for an out-of-pocket expenditure of $5 million. The taxpayer would contribute both the "long" option and the

"short" option, plus a comparatively small amount of cash (*e.g.*, $3 million), to a partnership established with another COBRA participant solely for the purpose of the transaction. The partnership would then purchase a relatively small quantity of assets (for example, $2 million worth of publicly traded stock or a foreign currency). When the offsetting options expired, the partnership would immediately dissolve and distribute its assets to the partners. The taxpayer would then sell the distributed assets, claiming a basis in them equal to the cost of the purchased option plus the cash contributed to the dissolved partnership—in this example, $103 million, generating a $101 million artificial tax loss.

That loss was generated through a manipulation of the rules governing a partner's "outside basis" in a partnership. "Outside basis" refers to the partner's capital stake in the partnership itself, as opposed to the partnership's own basis in assets it holds, which is called "inside basis." See generally *Fidelity Int'l Currency Advisor A Fund, LLC* v. *United States*, 661 F.3d 667, 669 (1st Cir. 2011). Ordinarily, when a partner contributes property to a partnership (such as the long option), his outside basis equals his basis in the contributed property, 26 U.S.C. 705(a), 722, while the partnership's assumption of a liability from the partner (as with the short option) reduces that basis, 26 U.S.C. 733, 752(b); see *Tigers Eye*, 138 T.C. at 112-113.[5] In 1975, however, the Tax Court issued a nonprecedential memorandum opinion holding that, for purposes of the partnership

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[5] Although each partner's outside basis would simultaneously increase by his share of the partnership's assumed liability, 26 U.S.C. 752(a), it would decrease by the same amount upon the subsequent extinguishment of the liability (as when the short option terminates unexercised). 26 U.S.C. 752(b).

basis rules, the obligation to perform under a short option is too contingent to be taken into account as a "liability." See *Helmer* v. *Commissioner*, 44 T.C.M. (P-H) ¶ 75,160, at 712 (1975); cf. 26 C.F.R. 1.752-1(a)(4)(ii) (2006) (superseding *Helmer*). Taxpayers who participated in COBRA attempted to exploit that opinion to generate an artificially high basis in the assets distributed by the sham partnership upon liquidation. In the example described above, the taxpayer would claim on his tax return that his outside basis in the partnership—and therefore his basis in the assets distributed by the partnership at liquidation, see 26 U.S.C. 732(b)—was $103 million, even though he effectively contributed only $8 million to the partnership (the $5 million difference between the prices of the offsetting options, plus the $3 million in cash).

Woods and McCombs together engaged in two COBRA transactions with two sham partnerships—one to generate ordinary losses and one to generate capital losses. Pet. App. 5a-6a, 17a n.7. Limited liability companies (LLCs) owned by Woods and McCombs acquired the requisite offsetting 30-day option positions for $2.3 million and contributed those positions, plus about $900,000 in cash, to the partnerships, which used the cash to purchase Canadian dollars and Sun Microsystems stock. *Id.* at 18a. After the option positions were terminated, the LLCs contributed their interests in each partnership to separate S corporations jointly owned by Woods and McCombs, which automatically terminated the partnerships (because each was 100% owned by a single S corporation). The partnerships accordingly distributed their assets to the S corporations, which sold those assets for small economic gains. See *id.* at 5a-6a, 18a-19a; Gov't C.A. Br. 13-14. By including the cost of

the purchased options as part of the basis of those assets, Woods and McCombs claimed huge losses on the 1999 returns of the S corporations (which then flowed through to the taxpayers individually, see 26 U.S.C. 1366). Pet. App. 19a; J.A. 192-211. Taking into account fees paid to other entities to participate in COBRA, Woods and McCombs together incurred only $1.37 million in real losses on the transactions, but they claimed more than $45 million in losses on the S corporations' tax returns. See *ibid.*; 9/16/2010 Trial Tr. (Morning Sess.) 25-26; J.A. 192-211.

B. Administrative And Judicial Proceedings Below

1. In accordance with the procedure prescribed by TEFRA, the IRS issued FPAAs to the partners of each of the two partnerships. The FPAAs disallowed the tax treatment of the COBRA transactions on the ground that the transactions lacked economic substance. Under the economic-substance doctrine, a longstanding common-law principle codified by Congress in 2010, a transaction will be disregarded altogether for tax purposes—and any associated tax benefits therefore will be disallowed—if the transaction does not have economic substance. See 26 U.S.C. 7701(*o*)(5)(A).

Applying that principle, each FPAA determined that "neither [the partnership] nor its purported partners have established the existence of [the partnership] as a matter of fact." J.A. 92, 146. The FPAAs further provided that, "[e]ven if [the partnership] existed as a partnership," all of its transactions should be "disregarded in full" because "the purported partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its purported partners." J.A. 92, 146-147. The FPAAs thus concluded that each of the steps in the

COBRA transaction—*i.e.*, "the acquisition of any interest in the purported partnership by the purported partner," "the transfer of offsetting options to a partnership in return for a partnership interest," and "the distribution of * * * assets to [the S Corporation]"—should be treated for federal tax purposes as a practical nullity. *Ibid.* The FPAAs also provided that "any * * * claimed increases in the outside basis in [the partnership] resulting from the contributions of the foreign currency option(s) are disallowed," and that "the partners * * * have not established adjusted bases in their respective partnership interests in an amount greater than zero." J.A. 94-95, 148-149.

Consistent with the procedure required by the Taxpayer Relief Act, the FPAAs concluded that certain penalties under Section 6662 applied to any underpayment of tax resulting from the COBRA shelter. J.A. 95-97, 149-151. One of the penalties was the basis-overstatement penalty. The invalidity of the transactions for tax purposes, the IRS concluded, meant that each partner's correct outside basis in the partnerships was zero. For that reason, the FPAAs determined that a 40% penalty for a gross misstatement of basis would apply to any tax underpayment predicated on a higher outside basis figure. J.A. 96, 150; see 26 C.F.R. 1.6662-5(g).

2. Woods sued the United States in the United States District Court for the Western District of Texas under TEFRA's judicial-review provision, 26 U.S.C. 6226(a), to challenge the FPAAs.[6] He sought to contest both the IRS's conclusion that COBRA lacked economic

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[6] Although the LLCs (and then the S Corporations) were the direct partners of the two partnerships, Woods and McCombs qualify as "partners" under TEFRA. See 26 U.S.C. 6231(a)(2)(B), (9) and (10).

substance and its determination that the overstatement penalty was applicable.

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

In a subsequent opinion, however, the district court held that the basis-overstatement penalty was inapplicable as a matter of law. Pet. App. 3a-14a. Citing the Fifth Circuit's decision in *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), the court stated that "[i]n this Circuit * * * it is clearly established that whenever the Internal Revenue Service totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction." Pet. App. 6a. Because the economic-substance doctrine had the effect of precluding the deductibility of any losses claimed from the transaction, the court reasoned, the penalty was inapplicable, even though the transaction was specifically designed to generate an artificially high basis in assets. See *id.* at 6a-7a.

3. a. While the government's appeal of the district court's penalty ruling was pending, the Fifth Circuit decided *Bemont Investments, L.L.C.* v. *United States*, 679 F.3d 339 (2012), a case involving a basis-inflating tax shelter similar to COBRA. Relying on *Heasley*, *supra*, and on its prior decision in *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988), the court in *Bemont Investments* held that the basis-overstatement penalty cannot apply when the IRS treats "transactions as a sham, and disallow[s] all tax attributes flowing from the transactions in full." 679 F.3d at 347-348.

Judge Prado issued a concurring opinion that was joined by the other two members of the panel. 679 F.3d at 351. The concurring opinion explained that "[a]rguably, if the *Todd/Heasley* rule did not bind us, tax underpayment in this case would be 'attributable to' a valuation overstatement." *Id*. at 353. The "basis misstatement and the transaction's lack of economic substance," Judge Prado reasoned, "are inextricably intertwined" because "[t]he basis misstatement was the engine of, the vehicle behind the sham transaction." *Id*. at 354. He further explained that COBRA's lack of economic substance "pulls the correct basis to zero, which eliminates the claimed loss, and renders the tax underpaid." *Ibid*. As a result, "disregarding the transaction for a lack of economic substance does not alter the reality that the tax underpayment was ultimately 'attributable to' the basis misstatement—or so one could argue, in a world without *Todd/Heasley*." *Ibid*. Judge Prado observed that "the *Todd/Heasley* rule could incentivize improper tax behavior" because it rewards taxpayers who do not merely misstate their basis in property but who "craft[ ] a more extreme scheme." *Id.* at 355.

b. Citing *Bemont Investments*, as well as *Todd* and *Heasley*, a different panel of the Fifth Circuit affirmed the district court's penalty ruling in this case in a one-paragraph per curiam opinion. Pet. App. 1a-2a.

SUMMARY OF ARGUMENT

The courts below correctly exercised jurisdiction to review the FPAAs' penalty-related determinations in this case. The courts erred, however, in holding that the basis-overstatement penalty is inapplicable when a basis-inflating transaction is found to lack economic substance.

A. 1. The district court had jurisdiction to decide in this partnership-level proceeding whether the basis-overstatement penalty applies to underpayments of tax resulting from invalid claims of loss on sham transactions. Under the Taxpayer Relief Act, a district court in a partnership-level proceeding has jurisdiction to determine "the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). That language encompasses the present dispute. The overstatement penalty "relates to," because it is imposed as a direct consequence of, the IRS's "adjustment[s] to * * * partnership item[s]"—specifically, the determinations, upheld by the district court, that the partnerships were shams created to inflate the partners' bases in the distributed assets, and that the COBRA transactions therefore were nullities for tax purposes.

