No. 10-41132

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BEMONT INVESTMENTS, L.L.C.,
by and through its Tax Matters Partner,
Plaintiff-Appellee-Cross-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant-Cross-Appellee.

BPB INVESTMENTS, L.C., by and through
its Tax Matters Partner, DANIEL BEAL,
BPB Investments, L.L.C. Tax Matters Partner,
Plaintiffs-Appellees-Cross-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant-Cross-Appellee.

Appeal from the United States District Court
for the Eastern District of Texas, Sherman Division
Nos. 4:07cv9 & 4:07cv10

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PER FIFTH CIRCUIT LOCAL RULES 26.1.1, 27.4, AND 28.2.1

(1) No. 10-41132: *Bemont Investments, L.L.C., by and through its Tax Matters Partner, Plaintiff-Appellee-Cross-Appellant v. United States of America, Defendant-Appellant-Cross-Appellee*; *BPB Investments, L.C., by and through its Tax Matters Partner, Daniel Beal, BPB Investments, L.L.C. Tax Matters Partner, Plaintiffs-Appellees-Cross-Appellant v. United States of America, Defendant-Appellant-Cross-Appellee.*

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

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STATEMENT REGARDING ORAL ARGUMENT

Oral argument has not yet been scheduled in this case. Oral argument would significantly aid this Court's decisional process. *See* Fed. R. App. P. 34(a)(2)(C).

TABLE OF CONTENTS

CERTIFICATE OF INTERESTED PERSONS PER FIFTH CIRCUIT LOCAL RULES 26.1.1, 27.4, AND 28.2.1 i

STATEMENT REGARDING ORAL ARGUMENT iii

INDEX OF AUTHORITIES vii

PRELIMINARY STATEMENT 1

STATEMENT OF JURISDICTION 3

ISSUES PRESENTED ON APPEAL 4

ISSUE PRESENTED ON CROSS-APPEAL 4

STATEMENT OF THE CASE 5

STATEMENT OF FACTS 6

A. The Solution 6 Investment 6

B. The Partnerships' Tax Returns 12

C. The Government's Examination 13

D. The Government's Discovery Misconduct 14

E. District Court Rulings 21

1. Bemont's 2001 Return 21

2. BPB's 2002 Return 23

SUMMARY OF ARGUMENT 24

STANDARD OF REVIEW 28

ARGUMENT 28

I. The District Court Correctly Determined That The FPAA Issued To Bemont For 2001 Was Time-Barred 28

TABLE OF CONTENTS-cont'd

A. The Government Fails To Mention Two Factual Findings That Belie Its Contention That It Lacked Timely Notice Of The Transactions 28

B. DB Identified The Partnerships To The Government In 2005 31

C. DB's Disclosure Satisfied The Regulatory Requirements 34

1. DB's Disclosure Complied With The Regulatory Requirements 35

a. Name, Address, And TIN 35

b. "Tax Analysis Or Opinions ... Given ... By The Organizer Or Seller" 37

c. Description Of The Purported Tax Shelter 38

2. In Any Case, Substantial Compliance Is Sufficient 39

3. The Government Has Conceded That Substantial Compliance Is Sufficient 41

4. The Government Concealed Information 42

5. *Auer* Deference Is Inappropriate 43

D. The 2005 Lists Were Properly Produced To The IRS 44

E. The Government's Other Arguments Lack Merit 45

1. The District Court's Ruling Is Consistent With Congressional Intent 45

2. The Statute Of Limitations Should Not Be Specially Construed 46

F. The Government's Discovery Misconduct Provides An Alternative Ground For Affirmance 47

1. The Government Committed Discovery Misconduct 48

TABLE OF CONTENTS-cont'd

2. Deeming Established Facts Sufficient To Trigger Section 6501(c)(10)'s One-Year Limitations Period Is The Necessary Sanction 51

II. The District Court Correctly Determined That Valuation Misstatement Penalties Were Inapplicable....................56

A. The Understatement Is Not Attributable To A Valuation Misstatement 56

B. No Deference Is Due 59

III. The District Court Erred In Upholding The IRS's Imposition of Substantial-Understatement And Negligence Penalties....................61

A. Substantial Authority Supported The Tax Treatment 61

1. Substantial Authority Indicated That The Swaps Did Not Affect BPB's Basis 62

2. Substantial Authority Indicated That The Swaps Had Economic Substance 66

3. The Losses Were Bona Fide 68

B. The Partnerships' Position Was Not Attributable To Negligence....................69

C. The Partnerships Acted In Good Faith And With Reasonable Cause....................69

1. The Court Ignored The Quality Of Coscia's Opinion 70

2. The Court Was Wrong To Doubt Coscia's Objectivity....................71

3. The Court Erroneously Penalized The Partnerships For Invoking Attorney-Client Privilege....................73

CONCLUSION 74

INDEX OF AUTHORITIES

Page(s)

Cases

Advanced Display Sys., Inc. v. Kent State Univ.,
212 F.3d 1272 (Fed. Cir. 2000)....................48

Alpha I, L.P. v. United States,
84 Fed. Cl. 622 (2008)....................58

American Air Filter Co. v. Commissioner,
81 T.C. 709 (1983) 39, 40

American Boat Co. v. United States,
583 F.3d 471 (7th Cir. 2009)....................71

American Tobacco Co. v. Wix,
62 F.2d 835, (C.C.P.A. 1933)....................36

Auer v. Robbins,
519 U.S. 452 (1997) 43, 59

Badaracco v. Commissioner,
464 U.S. 386 (1984) 46

Barnhart v. Thomas,
540 U.S. 20 (2003) 36

Bowen v. Georgetown Univ. Hosp.,
488 U.S. 204 (1988) 43

Bowers v. New York & Albany Lighterage Co.,
273 U.S. 346 (1927) 47

Branum v. Commissioner,
17 F.3d 805 (5th Cir. 1994)....................39

Brown Express, Inc. v. United States,
607 F.2d 695 (5th Cir. 1979)....................34

Burks v. United States,
633 F.3d 347 (5th Cir. 2011).................... 33, 34

INDEX OF AUTHORITIES-cont'd

Page(s)

Cannon v. Kroger Co.,
837 F.2d 660 (4th Cir. 1988) 40

Carson v. Polley,
689 F.2d 562 (5th Cir. 1982) 48

Chase Bank USA v. McCoy,
131 S. Ct. 871 (2011) 43

Chilcutt v. United States,
4 F.3d 1313 (5th Cir. 1993) .... *passim*

Compaq Computer Corp. v. Ergonome Inc.,
387 F.3d 403 (5th Cir. 2004) 52, 53

Stobie Creek Invs. LLC v. United States,
608 F.3d 1366 (Fed. Cir. 2010) 72

Crane v. Commissioner,
331 U.S. 1 (1947) 68

Curr-Spec Partners, L.P. v. Commissioner,
579 F.3d 391 (5th Cir. 2009) 31

Davidson v. Glickman,
169 F.3d 996 (5th Cir. 1999) 34

Early v. Bankers Life & Cas. Co.,
959 F.2d 75 (7th Cir. 1992) 40

FDIC v. Connor,
20 F.3d 1376 (5th Cir. 1994) 55

FDIC v. Lee,
130 F.3d 1139 (5th Cir. 1997) 33

Franconia Assocs. v. United States,
536 U.S. 129 (2002) 47

INDEX OF AUTHORITIES-cont'd

Page(s)

Frank Lyon Co. v. United States,
435 U.S. 561 (1978) 67

Gonzales v. Oregon,
546 U.S. 243 (2006) 60

Gould v. Gould,
245 U.S. 1512 (1917) 47

Heasley v. Commissioner,
902 F.2d 380 (5th Cir. 1990).................... 21, 56, 57, 58

Helmer v. Commissioner,
34 T.C.M. (CCH) 727 (1975).................... 12, 64

IDS Life Ins. Co. v. Royal Alliance Assocs., Inc.,
266 F.3d 645 (7th Cir. 2001)....................48

J.H. Rutter Rex Mfg. Co. v. Commissioner,
853 F.2d 1275 (5th Cir. 1988)....................30

Jama v. Immigration & Customs Enforcement,
543 U.S. 335 (2005) 35

Jaworowski v. Ciasulli,
490 F.3d 331 (3d Cir. 2007)....................40

Jones v. Bertrand,
171 F.3d 499 (7th Cir. 1999)....................40

Keller v. Commissioner,
556 F.3d 1056 (9th Cir. 2009)....................58

Klamath Strategic Inv. Fund LLC v. United States,
440 F. Supp. 2d 608 (E.D. Tex. 2006) 64

Klamath Strategic Inv. Fund LLC v. United States,
472 F. Supp. 2d 885 (E.D. Tex. 2007) 59

INDEX OF AUTHORITIES-cont'd

Page(s)

Klamath Strategic Inv. Fund v. United States,
568 F.3d 537 (5th Cir. 2009) 28, 67, 69

Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v. Dana Corp.,
383 F.3d 1337 (Fed. Cir. 2004) 73

Kornman & Assocs., Inc. v. United States,
527 F.3d 443 (5th Cir. 2008) 65, 66

La Rue v. Commissioner,
90 T.C. 465 (1988) 13, 65

La Union Del Pueblo Entero v. FEMA,
608 F.3d 217 (5th Cir. 2010) 60

Lamborn v. Dittmer,
873 F.2d 522 (2d Cir. 1989) 29

Long v. Commissioner,
71 T.C. 1 (1978) 13, 65

Lucas v. Pilliod Lumber Co.,
281 U.S. 245 (1930) 46

Mangaroo v. Nelson,
864 F.2d 1202 (5th Cir. 1989) 33

Marshall v. Segona,
621 F.2d 763 (5th Cir. 1980) 54, 55

McIntosh v. Partridge,
540 F.3d 315 (5th Cir. 2008) 33

Murfam Farms, LLC v. United States,
88 Fed. Cl. 516 (2009) 64

Nabisco, Inc. v. PF Brands, Inc.,
191 F.3d 208 (2d Cir. 1999) 73

INDEX OF AUTHORITIES-cont'd

Page(s)

Nobelman v. American Sav. Bank,
508 U.S. 324 (1993) 36

NRA v. City of Chicago,
567 F.3d 856 (7th Cir. 2009)..59

Osteen v. Commissioner,
62 F.3d 356 (11th Cir. 1995)..67

Parker v. Prudential Ins. Co.,
900 F.2d 772 (4th Cir. 1990)..74

Payne v. Commissioner,
224 F.3d 415 (5th Cir. 2000).. 30, 43

Professionals & Patients for Customized Care v. Shalala,
56 F.3d 592 (5th Cir. 1995)..34

Reser v. Commissioner,
112 F.3d 1258 (5th Cir. 1997)..73

Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner,
114 T.C. 533 (2000) 31

Sala v. United States,
552 F. Supp. 2d 1167 (D. Colo. 2008) 64

Scarborough v. Principi,
541 U.S. 401 (2004) 47

SEC v. First Houston Capital Resources Fund, Inc.,
979 F.2d 380 (5th Cir. 1992)..54

Shell Offshore Inc. v. Babbitt,
238 F.3d 622 (5th Cir. 2001)..33

Sobranes Recovery Pool I, LLC v. Todd & Hughes Constr. Corp.,
509 F.3d 216 (5th Cir. 2007)..36

INDEX OF AUTHORITIES-cont'd

Page(s)

Stobie Creek Invs. LLC v. United States,
82 Fed. Cl. 636 (2008) 64

Streber v. Commissioner,
138 F.3d 216 (5th Cir. 1998) 62, 67

Swayze v. United States,
785 F.2d 715 (9th Cir. 1986) 69

Texas Clinical Labs, Inc. v. Sebelius,
612 F.3d 771 (5th Cir. 2010) 43

Texas Sav. & Cmty. Bankers Ass'n v. Federal Hous. Fin. Bd.,
201 F.3d 551 (5th Cir. 2000) 34

The Colony, Inc. v. Commissioner,
357 U.S. 28 (1958) 47

Todd v. Commissioner,
862 F.2d 540 (5th Cir. 1988) 56

U.S. Steel Corp. v. EPA,
595 F.2d 207 (5th Cir. 1979) 32, 34

United States v. Bass,
404 U.S. 336 (1971) 36

United States v. BDO Seidman,
337 F.3d 802 (7th Cir. 2003) 46

United States v. Hayes,
129 S. Ct. 1079 (2009) 36

United States v. Standard Brewery,
251 U.S. 210 (1920) 36

Weiner v. United States,
389 F.3d 152 (5th Cir. 2004) 58

INDEX OF AUTHORITIES-cont'd

Page(s)

Wood-Ivey Sys. Corp. v. United States,
4 F.3d 961 (Fed. Cir. 1993) 40

Worldwide Primates, Inc. v. McGreal,
26 F.3d 1089 (11th Cir. 1994) 48

Young v. Commissioner.,
783 F.2d 1201 (5th Cir. 1986) 39

Statutes, Regulations, and Rules

5 U.S.C. §552(a)(1) 33

5 U.S.C. §553(b)(A) 32, 34

26 U.S.C. §722 63

26 U.S.C. §733 63

26 U.S.C. §752(b) 63

26 U.S.C. §1012 63

26 U.S.C. §6112 ..... *passim*

26 U.S.C. §6112(a) ..... *passim*

26 U.S.C. §6112(b) 31

26 U.S.C. §6112(b)(1)(A) 44

26 U.S.C. §6226(a) 4

26 U.S.C. §6226(e) 3, 4

26 U.S.C. §6226(g) 4

26 U.S.C. §6229 31

26 U.S.C. §6501 31

INDEX OF AUTHORITIES-cont'd

Page(s)

