Woods: A Path Through The Penalty Maze
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In this report, Burke and McCouch discuss the Supreme Court’s Woods decision concerning partnership-level penalty jurisdiction in proceedings under the 1982 Tax Equity and Fiscal Responsibility Act, and they explore the implications of the decision for subsequent partner-level proceedings.

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Introduction

The Supreme Court’s recent Woods decision1 answers two important questions concerning the applicability of penalties when a taxpayer reports artificial losses derived from an inflated basis in a sham partnership. One issue, which has generated a split among the circuits, is whether the 40 percent penalty can apply when the transaction lacks economic substance. The second issue is whether a court has jurisdiction in a partnership-level TEFRA proceeding2 to determine the applicability of penalties triggered by a partner’s misstatement of basis in a sham partnership. The Court has answered both questions in the affirmative, thereby overruling contrary decisions by the Fifth Circuit on the substantive issue and by the D.C. Circuit on the jurisdictional issue.

The Court’s resolution of the jurisdictional issue is especially welcome, not only because it clarifies the scope and sequence of partnership-level and partner-level proceedings in TEFRA cases, but also because it opens the way for prompt and conclusive penalty determinations in a large number of pending tax shelter cases. Although the type of shelter exemplified by Woods has been effectively shut down, a host of virtually identical transactions dating from the late 1990s and early 2000s have given rise to litigation involving billions of dollars in tax underpayments and penalties. Penalties are of particular concern because they represent the only real downside of the shelters (other than transaction and litigation costs) for die-hard taxpayers who turned down settlement offers and delayed paying most of their tax liability for more than a decade during protracted partnership-level proceedings. As those proceedings finally draw to a close, the Woods decision provides a glimmer of light at the end of the tunnel and focuses attention on the final stage of proceedings at the partner level. This report focuses on penalty determinations in TEFRA cases involving sham partnerships, beginning with a brief overview of TEFRA’s two-stage procedural framework and an analysis of the jurisdictional holding in Woods. The report explores the implications of the Supreme Court’s decision for partner-level proceedings and discusses the procedural alternatives and likely outcomes in those proceedings.

Penalty Determinations in TEFRA Proceedings

The transaction in Woods is a typical example of a tax shelter, known generically as son-of-BOSS, which was extensively marketed to high-income

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2See the 1982 Tax Equity and Fiscal Responsibility Act, section 402; Taxpayer Relief Act of 1997, section 1238.
taxpayers in the late 1990s and early 2000s.\textsuperscript{3} In the paired-option version of the shelter, the taxpayer contributes cash and a pair of offsetting currency options to a newly formed partnership. Because the premium paid for the purchased (long) option is netted against the premium received for the sold (short) option, the taxpayer’s actual investment is nominal. Nevertheless, the taxpayer claims an inflated outside basis in his partnership interest based on the cost of the long option with no reduction for the cost of the short option, and that inflated basis carries over to stock and currency which the partnership distributes to the taxpayer in liquidation of his partnership interest shortly before terminating the options. The taxpayer then sells the distributed assets and reports a large artificial loss. In Woods, for example, the taxpayers reported losses of more than $45 million from sales of distributed assets, based on a purported aggregate outside basis of more than $48 million and a net investment exceeding $3 million. On closer scrutiny, the anticipated tax benefits of the shelter have proved illusory. Courts uniformly hold that the purported partnership lacks economic substance and should be disregarded as a sham. Without a valid partnership, the taxpayer cannot establish an outside basis greater than zero (or indeed, any outside basis at all). Thus, the sham finding leads ineluctably to disallowance of the reported losses.

The dispute in Woods focused not on the taxpayer’s artificial losses, which were concededly invalid, but on the applicability of penalties attributable to the underpayment of tax. Under the procedural framework established by TEFRA, the tax treatment of partnership items is determined in a unified partnership-level proceeding, and any resulting adjustment of a partner’s affected items is implemented in a subsequent partner-level proceeding.\textsuperscript{4} The purpose of this bifurcated scheme is to promote efficiency and consistency by resolving, as far as possible, all matters arising from the partnership’s existence and operations in a centralized forum in which the partnership and all the partners are represented. Accordingly, the determinations made in the partnership-level proceeding are conclusive and binding in later partner-level proceedings.\textsuperscript{5} Nevertheless, because partnerships are pass-through entities, any additional tax liability resulting from partnership-level determinations must be imposed at the partner level. The mechanism for redetermining the partners’ respective tax liabilities is a computational adjustment made at the conclusion of the partnership-level proceeding.\textsuperscript{6} If no further partner-level fact findings are needed, the changes in a particular partner’s tax liability under the computational adjustment can be directly assessed against each partner without a deficiency notice, and the partner can contest the assessment only in a refund action (in the district court or the Court of Federal Claims) after payment of the disputed tax. In contrast, if the changes require further partner-level fact findings, the partner is entitled to a deficiency notice and an opportunity to challenge the deficiency in Tax Court without prepayment of the disputed tax.\textsuperscript{7}