Recent decisions from the D.C. and Federal Circuits have suggested that, if a penalty rests on an overstatement of a partner's *outside* basis in a partnership, an affected item, it does not "relate to" an adjustment to a partnership item. See *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1378-1380 (Fed. Cir. 2010); *Peta-*

luma FX Partners, LLC v. *Commissioner*, 591 F.3d 649, 654 (D.C. Cir. 2010). That reasoning is flawed. The fact that the penalty rests on an affected item actually *confirms* that it "relates to" an adjustment to a partnership item. An affected item, by definition, is a non-partnership item whose determination is affected by a partnership item. 26 U.S.C. 6231(a)(5). When a partnership item is adjusted in a way that requires an adjustment to an affected item and triggers a penalty, the penalty "relates to" the adjustment to the partnership item.

2. The interpretation suggested by the D.C. and Federal Circuits appears to reflect a concern that the court in a partnership-level proceeding cannot finally determine whether individual partners are subject to overstatement penalties premised on misstatements of outside basis because those determinations require further partner-level inquiries. That is true of virtually *any* penalty subject to the Taxpayer Relief Act procedure, however, since penalties are imposed on individual partners rather than on the partnership itself, and are premised on individual partners' underpayments of tax when they file their own returns. Congress nevertheless authorized both the IRS and the reviewing court to determine the "applicability" of penalties in partnership-level proceedings, while permitting partners to raise "partner level defenses" in refund proceedings. 26 U.S.C. 6230(c)(4). To hold that "the applicability of a penalty" cannot be determined in partnership-level proceedings unless no further partner-level determinations are required would effectively nullify Section 1238 of the Taxpayer Relief Act.

Read in context, the directive that courts determine the "applicability" of penalties in partnership-level pro-

ceedings means that the court should decide whether an error with respect to a partnership item, if reflected in a partner's own return, could trigger the penalty. After partnership-level proceedings conclude, the IRS determines whether to impose a penalty on any individual partner and, if so, assesses the penalty without having to follow the ordinary deficiency procedures. 26 U.S.C. 6230(a)(2). The partner may then challenge that determination in a refund proceeding. 26 U.S.C. 6230(c)(1) and (3).

That understanding of the statute's operation best effectuates the objectives of the Taxpayer Relief Act. Congress carved out an exception to the ordinary deficiency procedures for penalties related to partnership-level adjustments in order to relieve the administrative burden on the agency and the Tax Court. Congress established a reticulated scheme under which issues common to all partners, including issues concerning the applicability of penalties, would be conclusively resolved at the partnership level, while "partner level defenses" would be entertained in refund proceedings initiated by individual partners. See 26 U.S.C. 6230(c)(4). The merits question presented here—*i.e.*, whether the basis-overstatement penalty may be imposed on taxpayers who claim loss deductions premised on sham transactions—is a pure question of law whose resolution does not depend on factors specific to any individual partner. Deferring that issue to partner-level proceedings would create a risk of inconsistent decisions and would restore the inefficient scheme that Congress intended to do away with.

B. 1. Section 6662 of the Internal Revenue Code provides that the overstatement penalty shall apply to "the portion of any underpayment which is attributable to

* * * [a] substantial valuation misstatement." 26 U.S.C. 6662(b)(3). The term "substantial valuation misstatement" is defined to include certain situations in which the "adjusted basis of any property" is found to have been overstated. 26 U.S.C. 6662(e)(1)(A); see p. 4 & n.2, *supra*. Given the plain meaning of the word "attributable," the penalty applies whenever a substantial overstatement of basis causes or generates an underpayment of tax. See *Braunstein* v. *Commissioner*, 374 U.S. 65, 70 (1963). That causal link is generally (and readily) shown when a taxpayer uses an inflated basis to calculate his gain or loss from the sale of property, uses the inaccurate gain or loss figure to calculate his overall taxable income, and consequently pays less income tax than he actually owes. The "underpayment" that is "attributable to" the basis overstatement is the difference between the amount of tax actually paid and the amount of tax the taxpayer would have paid if he had used the correct basis figure and calculated his tax liability accordingly.

In one respect, the basis overstatements at issue here differ from more commonplace basis errors. The overstatements arise not from the taxpayers' factual misrepresentation about a particular purchase price or value, but rather from their erroneous asserted belief about the effect of the COBRA transactions on the bases of the distributed partnership assets on which they claimed a loss. The causal link between the basis overstatements and the underpayments of tax, however, was precisely the same as in the more typical situation.

Woods and McCombs ultimately paid far less tax than they owed, and far less tax than they would have paid if they had calculated their tax liabilities using as their bases in the purported partnerships the amount

(zero) that was ultimately determined to be correct. Their underpayments of tax therefore were "attributable to" their overstatements of basis in the same sense that tax underpayments are "attributable to" basis overstatements arising from more prosaic errors. Nothing in Section 6662 exempts a basis overstatement caused by an erroneous understanding of how to account for transactions in computing basis. And in numerous other contexts where Congress surely intended the penalty to be imposed, a basis overstatement can arise from a misapplication of basis-computation rules rather than from a factual inaccuracy.

2. The court of appeals' contrary view rests principally on the court's misinterpretation of a passage from the *Blue Book*. The relevant passage describes a situation in which two *different* deductions are improper, one because of a basis overstatement and one for a separate reason. The *Blue Book* sets forth a useful formula for isolating the portion of the total underpayment of tax that is "attributable to" the basis overstatement. In *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988), however, the court of appeals misinterpreted that passage to foreclose the overstatement penalty where the *same* deduction that reflects a basis overstatement is invalid on an alternative ground as well. See *id.* at 542-543. The *Blue Book* formula was not intended for that circumstance, and the court's holding has no support in the statute's text.

In any event, even if the rule announced in *Todd* was correct in an "alternative grounds" scenario, it would not bar imposition of the overstatement penalty here. The determination that COBRA lacked economic substance was not a ground for disallowance that was independent of the basis overstatement. Rather, the deter-

mination that each partner's actual basis in the partnership assets was zero, and that the partners' use of much larger bases constituted gross valuation misstatements, followed directly and necessarily from the determination that the COBRA transactions lacked economic substance. No plausible reading of Section 6662 or the *Blue Book* supports the court of appeals' holding that the penalty cannot apply in that circumstance.

3. The court of appeals' interpretation of the overstatement penalty would frustrate the penalty's purpose of deterring large basis overstatements. It would render the penalty inapplicable to particularly serious abuses where a taxpayer has engaged in a series of sham transactions designed to create the illusion that he has a far higher basis in an asset than he does. And it would foster the inequity that taxpayers who make simple errors on their returns are subject to a penalty that does not apply to those who engage in far more egregious misconduct.

ARGUMENT

A. The Courts Below Had Jurisdiction To Determine, In This Partnership-Level Proceeding, Whether A Claimed Loss Deduction Premised On A Sham Transaction Can Give Rise To A Basis-Overstatement Penalty

In its order granting certiorari in this case, the Court directed the parties to brief the following question: "Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty." In the government's view, the district court did have jurisdiction.

Under the Taxpayer Relief Act, when an appropriate partner seeks judicial review of an FPAA, the district court in considering the petition for review has jurisdiction to determine, *inter alia*, "the applicability of any

penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f); see 26 U.S.C. 6221. Section 6226(f) authorized the courts below to determine whether errors at the partnership level, if carried over to the individual partners' returns, could give rise to penalties under Section 6662. The basis-overstatement penalty "relates to" the "adjustment[s] to * * * partnership item[s]"—specifically, the determinations that the partnerships and transactions involving the partnerships were shams that must be disregarded for tax purposes. In light of those determinations, which (once reviewed and upheld by the reviewing courts) would be binding in any subsequent partner-level proceeding, the individual partners are potentially subject to overstatement penalties for using amounts greater than zero as the basis of assets distributed by the partnerships. That link establishes that the basis-overstatement penalty "relates to" the relevant "adjustment[s]."

To be sure, any basis-overstatement penalties that are ultimately imposed will be imposed on the individual partners rather than on the partnerships themselves. The partners' liability for those penalties depends, moreover, on whether the partners used the inflated basis figures for the partnership assets in calculating their own tax obligations. Recent rulings by the D.C. and Federal Circuits have suggested (without definitively holding) that those aspects of the statutory scheme preclude the court in a Section 6226 review proceeding from considering penalty-related issues in circumstances like the present one. See *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1378-1380 (Fed. Cir. 2010); *Petaluma FX Partners, LLC* v. *Commissioner*, 591 F.3d 649, 653 (D.C. Cir. 2010).

Read in isolation, Section 6226(f)'s authorization to determine the "applicability" of certain penalties could plausibly be read as limited to circumstances where the court has before it all the information it needs to decide definitively whether a particular person must pay a particular penalty. That language tracks the text of Section 6221, which governs the IRS's administrative review and similarly provides that "the applicability of any penalty * * * which relates to an adjustment to a partnership item[] shall be determined at the partnership level." 26 U.S.C. 6221. Given the larger statutory context in which it appears, however, the statutory command that the IRS and the reviewing court determine "the applicability of any penalty" at the partnership level would be a practical nullity if it were limited to situations where no further partner-level inquiries were needed. "When Congress enacted the penalty litigation amendments, it was well aware that a partnership-level proceeding under TEFRA does not result in the determination of an underpayment at the partnership level." *Tigers Eye Trading, LLC* v. *Commissioner*, 138 T.C. 67, 140 (2012). In directing the IRS and reviewing courts to make partnership-level determinations concerning the "applicability" of penalties, Congress must have had in mind an inquiry less comprehensive and particularized than the one needed to determine whether penalties should actually be imposed on specific partners.