26 U.S.C. §6501(a) 14, 24, 31

26 U.S.C. §6501(c)(10) .... *passim*

26 U.S.C. §6501(c)(10)(B) 31

26 U.S.C. §6662(b) 60

26 U.S.C. §6662(b)(1) 69

26 U.S.C. §6662(b)(2) 61

26 U.S.C. §6662(b)(3) 26, 56

26 U.S.C. §6662(d)(2)(B) 26, 62

26 U.S.C. §6662(h)(1) 26, 56

26 U.S.C. §6664(c)(1) 69

26 U.S.C. §6707 15

26 U.S.C. §6708 .... 15, 36

26 U.S.C. §7491(a) 30

28 U.S.C. §636(c) 4

28 U.S.C. §636(c)(3) 4

28 U.S.C. §1291 4

26 C.F.R. §1.6662 60

26 C.F.R. §1.6662-2(c) 5

26 C.F.R. §1.6662-3(b)(1) 27, 69

26 C.F.R. §1.6662-3(b)(3) 27, 69

26 C.F.R. §1.6662-3(d)(2) 27, 69

INDEX OF AUTHORITIES-cont'd

Page(s)

26 C.F.R. §1.6662-4(d) 62

26 C.F.R. §1.6662-4(d)(3)(i) 26, 62

26 C.F.R. §1.6662-4(d)(3)(iv)(C) 66

26 C.F.R. §1.6662-5 .... *passim*

26 C.F.R. §1.6662-5(a) 57, 58, 60

26 C.F.R. §1.6662-5(d) 58

26 C.F.R. §1.6662-5(e)(2) 57

26 C.F.R. §1.6662-5(g) 57, 58

26 C.F.R. §1.6664-4(b)(1) 69

26 C.F.R. §1.6664-4(c)(1) 73

26 C.F.R. §1.6664-4(d)(2) 62

26 C.F.R. §301.6112-1T 32, 37

26 C.F.R. §301.6112-1T (2002) 21

26 C.F.R. §301.6112-1T A-16 44

26 C.F.R. §301.6112-1T A-17(a)(3) 35

26 C.F.R. §301.6112-1T A-17(a)(7) 38

26 C.F.R. §301.6112-1T A-17(a)(9) 38

49 Fed. Reg. 34,201 (1984) 32

66 Fed. Reg. 41,135 (2001) 32

68 Fed. Reg. 37,435 (2003) 63

Fed. R. App. P. 4(a)(3) 4

INDEX OF AUTHORITIES-cont'd

Page(s)

Fed. R. App. P. 34(a)(2)(C) ii

Fed. R. Civ. P. 30(b)(6).......... *passim*

Fed. R. Civ. P. 37(b)(2)(A)(i) 26, 47, 51

Fed. R. Civ. P. 37(b)(2)(A)(ii) 53

Other Authorities

Australian Corporations Act, 2001, 636(1)(f) 8

Australian Takeover Panel,
Guidance Note 14: Funding Arrangements (2004)..........8

H.R. Rep. No. 98-432, pt. 2 (1984)..........46

Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance With Administrative Procedure Act Rulemaking Requirements,* 76 Geo. Wash. L. Rev. 1153 (2008) 33

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IRS Gen. Couns. Mem. 33,948 (Oct. 22, 1968) 64

William S. McKee, William F. Nelson, et al., *Federal Taxation of Partnerships and Partners* 63

Parker & Parsley Petroleum v Gantry Acquisition Corp. (1994), 13 A.C.S.R. 689 8

Rev. Rul. 73-301, 1973-2 C.B. 215 .... 12, 64, 66

2 John H. Wigmore, *Evidence* (Chadbourn ed., rev. ed. 1979)..........29

PRELIMINARY STATEMENT

This appeal demonstrates the government's unwillingness to accept the consequences of its choices. At the time the partnerships entered into the currency swaps at issue here, they reported a tax treatment that was consistent with longstanding law. Indeed, the IRS's own designated witness under Fed. R. Civ. P. 30(b)(6) testified that the transactions were *not* substantially similar to a "Son-of-Boss" transaction (which is subject to special reporting requirements). Unsurprisingly, the district court found that the IRS initially made a conscious choice not to challenge the transactions.

But the IRS later reversed course. When its delay became an issue, the IRS tried to hide evidence that it had known about the transactions all along—as the district court again explicitly found. The government's arguments to this Court attempt to conceal its unjustified delay and misconduct.

1. The district court correctly concluded that the government's challenge to Bemont's 2001 tax return was untimely. The normal statute of limitations is three years, but the government waited until nearly *four* years had passed. Its only argument that its adjustments were timely is that it received inadequate notice of the transactions in documents it requested and received from Deutsche Bank (DB), the partnerships' counterparty in the transactions.

That claim is wrong. The government *did* learn about the transactions from DB—as the district court found, the government simply "decided not to pursue these transactions" because it had other enforcement priorities. The government does not claim that that finding is clearly erroneous. So the IRS's argument reduces to a technicality: that, *regardless* of what it knew about the transactions, it was entitled to sit on its hands because, it claims, DB's disclosures did not "meticulously" comply with a regulation. But the IRS regulation was "temporary"—issued without notice and comment—and is therefore not binding. Moreover, DB's disclosures met those regulatory requirements. In any event, a failure to include minor details required under a technical reading of the regulation does not invalidate substantial compliance with the tax laws. There is no reason to excuse the government's tardiness.

2. The government's discovery misconduct provides a separate basis for affirming the statute-of-limitations ruling. The government's argument turns on what information it got from DB and when, but the government obstructed attempts to discover that information: The district court found that the government "misled" the court and was not "candid with the Court or opposing counsel." The district court's findings of discovery abuse on the crucial question underlying the government's limitations argument provide ample alternative basis for affirming the district court's judgment on that issue.

3. The government's penalties arguments are misplaced. The government admits that its attempt to impose valuation misstatement penalties is contrary to Fifth Circuit precedent. Its response is that the IRS has overruled that precedent via a 19-year-old regulation that no court has ever noticed before. But the government misreads that regulation and ignores crucial parts of it.

4. The penalties at issue in our cross-appeal are unsustainable. Although the government ultimately persuaded the district court that the transactions were substantially similar to a Son-of-Boss transaction targeted by IRS Notice 2000-44 and ultimately persuaded the court to invalidate the tax treatment, that conclusion was a close, fact-bound question. The government's own 30(b)(6) witness testified that the transactions were *not* substantially similar to those in Notice 2000-44. Nevertheless, the partnerships were penalized for concluding that the transaction was permissible, even though they relied in good faith on detailed and thorough tax advice that reasonably interpreted existing law.

STATEMENT OF JURISDICTION

On October 13, 2006, the Commissioner of Internal Revenue issued notices of Final Partnership Administrative Adjustment (FPAA) to the tax matters partner of Bemont Investments, LLC, and BPB Investments, LC, for the 2001 and 2002 tax years. The partnerships commenced timely actions for readjustment of partnership items by depositing with the IRS the amount required by 26 U.S.C.

§6226(e) and filing petitions in the United States District Court for the Eastern District of Texas, which had jurisdiction under *id*. §§6226(a) and (e).

The actions were consolidated and referred by consent to a magistrate judge. 28 U.S.C. §636(c). Following a bench trial, the district court entered a final judgment. An amended final judgment was entered on August 24, 2010.

On October 22, 2010, the United States filed a notice of appeal. On November 4, the partnerships filed a notice of appeal. *See* Fed. R. App. P. 4(a)(3). The jurisdiction of this Court rests on 26 U.S.C. §6226(g) and 28 U.S.C. §§636(c)(3) and 1291.

ISSUES PRESENTED ON APPEAL

1. Whether the district court correctly concluded that the FPAA issued by the IRS to Bemont for its 2001 tax year was time-barred.

2. Whether the government's repeated deceptions about what information it received provides an alternative basis for affirming the limitations ruling.

3. Whether the IRS successfully overruled circuit precedent barring the imposition of a valuation misstatement penalty for an underpayment attributable to the IRS's total disallowance of the transaction.

ISSUE PRESENTED ON CROSS-APPEAL

Whether the district court erred in imposing substantial-understatement and negligence penalties on BPB for tax year 2002.

STATEMENT OF THE CASE

This is a challenge to two FPAAs issued to Bemont and BPB in October 2006, disallowing losses from a foreign currency hedging transaction claimed on Bemont's 2001 partnership income tax return and BPB's 2002 return. Both FPAAs also imposed four, alternative penalties: (1) 40% for underpayment attributable to a gross valuation misstatement; (2) 20% for underpayment attributable to negligence; (3) 20% for underpayment attributable to a substantial understatement of income tax; and (4) 20% for underpayment attributable to a substantial valuation misstatement. The penalties are not cumulative. 26 C.F.R. §1.6662-2(c).

The partnerships petitioned for review of the FPAAs in the district court. Before trial, the court granted their motion for partial summary judgment, holding that Fifth Circuit precedent precluded imposition of valuation misstatement penalties (items (1) and (4) above).

Following a four-day bench trial, the court determined that the FPAA issued to Bemont for 2001 was time-barred. With respect to 2002, however, the court upheld the IRS's disallowance of the losses and its imposition of 20% penalties for negligence and substantial understatement of income tax (items (2) and (3) above).

STATEMENT OF FACTS

A. The Solution 6 Investment

D. Andrew Beal is the sole shareholder and chief executive officer of Beal Financial Corporation (BFC) and Beal Bank. R.5966/Op.2/¶2; R.5577; Tr.589.[1] Beal's investment successes have come from identifying investment opportunities that are undervalued by the marketplace. Tr.74, 540-42.

Thomas Montgomery, an accountant, was until 1999 the managing partner of Montgomery, Baggett & Drews, LLP. R.5966/Op.2/¶1. Beginning in 1997, Montgomery was a strategic-planning consultant to Solution 6 Holding Ltd, a publicly traded Australian company that provided software and services to accounting firms. Tr.51. As a key advisor to Solution 6, Montgomery traveled extensively to Australia to assist the company in numerous strategic acquisitions. R.5966/Op.2/¶¶4-5; Tr.51, 54. Montgomery became the chief financial officer of Solution 6 in 1999 and joined its board the next year. R.5966/Op.2/¶¶3-7.

In 2000, reports surfaced that the CEO of Solution 6, Chris Tyler, had an undisclosed drug conviction and had been involved in another company's bankruptcy. Tr.57. In May 2000, Tyler was replaced by interim CEO Lindsay Yellend. Tr.60. Montgomery backed Yellend to continue permanently, but was

[1] "Tr.___" refers to the consecutively paginated trial transcript. Other hearing transcripts are designated with the hearing date.

outvoted in August 2000. Yellend was replaced by Neil Gamble, another board member. Tr.62-63. Shortly thereafter, Montgomery was terminated without cause, along with Yellend's other supporter on the board. R.5967/Op.3/¶8; Tr.62-63.

In the spring of 2001, Beal hired Montgomery to identify new opportunities for BFC. R.5967/Op.3/¶12. Believing that Solution 6 stock was undervalued, Montgomery recommended that BFC invest in the company, and BFC began to acquire Solution 6 stock. R.5967/Op.3/¶¶10-14; Ex.P.-2000. Beal and Montgomery thereafter began to consider a takeover bid, with Jeff Crawford, a BFC employee, devoting several hundred hours to a plan for operating Solution 6 after a takeover. R.5968/Op.4/¶22.

By September, BFC had acquired 7.6 million shares of Solution 6—4.5% of the company's stock. R.5967-68/Op.3-4/¶¶17-18, 20. On September 13, Beal formed BPB Investments, a Texas LLC, to pursue a tender offer. R.5969/Op.5/¶34; R.5577. (BPB was set up as a separate takeover vehicle to reduce litigation risk to BFC and facilitate future transactions. Tr.115.) BFC distributed 7,678,467 shares of Solution 6 stock to Beal, and Beal then contributed the shares (which had a cost basis of $4 million) to BPB, along with $5 million in cash. R.5969/Op.5/¶34-35.

Beal and Montgomery explained that, as they continued to contemplate a takeover bid for Solution 6, they came to understand that a currency hedge would be required. Tr.104-09, 546-49. Because the tender offer would use Australian currency, it was necessary to hedge the risk that the Australian dollar would appreciate (relative to the U.S. dollar) before closing. Tr.104-09, 546-49. Beal also explained that a currency hedge was important to persuade the Australian corporate takeover board to approve the tender offer. Tr.546; *see also* Australian Corporations Act, 2001, 636(1)(f) (requiring information on "arrangements" to provide cash for takeover bids); *Parker & Parsley Petroleum v Gantry Acquisition Corp.* (1994), 13 A.C.S.R. 689, 691 (cited in Australian Takeover Panel, *Guidance Note 14: Funding Arrangements* 7 n.20 (2004), *see* R.5637).

Montgomery concluded that digital swaps would provide the lowest-cost opportunity to hedge the currency risk. Tr.102-05. This structure would permit an acceptable foreign exchange risk (up to 7% appreciation of the Australian dollar), while hedging against additional risk (7-14% appreciation). Tr.104-05. There was no need to hedge against any additional risk, because appreciation beyond 14% would permit withdrawal from any commitment to purchase Solution 6. Tr.105.

On September 14, 2001, BPB entered into digital currency swap transactions with DB. R.5969/Op.5/¶36. The swaps included two long positions and two corresponding short positions in the Australian Dollar. The long swaps each required BPB to pay DB a "yield adjustment fee" of US$101,250,000. Each corresponding short swap required DB to pay BPB a yield adjustment fee of

US$98,750,000 (hence, the term “swap”). R.5969-70/Op.5-6/¶37. The initial cash paid by BPB for the four swaps was US$5,000,000. BPB’s cash outlay for the swaps was later reduced by the difference between (i) four fixed payments of Australian dollars required to be paid by DB to BPB under the short swaps; and (ii) corresponding fixed payments required to be paid by BPB to DB under the long swaps. All told, BPB was out of pocket US$2,500,000. R.5970/Op.6/¶¶38-39.