Before 1997, penalties were treated as affected items that had to be determined separately for each partner, resulting in duplicative partner-level proceedings with potentially inconsistent outcomes. To alleviate the administrative and judicial burden, Congress amended TEFRA in 1997 by expanding the scope of partnership-level proceedings to embrace “the applicability of any penalty . . . which relates to an adjustment to a partnership item.”\textsuperscript{8} The 1997 amendments may be viewed as putting penalties that relate to partnership-item adjustments (partnership-item penalties) on a rough parity procedurally with partnership items by allowing those penalties to be determined at the partnership level, removing them from partner-level deficiency proceedings and giving conclusive effect to partnership-level penalty determinations in subsequent partner-level proceedings.\textsuperscript{9} Because partnership-item penalties are assessable at the conclusion of

\textsuperscript{3}The acronym refers to an earlier corporate tax shelter (Bond and Option Sales Strategy). The paired-option shelter in Woods is known as COBRA (Currency Options Bring Reward Alternatives). The shelter was effectively shut down by final regulations promulgated in 2005. See reg. section 1.752-6 and -7 (preventing the use of contingent liabilities to inflate outside basis). See generally Karen C. Burke and Grayson M.P. McCouch, “COBRA Strikes Back: Anatomy of a Tax Shelter,” 62 Tax L.R. 59 (2008).

\textsuperscript{4}See section 6221. Partnership items include “any item required to be taken into account for the partnership’s taxable year . . . to the extent regulations prescribed by the Secretary provide that . . . such item is more appropriately determined at the partnership level than at the partner level.” Section 6231(a)(3); see reg. section 301.2631(a)(3)-1. Affected items include any other item “to the extent such item is affected by a partnership item.” Section 6231(a)(5); see reg. section 301.2631(a)(5)-1.

\textsuperscript{5}See section 6230(c)(4).

\textsuperscript{6}See section 6231(a)(6).

\textsuperscript{7}See section 6230(a)(2)(A)(i); reg. section 301.6231(a)(6)-1(a).

\textsuperscript{8}See sections 6221 and 6226(f). See H. Rep. No. 105-148, at 594 (1997) (noting that applying penalties in partner-level deficiency proceedings “increases the administrative burden on the IRS and can significantly increase the Tax Court’s inventory”).

\textsuperscript{9}See section 6230(a)(2)(A)(i). Whenever an adjustment to a partnership item requires an associated adjustment to an affected item, any penalty that relates to the affected item necessarily also relates (at least indirectly) to the partnership-item adjustment and is therefore properly determined at the partnership level. Nevertheless, it is possible to imagine a penalty for
partnership-level proceedings without a deficiency notice, the 1997 amendments impose significant procedural constraints on the partners’ access to judicial review of penalties in a prepayment forum.

In keeping with TEFRA’s goals of efficiency and consistency, the 1997 amendments contemplate that factual and legal determinations concerning the applicability of partnership-item penalties will be made, to the extent possible, in a centralized partnership-level proceeding. Accordingly, defenses that relate to conduct at the partnership level or are common to all partners should be asserted in the partnership-level proceeding. Some defenses, however, may be personal to a partner or dependent on a partner’s separate return and therefore not properly determinable at the partnership level. These partner-level defenses may be raised at the partner level only in a refund action after the conclusion of partner-level proceedings. Consequently, the applicability of partnership-item penalties has been determined in a partnership-level proceeding, those penalties can be directly assessed against the partners without a deficiency notice, even if a final determination of the partners’ underlying tax liability (and hence of any accuracy-related penalty) may require additional fact findings in later partner-level deficiency proceedings.

A major stumbling block in implementing the amended TEFRA scheme arose from the D.C. Circuit’s narrow view of penalty jurisdiction in partnership-level proceedings. In Petaluma, involving another son-of-BOSS shelter, the D.C. Circuit upheld the Tax Court’s finding in a partnership-level proceeding that the partnership lacked economic substance and should therefore be disregarded. However, the D.C. Circuit reversed the Tax Court’s determination of a basis-misstatement penalty for lack of jurisdiction, holding that the penalty did not “relate to” an adjustment to a partnership item. Apparently, the D.C. Circuit believed that because misstating an affected item (for example, a partner’s misstatement of his distributive share) that does not relate to any partnership-item adjustment and is therefore properly determined at the partner level.

When the Supreme Court granted certiorari in Woods, it was clearly aware of the D.C. Circuit’s Petaluma decision and concerned by its implications for penalty jurisdiction in TEFRA proceedings. In Woods, as in Petaluma and a host of similar cases, a finding that a partnership lacks economic substance ensures that the partners’ spurious outside bases will be zeroed out and most or all of the losses reported on sale of the distributed assets will be disallowed. The determination of penalties, however, raises two separate issues. The narrow issue in Woods was whether the penalty for gross misstatement of basis could be imposed when the partners had no bases in their purported partnership interests because the partnership itself was a sham. To determine that penalties apply with respect to outside basis because those penalties do not relate to an adjustment to a partnership item. We agree.”).