Under an appropriate contextual interpretation, the IRS or a reviewing court determines the "applicability" of a penalty by deciding whether a particular error with respect to a partnership item, if reflected in the returns of individual partners, could trigger the penalty. That reading reflects a commonplace use of the word "applicability," and it is the only understanding of the stat-

ute that effectuates Congress's purpose to reduce the workload of the IRS and the Tax Court by exempting penalties related to adjustments to partnership items from the Internal Revenue Code's ordinary deficiency procedures. Congress intended the IRS to assess such penalties instead through computational adjustments, subject to judicial review through taxpayer-initiated refund proceedings. That streamlined process conserves administrative and judicial resources and avoids inconsistent determinations on issues whose resolution does not logically depend on factors specific to individual partners.

1. The basis-overstatement penalty applicable here "relates to" adjustments to partnership items

a. Under the Taxpayer Relief Act, "the applicability of any penalty * * * which relates to an adjustment to a partnership item [must] be determined at the partnership level" through the IRS's issuance of an FPAA. 26 U.S.C. 6221. If a timely petition for review of the FPAA is filed, the reviewing court in turn has "jurisdiction to determine * * * the applicability of any penalty * * * which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Accordingly, a court has jurisdiction in a partnership-level proceeding to determine whether a particular tax penalty is applicable whenever (i) the court has made or upheld an "adjustment to a partnership item," and (ii) the penalty "relates to" that adjustment. Both of those requirements are met here.

The IRS determined, and the district court agreed, that the COBRA transactions lacked economic substance and therefore must be disregarded for tax purposes. That determination constituted an "adjustment to a partnership item." 26 U.S.C. 6221, 6226(f). TEFRA defines a "partnership item" as "any item required to be

taken into account for the partnership's taxable year under any [income tax] provision" that, as provided in the pertinent Treasury regulations, "is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. 6231(a)(3). A regulation defines a "partnership item" to include "[t]he partnership aggregate and each partner's share of * * * [i]tems of income, gain, loss, deduction, or credit of the partnership," as well as "[c]ontributions to the partnership" by the partners, including "the partner's basis in the contributed property," and certain "[d]istributions from the partnerships." 26 C.F.R. 301.6231(a)(3)-1(a)(1)(i), (4)(i), (ii) and (c)(2)(iv). In addition, "the legal and factual determinations that underlie the determination of the amount, timing, and characterization" of those items are themselves partnership items. 26 C.F.R. 301.6231(a)(3)-1(b). As an implementation of an express delegation of authority to the agency, that regulation is entitled to *Chevron* deference. See *United States* v. *Mead Corp.*, 533 U.S. 218, 229 (2001).

As several circuits have held, a "determination that a partnership is a sham and lacks economic substance is a partnership item because it is a legal determination that underlies the amount and characterization of other partnership items." *Petaluma*, 591 F.3d at 653; see *Napoliello* v. *Commissioner*, 655 F.3d 1060, 1065 (9th Cir. 2011); *RJT Invs. X* v. *Commissioner*, 491 F.3d 732, 738 (8th Cir. 2007); see also *Duffie* v. *United States*, 600 F.3d 362, 378-379 (5th Cir.), cert. denied, 131 S. Ct. 355 (2010); *Keener* v. *Commissioner*, 551 F.3d 1358, 1366 (Fed. Cir.) (partnership transactions), cert. denied, 558 U.S. 825 (2009). In other words, the determination that a partnership may not be recognized for federal tax purposes means that none of the other partnership

items, such as income, losses, contributions, and distributions, may be recognized. See *Petaluma*, 591 F.3d at 653 ("The determination that a valid partnership exists is a *sine qua non* for determining the amount and characterization of all other partnership items."). And "[l]ogically, it makes perfect sense to determine whether a partnership is a sham at the partnership level" because "[a] partnership cannot be a sham with respect to one partner, but valid with respect to another." *Id.* at 654.

Accordingly, the district court's holding that COBRA lacked economic substance was an adjustment to a partnership item. That overarching adjustment had the effect of negating each of the transactions that made up the COBRA shelter. It therefore also resulted in the elimination of (*i.e.*, adjustments to) other partnership items, such as contributions to and distributions from the partnerships. See 26 C.F.R. 301.6231(a)(3)-1(a)(4)(i), (ii) and (b).

The second requirement for jurisdiction under Section 6226(f) is also met: Any overstatement penalty assessed in this case would "relate[] to" the "adjustment[s] to the partnership item[s]" made by the district court—*i.e.*, the legal determination that the partnerships were shams and that their transactions must be disregarded. The ordinary meaning of the word "relate" is "to bring into or establish association, connection, or relation." *Random House Unabridged Dictionary* 1626 (2d ed. 1993); see *Commissioner* v. *Brown*, 380 U.S. 563, 570-571 (1965) (where common term "is used in the Code without limiting definition," its ordinary meaning should be given effect). Accordingly, a penalty "relates to" an adjustment to a partnership item "if it has a connection with or reference to" the adjustment, at least where the

connection is not too "tenuous" or "remote." *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 384, 390 (1992) (citation omitted).

An evident connection exists between the district court's sham determination and any overstatement penalty that could be assessed here. The determination that the partnership and its transactions must be disregarded for tax purposes means that any claimed basis greater than zero in the distributed assets was an overstatement. Any overstatement penalty assessed in this case will be assessed because the partners claimed a basis higher than zero in those assets. The court's partnership-item adjustments therefore "relate[] to" the overstatement penalty.

b. The D.C. and Federal Circuits have suggested, in cases with similar facts, that the overstatement penalty does not "relate to" the determination that a partnership is a sham and that its transactions must be disregarded. See *Petaluma*, 591 F.3d at 655-656; *Jade Trading*, 598 F.3d at 1378-1380. Those courts have emphasized that in shelters like COBRA, the basis overstated is the partners' outside basis in the partnership, which attaches to the assets distributed by the partnership on liquidation, see 26 U.S.C. 732(b). Outside basis is ordinarily an affected item rather than a partnership item: it is generally not an item that the partnership is required to take into account, but it is affected by partnership items like capital contributions and distributions. See 26 C.F.R. 301.6231(a)(5)-1(b).[7] The D.C. and Feder-

[7] Outside basis could be a partnership item in circumstances not relevant here in which it is a component of another partnership item, such as inside basis. See, *e.g.*, *Home Concrete & Supply, LLC* v. *United States*, 634 F.3d 249, 252 (4th Cir. 2011), aff'd, 132 S. Ct. 1836 (2012).

al Circuits have thus reasoned that "the [overstatement] penalty * * * relates to an adjustment of an affected item, not a partnership item" as required by Section 6226(f). *Jade Trading*, 598 F.3d at 1380; see *Petaluma*, 591 F.3d at 655 ("True, the determination that [the partnership] should be disregarded for tax purposes is a partnership item, but the outside bases of the partners are affected items to be resolved at the partner level.").

That analysis ignores the relationship between partnership items and affected items. It is true that any overstatement penalty ultimately imposed on the taxpayers in this case will be premised on misstatements of outside basis, an affected item. Far from demonstrating that the penalty does not "relate[] to" an adjustment to a partnership item, however, the link between the penalty and an affected item confirms that the requisite "relat[ionship]" exists. An "affected item" is "any item to the extent such item is affected by a partnership item." 26 U.S.C. 6231(a)(5). Thus, an adjustment to a partnership item will typically require an associated adjustment to the affected item. When a penalty is triggered by an inaccurate affected item, and the affected item is rendered inaccurate because of an adjustment to a partnership item, the penalty logically "relates to" the adjustment to the partnership item.

Here, for example, the district court's determinations that the partnerships were shams, and that the contributions to the partnerships therefore should be given no tax effect—both adjustments to partnership items—precluded the partners from claiming outside bases greater than zero, implicating the overstatement penalty. The concomitant nullification of the distributions of the assets to the partners—another adjustment to a partnership item—likewise precluded the partners from

claiming a basis in those assets equal to their (purported) outside bases in the partnerships. There is consequently a direct causal relationship between the adjustments to partnership items and the applicability of the penalty. The penalty "relates to" the adjustments because the penalty would not be applicable without the adjustments.

That interpretation does not render the "relates to" limitation superfluous. All penalties that are related only to non-partnership items that are not affected items—*i.e.*, penalties that may apply to any individual partner for reasons unconnected to any error at the partnership level—are excluded from the Taxpayer Relief Act procedure. For example, a penalty might be imposed for a partner's failure to report income from a non-partnership source. The same is true of penalties for misstating affected items if liability for such penalties does not turn on adjustments to partnership items.

2. The IRS and the courts can determine the "applicability" of particular penalties in partnership-level proceedings, even though the ultimate decision whether to impose a penalty will depend in part on partner-level inquiries

a. As the D.C. and Federal Circuits have emphasized, the ultimate imposition of overstatement penalties in cases like this one will require some partner-level inquiries after the partnership-level proceedings have been completed. See *Petaluma*, 591 F.3d at 655-656; *Jade Trading*, 598 F.3d at 1378-1380. Read in isolation, Section 6226(f)'s authorization to determine the "applicability" of certain penalties could plausibly be read as limited to circumstances where the court has before it all the information it needs to decide whether a particular person is subject to a particular penalty. The lan-

guage of Section 6226(f) does not compel that reading, however, and the larger statutory context makes clear that it is incorrect.