Each short swap provided that, if the spot rate for the Australian Dollar equaled or exceeded a specified level on two identified days, then BPB would be required to pay DB a specified exchange amount. Each corresponding long swap similarly provided that, if the spot rate on those dates equaled or exceeded a specified price, then DB would be required to pay BPB a specified amount. The strike price of each short swap was higher than the strike price of its corresponding long swap. The strike prices were above the then-current spot price of the Australian dollar.

Under this structure, if the spot price of the Australian dollar had not appreciated above the strike price for the long swap on the relevant date, then no payment would be due from either party. If the spot price exceeded the strike prices for both swaps, then the payments would mostly offset, netting BPB US$2.5 million per pair. Finally, if the spot price fell into the “sweet spot” between the strike prices for the short and long swaps, then DB would make a payment but BPB would not, earning BPB US$552.5 million.

In sum, if the price of the Australian dollar appreciated beyond the 7% fluctuation Beal and Montgomery were willing to accept, the swaps allowed BPB to receive up to US$10 million (because there were two pairs of long and short swaps, and each pair had two rate determination dates). If the Australian dollar happened to appreciate just slightly less, and the spot price fell within the "sweet spot" on each date, BPB could receive payments totaling US$2.2 billion.

On September 20, 2001, Crawford completed his report on the Solution 6 investment, concluding that Solution 6's stock was "trading at roughly 50% of fair value." Ex.P-2026A, p.BPB002412. Based on that conclusion and a draft post-acquisition operating strategy, *see* Ex.P-2026A, p.BPB002428, Crawford recommended that BFC continue acquiring Solution 6 stock and investigating a tender offer.

On September 25, Beal and Montgomery formed Bemont,[2] a Delaware LLC. R.5970/Op.6/¶40. Beal caused BPB to contribute the swap positions and the 7.6 million shares of Solution 6 stock to Bemont, in exchange for a 99% capital interest and 90% profit interest in Bemont. R.5970/Op.6/¶40. Montgomery

[2] In the transactions and tax filings, Bemont was known as BM Investments, L.L.C. It has since changed its name. For simplicity, we call it Bemont.

transferred $64,862 in cash and 50,000 shares of Solution 6 stock to Bemont, in exchange for a 1% capital interest and 10% profit interest. R.5970/Op.6/¶40. On October 1, BPB admitted Beneficial Property (a Texas S corporation) as a member, turning BPB into a partnership for federal tax purposes. R.5970/Op.6/¶41.

Beal and Montgomery testified that they continued to consider a takeover but ultimately decided not to proceed, principally because Solution 6 had taken defensive measures designed to prevent a hostile takeover and because alternative investments had become more attractive. Tr.124-26, 550-51. Montgomery contacted potential legal counsel in Australia, but each firm was unable to accept the matter. Tr.210.

Beal and Montgomery testified that the final decision not to pursue Solution 6 was made on December 6, 2001. Tr.126, 592-93. On December 7, Bemont distributed to BPB the 7.6 million Solution 6 shares. On December 17, 2001, Bemont redeemed Montgomery's interest in the company for 215,000 shares of Solution 6 stock and a buyer's premium of $150,000. R.5976/Op.12/¶80. After the redemption, Bemont became a disregarded entity for U.S. federal income tax purposes. As a result, BPB was deemed to receive a liquidating distribution of Bemont's assets, including the Australian currency it had received from DB under the fixed-payment component of the swaps.

B. The Partnerships' Tax Returns

Bemont sold 75% of the Australian currency generated by the swaps in December 2001, and 25% in January 2002. R.5977/Op.13/¶81. In calculating BPB's tax basis in its interest in Bemont, BPB included the $202,500,000 it had paid for the long swaps and the $4 million cost of the Solution 6 stock it had contributed to Bemont. BPB's basis was not reduced by the obligations under the short swaps because of their contingent nature. Accordingly, BPB realized a roughly $153 million tax loss in 2001, and a roughly $46 million tax loss in 2002. R.5977/Op.13/¶81.

In adopting that tax treatment, Beal and Montgomery relied on the advice of accountant Matt Coscia, with whom Montgomery had worked at his old firm. R.5988/Op.24/¶¶104-106; Tr.47. In a 135-page opinion, Coscia concluded that the partnerships' tax treatment was likely correct. Ex.P-2013. Coscia concluded that BPB's obligations under the short swaps would not be treated as a partnership liability for the purposes of calculating BPB's basis in Bemont. Ex.P-2013, pp.BPB000067-75. Coscia explained that, in *Helmer v. Commissioner*, 34 T.C.M. (CCH) 727 (1975), the Tax Court had held (at the IRS's urging) that writing an option does not lead to a partnership liability. Coscia examined other precedents holding that contingent liabilities are not considered partnership liabilities for basis purposes. Ex.P-2013, pp.BPB000069-72 (discussing Revenue Ruling 73-301, 1973-2 C.B. 215, *Long v. Commissioner*, 71 T.C. 1 (1978), and *La Rue v. Commissioner*, 90 T.C. 465 (1988)).

Separately, Coscia considered "judicial doctrines" that courts have applied to invalidate transactions despite compliance with the Tax Code. Ex.P-2013, pp.BPB000093-108. After lengthy analysis, Coscia concluded that the swaps would "have the requisite economic substance and business purpose to be respected." Ex.P-2013, pp.BPB00108.

C. The Government's Examination

In April 2005, the IRS began an audit of Beal's 2002 personal income tax return. R.5978/Op.14/¶88; Ex.P-2109, p.IRS0361. During that audit, an IRS agent met with Beth Montgomery, the accountant who had prepared Beal's 2002 return. Tr.489. Beth Montgomery provided the agent with a copy of the agreement assigning BPB's rights and obligations under the swaps to Bemont, which listed all four swaps, with trade dates and reference numbers. Ex.P-2109, pp.IRS0541-49. She also provided copies of the confirmation letters for the long swaps but did not provide further detail on the short swaps, because (she explained at trial) their contingent nature meant that they did not affect BPB's basis and thus were irrelevant to substantiating that figure. Tr.503-04. The IRS made no adjustments to Beal's claimed basis in BPB as a result of the audit. R.5979/Op.15/¶90.

On October 15, 2005—three years after Beal, Bemont, and BPB filed their 2001 returns—the ordinary three-year statute of limitations for tax assessments, *see* 26 U.S.C. §6501(a), expired.

Almost a year later, on October 13, 2006, the IRS issued FPAAs to BPB and Bemont. R.5979/Op.15/¶92. The FPAA issued to Bemont covered the 2001 tax year, disallowing the losses from the swaps and determining that Bemont's partners had no basis in the partnership. Ex.P-2129. The FPAA issued to BPB dealt with the tax year ending December 31, 2002, but otherwise reached the same conclusion on the same grounds. Ex.P-2130.

D. The Government's Discovery Misconduct

The government has relied on 26 U.S.C. §6501(c)(10), which extends the limitations period if the taxpayer's return fails to disclose participation in certain "listed transactions." Section 6501(c)(10) holds the limitations period open until one year after the date that a "material advisor"—here, DB—provides certain identifying information described in 26 U.S.C. §6112(a). It was therefore crucial to determine what information the IRS received from DB, and when.

Beginning during pre-trial proceedings, the partnerships asked whether and when they had been identified to the IRS by DB. The government repeatedly represented that the partnerships were first identified by DB in February 2007. The government repeated that representation after being ordered by the district court to make a further search of the IRS's records and produce *any* list of currency swap transactions that included Bemont or BPB. The government consistently sought to limit further discovery into the issue.

When plaintiffs ultimately obtained third-party discovery from DB, however, it was revealed that the government's representations had been false. Bemont and BPB had been identified on two lists that had been produced to the government twice—first to the IRS in May 2005, and again to the Department of Justice team litigating this case in November 2007. The district court would ultimately conclude that these lists were dispositive of the 2001 tax year because they triggered the one-year limitations period under Section 6501(c)(10).

On August 1, 2007, the partnerships requested from the government documents demonstrating if and when the IRS learned about the swaps transaction from DB. Ex.P-2237. The request sought documents "related to examinations or requests under [26 U.S.C.] §6112 to Deutsche Bank for inspection or information allegedly required to be maintained on lists," Ex.P-2237, pp.6-7, and sought more generally any documents the IRS received from any material advisor (including DB) relating to the swaps or the entities involved in the case, Ex.P-2237, pp.8-9.

On September 10, 2007, IRS Revenue Agent Jeanne Whitney, the self-described "Co-Team Coordinator for the audit of Deutsche Bank, A.G. relating to its liability under 26 U.S.C. §§6707 and 6708," issued a declaration describing five

Section 6112 lists received from DB beginning in February 2007, which were attached to the declaration as exhibits. Ex.P-102. Whitney asserted that she had "searched the lists provided by Deutsche Bank" during the audit, Ex.P-102, p.3, and that the IRS's "records for the promoter audit reflect no other lists received from Deutsche Bank, A.G., pursuant to 26 U.S.C. §6112." Ex.P-102, p.4. By limiting its response in that manner, the government refused to comply fully with the document request.

On November 1, 2007, DB produced documents to the Department of Justice. R.2200. Included in that production were the two lists the IRS had received from DB in 2005 that identified the partnerships as participants in foreign currency transactions. One list identified "BPB Investments LC" with the description "SWAP," as well as an attribution of the transaction to Dallas. Ex.P-108A. The other identified "BM Investments LLC," and included Beal's last name and various financial details about the transaction. Ex.P-117A, pp.DBIRS-FX-00411341, 00411346, 00411351. Although the government forwarded copies of DB's document production to Bemont and BPB, R.2200, the two 2005 lists contain on their face no indication that they had *already* been produced to the IRS. That fact would emerge much later, when the partnerships obtained from DB the cover letter associated with DB's 2005 production, *see* Ex.P-2100, and a declaration from DB's counsel that permitted the partnerships to tie the Bates numbers referenced in the 2005 cover letter to those used for DB's document productions in this litigation, *see* Ex.P-2203.

The partnerships noticed the deposition of an IRS representative under Federal Rule of Civil Procedure 30(b)(6) regarding the IRS's requests for lists from DB and Whitney's September 10, 2007, declaration. R.2099, 2105-06. The government moved to block the deposition. R.2083. The government contended that the partnerships "require[d] no discovery regarding the dates on which the Service received §6112 lists from Deutsche Bank," R.2094, because "[t]he Whitney Declaration provides the relevant dates." R.2095.

At a hearing, government counsel repeated that Whitney's declaration rendered further discovery unnecessary. 5/28/08 Tr.78. When asked whether any lists had been produced before 2007 that dealt with currency swap transactions and the relevant parties in this case, government counsel said, "I am not aware of any." 5/28/08 Tr.79. The lawyer said he had told the IRS what to look for and "made it very clear" that, if any list identifying the partnerships had been produced before 2007, he would need to be informed. 5/28/08 Tr.79. The court granted the government's motion for a protective order, but ordered government counsel to make another inquiry, requiring the IRS to check again whether the partnerships had appeared "on a currency swap list that was furnished prior to 2007." 5/28/08

Tr.80; *see also* R.2811. The court also warned of "woe unto" any party acting in "bad faith." 5/28/08 Tr.81.

In a second declaration, Whitney repeated that the IRS had not received a list from DB, "pursuant to 26 U.S.C. §6112," earlier than the 2007 lists designated in her original declaration. Ex.P-103, p.4. Whitney thus did not disclose that the IRS had received the two lists from DB in 2005.

The government apparently based that omission on the qualification contained in Whitney's declarations—*i.e.*, that, before February 2007, DB had not produced lists *"pursuant to 26 U.S.C. §6112*." Ex.P-102, p.4; Ex.P-103, p.4 (emphasis added). The government apparently determined for itself that the 2005 lists did not comply with Section 6112, and withheld that information on that basis. *See* p.22, *infra*.

The partnerships pursued parallel discovery from DB. That process began with the issuance of a third-party subpoena on August 17, 2007, *see* Ex.P-2238, and required filing ancillary litigation against DB, as well as months of continued negotiation. The government sought to delay this third-party discovery—again citing the Whitney declarations—and also argued that further discovery was unnecessary: "Because the parties already have copies of Deutsche Bank's records relating to the Swaps transaction at issue, Plaintiffs' document subpoenas ... plainly serve no rational purpose." R.2948. The government said the third-party subpoenas "would yield no evidence that could affect the outcome of this litigation." R.2949; *see also* R.2972, 2974.

That was false. Not until DB produced third-party discovery in August 2009 would it be revealed that the two lists that the court would later conclude satisfied Section 6112 had been produced to the IRS on May 27, 2005, under a cover letter indicating that the documents were "responsive to IRS summons headed 'Son of Boss/Digital Options', dated October 20, 2004." Ex.P-2100, p.2; *see* Ex.P-2203, at Ex.A-1, 14 (declaration from DB's legal counsel permitting cross-reference between cover letter and documents produced by DB in this litigation). Although the critical cover letter was sent in May 2005, the government *never* produced it in this case, and did not otherwise disclose when the IRS had received the 2005 lists.

The partnerships continued efforts to learn what information the IRS had concealed. They moved to compel discovery, including a deposition of the IRS under Rule 30(b)(6). R.3037, 3044. At a hearing on the motion, the government insisted the Whitney declaration was sufficient and showed that DB's first disclosure regarding Bemont or BPB was made in February 2007. 9/17/09 Tr.21. The court ordered the deposition. R.3369.

The IRS designated as its 30(b)(6) witness Donald Berkowitz, an IRS revenue agent who, like Whitney, worked with the team auditing DB. Berkowitz Dep.15-16. Berkowitz "testified that the swap transactions were not substantially similar to Notice 2000-44 transactions." R.5994/Op.30; *see also* Berkowitz Dep.18 (agreeing that digital swap transactions like BPB's were not substantially similar to digital *option* transactions that Berkowitz had investigated as Notice 2000-44 transactions). Berkowitz acknowledged that the IRS had assigned a lower priority to investigating digital swap transactions than to investigating digital option transactions. Berkowitz Dep.17.

