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

REPLY BRIEF FOR THE UNITED STATES

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Respondent does not dispute that there exists a longstanding division of authority among the circuits over whether a taxpayer's underpayment of tax can be "attributable to" a misstatement of basis under 26 U.S.C. 6662 when the transaction that created an inflated basis is disregarded in its entirety as lacking economic substance. See Br. in Opp. 5 (acknowledging "disagreement among the circuits"). Respondent also does not attempt to explain, on the merits, how the minority view adopted by the Fifth and Ninth Circuits can be reconciled with the text and purpose of Section 6662. Rather, he urges the Court to deny review on the grounds that the issue is "obsolete" in light of the 2010 enactment of Section 6662(i) and is otherwise "unimportant." *Id.* at 2, 3.

Respondent is wrong. There are numerous docketed cases in the Fifth and Ninth Circuits in which the government is currently attempting to collect overstatement penalties from taxpayers who, like respondent, engaged in fraudulent tax schemes involving a basis overstatement. As the petition explains (at 31), moreover, the construction of Section 6662 adopted by the Fifth and Ninth Circuits will continue to apply in cases within those circuits where a deduction is entirely disallowed on a ground other than that the underlying transaction lacked economic substance. This Court should accordingly grant review to correct those circuits' erroneous interpretation of the statute.

1. In 2010, Congress added to Section 6662 a new subsection that imposes a 40% penalty on any underpayment of tax that is attributable to a "nondisclosed noneconomic substance transaction" entered into after March 30, 2010. 26 U.S.C. 6662(i) (Supp. V 2011); see Pet. 31. Respondent contends that Section 6662(i) "eliminate[s] any arguable importance the issue in this case might have possessed." Br. in Opp. 3-5.

Thousands of taxpayers, however, engaged in abusive, basis-inflating tax shelters before March 30, 2010. The government is currently pursuing numerous cases against such individuals in which appeals would be heard by the Fifth or Ninth Circuit (or by a circuit that has not yet addressed the question presented). Respondent asserts that "the Government offers no support" for its prediction that the minority rule, if left uncorrected, will deprive it of significant revenue. Br. in Opp. 6. The petition for certiorari, however, identifies a $360 million basis misstatement at issue in a *single case* pending within the Fifth Circuit. See Pet. 30. Eight additional related cases docketed in the Northern District of Texas

involve aggregate basis misstatements of approximately $4 billion,[1] and the government is actively litigating many other cases to which the minority rule currently applies. See, *e.g.*, *NPR Invs., L.L.C.* v. *United States* (5th Cir. No. 10-41219) ($65 million aggregate basis misstatement); *Seashore Broad. Corp.* v. *Commissioner* (Tax Ct. No. 23058-06) (approximately $40 million basis misstatement, appealable to Ninth Circuit); *Goddard* v. *Commissioner* (Tax Ct. Nos. 1145-05, 1504-06, and 20673-09) (approximately $28 million aggregate basis misstatement, appealable to Ninth Circuit). This case alone involves aggregate basis misstatements in excess of $45 million. See Pet. App. 5a-6a.

Those pending cases, involving significant overstatements of basis, illustrate the practical significance of the question presented. Moreover, although a three-year statute of limitations applies to assessments of tax deficiencies resulting from overstatements of basis, see *United States* v. *Home Concrete & Supply, LLC*, 132 S. Ct. 1836, 1839 (2012), taxpayers regularly agree to extend the period of limitations, often multiple times. The government therefore may pursue cases arising out of basis-inflating tax shelters entered into before March 30, 2010, for years to come. Accordingly, although respondent is surely correct that "most taxpayers" do not overstate their bases in property when reporting their taxable income (Br. in Opp. 6), the question presented has significant continuing fiscal importance for the government. The practical significance of the question

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[1] See *Southgate Master Fund, LLC* v. *United States* (Nos. 07-cv-02104, 12-cv-02824, and 12-cv-04480); *Southbrook Master Fund, LLC* v. *United States* (No. 09-cv-00664); *Pinnacle Mgmt. LLC* v. *United States* (Nos. 12-cv-02823 and 12-cv-04484); *Classic Paragon Mgmt. LLC* v. *United States* (Nos. 12-cv-02819 and 12-cv-04482).

presented, together with the lopsided circuit conflict on the issue (see Pet. 21-29), amply justifies further review.