For virtually *any* penalty subject to the Taxpayer Relief Act procedure, including all of the accuracy-related penalties set forth in Section 6662, some further partner-level inquiry will be necessary even after the partnership-level proceedings are complete. A partner's actual liability for any Section 6662 accuracy-related penalty requires that she have actually underpaid income tax, see 26 U.S.C. 6662(a), which would not be true if (for example) her taxable income were eliminated by other, legitimate losses. Because such facts cannot be known solely from examining the partnership's return and records, the Taxpayer Relief Act expressly provides that "partner level defenses" may be raised in a refund proceeding after the conclusion of the partnership-level proceedings. 26 U.S.C. 6230(c)(4); see, *e.g.*, 26 U.S.C. 6664(c) ("reasonable cause" defense to penalty liability). Section 6230(c)(4) also provides, however, that determinations in the partnership-level proceedings, including determinations concerning "the applicability of any penalty," are "conclusive" and unreviewable in any refund proceeding. 26 U.S.C. 6230(c)(4).

Section 6226(f)'s requirement that the reviewing court determine "the applicability of any penalty" at the partnership level therefore would be a practical nullity if it were limited to situations where liability for penalties could be finally determined in the partnership-level proceedings themselves. Section 6230(c)(4) likewise clearly presupposes that the "applicability of [a] penalty" may be determined in partnership-level proceedings even though "partner level defenses" remain to be determined. Under an appropriate contextual interpreta-

tion of the relevant phrase, the IRS or a reviewing court determines the "applicability" of a penalty by deciding whether a particular error with respect to a partnership item, if reflected in the returns of individual partners, could trigger the penalty.[8]

That reading is fully consistent with accepted understandings of the word "applicability" and its cognates. Title VII of the Civil Rights Act of 1964, for example, defines the term "employer" by reference to a 15-employee threshold. See *Arbaugh* v. *Y & H Corp.*, 546 U.S. 500, 503-504 (2006). If the parties to a particular Title VII suit disputed whether the defendant had the requisite 15 or more employees, the court in resolving that dispute would naturally be said to determine the "applicability" of Title VII, even though additional proceedings would be needed to determine whether Title VII had been *violated*. In that context, the statement that Title VII is "applicable" would simply mean that the defendant could be held liable under Title VII if it was ultimately found to have engaged in one of the discriminatory acts that the statute prohibits. Similarly in the Taxpayer Relief Act context, the court in a partnership-level proceeding can "determine * * * the applicability of [a] penalty * * * which relates to an ad-

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[8] TEFRA requires that each partner, on his own tax return, must "treat a partnership item in a manner which is consistent with the treatment of such partnership item on the partnership return," 26 U.S.C. 6222(a), or else notify the IRS of any inconsistency between the two returns, 26 U.S.C. 6222(b)(1). Section 6222 reflects Congress's judgment that, although an individual partner may sometimes have legitimate reasons for filing a return that treats partnership items differently than the items are treated on the partnership return, the default assumption is that the two returns will be consistent. Section 6226(f)'s reference to the "applicability" of penalties should be construed by reference to the same assumption.

justment to a partnership item," 26 U.S.C. 6226(f), by deciding whether individual partners will be subject to the penalty if they carry forward to their own returns the erroneous partnership-level information that is the subject of the adjustment, and an underpayment of tax results.

The present case furnishes an apt illustration. The district court held, and respondent does not currently dispute, that the COBRA transaction "was totally lacking in economic substance," and that "both the ordinary loss and the capital loss * * * should be disregarded for tax purposes." Pet. App. 21a. In this Court as in the court of appeals, the disputed question on the merits is whether a taxpayer who claims a loss deduction, based on the sale of assets distributed from a partnership that is ultimately determined to be a sham, is subject to the basis-overstatement penalty if the invalid deduction results in an underpayment of tax. That question is very naturally characterized as one concerning the "applicability" of a penalty. And because the answer to that pure question of law does not depend on factors specific to any individual partner, its resolution in a partnership-level proceeding promotes the efficiency goals that TEFRA and the Taxpayer Relief Act were intended to achieve.

b. The interpretation advanced here best effectuates Congress's objectives in the Taxpayer Relief Act, and neither the D.C. Circuit nor the Federal Circuit has identified any significant policy justification for the contrary view. Congress was concerned that "applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase

the Tax Court's inventory." 1997 House Report 594. The statute therefore allows the IRS to avoid the burdensome deficiency procedures when it assesses a penalty related to a partnership-level error that has been identified in an FPAA or by a court. Instead, the IRS may simply assess the penalty, where appropriate, after reviewing the partners' individual returns. The Taxpayer Relief Act then places the onus on each partner to challenge the assessment of the penalty in a refund proceeding if he believes that any individualized considerations negate his liability. See *ibid.*

That streamlined procedure not only reduces the burden on the agency and the Tax Court, but also avoids inconsistent treatment of different partners with respect to the same penalty. For example, if it is determined in a partnership-level proceeding that the negligence penalty applies because the partnership "fail[ed] to make a reasonable attempt to comply with" the tax laws, 26 U.S.C. 6662(b)(1) and (c), that determination will be binding in any subsequent refund proceeding. But if the Taxpayer Relief Act procedure were deemed inapplicable to any penalty that requires further partner-level determinations—*i.e.*, virtually all penalties—the IRS would be forced to litigate the common question of partnership negligence piecemeal against individual partners in the Tax Court, potentially leading to inconsistent rulings. That is precisely the risk the Taxpayer Relief Act procedure was intended to eliminate.

B. Section 6662's Basis-Overstatement Penalty Applies To An Underpayment Of Tax That Results From Claiming A Basis Derived From Transactions That Lacked Economic Substance

The plain text of Section 6662 refutes the court of appeals' conclusion that penalties for basis overstatements

cannot be imposed when a basis-inflating transaction is disregarded as lacking economic substance. In such a case, any underpayment of tax is "attributable to" an overstatement of basis because the taxpayer would have paid additional tax if she had used the correct basis on her return. The court of appeals' mistaken view, which has been rejected by eight other circuits (see Pet. 21-29), rested principally on a misreading of a passage from the *Blue Book*. Under the court's interpretation, moreover, taxpayers who engage in elaborate sham transactions for the sole purpose of inflating their bases in assets—often by tens of millions of dollars—would be immune from a penalty that applies to many other taxpayers who commit far less serious errors.

1. The plain text of Section 6662 makes the basis-overstatement penalty applicable when an underpayment of tax results from claiming a basis derived from transactions that lacked economic substance

a. Section 6662 of the Internal Revenue Code provides that a penalty shall be imposed on "the portion of any underpayment which is attributable to * * * [a] substantial valuation misstatement." 26 U.S.C. 6662(b)(3); see 26 U.S.C. 6662(h)(1) (applying greater penalty to the "portion of the underpayment * * * attributable to one or more gross valuation misstatements"). The term "substantial valuation misstatement" is defined to include overstatements of the "adjusted basis of any property." 26 U.S.C. 6662(e)(1)(A); see p. 4 & n.2, *supra*. The word "attributable" means "capable of being attributed," and to "attribute" is to "explain as caused or brought about by." *Webster's Third New International Dictionary of the English Language* 141, 142 (1993). As this Court explained in construing the words "gain attributable to such property" in another

provision of the Internal Revenue Code, "the phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question." *Braunstein* v. *Commissioner*, 374 U.S. 65, 70 (1963). An underpayment of tax therefore is "attributable to" an overstatement of basis if the overstatement "caused or generated" the underpayment.

For purposes of computing a taxpayer's gain or loss from the sale of property, the gain or loss is the difference (which may be positive or negative) between the amount realized from the sale and the taxpayer's adjusted basis in the property. See 26 U.S.C. 1001(a). If a taxpayer overstates the adjusted basis of a sold asset while accurately reporting the sale proceeds, the natural (indeed, mathematically inevitable) effect of the basis overstatement is to reduce the gain or increase the loss associated with the sale. If that inaccurate gain or loss is used to calculate the taxpayer's overall taxable income, an understatement of taxable income and a concomitant underpayment of tax may result. In prescribing penalties for tax underpayments "attributable to * * * substantial valuation misstatement[s]," and in defining the term "substantial valuation misstatement" to include overstatements of adjusted basis, Congress presumably intended that this causal link would trigger the imposition of penalties.

The COBRA tax-avoidance mechanism has the requisite causal connection to the ultimate underpayment of tax. As the district court explained, "the whole point of the COBRA strategy" is to create a huge paper loss by claiming that "the basis of [the distributed partnership property] [is] the cost of the 'long' currency options" contributed by the taxpayers, "while the 'short' options [can] be disregarded for tax purposes." Pet. App. 19a.

For federal tax purposes, however, there can be no partnership interests in a partnership that has been disregarded as a sham and, consequently, no basis in such nonexistent interests. See *Petaluma* v. *Commissioner*, 131 T.C. 84, 100 (2008), aff'd in part and rev'd in part, 591 F.3d 649 (D.C. Cir. 2010). Once the COBRA transactions in this case were determined to be a sham that had no purpose other than tax avoidance, the partners were not permitted to derive their outside bases in the partnerships from those transactions, and were required instead to use a basis figure of zero to compute their gain or loss from the sale of the distributed assets. See J.A. 95, 149. If the partners use a basis greater than zero, any resulting underpayment of tax is "attributable to" a basis overstatement. The use of the incorrect outside basis figure is what generates the underpayment.

b. In one respect, the basis overstatement produced by a shelter like COBRA differs from the run-of-the-mill case in which a taxpayer simply overstates the value or purchase price of an asset. The overstatement in the COBRA context arises not from the taxpayer's factual misrepresentation about the value of a particular asset, but rather from her erroneous asserted belief about the legal status of the COBRA transactions and their impact on her basis in the distributed assets.