This issue gave rise to a split among the circuits. The lower courts in Woods, adhering to “clearly established” Fifth Circuit precedent, held that the basis-misstatement penalty did not apply when the underlying loss was totally disallowed. See Woods v. United States, 794 F. Supp. 2d 714 (W.D. Tex. 2011), aff’d, 471 Fed. Appx. 320 (5th Cir. 2012); Bemont Investments L.L.C. v. United States, 679 F.3d 339, 346-348 (5th Cir. 2012). Except for the Ninth Circuit, however, all of the other circuit courts that considered the issue reached the opposite conclusion, as did the Supreme Court. The Court rejected the argument that the underpayment of tax was attributable to the sham finding and not to a basis misstatement: “The economic-substance determination and the basis misstatement are not ‘independent’ of one another. This is not a case where a valuation misstatement is a

(Commentary / Special Report)

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See reg. section 301.6221-1(d) (Partner-level defenses are limited to those that are personal to the partner or are dependent upon the partner’s separate return and cannot be determined at the partnership level.).

See section 6230(c)(4); reg. section 301.6221-1(c); reg. section 301.6221-1(d) (Partner-level defenses to any [partnership-item penalty] may not be asserted in the partnership-level proceeding, but may be asserted through separate refund actions following assessment and payment.).

See reg. section 301.6231(a)(6)-1(a)(3).


Id. at 655 (“Petaluma argues that since the Tax Court lacked jurisdiction to determine outside basis, it also lacks jurisdiction

Footnote continued in next column.)
reach the merits of that issue, however, it was necessary first to determine that the court had jurisdiction to determine penalties in a partnership-level proceeding. The D.C. Circuit's Petaluma decision, if followed, would foreclose most if not all partnership-level penalty determinations and relegate them to multiple separate partner-level proceedings. The Federal Circuit had already followed the D.C. Circuit's lead in Jade Trading,19 and despite doubts expressed by the Tax Court on remand in Petaluma, the D.C. Circuit showed no inclination to reconsider its position.20 Accordingly, although none of the parties in Woods contested penalty jurisdiction, the Supreme Court requested briefing and argument on that issue to resolve the Petaluma problem.21

In a unanimous opinion authored by Justice Antonin Scalia, the Supreme Court reduced the issue of penalty jurisdiction to a straightforward exercise in statutory interpretation and conclusively refuted the D.C. Circuit's Petaluma decision. The relevant statutory provision confers jurisdiction on a court in a partnership-level proceeding to determine the "applicability" of any penalty that "relates to" an adjustment to a partnership item.22 Since a finding that a partnership is disregarded as a sham clearly constitutes an adjustment to a partnership item,23 a threshold question is whether the penalty relates to the sham finding. Acknowledging that the statutory language is "essentially indeterminate," the Court proceeded to examine the structure of TEFRA proceedings.24 Under the bifurcated statutory scheme, the applicability of penalties is determined at the partnership level, and penalties are subsequently imposed (subject to partner-level defenses) at the partner level. As the Court observed, imposing penalties "always requires some determinations that can be made only at the partner level," and so it makes no sense to restrict jurisdiction at the partnership level to penalties that do not require any further partner-level inquiries, for that would render penalty jurisdiction at the partnership level "meaningless."25 In effect, the Court accepted the government's argument that the sham finding provides a sufficient basis for determining penalties at the partnership level, irrespective of the need for further determinations at the partner level.

A more difficult question is how a court in a partnership-level proceeding can determine the applicability of penalties that necessarily remain subject to partner-level defenses and may require further fact findings in a subsequent partner-level proceeding. The "peculiarity" of determining in a partnership-level TEFRA proceeding that a penalty applies when "neither the amount of the penalty nor its allocation among partners is known until after the underpayment is calculated at the partner level" has not gone unremarked in the Tax Court,26 and this apparent procedural anomaly may be largely responsible for the D.C. Circuit's confused analysis in Petaluma. As the Supreme Court explained, however, it is embedded in the bifurcated scheme of penalty jurisdiction implemented by the 1997 TEFRA amendments. The statutory scheme contemplates not only that a court in a partnership-level proceeding will determine the applicability of partnership item penalties, but also that the IRS will assess those penalties immediately after the conclusion of the partnership-level proceeding, relegating the partners to a refund action (after payment) as their sole avenue for raising partner-level defenses and contesting the assessment.27 "The applicability determination is therefore inherently provisional; it

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24Woods, 134 S. Ct. at 563.
25Id. at 564; see also id. at 565 (precluding consideration of penalties at the partnership level "would replicate the precise evil that TEFRA sets out to remedy: duplicative proceedings, potentially leading to inconsistent results, on a question that applies equally to all of the partners").
26Petaluma III, 135 T.C. at 601 (Marvel, J., dissenting); see also Domulewicz v. Commissioner, 129 T.C. 11, 23 (2007) (noting the anomaly of assessing "a partnership-item penalty before the deficiency to which the penalty relates is adjudicated").
27See Pisem, "What Happened to My Prepayment Forum? The Penalty Problem in TEFRA Partnership Audit Cases," 108 J. Tax’n 269 (2008). Of course, to the extent that a partner's underlying tax liability (as opposed to a partnership-item penalty) requires additional partner-level findings, the partner (Footnote continued on next page.)
is always contingent upon determinations that the court in a partnership-level proceeding does not have jurisdiction to make.” In other words, a partnership-level determination concerning the applicability of penalties establishes only that penalties may ultimately be imposed at the partner level; it establishes the factual and legal basis, equally applicable to all the partners, for the IRS to make computational adjustments and assess penalties against the partners. Nevertheless, the final determination of a partner’s liability for a penalty (and the amount of the penalty) must be made at the partner level. This procedural sequence is consistent with the goal of the 1997 amendments to centralize penalty determinations as much as possible at the partnership level.