On March 4, 2010, the court held an evidentiary hearing to address statute-of-limitations issues. At that hearing, and during trial, the government presented testimony from three IRS employees, none of whom could explain how the partnerships had been identified. 3/4/10 Tr.39, 42, 64; Tr.633-37, 650-52.

Finally, the court ordered the government "to conduct a thorough search regarding how and when" the partnerships were identified as potential Son-of-Boss transactions and to tender a representative to testify under Rule 30(b)(6). R.5727-28. This time, the government selected David Thurber, a senior IRS manager. 4/14/10 Tr.6. Thurber claimed that the IRS identified BPB's return as involving a potential Son-of-Boss transaction in December 2005, when the team auditing DB provided an investor list containing the name of another partnership that had issued a Schedule K-1 to Beal. 4/14/10 Tr.15.

E. District Court Rulings

Before trial, the court granted the partnerships partial summary judgment, holding that valuation misstatement penalties could not be imposed as a matter of law. The court observed that, "'[w]henever the I.R.S. totally disallows a deduction or credit,'" any "'underpayment is not attributable to a valuation overstatement,'" but is instead "'attributable to claiming an improper deduction or credit.'" R.5444 (quoting *Heasley v. Commissioner*, 902 F.2d 380, 383 (5th Cir. 1990)).

Following a bench trial, the court determined that the 2001 FPAA was time-barred. With respect to the 2002 tax year, however, the court upheld the IRS's disallowance of the claimed partnership loss, along with a 20% penalty based on negligence and a substantial understatement of income tax.

1. Bemont's 2001 Return

With respect to limitations, the court concluded that the swaps transaction was substantially similar to the transactions described in IRS Notice 2000-44. R.5988/Op.24. The court thus reasoned that 26 U.S.C. §6501(c)(10) extended the statute of limitations until one year after a material advisor provided the IRS with an investor list that complied with 26 U.S.C. §6112 and a temporary implementing regulation, 26 C.F.R. §301.6112-1T (2002). R.5994/Op.30, R.5998/Op.34.

The court held that the lists produced to the IRS by DB in May 2005 complied with that statute and regulation, and therefore the one-year extended period elapsed before the IRS issued an FPAA to Bemont in October 2006. R.6002/Op.38, R.6006/Op.42. The court further found that the IRS "had notice of BPB and BM's participation in the digital options early on but decided not to pursue these transactions" because it wanted to pursue other matters first. R.6006/Op.42.

The court then addressed a motion to sanction the government for its repeated discovery abuses by deeming established facts sufficient to trigger the one-year limitations period under Section 6501(c)(10). R.6006/Op.42; *see also* R.5812. The court "f[ound] that the Government was not candid with the Court or opposing counsel." R.6006/Op.42. In support of that finding, the court found that it had been "misled by the Government's hyper-technical position" that, because the lists produced by DB in 2005 were not *really* "lists," there was no need to disclose the IRS's receipt of them in 2005. R.6005/Op.41. The court also found that the government had "submitted evasive answers to legitimate discovery" and had "failed to produce information which was within its control, *i.e.*, information from Deutsche [Bank] received in 2005." R.6005/Op.41. Because the court had ruled the FPAA untimely, however, it held the sanctions motion moot. R.6006/Op.42.

2. BPB's 2002 Return

The district court relied on three alternative grounds in upholding the disallowance of BPB's claimed partnership losses for 2002. First, the court held that the swaps transaction "lacked economic substance," R.5981/Op.17, because (it found) BPB had abandoned the potential tender offer before entering into the swap, *see, e.g.*, R.5981/Op.17/¶a, and "[t]here was no reasonable expectation of profit from the transaction." R.5984/Op.20/¶t. Second, the court held that the "the short swaps were partnership liabilities and should have been accounted for by the partnerships in offsetting the basis generated by the long swaps." R.5984/Op.20. Third, the court concluded that the claimed losses were "not bona fide deductible losses" because they did not "correspond to actual economic losses." R.5984/Op.20.

As for penalties, the court held that the partnerships could not have relied on Coscia's opinion in good faith. The court asserted that "Coscia was not truly an independent advisor" as a result of his "close association with Montgomery." R.5989/Op.25/¶112. The court also stressed that Coscia had been paid $150,000 for his work on the opinion, and faulted him for having done "little independent research" and for using another opinion to produce portions of his own. R.5989/Op.25/¶¶112-13. The court further found that "neither Montgomery nor Coscia were credible in their testimony as to the real purpose behind the foreign currency swaps," and that "Coscia gave Montgomery what he wanted—an opinion that passed on the investment strategy." R.5989/Op.25/¶¶114-15.

The court did not, however, discuss *at all* the *quality* of Coscia's analysis. The court did not address *Helmer* or the other authorities Coscia had cited in concluding that the treatment of the swaps was more likely than not correct Nor did the court address the partnerships' argument that, apart from Coscia's opinion, substantial authority supported their treatment of the swaps.

SUMMARY OF ARGUMENT

The district court correctly concluded that the FPAA issued to Bemont for 2001 was time-barred. The court also correctly concluded that the 40% penalty for gross valuation misstatements was inapplicable. But the court erred in upholding the IRS's imposition of 20% penalties on BPB's 2002 return for substantial understatement of income tax and negligence.

I. The 2001 FPAA was time-barred under the ordinary three-year statute of limitations for tax assessments. *See* 26 U.S.C. §6501(a). The exception for situations in which a taxpayer does not include a disclosure statement with respect to certain "listed transaction[s]," 26 U.S.C. §6501(c)(10), does not render the FPAA timely.

DB produced lists identifying Beal and the partnerships to the IRS in May 2005, more than a year before the 2001 FPAA was issued. DB thereby satisfied 26

U.S.C. §6112(a), which required DB to "identify[]" participants in Son-of-Boss transactions. Although the government contends that DB's disclosure did not comply with an implementing regulation, the relevant regulation was issued without notice and comment and is thus invalid. In any event, DB's disclosure substantially complied with the regulation. Indeed, the 2005 lists are materially indistinguishable from, and indeed contain even more information than, lists produced by DB in 2007 that the government concedes substantially complied with §6112.

The district court's finding that the IRS had actual notice of the swaps disposes of the government's assertion that the lists were insufficient to alert the IRS to the swaps. The district court's ruling is also consistent with Congress's intent to stop taxpayers from playing the "audit lottery," because the transactions at issue here *were* audited within the ordinary limitations period. And the Supreme Court has rejected the government's request for a special construction of the statute of limitations.

Even if this Court concludes that the 2005 lists did not trigger §6501(c)(10)'s one-year limitations period, the statute-of-limitations ruling should be affirmed. The district court correctly found that the government engaged in prolonged and serious discovery misconduct to obstruct the partnerships' discovery of critical information regarding the 2005 lists. The necessary sanction for that misconduct is an order under Fed. R. Civ. P. 37(b)(2)(A)(i) deeming it established that sufficient information to trigger the running of §6501(c)(10)'s one-year limitations period was produced to the IRS before October 13, 2005.

II. The valuation misstatement penalties the government sought to impose apply only if the taxpayer makes an "underpayment which is attributable to ... a valuation misstatement." 26 U.S.C. §§6662(b)(3), (h)(1). As this Court has held, an underpayment is not attributable to a valuation misstatement if the IRS totally disallows a deduction under the economic substance doctrine. Contrary to the government's implausible suggestion, those decisions have not been overruled by 26 C.F.R. §1.6662-5, a 19-year-old regulation that does not even purport to construe the language at issue.

III. The district court erred in upholding the 20% penalties for substantial understatement of income tax and negligence.

The substantial-understatement penalty does not apply "if there is or was substantial authority" for the challenged tax treatment. 26 U.S.C. §6662(d)(2)(B). The substantial-authority standard is objective, asking whether "the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." 26 C.F.R. §1.6662-4(d)(3)(i). Here, the court overlooked a long line of authority, discussed at length in Coscia's 135-page opinion, establishing that contingent obligations do not constitute partnership liabilities for the purpose of calculating basis in a partnership interest. Because Bemont's obligations under the short swaps were contingent, there was substantial authority for the partnership's conclusion that the BPB's contribution of the short swaps to Bemont did not affect its basis. And, because there was substantial authority for the tax treatment, as a matter of law it was not negligent for the partnerships to adopt it. *See* 26 C.F.R. §§1.6662-3(b)(1), (b)(3), (d)(2).

The court's failure to engage with the merits of Coscia's opinion also infected its analysis of the partnerships' reasonable cause and good faith, a complete defense to all penalties. Coscia's opinion contained a detailed analysis of the relevant legal issues and, as expert testimony reflects, met the ordinary standards of the tax professional community.

The district court also erred in concluding that Coscia lacked the objectivity to support a reasonable cause and good faith defense. The court criticized Coscia for accepting a payment of $150,000 for his opinion, but there was no evidence that the fee was excessive in light of the hundreds of hours he spent on the matter. Nor did Coscia's prior business relationship with Montgomery prevent him from giving independent advice. Finally, the court erroneously penalized the partnerships for invoking their attorney-client privilege with respect to another tax opinion.

STANDARD OF REVIEW

The district court's findings of fact are reviewed for clear error, and legal issues are reviewed *de novo*. *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 543 (5th Cir. 2009).

ARGUMENT

I. The District Court Correctly Determined That The FPAA Issued To Bemont For 2001 Was Time-Barred

A. The Government Fails To Mention Two Factual Findings That Belie Its Contention That It Lacked Timely Notice Of The Transactions

In arguing that the lists produced by DB to the IRS in 2005 did not trigger the one-year limitations period in 26 U.S.C. §6501(c)(10), the government ignores two factual findings crucial to this appeal: (1) that the government actually knew about the transactions before October 2005; and (2) that the government actively sought to conceal that actual knowledge.

First, the district court found that the government had *actual notice* of the partnerships' participation in the Solution 6 transactions: "[T]he Court concludes that the IRS had notice of BPB and [Bemont]'s participation in the digital options early on but *decided not to pursue these transactions* because there were other shelters which it wanted to pursue first." R.6006/Op.42 (emphasis added). That finding belies the government's complaints about the supposed technical inadequacy of the information it received. Rather, as the court found, "[t]he IRS simply failed to act on and ignored the very information it sought." R.6002/Op.38.

The government does not challenge these findings as clearly erroneous. Instead, the government ignores them, asserting (Br. 14-16) that the IRS learned of Bemont and BPB's participation in the swaps in December 2005. Although the government summarizes the testimony provided by its witness, the district court *did not credit* that testimony—instead, it found that the IRS knew about the transaction and then attempted to conceal that information during discovery. *See, e.g.*, *Lamborn v. Dittmer*, 873 F.2d 522, 526 (2d Cir. 1989) ("'[A] party's ... suppression of evidence ... is receivable against him as an indication of his consciousness that his case is a weak or unfounded one; and from that consciousness may be inferred the fact itself of the cause's lack of truth and merit.'") (quoting 2 John H. Wigmore, *Evidence* §278, p.133 (Chadbourn ed., rev. ed. 1979)).

Second, the government engaged in extensive discovery misconduct, which has made it impossible to conclude that the statute of limitations had not run. The limitations issue turns on what information the government received from DB. Even now, we do not know the full scope of that information. The government refused to disclose information in its possession that would have shown whether the partnerships had been identified on lists produced to the IRS by DB in May

2005. *See* R.6005/Op.41 ("[T]he Government ... has failed to produce information which was within its control, *i.e.*, the information from Deutsche received in 2005."). Plaintiffs were able to get some of that information from DB directly, but for all we know there may be more.

Moreover, the government never produced information necessary to put into context the 2005 information that DB produced. The lists apparently were produced in response to an IRS summons about so-called Son-of-Boss transactions. But the government refused to produce that summons in discovery. R.5994/Op.30. Consequently, the record does not show whether the summons specifically requested 26 U.S.C. §6112 "lists" for Son-of-Boss transactions, asking DB to provide *exactly* the details that it did.

These latter omissions are crucial because, "when the government relies on an exception to the three-year statute of limitations, it bears the burden of proving its entitlement to rely on that exception." *Payne v. Commissioner*, 224 F.3d 415, 420 (5th Cir. 2000); *see also J.H. Rutter Rex Mfg. Co. v. Commissioner*, 853 F.2d 1275, 1281 (5th Cir. 1988) (same).[3] The government cannot carry that burden while simultaneously (and deliberately) obscuring the essential facts on which it turns.

[3] That burden would also have shifted to the government under 26 U.S.C. §7491(a).

B. DB Identified The Partnerships To The Government In 2005

Bemont and Beal's 2001 returns were filed October 15, 2002, Ex.P-2121; Ex.P-2122, and the 2001 FPAA was issued October 13, 2006, Ex.P-2129. The FPAA was thus untimely under the ordinary three-year statute of limitations. 26 U.S.C. §§6229, 6501(a).[4] But the IRS has invoked a limited exception, based on purported deficiencies in Beal's return.

If a taxpayer does not include with his tax return required information regarding a "listed transaction," a special 1-year limitations period runs from "the date that a material advisor meets the requirements of section 6112 with respect to a request by the Secretary under section 6112(b) relating to such transaction with respect to such taxpayer." 26 U.S.C. §6501(c)(10)(B). Under Section 6112, DB was required to "maintain (in such manner as the Secretary may by regulations prescribe) a list *identifying* each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require." 26 U.S.C §6112(a) (emphasis added).

DB sent the IRS information identifying Beal and the partnerships in May 2005, more than a year before the 2001 FPAA was issued. DB's conduct

[4] In *Curr-Spec Partners, L.P. v. Commissioner*, this Court held that the separate partnership limitations period, 26 U.S.C. §6229, "can never shorten" the statute of limitations under 26 U.S.C. §6501. 579 F.3d 391, 396 (5th Cir. 2009). We respectfully reserve the right to challenge that holding before this Court *en banc* or before the Supreme Court. *See Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner*, 114 T.C. 533, 565-69 (2000) (Parr, J., dissenting).

manifestly complied with the statute itself, which required DB to "identify" the purchaser of "an interest" in the Son-of-Boss transactions. Indeed, as the district court found, "[w]hat is clear is that, by July 2005, the IRS had information which identified BPB and Bemont." R.5994/Op.30. That is all the statute requires.[5]

The government's appeal turns on a claim that the lists failed to contain "such other information as the Secretary may by regulations require." 26 U.S.C. §6112(a). But in 2005 the only regulation promulgated under Section 6112 was a temporary regulation that was invalid, and therefore irrelevant to DB's compliance with the statutory requirement.