That difference, however, is immaterial to the application of the overstatement penalty. The statutory definition of "substantial valuation misstatement," 26 U.S.C. 6662(e)(1)(A), does not distinguish between basis overstatements that result from factual errors and those caused by legal errors regarding the basis-calculation rules. This distinction is similarly irrelevant to the question whether the individual partners' underpay-

ments of tax were "attributable to" the basis overstatement. By treating as their S corporations' bases in the partnerships amounts that were (substantially) greater than the correct amount of zero, Woods and McCombs claimed large paper losses to which they were not entitled, which in turn caused them to underreport their overall taxable income and ultimately to underpay their taxes. That is precisely the same causal link that exists between taxpayers' overstatements of basis and their resulting underpayments of tax in cases involving inflation of the value or purchase price of an asset.

Indeed, in many contexts other than transactions that lack economic substance, a basis overstatement is produced by a misapplication of basis-computation rules rather than by a simple factual error. For example, a corporation may overstate its basis in a subsidiary due to a misapplication of regulations relating to consolidated returns. See 26 C.F.R. 1.1502-32. If the corporation were to determine its gain or loss on the sale of the subsidiary using the overstated basis, resulting in an understatement of the corporation's overall taxable income and ultimately in an underpayment of tax, the overstatement penalty would surely apply. There is no sound reason for a different result here, where the partners claimed a large basis that was erroneous in light of the underlying transactions' lack of economic substance.

Nor does the fact that the legally correct basis in the assets distributed in a COBRA shelter is zero bar application of the overstatement penalty. The statute contains "no suggestion that the penalty should not apply when the correct basis * * * is determined to be zero because the transaction is completely lacking in economic substance." *Gustashaw* v. *Commissioner*, 696 F.3d 1124, 1136 (11th Cir. 2012). Regardless of whether an

underpayment of tax results from an overstatement of basis in property having a correct basis of zero or in property having a correct basis greater than zero, the underpayment is "attributable to" an overstatement of basis.

Even if Section 6662 were ambiguous on that question, the issue was resolved in 1991 by Treasury Regulation 1.6662-5(g), which provides that the "adjusted basis claimed on a return of any property with a correct * * * adjusted basis of zero is considered to be 400 percent or more of the correct amount." 26 C.F.R. 1.6662-5(g). In that circumstance, the regulation instructs, "[t]here is a gross valuation misstatement with respect to such property." *Ibid*. That regulation reflects a reasonable interpretation of Section 6662 and is accordingly entitled to judicial deference. See *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842-845 (1984); see also *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704, 711-714 (2011) ("We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.").

2. The **Blue Book** *does not support the interpretation of the basis-overstatement penalty adopted by the court of appeals*

The court of appeals' understanding of the overstatement penalty rested on a mistaken interpretation of a passage in the *Blue Book*. The Fifth Circuit adopted that reading in its 1988 decision in *Todd* v. *Commissioner*, 862 F.2d 540, in which it erroneously held that when the *same* deduction is improper for two alternative reasons, only one of which is a basis overstatement, the penalty does not apply. That reading conflicts with the plain text of Section 6662, and it reflects a misinterpre-

tation of the relevant passage from the *Blue Book*, which discussed a hypothetical scenario involving two *different* deductions. But even if *Todd* were correctly decided, it would not support the Fifth Circuit's decision in the present case, where the determination that the partnerships lacked economic substance was inextricably linked to the conclusion that the partners had overstated their bases in their partnership interests.

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

The Fifth Circuit held that the basis-overstatement penalty could not be imposed on the plaintiffs because, in the court's view, the underpayment of tax was "attributable to" the disallowance of the deduction for failure to place the units in service during the relevant tax years, rather than to the overstatement of basis in the refrigerated units. See 862 F.2d at 541-545. The court deemed the words "attributable to" ambiguous as applied to a deduction that, in addition to being invalid in part because it was premised on an overstatement of

basis, was invalid in its entirety for a reason independent of that overstatement. Finding the "formal legislative history" of the Economic Recovery Tax Act unhelpful on the question, the court turned to the formula set forth in the *Blue Book*: that the "underpayment resulting from a valuation overstatement" equals "actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments)" minus "actual tax liability as reduced by taking into account the valuation overstatement." *Blue Book* 333; see *Todd*, 862 F.3d at 542-543. The court of appeals reasoned that, in the case before it, the taxpayers' "actual tax liability" was no greater than their "actual tax liability as reduced by taking into account the valuation overstatement." *Id.* at 543 (citation omitted). The court explained that, "where the deductions and credits for these refrigeration units were inappropriate altogether, the [taxpayers'] valuation of the property supposedly generating the tax benefits had no impact whatsoever on the amount of tax actually owed." *Ibid.*

That holding reflected a misreading of the *Blue Book*. See *Bemont Invs., L.L.C.* v. *United States*, 679 F.3d 339, 352 (5th Cir. 2012) (Prado, J., concurring); Pet. 21-29 (citing cases). The pertinent *Blue Book* passage, reprinted above, describes a situation in which a taxpayer understates his taxable income by $40,000 by claiming two *different* improper $20,000 deductions, one of which is excessive because it is based on a valuation overstatement, and the other of which "is disallowed totally for reasons apart from the valuation overstatement." *Blue Book* 333 n.2; see pp. 6-7, *supra*. The *Blue Book* simply explains that only the deduction to which the basis overstatement pertains, and not the unrelated deduction, should be considered in determining what

portion of the underpayment of tax is "attributable to" the basis overstatement. See *ibid.*

Todd, by contrast, involved a *single* deduction that was both overstated due to a basis misstatement and disallowed in its entirety due to an unrelated legal defect. The *Blue Book* does not address the proper application of Section 6662 to that scenario. The *Blue Book* does not, in particular, endorse the anomalous result that follows from the *Todd* court's analysis, under which the existence of an *additional* ground for disallowing a deduction may serve to exempt a taxpayer from a penalty to which he would otherwise be subject. Indeed, some of the taxpayers who had participated in the same scheme at issue in *Todd* but who had placed the units in service in the correct tax year were subject to the basis-overstatement penalty, underscoring the inequity of the court of appeals' holding. See 862 F.2d at 541.

In any event, the *Blue Book*, a post-enactment legislative report, could not trump the plain text of Section 6662. By overstating their basis in the property, the plaintiffs in *Todd* claimed a larger deduction—and thus paid less tax—than they would have paid if their basis in the refrigerated units had been accurately reported. To be sure, even accurate reporting of the plaintiffs' basis in the units would have resulted in *some* underpayment of tax, given the IRS's determination that no deduction was permissible because the units had not been placed in service. But the difference between that smaller underpayment and the larger underpayment that actually occurred is naturally characterized as "attributable to" the basis overstatement. See *Todd* v. *Commissioner*, 89 T.C. 912, 914 (1987) (noting that the government sought the overstatement penalty "only with respect to the difference between the basis claimed on the return

* * * and [the plaintiffs'] cash investment"), aff'd, 862 F.2d 540 (5th Cir. 1988).

b. The deductions at issue in *Todd* were disallowed in their entirety on a ground *unrelated* to the taxpayers' overstatements of basis. In subsequent decisions, however, including in this case, the Fifth Circuit has extended the *Todd* rule to encompass *all* cases involving total disallowance of deductions. In *Heasley* v. *Commissioner*, 902 F.2d 380 (5th Cir. 1990), the court stated 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." *Id*. at 383; see *Bemont Invs.*, 679 F.3d at 347-348. In such a case, the Fifth Circuit has concluded, "the underpayment is not attributable to a valuation overstatement," but rather "is attributable to claiming an improper deduction or credit." *Heasley*, 902 F.3d at 983. The court has applied that approach "even if the possible grounds for denying the same deduction—overvaluation and a lack of economic substance, for example—emerge from the same factual nucleus." *Bemont Invs.*, 679 F.3d at 353 (Prado, J., concurring).

Even if *Todd* established the correct rule for cases in which a deduction premised on an overstatement of basis is also subject to disallowance on an unrelated ground, there would be no plausible rationale for extending the rule to a case like this one. Here, the IRS's determination that each partner had a zero basis in the distributed partnership assets was inextricably linked to its determination that the relevant partnerships lacked economic substance. The economic-substance finding was not an independent ground for disallowing the partners' claimed deductions; it was the reason why the

basis figures on which those deductions were premised were legally incorrect.