Having resolved the jurisdictional issue, the Court finally reached the substantive merits of the basis-misstatement penalty. Because the partnership was disregarded as a sham, the partners were precluded as a matter of law from establishing any outside basis in their purported partnership interests. Accordingly, to the extent they relied on an outside basis greater than zero to generate a disallowed loss, the resulting underpayment of tax was necessarily attributable to a basis overstatement within the meaning of the penalty statute. Moreover, assuming a true basis of zero in their purported partnership interests, any basis overstatement would automatically be considered “gross” for purposes of the 40 percent basis-misstatement penalty.

In keeping with the Supreme Court’s broad view of penalty jurisdiction, the regulations authorize a court in partnership-level proceedings to make all legal and factual determinations bearing on partnership-item penalties, except for “partner-level defenses” (which must be asserted in separate refund actions after assessment and payment). Partner-level defenses are expressly limited to defenses that are “personal to the partner” or “dependent upon the partner’s separate return” and incapable of determination at the partnership level. In contrast, a defense is properly determined at the partnership level to the extent it requires fact findings that are generally relevant to all partners and not unique to any particular partner. Frequently, in asserting a partnership-level penalty defense, a taxpayer seeks to demonstrate that a reporting position was based on reasonable cause and good faith, relying on professional advice such as a legal opinion concerning the structure and anticipated tax treatment of the transaction. However, the reliability of the advice depends crucially on whether the adviser is competent and disinterested. If the adviser participated in structuring the transaction or has a financial stake in its outcome, he will be treated as a promoter and a court will almost certainly conclude that the advice is unreliable and therefore worthless as a penalty shield.

As a practical matter, a partnership-level determination that a legal opinion is tainted by conflict of interest virtually forecloses reliance on the opinion as a penalty defense both at the partnership level and in subsequent partner-level proceedings.

In Woods, for example, Woods (the tax matters partner) sought to rebut accuracy-related penalties by claiming reasonable reliance on professional advice from an accounting firm and two law firms.

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33See Tigers Eye Trading LLC v. Commissioner, T.C. Memo. 2009-121 (Tigers Eye I) (“In a partnership-level proceeding, the Court has jurisdiction to decide the applicability of a penalty including any defenses to the penalty that are suitably determined at the partnership level; i.e., all defenses that are neither personal to the partner nor dependent upon the partner’s separate return and can be determined at the partnership level.” (emphasis in original)).

Section 6664(c)(1) (accuracy-related penalties inapplicable if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion); see also reg. section 1.6664-4 (discussing relevant factors bearing on reasonable cause and good faith); Pisem, “The Uncertain Boundary Between ‘Partner-Level’ and ‘Partnership-Level’ Defenses.” 111 J. Tax’n 151 (2009).


36Tigers Eye II, T.C. Memo. 2009-121 (“If a partner’s defense is reliant on advice from an adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction, i.e., is considered a ‘promoter’ of the transaction, that defense requires factual findings that would be generally relevant to all similarly situated partners and not unique to that particular partner. A defense that relates to all such partners and is an integral part of the investment program is not personal to a particular partner. The Court has jurisdiction in a partnership-level proceeding to decide the applicability of that defense.”).
The district court, however, found that his reliance was not reasonable. Not only did each of the firms have “an inherent conflict of interest which was too obvious to be ignored,” but in light of all the circumstances, including Woods’s own education, sophistication, and experience, Woods should have known that the transaction was “too good to be true.”

Although these findings relate specifically to penalties for negligence and understatement of tax, they clearly negate any reasonable-reliance defense to the basis-misstatement penalty as well and effectively foreclose a similar defense in a subsequent partner-level proceeding.

The Supreme Court’s decision in Woods will have a salutary effect in clearing up a substantial backlog of tax shelter litigation in the lower courts. By correcting the D.C. Circuit’s misguided Petaluma decision concerning penalty jurisdiction and the Fifth Circuit’s equally objectionable Woods decision concerning the basis-misstatement penalty, the Court has opened the way for penalty assessments in myriad pending son-of-BOSS cases. In all those cases, once a court determines in a partnership-level proceeding that a partnership is disregarded as a sham, the focus shifts to determining the application of penalties at the partner level.

Partner-Level Consequences

At the conclusion of partnership-level proceedings, the IRS can make computational adjustments to reflect changes in the partners’ respective tax liabilities and applicable penalties resulting from determinations made at the partnership level. If further fact findings are needed to determine a particular partner’s tax liability, the partner is entitled to a deficiency notice and judicial review in Tax Court before assessment or collection. However, if the adjustments require only a mathematical recomputation of the partner’s tax liability, the computational adjustments can be assessed directly without a prior deficiency notice. In any case, penalties determined at the partnership level can be assessed directly, irrespective of whether further partner-level fact findings are needed. As a result, once penalties (including partnership-level defenses) have been determined at the partnership level, a partner can raise partner-level defenses only in a refund action after payment of the disputed penalties; deficiency proceedings do not apply to penalties at the partner level.