The Administrative Procedure Act generally requires an agency to provide notice and seek comment before publishing a regulation. 5 U.S.C. §553(b)(A). Yet 26 C.F.R. §301.6112-1T—the regulation under Section 6112 purportedly in effect in 2005—was adopted as a "temporary" regulation without notice and comment. *See* 49 Fed. Reg. 34,201 (1984); *see also* 66 Fed. Reg. 41,135 (2001). When an agency has "failed to follow the procedures required by the Administrative Procedure Act," a regulation thus promulgated must be "set aside." *U.S. Steel Corp. v. EPA*, 595 F.2d 207, 210 (5th Cir. 1979). As this Court recently confirmed, Treasury regulations cannot be given legislative effect when "the

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[5] The disclosures also identified Beal himself, even though that was *not* required. *See* p.36, *infra*. And the IRS's own witness testified that a partnership's name is sufficient for the IRS to locate the partnership's records. 4/14/10 Tr.41.

government issued the Temporary Regulations without subjecting them to notice and comment procedures." *Burks v. United States*, 633 F.3d 347, 360 n.9 (5th Cir. 2011) (citing Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance With Administrative Procedure Act Rulemaking Requirements,* 76 Geo. Wash. L. Rev. 1153, 1158-60 (2008)); *see also* Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance With Administrative Procedure Act Rulemaking Requirements*, 82 Notre Dame L. Rev. 1727, 1732-35 (2007). Because the rule "should have been submitted for notice and comment before adoption" but was not, the partnerships "'may not in any manner be required to resort to, or be adversely affected by'" it. *Shell Offshore Inc. v. Babbitt*, 238 F.3d 622, 630 (5th Cir. 2001) (quoting 5 U.S.C. §552(a)(1)).[6]

The temporary regulations fall within no exemption from the APA's notice-and-comment requirement. The IRS frequently attempts to avoid notice and comment on the ground that its regulations are interpretive. Hickman, 82 Notre Dame L. Rev. at 1760. But the regulation here does not "interpret" *any* statutory text; rather it attempted to "exercise[] th[e] authority" that is "delegated to the

[6] Although the procedural invalidity of the regulation was not explicitly argued to the court below—which ruled before this Court decided *Burks*—this Court "may affirm the judgment of a district court if there are any grounds in the record to support the judgment," *Mangaroo v. Nelson*, 864 F.2d 1202, 1204 n.2 (5th Cir. 1989), and "'the record appears to be adequately developed.'" *McIntosh v. Partridge*, 540 F.3d 315, 326 (5th Cir. 2008) (quoting *FDIC v. Lee*, 130 F.3d 1139, 1142 (5th Cir. 1997)).

Treasury Department," Gov't Br. 40, by 26 U.S.C. §6112(a) to require "other information" in addition to an actual identification of the taxpayers. It is thus "substantive," not "interpretive." *Professionals & Patients for Customized Care v. Shalala*, 56 F.3d 592, 595 (5th Cir. 1995); *Texas Sav. & Cmty. Bankers Ass'n v. Federal Hous. Fin. Bd.*, 201 F.3d 551, 556 (5th Cir. 2000); *Davidson v. Glickman*, 169 F.3d 996, 999 (5th Cir. 1999).

Second, the temporary regulation is not a "rule[] of agency organization, procedure, or practice." 5 U.S.C. §553(b)(A). The detailed list-keeping requirements have "a *substantial impact* on the regulated industry, or an important class of the members or the products of that industry." *Brown Express, Inc. v. United States*, 607 F.2d 695, 702 (5th Cir. 1979) (internal quotation marks omitted).

Finally, it is irrelevant that the Treasury Department allowed for notice and comment *after* promulgating the regulation. *Burks*, 633 F.3d at 360 n.9 ("not an acceptable substitute for pre-promulgation notice and comment.") (citing *U.S. Steel Corp.*, 595 F.2d at 214-15). DB's compliance with Section 6112 in 2005 thus ends the inquiry—there was no lawful regulation in 2005 to consider.

C. DB's Disclosure Satisfied The Regulatory Requirements

Even under the invalid temporary regulation, the limitations period has run. As the district court found, DB's 2005 disclosure complied with the regulatory requirements by communicating all of the relevant information DB had about the partnerships. Further, even if, as a technical matter, the 2005 lists did not include certain information called for in one or two detailed subparts of the regulation, DB's 2005 production constitutes "substantial compliance," a long-recognized doctrine that excuses minor omissions in complying with tax regulations and that is particularly sensible when, as here, the government had *actual knowledge*.

1. DB's Disclosure Complied With The Regulatory Requirements

a. Name, Address, And TIN

DB was required to provide "the name, address, and TIN of each investor and any indirect corporate participant in the shelter if known to the organizer or seller." 26 C.F.R. §301.6112-1T A-17(a)(3); Gov't Br. 48. The government claims that the lists inadequately disclosed the name, address, and TIN for Beal and the partnerships. But the regulation requires that information only "if known to the organizer or seller," *id*., and there is no evidence that DB knew any information that it omitted.[7]

The government invokes the "grammatical 'rule of the last antecedent.'" Gov't Br. 48 (citing *Jama v. Immigration & Customs Enforcement*, 543 U.S. 335,

[7] The government disputes the district court's factual finding that "there is no showing that Bemont's TIN was known to Deutsche," Gov't Br. 46 (quoting R.6000-6001/Op.36-37), but it cannot show that finding to be clearly erroneous. The government points to a DB form letter *requesting* a TIN, Gov't Br. 47, but the court found that there was no evidence that Bemont ever *supplied* its TIN or that DB retained it, R.6000-6001/Op.36-37.

343 (2005)). But "[t]he rule of the last antecedent, ... 'is not an absolute and can assuredly be overcome by other indicia of meaning.'" *United States v. Hayes*, 129 S. Ct. 1079, 1086 (2009) (quoting *Barnhart v. Thomas*, 540 U.S. 20, 26 (2003)); *Nobelman v. American Sav. Bank*, 508 U.S. 324, 330-331 (1993); *United States v. Bass*, 404 U.S. 336, 340 n.6 (1971); *United States v. Standard Brewery*, 251 U.S. 210, 218 (1920); *Sobranes Recovery Pool I, LLC v. Todd & Hughes Constr. Corp.*, 509 F.3d 216, 223 (5th Cir. 2007).

It makes no sense to read the statutory scheme—as the government does—to require DB to disclose more than it knew. DB already had other incentives to maintain complete records—as the government points out, Gov't Br. 57-58 (citing 26 U.S.C. §6708)—and was fully candid by disclosing all that it knew.

Even if DB's disclosure could be attacked for failing to contain information that it could not *possibly* have contained, the government's criticisms remain exaggerated. For example, the argument that "Beal" is not Beal's "name," Gov't Br. 43-45, is nonsensical. A surname is a person's name, as a court held long ago in concluding that a surname alone was the "name of an individual" within the meaning of a federal trademark statute, *American Tobacco Co. v. Wix*, 62 F.2d 835, 837 (C.C.P.A. 1933). And the number of Beals *nationwide* is beside the point. The IRS's audit strategy surely does not rely solely on the phone book.

The same is true of the government's complaint that the list gave the partnerships' address as "Dallas" rather than "Plano." Plano is in the Dallas-Fort-Worth metropolitan area, and it was not clearly erroneous for the district court to conclude that the list's reference to Dallas was "a partial address for the partnerships at issue" here. R.6001/Op.37.

Finally, the regulation did not require the disclosure of any information about *Beal* at all. Only the name, address, and TIN "of each *investor*" need be disclosed. The regulation uses the term "list of investors," 26 C.F.R. §301.6112-1T (preliminary material before Q-1) interchangeably with "persons who acquire interests in the tax shelter," *id*. (A-8(a)). Here, *Bemont* was the "person" that acquired the interest in the purported tax shelter because it "paid consideration" for "services necessary to the organization or structure of such tax shelter." *Id*. (A7(c)). Hence, Beal's name, address, and TIN were not necessary.

b. "Tax Analysis Or Opinions ... Given ... By The Organizer Or Seller"

The government argues that the Section 6112 list "'must contain' copies of (among other things) 'tax analyses or opinions' relating to the tax shelter," Gov't Br. 50, so that DB was required to give the IRS a draft tax opinion it allegedly received from Coscia. But the regulation actually requires the production of such materials "that have been given *to* any potential participants in the tax shelter or to any representatives, tax advisors, or agents of such potential participants *by the* *organizer or seller* or by any other person who has participated in the offering of the tax shelter (excluding any written materials that the organizer or seller has never possessed)." 26 C.F.R. §301.6112-1T A-17(a)(9) (emphasis added). There is no record of any such opinions *by* DB.

c. Description Of The Purported Tax Shelter

The government argues that the DB production was insufficiently detailed, and therefore is not a "detailed description of the tax shelter that describes both the structure of the tax shelter and the intended tax benefits for participants in the tax shelter." Gov't Br. 48-49 (quoting 26 C.F.R. §301.6112-1T A-17(a)(7)). Viewed in context, however, the information DB provided was plainly adequate.

The district court found that DB "identified BPB and Bemont, and, as to BPB or [Bemont], the account number for buy and sell, the foreign exchange amount, the foreign exchange rate, the USD involved, the trade and sell dates, and the percentage sold." R.5994/Op.30. Moreover, DB produced the 2005 lists under a cover letter indicating that the documents were "responsive to IRS summons headed 'Son of Boss/Digital Options', dated October 20, 2004." Ex P. 2100, p.2; *see also* R.5993/Op.29 ("information was furnished as part of the Government's investigation of Son of Boss transactions"). The cover letter's reference to Notice 2000-44 thus incorporated the IRS's own general description of the structure and intended tax benefits of the transactions targeted by that notice. *See* IRS Notice

2000-44, 2002-2 C.B. 255. The 2005 lists then provided additional details to flesh out that description.

2. In Any Case, Substantial Compliance Is Sufficient

Even if DB's disclosure did not comply with every jot and tittle of the (invalid) temporary regulation, its compliance sufficed to trigger the statute of limitations. Courts have repeatedly "determined that a taxpayer has substantially complied with a statute of the tax code, even though he failed to follow the strict procedures ... set forth in a regulation promulgated pursuant to the statute." *Young v. Commissioner*., 783 F.2d 1201, 1205 (5th Cir. 1986) (citing *American Air Filter Co. v. Commissioner*, 81 T.C. 709, 719 (1983)); *see also Branum v. Commissioner*, 17 F.3d 805, 810 n.15 (5th Cir. 1994).

In *American Air Filter*, the taxpayers failed to file an "election statement" required by IRS regulations to exclude income under subpart F. 81 T.C. at 718. The court held that circumstances "permit[ted] less-than-literal compliance with regulatory requirements," looking principally to three factors: "whether the taxpayer's failure to comply fully defeats the purpose of the statute," *id*. at 719, 720-21; "whether the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with his original action or omission," *id*. at 719, 721-722; and "whether the Commissioner is prejudiced by the untimely election," *id*. at 719, 722.[8]

Those factors amply demonstrate substantial compliance here:

- DB's disclosure did not "fully defeat[] the purpose of the statute." *Id*. at 719. Rather, it *complied* with the central requirement of identifying the taxpayers.

- The partnerships are not "adopting a position inconsistent with [their] original action or omission." *Id*. at 719. They have always maintained that DB's disclosure was sufficient.

- Nor is the IRS "prejudiced," *id*. at 719, by any technical defects. The district court found that the IRS knew about the transactions all along, and "decided not to pursue these transactions." R.6006/Op.42.

In several contexts, courts have recognized that "the statute of limitations [is] satisfied where the plaintiff's actions were in 'substantial compliance'" with the relevant rules. *Cannon v. Kroger Co.*, 837 F.2d 660, 667 n.12 (4th Cir. 1988); *see also Jones v. Bertrand*, 171 F.3d 499, 504 (7th Cir. 1999); *Early v. Bankers Life & Cas. Co.*, 959 F.2d 75, 80 (7th Cir. 1992); *Jaworowski v. Ciasulli*, 490 F.3d 331, 335 (3d Cir. 2007); *Wood-Ivey Sys. Corp. v. United States*, 4 F.3d 961, 966 (Fed. Cir. 1993). Here, DB's lists gave the government enough information to identify

[8] *American Air Filter* noted that prior cases had also looked to "whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default; and whether the regulation provided with detailed specificity the manner in which an election was to be made," 81 T.C. at 719-720, but the Court did not apply those factors.

the transactions, and gave the government actual notice. Holding those lists insufficient would exalt form over substance.

3. The Government Has Conceded That Substantial Compliance Is Sufficient

Any doubt that substantial compliance were sufficient would be settled by the government's concessions in this case. The government produced Section 6112 lists that it received from DB in *2007*. The government's declarant, agent Jeanne Whitney, swore that those lists were "maintained by [DB] pursuant to 26 U.S.C. §6112." Ex.P-102, p.3. And the government's lawyers similarly acknowledged that those lists were sufficient to "comply[] with the regulation's requirements." R.5742.