Taken literally, the Fifth Circuit's language in *Heasley* suggests that the basis-overstatement penalty would be inapplicable if the IRS concluded that the true adjusted basis in sold property was less than or equal to the property's sale price, and accordingly disallowed the taxpayer's claimed loss deduction in its entirety. That cannot be right. When the IRS's *reason* for wholly disallowing a claimed deduction is that the deduction rests on an overstatement of basis, the disallowance cannot plausibly be thought to break the causal chain between the overstatement and the ultimate underpayment of tax. The underpayment is accordingly "attributable to" the overstatement of basis, and the Section 6662 penalty applies. That is the case here.[9]

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[9] In 1992, the IRS issued non-binding guidelines for its attorneys, in which the agency outlined its litigation position on the overstatement penalty and stated its disagreement with *Heasley*. See Litigation Guideline Memorandum, IRS LGM TL-68, 1992 WL 1355877 (Aug. 12, 1992). With respect to *Todd*, the memorandum recommended that attorneys not seek the penalty when the taxpayer has conceded an alternative ground for disallowance prior to trial, relying on Tax Court decisions that have distinguished between pre- and post-trial concessions. In 2011, however, the IRS's Office of Chief Counsel issued a notice that instructed its attorneys to address pretrial *Todd* concessions "on a case-by-case basis" and stated that "[p]roposed concessions should be opposed in cases involving abusive tax shelter transactions if the application of valuation misstatement penalties is at issue." Notice CC-2012-001, at 4 (Oct. 5, 2011), http://www.irs.gov/pub/irs-ccdm/cc-012-001.pdf.

3. Under the court of appeals' interpretation of Section 6662, the most egregious misstatements of basis would be immune from the basis-overstatement penalty

The court of appeals' interpretation of Section 6662 frustrates Congress's effort to deter overstatements of basis by penalizing taxpayers who engage in that practice. See *Fidelity Int'l Currency Advisor A Fund, LLC* v. *United States*, 661 F.3d 667, 673-674 (1st Cir. 2011). That important deterrence objective is at least as strongly implicated in the present case, where the taxpayers devised sham partnerships in order to create inflated bases in the partnership assets they intended to sell, as in the more prosaic situation where a taxpayer overstates his basis in sold property by misrepresenting the relevant facts. The IRS and the district court found in this case that Woods and McCombs had engaged in an elaborate tax shelter for the sole purpose of inflating their S corporations' bases in the distributed assets, thereby allowing the taxpayers to claim an enormous illusory tax loss and to avoid millions of dollars in income tax. The text of Section 6662 does not suggest, and there is no plausible reason to suppose, that Congress intended to exempt schemes like this one from the basis-overstatement penalty.

The Fifth Circuit's approach also creates unfair and unjustified distinctions between taxpayers. It exempts from the basis-overstatement penalty those who conduct sham transactions to give the illusion of millions of dollars in tax losses, even though taxpayers who make simple errors in computing their bases in property are subject to the penalty. As explained above (see pp. 45-46, *supra*), moreover, the rule announced in *Todd* gives *more favorable* treatment to taxpayers who claim deduc-

tions that are improper in two distinct respects—*i.e.*, deductions that reflect overstatements of basis and are disallowed on an independent ground as well—than to taxpayers who overstate their bases in sold property in claiming deductions that are otherwise appropriate. The Fifth Circuit's approach thus creates the "anomalous result [of] allowing a party to avoid tax penalties by engaging in behavior one might suppose would implicate more tax penalties, not fewer." *Keller* v. *Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009). Nothing in the text, history, or purposes of Section 6662 suggests that Congress intended that anomaly.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

1. 26 U.S.C. 6221 provides:

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.

2. 26 U.S.C. 6226 provides:

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.

(b) Petition by partner other than tax matters partner

(1) In general

If the tax matters partner does not file a readjustment petition under subsection (a) with respect to any final partnership administrative adjustment, any notice partner (and any 5-percent group) may, within 60 days after the close of the 90-day period set forth in subsection (a), file a petition for a readjustment of the partnership items for the taxable year involved with any of the courts described in subsection (a).

(2) Priority of the Tax Court action

If more than 1 action is brought under paragraph (1) with respect to any partnership for any partnership taxable year, the first such action brought in the Tax Court shall go forward.

(3) Priority outside the Tax Court

If more than 1 action is brought under paragraph (1) with respect to any partnership for any taxable year but no such action is brought in the Tax Court, the first such action brought shall go forward.

(4) Dismissal of other actions

If an action is brought under paragraph (1) in addition to the action which goes forward under paragraph (2) or (3), such action shall be dismissed.

(5) Treatment of premature petitions

If—

(A) a petition for a readjustment of partnership items for the taxable year involved is filed by a notice partner (or a 5-percent group) during the 90-day period described in subsection (a), and

(B) no action is brought under paragraph (1) during the 60-day period described therein with respect to such taxable year which is not dismissed,

such petition shall be treated for purposes of paragraph (1) as filed on the last day of such 60-day period.

(6) Tax matters partner may intervene

The tax matters partner may intervene in any action brought under this subsection.

(c) Partners treated as parties

If an action is brought under subsection (a) or (b) with respect to a partnership for any partnership taxable year—

(1) each person who was a partner in such partnership at any time during such year shall be treated as a party to such action, and

(2) the court having jurisdiction of such action shall allow each such person to participate in the action.

(d) Partner must have interest in outcome

(1) In order to be party to action

Subsection (c) shall not apply to a partner after the day on which—

(A) the partnership items of such partner for the partnership taxable year became non-partnership items by reason of 1 or more of the events described in subsection (b) of section 6231, or

(B) the period within which any tax attributable to such partnership items may be assessed against that partner expired.

Notwithstanding subparagraph (B), any person treated under subsection (c) as a party to an action shall be permitted to participate in such action (or file a readjustment petition under subsection (b) or paragraph (2) of this subsection) solely for the purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired with respect to such person, and the court having jurisdiction of such action shall have jurisdiction to consider such assertion.

(2) To file petition

No partner may file a readjustment petition under subsection (b) unless such partner would (after the application of paragraph (1) of this subsection) be treated as a party to the proceeding.

(e) Jurisdictional requirement for bringing action in district court or Court of Federal Claims

(1) In general

A readjustment petition under this section may be filed in a district court of the United States or the Court of Federal Claims only if the partner filing the petition deposits with the Secretary, on or before the day the petition is filed, the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner's return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment. In the case of a petition filed by a 5-percent group, the requirement of the preceding sentence shall apply to each member of the group. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirements and any shortfall in the amount required to be deposited is timely corrected.

(2) Refund on request

If an action brought in a district court of the United States or in the Court of Federal Claims is dismissed by reason of the priority of a Tax Court action under paragraph (2) of subsection (b), the Secretary shall, at the request of the partner who made the deposit, refund the amount deposited under paragraph (1).

(3) Interest payable

Any amount deposited under paragraph (1), while deposited, shall not be treated as a payment of tax for purposes of this title (other than chapter 67).

(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.

(g) Determination of court reviewable

Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Court of Federal Claims, as the case may be, and shall be reviewable as such. With respect to the partnership, only the tax matters partner, a notice partner, or a 5-percent group may seek review of a determination by a court under this section.

(h) Effect of decision dismissing action

If an action brought under this section is dismissed (other than under paragraph (4) of subsection (b)), the decision of the court dismissing the action shall be considered as its decision that the notice of final part-

nership administrative adjustment is correct, and an appropriate order shall be entered in the records of the court.

3. 26 U.S.C. 6230 provides:

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 6013(e) 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 6013(e) 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.

(d) Special rules with respect to credits or refunds attributable to partnership items

(1) In general

Except as otherwise provided in this subsection, no credit or refund of an overpayment attributable to a partnership item (or an affected item) for a partnership taxable year shall be allowed or made to any partner after the expiration of the period of limitation prescribed in section 6229 with respect to such partner for assessment of any tax attributable to such item.

(2) Administrative adjustment request

If a request for an administrative adjustment under section 6227 with respect to a partnership item is timely filed, credit or refund of any overpayment attributable to such partnership item (or an affected item) may be allowed or made at any time before the expiration of the period prescribed in section 6228 for bringing suit with respect to such request.

(3) Claim under subsection (c)

If a timely claim is filed under subsection (c) for a credit or refund of an overpayment attributable to a partnership item (or affected item), credit or refund of such overpayment may be allowed or made at any time before the expiration of the period specified in section 6532 (relating to periods of limitations on suits) for bringing suit with respect to such claim.

(4) Timely suit

Paragraph (1) shall not apply to any credit or refund of any overpayment attributable to a partnership item (or an item affected by such partnership item) if a partner brings a timely suit with respect to a timely administrative adjustment request under section 6228 or a timely claim under subsection (c) relating to such overpayment.

(5) Overpayments refunded without requirement that partner file claim

In the case of any overpayment by a partner which is attributable to a partnership item (or an affected item) and which may be refunded under this subchapter, to the extent practicable credit or refund of such overpayment shall be allowed or made without any requirement that the partner file a claim therefor.

(6) Subchapter B of chapter 66 not applicable

Subchapter B of chapter 66 (relating to limitations on credit or refund) shall not apply to any credit or refund of an overpayment attributable to a partnership item.

(e) Tax matters partner required to furnish names of partners to Secretary

If the Secretary mails to any partnership the notice specified in paragraph (1) of section 6223(a) with respect to any partnership taxable year, the tax matters partner shall furnish to the Secretary the name, address, profits interest, and taxpayer identification number of each person who was a partner in such partnership at any time during such taxable year. If the tax matters partner later discovers that the information furnished to the Secretary was incorrect or incomplete, the tax matters partner shall furnish such revised or additional information as may be necessary.

(f) Failure of tax matters partner, etc., to fulfill responsibility does not affect applicability of proceeding

The failure of the tax matters partner, a pass-thru partner, the representative of a notice group, or any other representative of a partner to provide any notice or perform any act required under this subchapter or under regulations prescribed under this subchapter on behalf of such partner does not affect the applicability of any proceeding or adjustment under this subchapter to such partner.

(g) Date decision of court becomes final

For purposes of section 6229(d)(1) and section 6230(c)(2)(B), the principles of section 7481(a) shall be applied in determining the date on which a decision of a district court or the Court of Federal Claims becomes final.