Given the blurry line between affected items that require additional fact findings and those that do not, it may be unclear whether a partner is entitled to deficiency proceedings at the partner level. On one hand, if the IRS directly assesses a computational adjustment without issuing a deficiency notice, the taxpayer may complain that the assessment is invalid and that he was entitled to challenge the deficiency in Tax Court. On the other hand, if the IRS issues a deficiency notice and the Tax Court eventually determines that it lacks jurisdiction because the affected items do not require any further fact findings, a subsequent assessment of computational adjustments (including penalties) may be barred by the statute of limitation.

To avoid this jurisdictional whipsaw, the IRS follows a protective procedure in TEFRA cases when a partner has reported a loss from the sale of distributed assets (or a partnership interest). At the conclusion of partnership-level proceedings, after making computational adjustments, the IRS issues a deficiency notice, which opens a 90-day window for the partner to file a petition in Tax Court; then, at the end of the 90-day period, regardless of whether a petition is filed, the IRS makes a protective assessment of the underlying tax and penalties. If the taxpayer has already filed a petition in Tax Court, he may seek to enjoin the assessment, and if the Tax Court assumes jurisdiction in the deficiency proceeding — in other words, if additional partner-level fact findings are needed — it may grant the injunction with respect to the underlying tax deficiency, but it will almost certainly refuse to enjoin penalties over which it has no jurisdiction.

In effect, the protective procedure preserves the IRS’s ability to assess penalties even if the underlying tax liability is the subject of a separate partner-level deficiency proceeding.

A question raised but not resolved by the Woods decision is whether the taxpayer is entitled to a partner-level deficiency proceeding to determine his underlying tax liability or whether he must file a refund action after paying the disputed amount.

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37Woods, 794 F. Supp. 2d at 719-720. Commenting on Woods’s practical experience and business acumen, the district court noted that he was “a far cry from a man who had just fallen off a turnip truck.” Id. at 718. Further, it should have been obvious to anyone with his background and experience that the transactions “did not possess economic substance, and were being undertaken for the sole purpose of establishing a large paper tax loss.” Id. at 719.

38See section 6662(b)(1) and (c) (negligence); section 6662(b)(2) and (d) (understatement of tax).

39Cf. Stobie Creek, 82 Fed. Cl. at 708 (discussing reliance on professional advice as defense to negligence and accuracy-related penalties, and noting “significant overlap”).

40Thompson v. Commissioner, 137 T.C. 220, 244 (2011) (Holmes, J., dissenting), rev’d, 729 F.3d 869 (8th Cir. 2013).

41See CC-2009-011.

42See Domulewicz, 129 T.C. at 21-24, aff’d on this issue sub nom., Desmet v. Commissioner, 581 F.3d 297 (6th Cir. 2009) (asserting jurisdiction over tax deficiency but not penalties in partner-level deficiency proceeding).
The question arises because the disallowed losses reported by Woods depended on his basis in the distributed assets, which in turn derived from his purported outside basis in the (nonexistent) partnership. Because outside basis is generally characterized as an affected item rather than a partnership item, it cannot be directly determined in a partnership-level proceeding, and if the determination of Woods’s tax liability requires additional fact findings concerning outside basis, he may be entitled to a partner-level deficiency proceeding. Nevertheless, it is clear that the penalties determined at the partnership level can be assessed without a deficiency notice. The Supreme Court acknowledged the apparent anomaly of assessing a penalty before determining the underlying tax liability but found it “not readily apparent why additional partner-level determinations would be required before adjusting outside basis in a sham partnership.” Thus, if it is possible to compute Woods’s tax liability accurately based on determinations already made in the partnership-level proceeding without additional fact findings, there is no reason why the expedited assessment procedure should not apply to the underlying tax liability as well as the penalties.

In Woods, the Court observed that “once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim an outside basis greater than zero.” This statement suggests that in making a computational assessment based on partnership-level determinations, the IRS may treat Woods as having a zero basis in the distributed assets, disregarding his purported outside basis in the sham partnership. Of course, in Woods the sale of the distributed assets actually yielded a small economic gain, even though the partners reported enormous tax losses attributable to their spurious outside bases. Thus, the zero-basis approach would ignore any basis the partners might legitimately claim in the distributed assets, transforming a large artificial loss into a much smaller artificial gain. While the zero-basis approach concededly may distort the amount (and possibly the character) of the taxpayer’s gain, it is likely to be far more accurate than the inflated basis originally claimed by the taxpayer, and it is fully consistent with the computation of the basis-misstatement penalty upheld by the Court. If the correct amount of the partners’ tax liability can be determined without additional partner-level fact findings, based on determinations already made at the partnership level, there is no reason why a final determination of the partners’ liability for tax and penalties cannot be determined in a single partner-level refund action.