But the 2007 lists contain the *very same omissions* the government criticizes in the 2005 lists. The government attacks the lack of TINs in the 2005 list, Gov't Br. 48, but the first two 2007 lists do not contain them either, and *none* contains one for Beal. Ex.P-102, at Ex.A The government complains that Coscia's draft tax opinion was not attached to the 2005 list, Gov't Br. 50, but neither was it attached to the 2007 lists. Ex.P-102, at Ex.A. The government argues that the 2005 list has an insufficiently "detailed description," Gov't Br. 48-49, but the 2005 list was *more* informative than the 2007 lists: DB explicitly produced the former as relating to a "Son of Boss" transaction, Ex.P-2100, p.2, while the 2007 lists merely include the label "FX Swaps." P.102, at Ex.A. At the very least, the government's concession confirms that substantial compliance triggers the limitations period under §6501(c)(10).

4. The Government Concealed Information

The government's argument fails for another reason. Plaintiffs still do not know what other information the government received from DB, because the government has refused to produce it. The 2005 lists that the trial court found dispositive were *never* produced from the IRS's files. Even after the government produced copies of the two lists after DB produced them again in response to a subpoena, the government withheld information that would have allowed plaintiffs to determine when the lists had been produced. Plaintiffs could make that connection only after obtaining third-party discovery from DB. The government repeatedly concealed critical facts regarding these lists from the trial court; it may have concealed more. Similarly, the government has *still* never produced the summons issued by the IRS to DB. *For all the record reveals*, the summons makes explicit that the government already contemplated Son-of-Boss transactions with particular structures and tax benefits, and needed DB only to fill in the blanks—as DB did.

These concealments are not trifles. As we explain below, *see* pp.47-56, *infra*, the government's discovery abuse provides an independent basis for affirmance. But that misconduct also provides further reason to reject the government's hypertechnical reading of the regulation. The government bore the burden of proof, *Payne*, 224 F.3d at 420, so it was required to show that the information it received from DB was inadequate to identify Beal and the partnerships.

5. *Auer* Deference Is Inappropriate

The government's plea for deference is unfounded. *See* Gov't Br. 50-51 (citing *Chase Bank USA v. McCoy*, 131 S. Ct. 871, 880 (2011); *Auer v. Robbins*, 519 U.S. 452, 461-62 (1997)). The government cites two cases in which the Court deferred to positions taken in amicus briefs because there was "no reason to suspect that the position ... reflects anything other than the agency's fair and considered judgment as to what the regulation required at the time this dispute arose." *Chase Bank*, 131 S. Ct. at 881.

But here the government's brief is inconsistent with the position it took *in this very case*. It said one thing about the 2005 lists and the opposite about the 2007 lists, even though they are materially indistinguishable. *Auer* deference "is inappropriate ... where the interpretation is a novel litigating position 'wholly unsupported by regulations, rulings, or administrative practice.'" *Texas Clinical Labs, Inc. v. Sebelius*, 612 F.3d 771, 777 (5th Cir. 2010) (quoting *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988)).

D. The 2005 Lists Were Properly Produced To The IRS

The government argues that, even if the *contents* of the lists provided by DB in 2005 substantially complied with the regulation, they were produced in an improper manner. The district court correctly found otherwise.

The government suggests that the lists can be ignored because they were "neither created nor maintained by [DB] as a §6112 tax-shelter-investor list," Gov't Br. 51, and because DB "did not designate" the lists when they were produced, Gov't Br. 52. As DB's cover letter makes clear, however, the lists were produced pursuant to a summons seeking just such investor lists. And there is no requirement that a Section 6112 list be expressly labeled as such.

The government argues that DB failed to "make such list available to the Secretary for inspection" 26 U.S.C. §6112(b)(1)(A), and did not comply with the regulatory requirement that the list "enable[] the [government] to determine without undue delay or difficulty the information required." 26 C.F.R. §301.6112-1T A-16. That argument also fails.

The district court found as fact that the government could and did "inspect" the lists and find the information they contained. Rejecting the argument the government now makes, the court found that "[f]or the IRS to claim that they could not use the information provided by Deutsche is patently wrong." R.6003/Op.39.

Rather, "[t]he IRS simply failed to act on and ignored the very information it sought." R.6002/Op.38. The government does not even acknowledge this finding.

The district court also found that the government "had notice of BPB and BM's participation in the digital options early on but decided not to pursue these transactions." R.6006/Op.42. So the government is arguing that it was *impossible* to know what it *did* know.

The government's challenge to the quantity of documents produced is likewise baseless. It likely received a lot of documents because it asked for a lot. Private parties in civil litigation face this burden all the time and are not freed from obligations of diligence because they have made extremely broad demands.

E. The Government's Other Arguments Lack Merit

1. The District Court's Ruling Is Consistent With Congressional Intent

Contrary to the government's protestations, nothing in the district court's ruling contravenes Congress's intent in enacting the list-maintenance requirements of Section 6112. The Seventh Circuit has explained:

> Before 1984, no systematic information was available to assist the IRS in identifying the shelters that should be investigated. The IRS could audit individual taxpayers, but such a process only randomly identified participants in potentially abusive tax shelters. The statutory registration and list-keeping provisions allow the IRS to identify more easily those transactions that it deems to be abusive and "to identify quickly all of the participants in related tax-shelter investments."

United States v. BDO Seidman, 337 F.3d 802, 809 (7th Cir. 2003) (quoting H.R. Rep. No. 98-432, pt. 2, 1351-52 (1984) (citations omitted)). In other words, the purpose of Section 6112 was to stop taxpayers from playing the "audit lottery." Gov't Br. 55.

But the transactions at issue here *were* audited—well within the limitations period—as Section 6112 anticipates. Similarly, DB's disclosure identified the transactions as "Son of Boss" transactions (the IRS's own designation), thus "allow[ing] the IRS to identify more easily those transactions that it deems to be abusive." *BDO Seidman*, 337 F.3d at 809.

Again, the district court found that the government had *actual* notice of the basic structure and benefits of the transaction and simply "decided not to pursue these transactions because there were other shelters which it wanted to pursue first." R.6006/Op.42.

2. The Statute Of Limitations Should Not Be Specially Construed

The government argues that the statute of limitations should be "'strictly construed in favor of the Government,'" Gov't Br. 60 (quoting *Badaracco v. Commissioner*, 464 U.S. 386, 392 (1984)), and that the taxpayer must demonstrate "meticulous compliance" with the regulation, Gov't Br. 60 (quoting *Lucas v. Pilliod Lumber Co.*, 281 U.S. 245, 249 (1930)).

That is not the law. *Scarborough v. Principi*, 541 U.S. 401 (2004), involved compliance with the 30-day filing period for fees under the Equal Justice Act. The government argued that the statute should be construed in its favor and demanded "meticulous compliance with each and every requirement of [the statute] within [the time period]." *Id.* at 420. But the Court held that "'limitations principles should generally apply to the Government '*in the same way that' they apply to private parties*.'" *Id.* at 421 (quoting *Franconia Assocs. v. United States*, 536 U.S. 129, 145 (2002)) (emphasis added).[9]

F. The Government's Discovery Misconduct Provides An Alternative Ground For Affirmance

At the close of trial, the partnerships moved for an order under Fed. R. Civ. P. 37(b)(2)(A)(i) sanctioning the government for discovery misconduct by deeming it established that information sufficient to trigger the running of Section 6501(c)(10)'s one-year limitations period was produced to the IRS before October 13, 2005. The district court condemned the government's discovery misconduct—finding that the court had been "misled by the Government's hyper-technical position," R.6005/Op.41, and "that the Government was not candid with the Court or opposing counsel," R.6006/Op.42—but ultimately concluded that the motion

[9] The government ignores earlier cases contradicting its theory of construction. *See Gould v. Gould*, 245 U.S. 1512 (1917) ("[S]tatutes levying taxes ... are construed most strongly *against* the government") (emphasis added); *see also The Colony, Inc. v. Commissioner*, 357 U.S. 28, 33 (1958); *Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 350 (1927).

was moot because the 2005 lists met the requirements of Section 6112. R.6006/Op.42. If this Court disagrees with that conclusion, the sanctions motion provides an alternative ground for affirming the statute-of-limitations judgment.

The decision to impose sanctions is generally committed to the district court's discretion. *See, e.g.*, *Carson v. Polley*, 689 F.2d 562, 586 (5th Cir. 1982). Where the case for sanctions is sufficiently clear, however, appellate courts have ordered their imposition, *see IDS Life Ins. Co. v. Royal Alliance Assocs., Inc.*, 266 F.3d 645, 654 (7th Cir. 2001); *Worldwide Primates, Inc. v. McGreal*, 26 F.3d 1089, 1091-93 (11th Cir. 1994), including sanctions in response to discovery abuses, *see Advanced Display Sys., Inc. v. Kent State Univ.*, 212 F.3d 1272, 1288-89 (Fed. Cir. 2000). In light of the express findings of discovery misconduct contained in the district court's opinion, this is such a case.

1. The Government Committed Discovery Misconduct

The district court's findings demonstrate that the government committed discovery misconduct. It has always been clear that the government's compliance with the statute of limitations was a pivotal issue. The government has consistently sought to obscure the issue and prevent the partnerships from obtaining needed discovery.

The government first responded to discovery requests regarding what information DB had provided to the IRS by filing Jeanne Whitney's declaration asserting that a search of the IRS's records did not reveal that any lists pertaining to the partnerships had been produced to the IRS under Section 6112 before February 2007. Ex.P-102, p.3-4. The government sought to limit further discovery on the issue, seeking a protective order on the ground that "[t]he Whitney declaration provides the relevant dates." R.2095. At the hearing on the motion, government counsel asserted that he had made the need for accurate discovery "very clear" to the IRS, and that he was not aware of any list produced to the IRS before 2007. 5/28/08 Tr.79.

Those representations were (at best) highly misleading. In May 2005, DB had produced to the IRS the two lists identifying Bemont and BPB that the district court would ultimately conclude were sufficient under Section 6112. *See* Ex.P-108A; Ex.P-117A. DB also produced copies of the same lists to the Department of Justice team *litigating this case* on November 2, 2007—more than five months before the protective order was sought, and six months before the hearing. *See* Ex.P-2203, at Ex.A-1, 14. Although the government turned over copies of the lists to the partnerships, the lists did not disclose that they had previously been produced to the IRS in 2005.

The government persisted in its misstatements. The court ordered government counsel to check again whether Bemont or BPB had appeared "on a currency swap list that was furnished prior to 2007." 5/28/08 Tr.80; *see also*

R.2811. Whitney issued a second declaration, in which she asserted that another search did not locate any additional lists. Ex.P-103. That erroneous answer violated the court's order to produce any "currency swap list that was furnished prior to 2007" on which Bemont or BPB appeared. 5/28/08 Tr.80.

The government's response was a calculated gambit, not a mistake. The district court explicitly found that the government "was not candid and consistently relied on hyper-technical positions in order to not cooperate in discovery." R.6003/Op.39.

Subsequent events confirm the intentional nature of the government's violation of the court's discovery order. The government continued to frustrate plaintiffs' attempts to obtain crucial statute-of-limitations evidence through third-party discovery of DB—the only way plaintiffs ultimately determined when DB had produced the 2005 lists to the IRS. The government insisted that, "[b]ecause the parties already have copies of [DB's] records relating to the Swaps transaction at issue, Plaintiffs' document subpoenas ... plainly serve no rational purpose." R.2948. Although the government had never disclosed to plaintiffs when the 2005 lists had been produced—and had misled plaintiffs by claiming that no list identifying them had been produced before February 2007—the government falsely assured that the third-party subpoenas "would yield no evidence that could affect the outcome of this litigation." R.2949.

The obstruction continued through trial. Although in August 2009 plaintiffs at last received a copy of DB's cover letter for its 2005 production to the IRS—which would allow plaintiffs to establish when the lists were produced to the IRS—DB's document production in this litigation were made with different Bates numbers from those referenced on the cover letter. Consequently, it was initially impossible for the partnerships to tie the lists to the numbers in the original cover letter. The government had all versions of the documents in its possession, but refused to stipulate that they were the same. The 2005 lists were admitted into evidence only over the government's objection. *See* 3/8/10 Tr.37-62; *see also* R.6004/Op.40 (criticizing the government for "object[ing] to the introduction of documents which it had clearly received but never produced").

2. Deeming Established Facts Sufficient To Trigger Section 6501(c)(10)'s One-Year Limitations Period Is The Necessary Sanction

a. A party's failure to obey a discovery order authorizes the district court to "issue further just orders," including one "directing that the matters embraced in the order or other designated facts be taken as established for purposes of the action." Fed. R. Civ. P. 37(b)(2)(A)(i). As this Court observed in affirming such an order against the government, that sanction is justified if it is "just" and "specifically relate[s] to the particular claim which was at issue in the order to provide discovery." *Chilcutt v. United States*, 4 F.3d 1313, 1320-21 (5th Cir.

1993) (internal quotation marks omitted). The sanction must also "meet the Rule 37 goals of punishing the party which has obstructed discovery and deterring others who would be inclined to pursue similar behavior." *Id.* at 1321. All those requirements are satisfied here.

The sanction is fair. As in *Chilcutt*, 4 F.3d at 1321, the government was warned that misconduct could result in a sanction. In May 2008, after ordering the government to make a second search of the IRS's records, the court warned of the consequences of "bad faith." 5/28/08 Tr.81. Later, the court warned the government again. *See* 3/4/10 Tr.33.

The sanction is also fair because the partnerships "struggled for ... over two years to obtain sufficient [statute-of-limitations] discovery" from the government. *Compaq Computer Corp. v. Ergonome Inc.*, 387 F.3d 403, 413 (5th Cir. 2004). During that time, the government engaged in "abusive practices for the sole purpose of frustrating [their] ability to extract the discovery." *Id.* at 414. The government "not only intentionally withheld" critical information, "but it also made blatant misrepresentations to the court." *Chilcutt*, 4 F.3d 1322-23.

Even now, no one can be confident that all the relevant evidence has been produced. For all we know, DB may have produced *even more* pertinent information by 2005, and the government may *still* be sitting on it.