(h) Examination authority not limited

Nothing in this subchapter shall be construed as limiting the authority granted to the Secretary under section 7602.

(i) Time and manner of filing statements, making elections, etc.

Except as otherwise provided in this subchapter, each—

(1) statement,

(2) election,

(3) request, and

(4) furnishing of information,

shall be filed or made at such time, in such manner, and at such place as may be prescribed in regulations.

(j) Partnerships having principal place of business outside the United States

For purposes of sections 6226 and 6228, a principal place of business located outside the United States shall be treated as located in the District of Columbia.

(k) Regulations

The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subchapter. Any reference in this subchapter to regulations is a reference to regulations prescribed by the Secretary.

(*l*) Court rules

Any action brought under any provision of this subchapter shall be conducted in accordance with such rules of practice and procedure as may be prescribed by the Court in which the action is brought.

4. 26 U.S.C. 6231 provides:

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.

(8) Notice partner

The term "notice partner" means a partner who, at the time in question, would be entitled to notice under subsection (a) of section 6223 (determined without regard to subsections (b)(2) and (e)(1)(B) thereof).

(9) Pass-thru partner

The term "pass-thru partner" means a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which proceedings under this subchapter are conducted.

(10) Indirect partner

The term "indirect partner" means a person holding an interest in a partnership through 1 or more pass-thru partners.

(11) 5-percent group

A 5-percent group is a group of partners who for the partnership taxable year involved had profits interests which aggregated 5 percent or more.

(12) Husband and wife

Except to the extent otherwise provided in regulations, a husband and wife who have a joint

interest in a partnership shall be treated as 1 person.

(b) Items cease to be partnership items in certain cases

(1) In general

For purposes of this subchapter, the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date—

(A) the Secretary mails to such partner a notice that such items shall be treated as nonpartnership items,

(B) the partner files suit under section 6228(b) after the Secretary fails to allow an administrative adjustment request with respect to any of such items,

(C) the Secretary or the Attorney General (or his delegate) enters into a settlement agreement with the partner with respect to such items, or

(D) such change occurs under subsection (e) of section 6223 (relating to effect of Secretary's failure to provide notice) or under subsection (c) of this section.

(2) Circumstances in which notice is permitted

The Secretary may mail the notice referred to in subparagraph (A) of paragraph (1) to a partner with respect to partnership items for a partnership taxable year only if—

(A) such partner—

(i) has complied with subparagraph (B) of section 6222(b)(1) (relating to notification of inconsistent treatment) with respect to one or more of such items, and

(ii) has not, as of the date on which the Secretary mails the notice, filed a request for administrative adjustments which would make the partner's treatment of the item or items with respect to which the partner complied with subparagraph (B) of section 6222(b)(1) consistent with the treatment of such item or items on the partnership return, or

(B)(i) such partner has filed a request under section 6227(d) for administrative adjustment of one or more of such items, and

(ii) the adjustments requested would not make such partner's treatment of such items consistent with the treatment of such items on the partnership return.

(3) Notice must be mailed before beginning of partnership proceeding

Any notice to a partner under subparagraph (A) of paragraph (1) with respect to partnership items for a partnership taxable year shall be mailed before the day on which the Secretary mails to the tax matters partner a notice of the

beginning of an administrative proceeding at the partnership level with respect to such items.

(c) Regulations with respect to certain special enforcement areas

(1) Applicability of subsection

This subsection applies in the case of—

(A) assessments under section 6851 (relating to termination assessments of income tax) or section 6861 (relating to jeopardy assessments of income, estate, gift, and certain excise taxes),

(B) criminal investigations,

(C) indirect methods of proof of income,

(D) foreign partnerships, and

(E) other areas that the Secretary determines by regulation to present special enforcement considerations.

(2) Items may be treated as nonpartnership items

To the extent that the Secretary determines and provides by regulations that to treat items as partnership items will interfere with the effective and efficient enforcement of this title in any case described in paragraph (1), such items shall be treated as nonpartnership items for purposes of this subchapter.

(3) Special rules

The Secretary may prescribe by regulation such special rules as the Secretary determines to be necessary to achieve the purposes of this subchapter in any case described in paragraph (1).

(d) Time for determining partner's profits interest in partnership

(1) In general

For purposes of section 6223(b) (relating to special rules for partnerships with more than 100 partners) and paragraph (11) of subsection (a) (relating to 5-percent group), the interest of a partner in the profits of a partnership for a partnership taxable year shall be determined—

(A) in the case of a partner whose entire interest in the partnership is disposed of during such partnership taxable year, as of the moment immediately before such disposition, or

(B) in the case of any other partner, as of the close of the partnership taxable year.

(2) Indirect partners

The Secretary shall prescribe regulations consistent with the principles of paragraph (1) to be applied in the case of indirect partners.

(e) Effect of judicial decisions in certain proceedings

(1) Determinations at partner level

No judicial determination with respect to the income tax liability of any partner not conducted under this subchapter shall be a bar to any adjustment in such partner's income tax liability resulting from—

(A) a proceeding with respect to partnership items under this subchapter, or

(B) a proceeding with respect to items which become nonpartnership items—

(i) by reason of 1 or more of the events described in subsection (b), and

(ii) after the appropriate time for including such items in any other proceeding with respect to nonpartnership items.

(2) Proceedings under section 6228(a)

No judicial determination in any proceeding under subsection (a) of section 6228 with respect to any partnership item shall be a bar to any adjustment in any other partnership item.

(f) Special rule for deductions, losses, and credits of foreign partnerships

Except to the extent otherwise provided in regulations, in the case of any partnership the tax matters partner of which resides outside the United States or the books of which are maintained outside the United States, no deduction,

loss, or credit shall be allowable to any partner unless section 6031 is complied with for the partnership's taxable year in which such deduction, loss, or credit arose at such time as the Secretary prescribes by regulations.

(g) Partnership return to be determinative of whether subchapter applies

(1) Determination that subchapter applies

If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter applies to such partnership for such year but such determination is erroneous, then the provisions of this subchapter are hereby extended to such partnership (and its items) for such taxable year and to partners of such partnership.

(2) Determination that subchapter does not apply

If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter does not apply to such partnership for such year but such determination is erroneous, then the provisions of this subchapter shall not apply to such partnership (and its items) for such taxable year or to partners of such partnership.

5. 26 U.S.C. 6233 provides:

Extension to entities filing partnership returns, etc.

(a) General rule

If a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, then, to the extent provided in regulations, the provisions of this subchapter are hereby extended in respect of such year to such entity and its items and to persons holding an interest in such entity.

(b) Similar rules in certain cases

If a partnership return is filed for any taxable year but it is determined that there is no entity for such taxable year, to the extent provided in regulations, rules similar to the rules of subsection (a) shall apply.

6. 26 U.S.C. 6662 (2000) provides:

Imposition of accuracy-related penalty

(a) Imposition of penalty

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

(b) Portion of underpayment to which section applies

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

following:

(1) Negligence or disregard of rules or regulations.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

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

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

(c) Negligence

For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

(d) Substantial understatement of income tax

(1) Substantial understatement

(A) In general

For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the under-

statement for the taxable year exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) Special rule for corporations

In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

(2) Understatement

(A) In general

For purposes of paragraph (1), the term "understatement" means the excess of—

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

(B) Reduction for understatement due to position of taxpayer or disclosed item

The amount of the understatement under subparagraph (A) shall be reduced by that

portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation.

(C) Special rules in cases involving tax shelters

(i) In general

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

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

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

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

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

(iii) Tax shelter

For purposes of this subparagraph, the term "tax shelter" means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(D) Secretarial list

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

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

(ii) which affect a significant number of taxpayers.

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

(e) Substantial valuation misstatement under chapter 1

(1) In general

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

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

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

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the

lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation

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

(3) Net section 482 transfer price adjustment

For purposes of this subsection—

(A) In general

The term "net section 482 transfer price adjustment" means, with respect to any taxable year, the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under section 482 in the price for any property or services (or for the use of property).

(B) Certain adjustments excluded in determining threshold

For purposes of determining whether the threshold requirements of paragraph (1)(B)(ii) are met, the following shall be excluded:

(i) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to any redetermination of a price if—

(I) it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the regulations prescribed under section 482 and that the taxpayer's use of such method was reasonable,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.

(ii) Any portion of the net increase in taxable income referred to in subparagraph (A) which is attributable to a redetermination of price where such price was not determined in accordance with such a specific pricing method if—

(I) the taxpayer establishes that none of such pricing methods was likely to result in a price that would clearly reflect income, the taxpayer used another pricing method to determine such price, and such other pricing method was likely to result in a price that would clearly reflect income,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such other method and which establishes that the requirements of subclause (I) were satisfied, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of request for such documentation.

(iii) portion of such net increase which is attributable to any transaction solely between foreign corporations

unless, in the case of any such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(C) Special rule

If the regular tax (as defined in section 55(c)) imposed by chapter 1 on the taxpayer is determined by reference to an amount other than taxable income, such amount shall be treated as the taxable income of such taxpayer for purposes of this paragraph.

(D) Coordination with reasonable cause exception

For purposes of section 6664(c) the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the requirements of clause (i), (ii), or (iii) of subparagraph (B) with respect to such portion.