In fact, in Woods and similar son-of-BOSS cases involving sham partnerships, it may be relatively easy to compute the partners’ tax liability accurately in partner-level proceedings based solely on items already established at the partnership level without even mentioning outside basis. As explained in a line of Tax Court cases beginning with Judge Renato Beghe’s insightful majority opinion in Tigers Eye, the shelter transaction can readily be recast by treating the sham partnership as a mere nominee or agent for the purported partners. Under this “hypothetical entity” approach, the partners recognize no gain or loss either on contributing offsetting options or on distributions of assets (stock and currency). Instead, the partners are treated as purchasing the stock and currency (with a cost basis equal to the amount paid by the partnership) and then selling the assets and closing out the options.

The Tax Court’s hypothetical entity approach recognizes that while a sham partnership and its purported partners are subject to TEFRA’s procedural provisions, the sham partnership is disregarded in determining the substantive tax consequences for the purported partners. It also allows the IRS to determine the partners’ correct cost basis in the distributed assets through computational adjustments, by substituting the partnership’s purported inside basis (concededly a partnership item) for the basis originally reported by the partners. This conceptually elegant approach avoids any need to determine outside basis and thus provides a clear path to direct assessment of liability.

43See reg. section 301.6231(a)(5)-1(b) (defining outside basis as “an affected item to the extent it is not a partnership item”).

44Woods, 134 S. Ct. at 565, n.2 (describing the sequence as an “odd procedural result”); cf. Tigers Eye Trading LLC v. Commissioner, 138 T.C. 67, 189 (2012) (Tigers Eye II) (Holmes, J., dissenting) (“it’s usually only in Wonderland . . . , or in the more unpleasant judicial systems around the world that ‘penalty first — verdict afterwards’ is the rule”).

45Woods, 134 S. Ct. at 565-566; see also id. at 565 (noting “the legal impossibility of any partner’s possessing an outside basis greater than zero in a partnership that, for tax purposes, did not exist”).

46See section 6233; reg. section 301.6233-1.

47Not all son-of-BOSS cases involve an inflated outside basis. Some paired-option transactions purport to inflate the basis of assets inside the partnership; the assets are then distributed to the partners, who realize an artificial loss on a subsequent sale. See, e.g., 6611 Ltd. v. Commissioner, T.C. Memo. 2013-49. In these “inside basis” shelters, the Tax Court’s penalty jurisdiction has gone unchallenged because inside basis is invariably conceded to be a partnership item.
Tax liabilities and penalties without any partner-level deficiency proceedings. Indeed, it neatly sidesteps the questions left open by the Supreme Court’s zero-basis approach in Woods and reveals that the recent furor over outside basis is largely beside the point.

Even before the Woods decision, the Court of Federal Claims relied on the Tax Court’s hypothetical entity approach to escape the jurisdictional straitjacket fashioned by the D.C. Circuit and uncritically adopted by the Federal Circuit in Jade Trading.50 In Arbitrage Trading,51 another son-of-BOSS transaction closely resembling Jade Trading, the Court of Federal Claims asserted jurisdiction to determine penalties at the partnership level. Citing Tigers Eye, the court explained that the partners’ basis in the distributed assets could be determined from the sham partnership’s cost basis without relying on outside basis.52 Because the partnership was required to determine how much of each partner’s funds it expended to acquire the assets, the correct basis of those assets in the partners’ hands could be derived directly from the partnership’s own records. Without relying on the sham partnership finding, the court asserted penalty jurisdiction based on the zeroing out of purported partnership contributions and distributions, which clearly constituted adjustments to partnership items.53 The Tax Court’s hypothetical entity approach thus offers a conceptually satisfying alternative to the Supreme Court’s zero-basis approach as well as a persuasive rationale for dispensing with partner-level deficiency proceedings in sham partnership cases.

After Woods: Pending Litigation

The Woods decision provides helpful guidance for resolving son-of-BOSS cases pending in lower courts. Specifically, the decision controls the disposition of partnership-level proceedings in Petaluma and Tigers Eye, both of which are on appeal to the D.C. Circuit.54 In Jade Trading, the Federal Circuit’s decision denying penalty jurisdiction at the partnership level has already become final, leaving penalties to be determined in partner-level proceedings. All three cases involve paired-option tax shelters with sham partnerships that are essentially indistinguishable from the Woods transaction.

There should be no doubt about the outcome in Petaluma. The Supreme Court has unequivocally rejected the D.C. Circuit’s narrow reading of penalty jurisdiction at the partnership level. Fortunately, because the Tax Court’s decision in Petaluma has not yet become final, the D.C. Circuit now has an opportunity to correct its own error in the pending partnership-level proceeding. Proceedurally, the simplest course would be for the D.C. Circuit to reverse the Tax Court’s 2012 decision denying penalty jurisdiction55 and simultaneously reinstate the Tax Court’s 2008 decision concerning the basis-misstatement penalty.56 In its 2008 decision, the Tax Court held that the partnership was a sham and (anticipating the Supreme Court’s holding) determined the applicability of a 40 percent penalty for gross basis misstatement. To the extent the Tax Court erred in determining outside basis at the partnership level, its error was harmless. The taxpayer in Petaluma has already waived any partnership-level penalty defenses, except for contested issues of jurisdiction and applicability, which have been conclusively resolved in Woods.57 The D.C. Circuit can wind up the partnership-level proceeding with a summary disposition, clearing the way for the taxpayer to assert any remaining partner-level penalty defenses in a separate refund proceeding after assessment and payment.