2. Respondent entirely fails to address the fact that Section 6662(i) will have no effect on cases where value- or basis-related deductions are disallowed in full on a ground *other than* a lack of economic substance. See Pet. 31. By providing an authoritative construction of Section 6662's overstatement penalty, this Court's resolution of the question presented will likely resolve that issue as well. The court of appeals' summary ruling in this case (Pet. App. 1a-2a) relied in part on *Heasley* v. *Commissioner*, 902 F.2d 380 (5th Cir. 1990), and *Todd* v. *Commissioner*, 862 F.2d 540 (5th Cir. 1988), which reflect the Fifth Circuit's longstanding view 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." *Heasley*, 902 F.2d at 383; see Pet. 16-20. If the Court rejects that interpretation of the statute, it will enable the government to collect overstatement penalties in cases where, for example, a claimed charitable deduction that involves a gross misstatement of value is totally disallowed due to the taxpayer's lack of donative intent. See, *e.g.*, *Derby* v. *Commissioner*, 95 T.C.M. (CCH) 1177, 1194 (2008).

3. Respondent also asserts (Br. in Opp. 7) that the government's request for review is "undercut by the fact that the circuit differences identified by the Government have existed for nearly 25 years." But the pre-2000s cases involved relatively simple, low-value schemes. See Pet. 25. The tax deficiencies in *Todd* and *Heasley*, for example, amounted to approximately $125,000 and $23,000, respectively. See *Noonan* v. *Commissioner*, 52 T.C.M. (CCH) 534, 557 (1986) (consolidated test case

involving the Todds), aff'd *sub nom. Hillendahl* v. *Commissioner*, 976 F.2d 737 (9th Cir. 1992); *Heasley*, 902 F.2d at 382. It was only with the proliferation of high-value, basis-inflating shelters like COBRA beginning in the late 1990s—which did not reach appellate courts until the late 2000s—that this issue took on added urgency. See Pet. 7-9.[2]

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[2] The district court in this case decided the question presented in a partnership-level proceeding, exercising jurisdiction under 26 U.S.C. 6226(a)(2). See Pet. App. 15a-16a. The court in such a proceeding "shall have jurisdiction to determine all partnership items of the partnership * * * and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item." 26 U.S.C. 6226(f). Respondent did not contest the jurisdiction of the courts below to determine the threshold applicability of the basis-overstatement penalty, and the courts' assertion of jurisdiction was authorized by Section 6226(a) and (f).

Two recent appellate decisions have called into question, without definitively resolving, whether the court in a partnership-level proceeding may determine the threshold applicability of the overstatement penalty for a partnership's participation in sham transactions. See *Petaluma FX Partners, LLC* v. *Commissioner*, 591 F.3d 649, 655-656 (D.C. Cir. 2010); *Jade Trading, LLC* v. *United States*, 598 F.3d 1372, 1378-1380 (Fed. Cir. 2010). Both the Tax Court and the Court of Federal Claims have since concluded, however, that those decisions, properly understood, do not preclude partnership-level review of penalty issues similar to the one presented here. See *Tigers Eye Trading, LLC* v. *Commissioner*, 138 T.C. 67, 130-134 (2012); *Arbitrage Trading, LLC* v. *United States*, No. 06-202, 2013 WL 365601, at *13 (Fed. Cl. Jan. 30, 2013). *Petaluma* has twice been remanded to the Tax Court for further proceedings, and the government's appeal from the most recent Tax Court decision in the case is currently pending before the D.C. Circuit (No. 12-1364).

If this Court concludes that the question presented in the petition otherwise warrants review, the jurisdictional issue described above provides no reason to view this case as an unsuitable vehicle for resolving it. A jurisdictional issue could arise in any case raising the

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For the foregoing reasons and those stated in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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question presented—whether a partnership-level or partner-level proceeding—because matters that may be decided in a partnership-level proceeding may not be decided in a partner-level proceeding, and vice versa. See 26 U.S.C. 6221, 6230(a)(2)(A)(i), (c)(4), and (c)(5)(D). Moreover, because courts in practice have determined the applicability of penalties at the partnership level, appropriately precluding consideration of that threshold issue at the partner level, the vehicles available to this Court for resolving the question presented can be expected to resemble this case in that they will arise from partnership-level proceedings.