(f) Substantial overstatement of pension liabilities

(1) In general

For purposes of this section, there is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under paragraph (1) or (2) of section 404(a) is 200 percent or more of the amount determined to be the correct amount of such liabilities.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(4) unless the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

(g) Substantial estate or gift tax valuation understatement

(1) In general

For purposes of this section, there is a substantial estate or gift tax valuation understatement if the value of any property claimed on any return of tax imposed by subtitle B is 50 percent or less of the amount determined to be the correct amount of such valuation.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(5) unless the portion of the underpayment attributable to substantial estate or gift tax

valuation understatements for the taxable period (or, in the case of the tax imposed by chapter 11, with respect to the estate of the decedent) exceeds $5,000.

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

(1) In general

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

(2) Gross valuation misstatements

The term "gross valuation misstatements" means—

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

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

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

(iii) in paragraph (1)(B)(ii)—

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

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

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

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

7. 26 C.F.R. 1.6662-5 provides:

Substantial and gross valuation misstatements under chapter 1.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and § 1.6664-2, of any income tax imposed under chapter 1 of subtitle A of the Code that is required to be shown on a return is attributable to a substantial valuation misstatement under chapter 1 ("substantial valuation misstatement"), there is added to the tax an amount equal to 20 percent of such portion. Section 6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement under chapter 1 ("gross valuation misstatement"). No penalty under section 6662(b)(3) is imposed, however, on a portion of an underpayment that is attributable to a substantial or gross valuation misstatement unless the aggregate of all portions of the underpayment attributable to substantial or gross

valuation misstatements exceeds the applicable dollar limitation ($5,000 or $10,000), as provided in section 6662(e)(2) and paragraphs (b) and (f)(2) of this section. This penalty also does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664–4 applies. There is no disclosure exception to this penalty.

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

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

(2) *Transition rule for carrybacks to pre-1990 years.* The penalty under section 6662(b)(3) is im-

posed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

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

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

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

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

Example 1. Corporation Q is a C corporation. In 1990, the first year of its existence, Q had taxable income of $200,000 without considering depreciation of a particular asset. On its calendar year 1990 return, Q overstated its basis in this asset by an amount that caused a substantial valuation misstatement. The overstated basis resulted in depreciation claimed of $350,000, which was $250,000 more than the $100,000 allowable. Thus, on its 1990 return, Q showed a loss of $150,000. In 1991, Q had taxable income of $450,000 before application of the loss carryover, and

Q claimed a carryover loss deduction under section 172 of $150,000, resulting in taxable income of $300,000 for 1991. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $250,000. For 1990, the underpayment resulting from the $100,000 taxable income (- $150,000+$250,000) is attributable to the valuation misstatement. Assuming the underpayment resulting from the $100,000 taxable income exceeds the $10,000 limitation, the penalty will be imposed in 1990. For 1991, the elimination of the loss carryover results in additional taxable income of $150,000. The underpayment for 1991 resulting from that adjustment is also attributable to the substantial valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $150,000 additional taxable income for 1991 exceeds the $10,000 limitation, the substantial valuation misstatement penalty also will be imposed for that year.

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

section 172 in the amount of $4,500,000, resulting in taxable income of zero for that year and leaving a $2,000,000 carryover available. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $2,500,000.

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

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

Example 3. Corporation V is a C corporation. In 1990, V had a loss of $100,000 without considering depreciation of a particular asset which it had fully depreciated in earlier years. V had a depreciable basis in the asset of zero, but on its 1990 calendar year return erroneously claimed a basis in the asset of $1,250,000 and depreciation of $250,000. V reported a $350,000 loss for the year 1990, and carried back the loss to the 1987 and 1988 tax years. V had reported taxable income of $300,000 in 1987 and $200,000 in

1988, before application of the carryback. The $350,000 carryback eliminated all taxable income for 1987, and $50,000 of the taxable income for 1988. After disallowance of the $250,000 depreciation deduction for 1990, V still had a loss of $100,000. Because there is no underpayment for 1990, no valuation misstatement penalty is imposed for 1990. However, as a result of the 1990 depreciation adjustment, the carryback to 1987 is reduced from $350,000 to $100,000. After absorption of the $100,000 carryback, V has taxable income of $200,000 for 1987. This adjustment results in an underpayment for 1987 that is attributable to the valuation misstatement on the 1990 return. The valuation misstatement for 1990 is a gross valuation misstatement because the correct adjusted basis of the depreciated asset was zero. (See paragraph (e)(2) of this section.) Therefore, the 40 percent penalty rate applies to the 1987 underpayment attributable to the 1990 misstatement, provided that this underpayment exceeds $10,000. The adjustment also results in the elimination of any loss carryback to 1988 resulting in an increase in taxable income for 1988 of $50,000. Assuming the underpayment resulting from this additional $50,000 of income exceeds $10,000, the gross valuation misstatement penalty is imposed on the underpayment for 1988.

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

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

(3) *Property.* For purposes of this section, the term "property" refers to both tangible and intangible property. Tangible property includes property such as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action.

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

(2) *Application of dollar limitation.* For purposes of applying the dollar limitation set forth in section 6662(e)(2), the determination of the portion of an un-

derpayment that is attributable to a substantial or gross valuation misstatement is made by aggregating all portions of the underpayment attributable to substantial or gross valuation misstatements. Assume, for example, that the value claimed for property C on a return is 250 percent of the correct value, and that the value claimed for property D on the return is 400 percent of the correct value. Because the portions of an underpayment that are attributable to a substantial or gross valuation misstatement on a return are aggregated in applying the dollar limitation, the dollar limitation is satisfied if the portion of the underpayment that is attributable to the misstatement of the value of property C, when aggregated with the portion of the underpayment that is attributable to the misstatement of the value of property D, exceeds $5,000 ($10,000 in the case of most corporations).

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

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

the shareholder, partner, beneficiary, or holder of a residual interest in a REMIC).

(2) *Example*

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

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

(i) [Reserved]

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

(k) *Returns affected*. Except in the case of rules relating to transactions between persons described in section 482 and net sections 482 transfer price adjust-

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

8. 26 C.F.R. 301.6221-1 provides:

Tax treatment determined at partnership level.

(a) *In general.* A partner's treatment of partnership items on the partner's return may not be changed except as provided in sections 6222 through 6231 and the regulations thereunder. Thus, for example, if a partner treats an item on the partner's return consistently with the treatment of the item on the partnership return, the IRS generally cannot adjust the treatment of that item on the partner's return except through a partnership-level proceeding. Similarly,

the taxpayer may not put partnership items in issue in a proceeding relating to nonpartnership items. For example, the taxpayer may not offset a potential increase in taxable income based on changes to nonpartnership items by a potential decrease based on partnership items.

(b) *Restrictions inapplicable after items become nonpartnership items*. Section 6221 and paragraph (a) of this section cease to apply to items arising from a partnership with respect to a partner when those items cease to be partnership items with respect to that partner under section 6231(b).

(c) *Penalties determined at partnership level*. Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be determined at the partnership level. Partner-level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership-level determinations. Partnership-level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount, other than partner-level defenses specified in paragraph (d) of this section.

(d) *Partner-level defenses*. Partner-level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item may not be asserted in the partnership-level proceed-

ing, but may be asserted through separate refund actions following assessment and payment. See section 6230(c)(4). Partner-level defenses are limited to those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level. Examples of these determinations are whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of section 6664(b) (penalties applicable only where return is filed), or section 6664(c)(1) (reasonable cause exception) subject to partnership-level determinations as to the applicability of section 6664(c)(2).

(e) *Cross-references*. See §§ 301.6231(c)-1 and 301.6231(c)-2 for special rules relating to certain applications and claims for refund based on losses, deductions, or credits from abusive tax shelter partnerships.

(f) *Effective date*. This section is applicable to partnership taxable years beginning on or after October 4, 2001. For years beginning prior to October 4, 2001, see § 301.6221–1T contained in 26 CFR part 1, revised April 1, 2001.

9. 26 C.F.R. 301.6231(a)(3)-1 provides:

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.

(4) *Transactions to which section 707 (a) applies.* For purposes of its books and records, the partnership needs to determine:

(i) The amount transferred from the partnership to a partner or from a partner to the partnership in any transaction to which section 707(a) applies;

(ii) The character of such an amount (for example, whether or not it is a loan; in the case of amounts paid

over time for the purchase of an asset, what portion is interest); and

(iii) The percentage of the capital interests and profits interests in the partnership owned by each partner.

To the extent that a determination of an item relating to a transaction to which section 707(a) applies 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. An example of such other information is the cost to the partner of goods sold to the partnership.

(d) *Effective date*. This section shall apply with respect to partnership taxable years beginning after September 3, 1982. This section shall also apply with respect to any partnership taxable year ending after September 3, 1982, if with respect to that year there is an agreement entered into pursuant to section 407(a)(3) of the Tax Equity and Fiscal Responsibility Act of 1982.

10. 26 C.F.R. 301.6231(a)(5)-1 provides:

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.

(f) *Effective date*. This section is applicable to partnership taxable years beginning on or after October 4, 2001. For years beginning prior to October 4, 2001, see § 301.6231(a)(5)-1T contained in 26 CFR part 1, revised April 1, 2001.

11. 26 C.F.R. 301.6231(a)(6)-1 provides:

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.

(b) *Interest*. A computational adjustment includes any interest due with respect to any underpayment or overpayment of tax attributable to adjustments to reflect properly the treatment of partnership items.

(c) *Effective date*. This section is applicable to partnership taxable years beginning on or after Octo-

ber 4, 2001. For years beginning prior to October 4, 2001, see § 301.6231(a)(6)-1T contained in 26 CFR part 1, revised April 1, 2001.