The sanction is closely related to the government's violations. *See Chillcut*, 4 F.3d at 1320. The partnerships' requests for documents showing what information DB had disclosed to the IRS were meant to support their statute-of-limitations argument. The government withheld the *very* evidence the district court found dispositive. *See Compaq*, 387 F.3d at 414 (upholding deemed finding of corporate veil piercing, since "[t]he purpose of the discovery, from its very inception, was to discover facts that would support a finding of alter ego").

Finally, the sanction would serve the Rule 37 goals of punishment and deterrence. *Chillcut*, 4 F.3d at 1321. The trial is over. The damage is done. It is impossible to use a lesser sanction to urge compliance. Deeming the relevant facts established is the only way to punish the government's serious misconduct and deter similar misconduct in the future. *Id.* at 1325.

b. Below, the government offered two principal arguments against sanctions. Neither has merit.

First, the government argued that, because granting the sanctions motion would prevent the government from recovering taxes or penalties for 2001, the motion should face special hurdles applicable to orders *dismissing claims* as a discovery sanction. *See* Fed. R. Civ. P. 37(b)(2)(A)(ii). But there is no reason to impose such a requirement.

In *Marshall v. Segona*, 621 F.2d 763 (5th Cir. 1980), this Court suggested that an order deeming facts established "will be tantamount to dismissal in some cases." *Id.* at 766 n.3. But this is not such a case. *Marshall* involved an *actual* order of dismissal that terminated the entire litigation in the defendants' favor. *See* 621 F.2d at 766. But the sanction plaintiffs requested here would apply only to the 2001 tax year—the one to which the government's discovery violations "specifically relate." *Chilcutt*, 4 F.3d at 1320. The disputed taxes and penalties for 2002 would be unaffected.

Even if the partnerships *had* sought a sanction applicable to both years, the footnote in *Marshall* was *dicta*. That case involved an actual order of dismissal, not a motion to deem facts. Similarly, though the *Chilcutt* Court appeared to *assume* that an order deeming facts established that decided all litigation in one party's favor could be subject to the same prerequisites as an order of dismissal, *see* 4 F.3d at 1320, the assumption was again *dicta*. The Court concluded that the order at issue there did *not* decide the litigation in the plaintiff's favor. *See id.*

In any event, any heightened standard would be met here. There is a "clear record of delay or contumacious conduct" on the part of the government. *SEC v. First Houston Capital Resources Fund, Inc.*, 979 F.2d 380, 382 (5th Cir. 1992) (internal quotation marks omitted). The government's obstruction resulted in a two-year delay before plaintiffs received the information to which they were entitled—which the government had all along. There is also every indication that the government's discovery misconduct was the result of bad faith. *Marshall*, 621 F.2d at 767 n.8. As the court found, the government "consistently relied on hyper-technical positions in order to not cooperate in discovery." R.6003/Op.39. An order deeming the relevant facts established is the only way to punish and deter future misconduct, and is therefore the necessary "remedy of last resort." *FDIC v. Connor*, 20 F.3d 1376, 1380 (5th Cir. 1994) (internal quotation marks omitted).

The government also argued below that the sanctions motion should be denied because the proposed facts were "wholly inconsistent" with the evidence in the case. R.5906. But this Court has rejected that argument before, holding that the sanction of deeming facts established may be warranted even though a party has belatedly complied with a discovery order—and thus belatedly allowed the concealed evidence to be admitted. *Chilcutt*, 4 F.3d at 1318-19. Indeed, the misconduct in this case is even more egregious than the one in *Chilcutt*, because the government has *never* complied with its discovery obligations. The partnerships were able to obtain information about the 2005 lists only through third-party discovery.

In sum, the government's discovery misconduct should be sanctioned with an order deeming established that the IRS had enough information to trigger the one-year limitations period before October 13, 2005. The matter is clear enough for this Court to affirm on that basis. If this Court does not affirm, it should at a minimum remand the case so that the district court may decide how to sanction the government's misconduct.

II. The District Court Correctly Determined That Valuation Misstatement Penalties Were Inapplicable

A. The Understatement Is Not Attributable To A Valuation Misstatement

The valuation misstatement penalties that the government sought to impose apply only if the taxpayer makes an "underpayment which is attributable to ... [a] substantial [or gross] valuation misstatement." 26 U.S.C. §6662(b)(3), (h)(1). But this Court has held that a tax "underpayment is *not* attributable to a valuation overstatement" when "the I.R.S. totally disallows a deduction or credit." *Heasley v. Commissioner*, 902 F.2d 380, 383 (5th Cir. 1990) (emphasis added). "In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit." *Id.*; *accord Todd v. Commissioner*, 862 F.2d 540, 543 (5th Cir. 1988). The IRS and the district court *did* "totally disallow" Bemont's claimed deduction. The penalty is therefore inapplicable.

The district court correctly recognized this, R.5444-46, and the government does not dispute that *Heasley* forbids valuation misstatement penalties here. *See* Gov't Br. 66-68. Instead, the government asks this Court to overrule *Heasley* on the basis of a 19-year-old regulation, 26 C.F.R. §1.6662-5, 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," and that "[t]here is a gross valuation misstatement with respect to such property." 26 C.F.R. §1.6662-5(g). This attack on *Heasley* is flawed for multiple reasons.

First, by its own terms, the regulation does not apply. The parts of the regulation the government cites state how to determine the *amount* of a misstatement in certain cases. But they do not determine *when* a penalty applies. The first section clarifies that a valuation misstatement penalty is applicable only "[i]f any portion of an underpayment ... is *attributable to* a substantial [or gross] valuation misstatement." 26 C.F.R. §1.6662-5(a) (emphasis added). The government never *mentions* this section of the regulation, even though, as the district court observed, that language was the express basis of *Heasley*'s rejection of such penalties. 902 F.2d at 383; R.5446.

The language the government now cites was instead designed to solve a basic mathematical problem. A gross valuation misstatement exists "if the ... adjusted basis of any property claimed on a return ... is 400 percent or more of the correct amount." 26 C.F.R. §1.6662-5(e)(2). If an asset's correct basis is zero, the formula requires division by zero, a mathematical impossibility. The regulation sensibly addresses this problem by providing that, in zero-basis cases, the "gross" valuation misstatement penalty applies—but *only if* the underpayment is otherwise attributable to a valuation misstatement. 26 C.F.R. §1.6662-5(a).

The government counters that 26 C.F.R. §1.6662-5(g) must be understood to overrule *Heasley*, because otherwise it would be a "nullity." But that argument proceeds from an erroneous premise—namely, that under *Heasley* "the penalty can never apply if the correct basis is zero," Gov't Br. 70. In some cases, the *only* basis for disallowing a deduction is that the correct adjusted basis of a piece of property is zero. Indeed, the example given in the regulation the government relies upon is just such a case. If a corporation fully depreciates an asset so that its basis is zero, and then claims a further depreciation deductions, *see* 26 C.F.R. §1.6662-5(d) (example 3), that valuation misstatement is subject to the gross valuation misstatement penalty. In that situation, the taxpayer's underpayment is not "attributable to claiming an improper deduction or credit," *Heasley*, 902 F.2d at 383, for any reason independent of the fact that the property's correct basis is zero. *Heasley* and *Todd* do not apply because there is no separate invalidation of the entire transaction.

In light of all this, it is not surprising that courts have continued to apply the *Heasley* rule long after the adoption of 26 C.F.R. §1.6662-5. *Weiner v. United States*, 389 F.3d 152, 161 (5th Cir. 2004); *Keller v. Commissioner*, 556 F.3d 1056, 1060-62 (9th Cir. 2009); *Alpha I, L.P. v. United States*, 84 Fed. Cl. 622, 626-32

(2008); *Klamath Strategic Inv. Fund LLC v. United States*, 472 F. Supp. 2d 885, 899-900 (E.D. Tex. 2007).

The government dismisses *Weiner* because "the Court was not presented with—and therefore did not address"—the government's new argument. Gov't Br. 69 n.29. Of course it did not, because the government had not invented it yet. That is an overly grudging view of this Court's ability to establish precedent. *Cf. NRA v. City of Chicago*, 567 F.3d 856, 857-58 (7th Cir. 2009) ("If a court of appeals could disregard a decision of the Supreme Court by identifying, and accepting, one or another contention not expressly addressed by the Justices, the Court's decisions could be circumvented with ease."), *rev'd on other grounds, approved in relevant part*, 130 S. Ct. 3020, 3027 (2010). In any event, the reason the government has taken so long to float this novel reading of the regulation is that it cannot withstand scrutiny.

B. No Deference Is Due

The government contends that it is owed *Auer* deference in interpreting §1.6662-5. Gov't Br. 71 (citing *Auer v. Robbins*, 519 U.S. 452, 461-62 (1997)). But no deference is due. First, *Auer* deference does not apply if the government's interpretation is "inconsistent with the regulation." *Auer*, 519 U.S. at 461 (internal quotation marks omitted). Nor does *Auer* apply to a "*post hoc* rationalization advanced by an agency seeking to defend past agency action against attack." *Id*. at

462 (internal quotation marks omitted). Yet, as explained above, the government's interpretation is *both* inconsistent with the regulation *and* a post hoc rationalization.

Deference is also inappropriate because the crucial phrase of §1.6662-5 merely repeats the language of 26 U.S.C. §6662(b). Both the statute and the regulation impose the penalty only if it is "attributable to" a "valuation misstatement." 26 U.S.C. §6662(b); 26 C.F.R. §1.6662-5(a). When an agency "has elected merely to paraphrase the statutory language," it is not entitled to *Auer* deference. *Gonzales v. Oregon*, 546 U.S. 243, 257 (2006). "[A]n agency is not entitled to additional deference when its 'interpretation' of the statute simply repeats the statute's language." *La Union Del Pueblo Entero v. FEMA*, 608 F.3d 217, 222 (5th Cir. 2010).

Finally, the government suggests that other circuits have agreed with its interpretation of the regulation. Gov't Br. 71. But that is false. No court has *ever* found 26 C.F.R. §1.6662 to overrule a prior precedent interpreting the "attributable to" requirement. In every case the government cites, the court sided with the government only because it already interpreted the *statute* differently than this

Court's precedent has long required. *See* Gov't Br. 67 n.27, 71. No court has ever credited its novel reading of the *regulation*.[10]

III. The District Court Erred In Upholding The IRS's Imposition of Substantial-Understatement And Negligence Penalties

The government persuaded the district court that the transaction at issue here was substantially similar to those deemed improper by IRS Notice 2000-44, and, while respectfully disagreeing, we have not appealed that fact-intensive ruling. But it does not follow that that conclusion was inescapable, or that the partnerships can be penalized for thinking otherwise. Indeed, the government's *own* Rule 30(b)(6) witness acknowledged that the transaction *was not* substantially similar to other Notice 2000-44 transactions he had investigated. The partnerships reached the same conclusion in reliance on detailed professional advice. The partnerships therefore had substantial authority for their tax position; did not act negligently in adopting it; and acted with good faith and reasonable cause.

A. Substantial Authority Supported The Tax Treatment

Section 6662(b)(2) of Title 26 imposes a 20% penalty on "the portion of any underpayment which is attributable to ... [a]ny substantial understatement of income tax." There is no penalty, however, "if there is or was substantial authority

[10] Even if the Court concludes that *Heasley* and *Todd* should be overruled, the penalties would be inapplicable because Beal and Montgomery acted in good faith and with reasonable cause, *see* pp.69-73, *infra*, which is a defense to all penalties.

for such treatment." 26 U.S.C. §6662(d)(2)(B). The substantial-authority standard is an "objective standard involving an analysis of the law and application of the law to relevant facts," 26 C.F.R. §1.6664-4(d)(2). It asks whether "the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." 26 C.F.R. §1.6662-4(d)(3)(i). It does *not* require that a tax treatment be likely to prevail; it need only be well supported. 26 C.F.R. §1.6662-4(d). The partnerships satisfied that standard.

The district court's first error was not even addressing the partnerships' argument, R.5628, that substantial authority supported their tax position. The district court rejected the underlying tax treatment in the first portion of its opinion. But ultimately deeming a tax treatment incorrect does not answer whether the taxpayer had substantial authority for it. *See, e.g.*, *Streber v. Commissioner*, 138 F.3d 216, 218-19, 223 (5th Cir. 1998) (upholding substantial-authority defense even though taxpayers did not challenge disallowance of underlying tax benefits). The opinion never examines the *objective legal basis* of the Coscia opinion, only the *separate* defense of good faith, *see* pp.69-73, *infra*. The court should have examined both and recognized that the partnerships had substantial authority.

1. Substantial Authority Indicated That The Swaps Did Not Affect BPB's Basis

In analyzing the swap contributions, the partnerships followed longstanding authority governing the calculation of a partner's outside basis (its basis in its partnership interest). The initial step of the outside-basis calculation was for the long swaps. BPB's outside basis was the cost of the property it contributed: the $202,500,000 paid for the long swaps and the $4,000,000 paid for the Solution 6 shares. *See* 26 U.S.C. §722 ("The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution."); *id*. §1012 ("The basis of property shall be the cost of such property").

The next step is to consider whether contribution of the short swaps affected the basis calculation. Under 26 U.S.C. §752(b), "any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership" and reduce the partner's basis accordingly, *id*. §733. The question was whether the *contingent possibility* that BPB *might* have to make a payment under the short-swap position was a "liability" under Section 752. Three decades of substantial authority said it was not.

Before the promulgation of regulations in 2003 (*after* these transactions), there was "no statutory or regulatory definition of liabilities for purposes of section 752." 68 Fed. Reg. 37,435 (2003). But the consensus view before 2003 was that "contingent liabilities were simply ignored for §752 purposes." William S.

McKee, William F. Nelson, et al., *Federal Taxation of Partnerships and Partners* §7.04. Indeed, a number of recent decisions have observed that, prior to the 2003 regulations, a long line of administrative and judicial authority instructed taxpayers that contingent liabilities were not to be taken into account when calculating a partner's outside basis. *See Klamath Strategic Inv. Fund LLC v. United States*, 440 F. Supp. 2d 608, 614-17, 620 (E.D. Tex. 2006); *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 521-22 (2009); *Stobie Creek Invs. LLC v. United States*, 82 Fed. Cl. 636, 664-67, 668 (2008); *Sala v. United States*, 552 F. Supp. 2d 1167, 1197, 1202 (D. Colo. 2008), rev'd on other grounds, 613 F.3d 1249 (10th Cir. 2010).