In Tigers Eye, shortly before the scheduled trial in 2009, the taxpayer entered into a stipulated decision finding that the partnership was a sham, zeroing out specified partnership items, and upholding the applicability of a 40 percent penalty for gross basis misstatement.58 The stipulation allowed the taxpayer to avoid a trial on the issue of penalties,

Footnote continued in next column.

50Jade Trading II, 598 F.3d at 1379-1380.
52Id. at 605-608; id. at 606 (“the correct basis of the distributed property of a disregarded partnership is what the partnership paid for the property”).
53Id. at 608-609 (rejecting taxpayer’s argument that these partnership items were “surrogates for outside basis” and that the government was “using a Trojan horse to enter . . . forbidden territory”). In asserting jurisdiction, the court found it necessary to distinguish Jade Trading, in which the Federal Circuit had ruled out a sham partnership finding as a basis for partnership-level penalty jurisdiction. Id. at 600-602 and 604.
54In October 2013 the D.C. Circuit stayed proceedings in both cases pending the Supreme Court’s decision in Woods. Appeals from Tax Court decisions in partnership-level proceedings lie to the D.C. Circuit if a partnership has no principal place of business at the time the petition is filed. See section 7482(b)(1).
55See Petaluma III, 135 T.C. at 585-587. When pressed to explain an apparent inconsistency with its subsequent decision in Tigers Eye, the Tax Court pointed out that in deciding Petaluma, it was constrained by the D.C. Circuit’s mandate. Petaluma FX Partners LLC v. Commissioner, T.C. Memo. 2012-142 (the D.C. Circuit “instructed this Court to chart the course on borrowed maps; we did so”).
57See Petaluma III, 131 T.C. at 108.
58See Tigers Eye II, 138 T.C. at 87 and 143 (accepting the IRS’s administrative findings as “correct” and noting applicability of penalty both to a “relatively small” deficiency attributable to
including partnership-level defenses. In an earlier decision, the Tax Court had already held that it had jurisdiction in the partnership-level proceeding to determine whether a law firm (Curtis Mallet) that provided identical tax opinions to the partners (at $100,000 apiece) acted as a promoter of the transaction and whether the opinions were therefore "inherently unreliable" as a penalty shield. 59 Although the court did not actually determine Curtis Mallet's promoter status, it noted indications in the record that the firm's lawyers "may have played a role in preparing the forms of documents that were used to implement the transactions in issue in this and other cases." 60 As a matter of litigation strategy, therefore, the taxpayer may have wished to preserve his right to assert a reasonable-reliance defense in a separate partner-level proceeding. 61

The strategic outlook changed shortly after the entry of the stipulated decision when the D.C. Circuit announced its restrictive view of penalty jurisdiction in Petaluma. The taxpayer in Tigers Eye promptly sought to vacate the penalty determination for lack of jurisdiction, 62 but the Tax Court reaffirmed the earlier stipulation in a court-reviewed decision. The majority opinion, a tour de force authored by Judge Beghe, sidestepped Petaluma and explained how a court can exercise partnership-level penalty jurisdiction in sham partnership cases without relying on outside basis. 63 An appeal in Tigers Eye is pending in the D.C. Circuit, but the Supreme Court's intervening Woods decision makes the appeal essentially pointless. The simplest course for the D.C. Circuit in Tigers Eye would be to affirm the result on the authority of Woods, so that the taxpayer can pursue any partner-level penalty defenses in a separate refund action after assessment and payment.

The transactions in Jade Trading and Tigers Eye are essentially indistinguishable. Both cases involve paired-option shelters that were designed and marketed by the same accounting firm (BDO Seidman) in collaboration with the same hedge fund manager (Sentinel Advisors LLC), and in both cases the taxpayers received tax opinions from the same law firm (Curtis Mallet). 64 In the original partnership-level proceeding in Jade Trading, after finding that the transaction "lacked economic reality and must be disregarded," the Court of Federal Claims determined penalties for basis overstatement, negligence, and understatement of tax. 65 On appeal, the Federal Circuit agreed that the transaction lacked economic substance but vacated the penalty determination for lack of jurisdiction, relying on the D.C. Circuit's Petaluma rationale. 66 As a result, after a remand and further appeal, the partnership-level proceeding in Jade Trading concluded in 2012 without any determination concerning penalties. 67

In Jade Trading, the IRS issued a deficiency notice and assessed a tax deficiency and penalties, prompting the partners (the Ervins) to file a refund action in district court. 68 In the partner-level proceeding, the findings of the Court of Federal Claims at the partnership level (including the lack of economic substance and the zeroed-out partnership items) are binding. A question may arise, however, whether the Supreme Court's intervening decision in Woods, which flatly contradicts the Federal Circuit's jurisdictional holding, implicitly raises an obstacle to penalty jurisdiction at the partner level. The answer should be negative, for two reasons. First, the premise of the Federal Circuit's decision was that to the extent a partner's tax underpayment cannot be computed without reference to outside basis, the resulting penalty must be determined at the partner level.
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(rather than the partnership level); in effect, the Federal Circuit determined that the penalties related to affected items and not to partnership items. The premise may be flawed (as the Supreme Court eventually held), but having relied on the Federal Circuit’s decision at the partnership level, the partners should be estopped to repudiate it at the partner level. A second, more fundamental reason for partner-level penalty jurisdiction is that the penalties in question relate to the partners’ conduct in reporting artificial losses derived from gross basis misstatements. Especially in son-of-BOSS cases involving sham partnerships, penalties may be based on conduct occurring at both the partnership level and the partner level. Although the 1997 TEFRA amendments withdrew partnership-item penalty jurisdiction from partner-level deficiency proceedings, nothing in the text, purpose, or structure of the amendments precludes penalty determinations in a partner-level refund action. Indeed, the regulations expressly make such a proceeding the exclusive forum for asserting partner-level defenses.