In a foundational Revenue Ruling, the IRS determined that the term "liability" in Section 752 did not include "unrealized receivables." Rev. Rul. 73-301, 1973-2 C.B. 215. Instead, "[t]he liabilities referred to in section 752 ... are those liabilities which arise from a debtor-creditor relationship with a *sum certain* due at a *fixed or determinable* date of maturity." IRS Gen. Couns. Mem. 33,948 (Oct. 22, 1968) (emphasis added).

The Tax Court agreed that liabilities under Section 752 cannot be contingent. In *Helmer v. Commissioner*, 34 T.C.M. (CCH) 727 (1975), the court held "no liability arose under section 752" because "[t]he option agreement" in question "created no liability on the part of the partnership to repay the funds paid nor to perform any services in the future." That doctrine was repeatedly confirmed. *Long v. Commissioner*, 71 T.C. 1 (1978), held that unresolved legal claims against a partnership did not create Section 752 liabilities because "contingent or contested liabilities ... are not 'liabilities' for partnership basis purposes at least until they have become fixed or liquidated." *Id.* at 7. *La Rue v. Commissioner*, 90 T.C. 465, 479-80 (1988), rejected a taxpayer's efforts to treat reserves for potential liabilities as Section 752 liabilities, because the amounts were contingent.

Thus, when the partnerships filed their returns, clear authority held that contingent obligations do not affect a partner's outside basis. The short-swap position here was likewise contingent—Bemont had no obligation to pay DB unless the value of the Australian dollar appreciated above the strike price.

In nonetheless concluding that those swaps *were* liabilities, the district court relied on *Kornman & Assocs., Inc. v. United States*, 527 F.3d 443 (5th Cir. 2008), which held that the obligation to close a short sale is a liability under Section 752. R.5984/Op.20. But its reliance on *Kornman* was based on the premise that Bemont's obligations were not truly contingent. R.5984/Op.20. That was wrong—Bemont in fact *did not* make any payment, because the Australian dollar did not appreciate above the strike price. Moreover, even if the court was correct to extend *Kornman*'s holding in the short-sale context to currency swaps, that would not undermine the partnerships' substantial-authority defense. *Kornman* was decided in 2008, long after the tax returns at issue here were filed. Such after-the-fact authority cannot be the basis for penalties. *See* 26 C.F.R. §1.6662-4(d)(3)(iv)(C) ("at the time the return containing the item is filed").

Indeed, that decision *confirms* that the partnerships' tax treatment of the swaps accorded with settled law. *Kornman* emphasized that a short sale is a "unique transaction," and painstakingly *distinguished* the transaction at issue there from the ones in *Helmer*, *Long*, *LaRue*, and Revenue Ruling 73-301. 527 F.3d at 461-62. The Court thereby *confirmed* that those rulings otherwise reflected the settled understanding of the scope of partnership liabilities under Section 752.

2. Substantial Authority Indicated That The Swaps Had Economic Substance

Nor does the district court's factbound determination that the swap transaction lacked economic substance imply that the partnerships lacked substantial authority. The court's list of reasons for concluding that the swap transaction lacked economic substance, *see* R.5981-84/Op.17-20, distills into two themes—that the swaps were not actually linked to a takeover bid for Solution 6 and therefore lacked a business purpose, *e.g.*, R.5981-82/Op.17-18, and that "[t]here was no reasonable expectation of profit from the transaction." R.5984/Op. 20.

Even if those findings were correct, they would not undermine the substantial-authority defense. This Court has held that "'there is substantial authority from a factual standpoint for the taxpayer's position'" so long as there is "evidence going both ways." *Streber*, 138 F.3d at 223 (quoting *Osteen v. Commissioner*, 62 F.3d 356, 359 (11th Cir. 1995)). "'Only if there was a record upon which the Government could obtain a reversal under the clearly erroneous standard could it be argued that from an evidentiary standpoint, there was not substantial authority.'" *Id.* (quoting *Osteen*, 62 F.3d at 359).

Although the district court did not agree with Beal and Montgomery's testimony regarding the purpose of the swaps, there is no question that it *could permissibly* have done so. Likewise, expert testimony that the value of the swaps was roughly $2.2 million and that they had a roughly 6.75% chance of profit, Tr.259, 262, means at the least that the district court *could* have found that the swaps "presented a reasonable possibility of profit." *Klamath*, 568 F.3d at 545; *see also* Tr.253-54, 269, 271. Moreover, the swaps provided risk protection necessary under Australian law, *see* p.8, *supra*, and were therefore "compelled or encouraged by business or regulatory realities." *Frank Lyon Co. v. United States*, 435 U.S. 561, 583 (1978). This is thus not a case with facts so one-sided that "the Government could obtain a reversal under the clearly erroneous standard," *Streber*, 138 F.3d at 223 (quotation marks omitted), on the factual issues underlying the substance of the swaps.

Indeed, the evidence was overwhelmingly in the partnerships' *favor*. Beal and Montgomery testified that the swaps had a specific business purpose: hedging against foreign currency risk inherent in the contemplated acquisition of Solution 6. Tr.104-09, 546-49. *No* documentary evidence or fact witness contradicted that testimony, and as noted above, expert testimony established a reasonable possibility of profit.

3. The Losses Were Bona Fide

Finally, the district court reasoned that the losses claimed by the partnerships were "not bona fide deductible losses" because they did not "correspond to actual economic losses." R.5984/Op.20. But that ground was neither raised in the FPAAs nor advanced at trial, for good reason: Whether tax losses correspond to "economic losses" is not a litmus test for deductibility. Since *Crane v. Commissioner*, 331 U.S. 1 (1947), for example, a taxpayer has been allowed to include in his cost basis the principal amount of an encumbering mortgage, even if the taxpayer is not personally liable for the mortgage. *Id.* at 9-10. The taxpayer may then claim depreciation deductions—*i.e.*, tax losses—using that basis figure. Thus, a taxpayer who borrows $99,000 and invests $1,000 in cash to purchase a building can claim depreciation deductions based on the building's full $100,000 value—even though the depreciation deductions will far exceed any "economic loss" actually experienced.

B. The Partnerships' Position Was Not Attributable To Negligence

Because the partnerships satisfy the substantial-authority standard, the 20% penalty for "the portion of any underpayment which is attributable to ... [n]egligence or disregard of rules of regulations," 26 U.S.C. §6662(b)(1), also cannot be imposed. A position supported by substantial authority is not attributable to negligence. 26 C.F.R. §§1.6662-3(b)(1), (b)(3), (d)(2); R.5990/Op.26. From the existence of substantial authority (established above), it follows that the negligence penalty is inapplicable too.

C. The Partnerships Acted In Good Faith And With Reasonable Cause

The district court further erred in concluding that the partnerships did not act "in good faith" and with "reasonable cause"—a complete defense to all penalties. 26 U.S.C. §6664(c)(1). The defense turns on "the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." 26 C.F.R. §1.6664-4(b)(1). If taxpayers have relied on professional tax advice, "the validity of this reliance turns on 'the quality and objectivity of the professional advice which they obtained.'" *Klamath*, 568 F.3d at 548 (quoting *Swayze v. United States*, 785 F.2d 715, 719 (9th Cir. 1986)).

1. The Court Ignored The Quality Of Coscia's Opinion

The district court overlooked abundant evidence of the "quality" of Coscia's 135-page opinion, which contained an in-depth analysis of the economic-substance doctrine and related judicial doctrines as they applied to the swaps transaction. *See* Ex.P-2013, pp.BPB000093-108. Coscia distinguished precedents finding transactions to lack economic substance, Ex.P.2013, p.BPB000095-97, and relied on several cases in which taxpayers had prevailed against economic-substance challenges, *see* Ex.P-2013, pp.BPB000097-101. The opinion also contained an exhaustive discussion of *Helmer* and related precedents dealing with the calculation of a partner's outside basis. Ex.P-2013, pp.BPB000066-75; *see also* pp.62-65, *supra*. In short, the Coscia opinion anticipated and analyzed (in detail) the legal issues related to the tax treatment of the swaps. Yet the district court did not critique the quality of the opinion *at all*.

The court also ignored the uncontradicted expert testimony of David Weisbach, a tax professor at the University of Chicago Law School, Tr.434-35. In his expert opinion, "the Coscia opinion met with the ordinary standards for ... opinions of this sort within the community" of tax professionals. Tr.440-41. Professor Weisbach "thought the opinion was actually quite good," adding that it "did a particularly good job applying the Economic Substance Doctrine." Tr.444.

The court did not *mention* Professor Weisbach's testimony—much less offer reasons for discounting it.

2. The Court Was Wrong To Doubt Coscia's Objectivity

In assessing Coscia's objectivity—the court's almost exclusive basis for imposing penalties—the court stressed that Coscia was paid $150,000 for the opinion. R.5989/Op.25/¶112. But Coscia testified without contradiction that he spent *several hundred* hours working on the opinion. Tr.365. The court did not appear to consider whether this was a reasonable payment for such significant work.

Similarly, the court criticized Coscia for having used portions of a prior opinion prepared by a law firm, declaring that "Coscia did little independent research." R.5989/Op.25/¶113. But Coscia testified without contradiction that, although he *used* that opinion, he did so only after spending hundreds of hours independently analyzing the substance of that opinion and the authorities it cited. Tr.365, 393. Indeed, his research binder contained more than 1,500 pages of research materials. Ex.P-2010, pp.BPB000280-1796. Professor Weisbach testified that the use of the prior opinion was beside the point. As he explained, "[w]hat matters is whether [Coscia] did the research and believed the advice to be correct." Tr.449. In any event, the court did not find that the partnerships had any reason to know that Coscia had worked from another opinion. And the reasonableness of *their* reliance on Coscia's advice is the ultimate issue. *See American Boat Co. v. United States*, 583 F.3d 471, 485 (7th Cir. 2009) (upholding good faith defense where taxpayer "had no reason to know that [his advisor] had a disqualifying conflict of interest").

The district court was equally off base in concluding that Coscia's "close association with Montgomery weigh[ed] against him rendering unbiased advice." R.5989/Op.25. The court appeared to fixate on Coscia's having previously worked with Montgomery. But Coscia worked for a different, independent accounting firm when he rendered his tax opinion. Moreover, Montgomery testified without contradiction that he selected Coscia because their time together had led him to trust Coscia's qualifications and judgment. Tr.132-33. The district court's rejection of these entirely appropriate criteria was error.

There was no other basis to conclude that Coscia did not give independent advice. No evidence suggested that Beal and Montgomery "shopped" for a favorable opinion. Nor did Coscia have a financial stake in the transaction, or participate in structuring or promoting it. *Compare Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1381-82 (Fed. Cir. 2010). And the court's passing reference to Coscia's work on other unnamed transactions "involving questionable deductions," R.5989/Op.25/¶112, is no more than speculation about transactions not in evidence. In short, the district court's finding that "Coscia gave

Montgomery what he wanted," R.5989/Op.25/¶114, was a pejorative characterization without basis in the record.

3. The Court Erroneously Penalized The Partnerships For Invoking Attorney-Client Privilege

Finally, the court erred in its treatment of the partnerships' failure to waive their attorney-client privilege for a separate tax opinion prepared by the law firm of De Castro West. The court complained that, "for some reason, Plaintiffs chose to rest their defenses on the shoulders of Coscia," and stated that, had the De Castro opinion been introduced to support the tax treatment, the court would likely have denied penalties. R.5992/Op.28.

The court may have mistakenly believed that only advice from a lawyer will satisfy the reasonable cause and good faith standard. During the trial, the court appeared to doubt that Coscia, as a certified public accountant, was equipped to understand the legal authorities he relied upon. *See* Tr.393-94, 430. But IRS regulations authorize advice from any "professional tax advisor," 26 C.F.R. §1.6664-4(c)(1), not only a lawyer, and this Court has held likewise, *Reser v. Commissioner*, 112 F.3d 1258, 1271-72 (5th Cir. 1997)

Alternatively, the court may have drawn an adverse inference from the partnerships' failure to waive their attorney-client privilege and assumed that the privileged opinion was incriminating. But that adverse inference is forbidden. *Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v. Dana Corp.*, 383 F.3d 1337, 1345 (Fed. Cir. 2004) (en banc); *Nabisco, Inc. v. PF Brands, Inc.*, 191 F.3d 208, 225-26 (2d Cir. 1999); *Parker v. Prudential Ins. Co.*, 900 F.2d 772, 775 (4th Cir. 1990).

CONCLUSION

The district court's holding that the 2001 FPAA was time-barred should be affirmed, for one of three reasons: (1) DB's 2005 disclosures satisfied 26 U.S.C. §6112's identification requirement, and did not need to conform to the invalid temporary implementing regulation; (2) in any case, the 2005 disclosures substantially complied with the temporary regulation; and (3) the government's discovery misconduct should be sanctioned with an order deeming the relevant facts established. If the Court does not affirm on any of these grounds, it should remand for the district court to consider sanctions.

The district court's holding that the government could not impose valuation misstatement penalties should be affirmed. The district court's holding that the government could impose penalties for negligence and substantial understatement of income tax should be reversed.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on May 2, 2011, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Fifth Circuit by using the CM/ECF system. Participants in the case who are registered CM/ECF users will be served by the CM/ECF system.

/s/ M. Todd Welty
M. Todd Welty

CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitations of Fed. R. App. P. 28.1(e)(2)(B)(i) because this brief contains 16,492 words (as counted by Microsoft Word 2003), excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2003 in 14-point Times New Roman typeface (except for the footnotes, which are in 12-point Times New Roman typeface).

/s/ M. Todd Welty
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