In the partner-level refund action, the Ervins are free to assert their partner-level defenses, including reasonable reliance on Curtis Mallet’s tax opinions. Such a defense would reopen the questions — discussed but not decided in Tigers Eye — whether Curtis Mallet acted as a promoter of the shelter and, if so, whether the Ervins would be precluded from relying on the tax opinions as a penalty shield. Even if Curtis Mallet is found not to be a promoter of the Jade Trading shelter, it may be difficult for the Ervins to show an objectively reasonable expectation of making a profit. If they in fact relied on professional advice that turned out to be unreliable, they can seek to recover damages from their advisers in a separate action.

Conclusion

The Supreme Court’s decision in Woods resolves important issues concerning partnership-level penalty jurisdiction and the applicability of basis-misstatement penalties in son-of-BOSS cases involving sham partnerships. The Court’s decision also clears a path for lower courts to wind up partnership-level proceedings in pending cases so that penalties can be promptly assessed and determined in separate partner-level refund actions. In dispelling the confusion engendered by the appellate decisions in Petaluma and Jade Trading, the Court has effectively blocked the efforts of shelter investors and their lawyers to avoid paying real penalties on their illusory tax losses. In most of the pending cases, taxpayers may reach a settlement, including payment of the 40 percent penalties that have been fueling litigation. Those who choose to assert penalty defenses in refund actions (after payment of taxes and penalties) may discover in the end that the professional advice on which they relied, like the underlying shelter, was simply too good to be true.

69 Nothing about the concept of outside basis indicates that it is more appropriately determined at the partnership level. If disregarding a partnership leads ineluctably to the conclusion that its partners have no outside basis, that should be just as obvious in partner-level proceedings as it is in partnership-level proceedings. Moreover, with the invalidity of the partnership conclusively established as a partnership-level determination, there is little danger that outside basis will receive inconsistent treatment at the individual partner level. Jade Trading II, 598 F.3d at 1380 (quoting Petaluma II).

70 Cf. Ervin complaint, supra note 68, at 12 (“The outcome of [Woods] has no bearing here since the Jade Trading case is final, and the law of the case must be followed.”); id. at 33 (“The decisions and findings in Jade Trading are res judicata and bind the IRS, the Ervins, and this Court.”).

71 Technically, the shelter in Jade Trading was invalidated for lack of economic substance, producing the same substantive result as a sham partnership finding. See Jade Trading I, 80 Fed. Ct. at 56 (describing the shelter as “an elaborate fictional construct with no economic consequences other than tax benefits”); Southgate Master Fund LLC v. United States, 659 F.3d 466, 491 (Sth Cir. 2011) (disregarding partnership as a sham because it lacked any “nontax business purpose”).

72 See Arbitrage Trading, 108 Fed. Ct. at 608 (“The penalty may relate to the conduct that led to [the partnership] being disregarded… and may also relate, in the alternative, to alleged misconduct by the partners in inflating the outside basis each partner claimed in its partnership interest. That the first determination is made in partnership-level proceedings and the second is made in partner-level proceedings is consistent with the legislative intent that penalties be applied to partnership conduct in partnership-level proceedings and to partner conduct in partner-level proceedings.”); Petaluma III, 135 T.C. at 605, n.13 (Marvel, J., dissenting) (“In my opinion, a finding of negligence at the partnership level in a Son-of-BOSS case such as Petaluma does not preclude a finding of partner-level negligence. That is because of the unique nature of many Son-of-BOSS transactions, which require partnership-level and partner-level actions to generate the loss.”).

73 See reg. section 301.6221-1(d); Jade Trading I, 80 Cl. Ct. at 59 (“The upshot is that the Ervins must pay the penalty and file individual refund actions in order to litigate reasonable cause.”).

74 After the IRS issued Notice 2000-44, 2000-2 C.B. 255, identifying paired-option shelters as listed transactions, Curtis Mallet issued a supplemental memorandum to the Ervins reaffirming the conclusions in its original tax opinion. See Jade Trading I, 80 Fed. Ct. at 40.

75 See Tigers Eye I (“If the Court should decide that Curtis Mallet was a promoter of the transactions at issue and that the Curtis Mallet opinion was inherently unreliable, reliance on the opinion would not be a partner-level defense.”)

76 See Jade Trading I, 80 Cl. Ct. at 49-50 (“The fact that the Ervins had to spend over $934,000 to obtain an investment return of $140,000, establishes that no reasonable investor would engage in such a transaction to earn a profit.”)