Case No. 09-11166

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

SOUTHGATE MASTER FUND, L.L.C.,
by and through Montgomery Capital
Advisors, LLC its Tax Matters Partner,

Plaintiff-Appellant Cross-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee Cross-Appellant.

Appeal from the United States District Court
for the Northern District of Texas, Dallas Division
No. 3:06-CV-2335-K

APPELLANT'S BRIEF

SONNENSCHEIN NATH & ROSENTHAL LLP
M. Todd Welty
2000 McKinney Avenue, Suite 1900
Dallas, TX 75201-1858
Telephone: (214) 259-0953
Facsimile: (214) 259-0910

SONNENSCHEIN NATH & ROSENTHAL LLP
Justin N. Kattan
1221 Avenue of the Americas
New York, NY 10020-1089
Telephone: (212) 768-6923
Facsimile: (212) 768-6800

ROBBINS, RUSSELL, ENGLERT, ORSECK, UNTEREINER & SAUBER LLP
Roy T. Englert, Jr.
Mark T. Stancil
William P. Baude
1801 K Street, NW, Suite 411
Washington, D.C. 20006
Telephone: (202) 775-4500
Facsimile: (202) 775-4510

CHICOINE & HALLETT, P.S.
Darrell D. Hallett
John M. Colvin
Millennium Tower
719 Second Avenue, Suite 425
Seattle, WA 98104
Telephone: (206) 223-0800
Facsimile: (206) 467-8170

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP
Martin D. Ginsburg
Alan S. Kaden
1001 Pennsylvania Avenue, NW
Washington, DC 20004
Telephone: (202) 639-7000
Facsimile: (202) 639-7003

ATTORNEYS FOR APPELLANT CROSS-APPELLEE

CERTIFICATE OF INTERESTED PERSONS

PER FIFTH CIRCUIT LOCAL RULES 26.1.1, 27.4, AND 28.2.1

(1) 09-11166: *Southgate Master Fund, LLC, by and through Montgomery Capital Advisors, LLC, its Tax Matters Partners, Plaintiff - Appellant Cross-Appellee, v. United States of America, Defendant - Appellee Cross-Appellant*.

(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 this case. These representations are made in order that the judges of this Court may evaluate possible disqualification or recusal.

Appellees	**Counsel**
United States of America	
Appellants	**Counsel**
SOUTHGATE MASTER FUND, L.L.C., by and through Montgomery Capital Advisors, LLC, its Tax Matters Partners	M. Todd Welty Justin N. Kattan SONNENSCHEIN NATH & ROSENTHAL LLP
	Roy T. Englert, Jr. Mark T. Stancil William P. Baude ROBBINS, RUSSELL, ENGLERT, ORSECK, UNTEREINER & SAUBER LLP
	Martin D. Ginsburg Alan S. Kaden FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP

	Darrell D. Hallett John M. Colvin CHICOINE & HALLETT, P.S.
Montgomery Capital Advisors, LLC	
Thomas A. Montgomery	
Beth E. Montgomery	
D. Andrew Beal	
Simona G. Beal	

/s/ M. Todd Welty
M. Todd Welty

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).

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PRELIMINARY STATEMENT

In this partnership tax case, the district court got virtually every factual finding right but committed three independent errors of law. Those errors led it to uphold the IRS's disallowance of losses related to Appellant's 2002 tax return.

The first mistake was one of statutory interpretation. The tax treatment at issue here was expressly *required* by law, and the district court conceded that Appellant was in "literal" compliance with the statutory and regulatory regime. But the district court mistook—and, in certain respects, ignored—overwhelming evidence that Congress deliberately chose that treatment. The district court was therefore wrong to invoke the so-called "judicial doctrines," which allow courts to disregard tax consequences that offend a statute's purpose.

The district court erred again in its unprecedented application of those doctrines. In the face of numerous factual findings establishing that this partnership was a legitimate, profit-seeking enterprise, the district court held that an allegedly deficient transaction by one partner, four months later, somehow retroactively invalidated the entire partnership. Such a result is without legal basis, and the district court's holding portends serious adverse consequences far beyond this case.

In any event, the district court was wrong in concluding that the partner's subsequent transaction (a capital contribution) was deficient. Here again, the district court made numerous factual findings that the contribution presented a reasonable possibility of profit for, and altered the legal relationships of, all partners. That is all the law requires.

STATEMENT OF JURISDICTION

On October 13, 2006, the Commissioner of Internal Revenue issued a Notice of Final Partnership Administrative Adjustment ("FPAA") to the tax matters partner of Appellant Southgate Master Fund LLC ("Southgate") for the tax year ending December 31, 2002. Southgate commenced a timely action for readjustment of partnership items by filing a petition in the United States District Court for the Northern District of Texas, which had jurisdiction under 26 U.S.C. § 6226(a) and 28 U.S.C. § 1346(e). Before filing its petition, Southgate's members deposited with the Internal Revenue Service the amount required by 26 U.S.C. § 6226(e).

Following a bench trial, on October 1, 2009, the district court entered a final judgment. On November 25, 2009, Southgate timely filed a notice of appeal. On December 3, 2009, the United States also filed a notice of appeal. Jurisdiction is conferred on this Court by 26 U.S.C. § 6226(g) and 28 U.S.C. § 1291.

ISSUES PRESENTED

1. Whether the district court erred in holding that 26 U.S.C. § 704(c)(3) and the applicable Treasury Regulations do not "clearly express" an intent to

require the allocation of a portion of a partnership's losses to a partner that purchased its interest in the partnership from a partner that had contributed property with a built-in loss.

2. Whether a partner's subsequent contribution of capital to an otherwise valid, profit-seeking partnership can retroactively render the entire partnership a "sham" if that contribution is determined to lack economic substance.

3. Whether the district court erred in concluding that a partner's subsequent capital contribution to a partnership lacked economic substance, even though the district court found that the contribution presented a reasonable possibility of profit for, and altered the legal relationships of, all partners.

STATEMENT OF THE CASE

This is an appeal from a judgment rejecting in part Southgate's challenge to the FPAA issued by the IRS to Southgate in October 2006. The FPAA (1) disallowed losses claimed by Southgate on its 2002 partnership income tax return arising from the sale of Chinese loans; (2) rejected the allocation of losses among Southgate's partners; (3) determined that no partner made a contribution to Southgate in a manner that would increase that partner's basis in Southgate; and (4) imposed substantial penalties.

Southgate petitioned for review of the FPAA in the United States District Court for the Northern District of Texas, under 26 U.S.C. § 6226(a)(2). After a bench trial, the district court issued findings of fact and conclusions of law upholding the IRS's disallowance of the claimed partnership losses. Because the tax treatment was supported by "substantial authority" and because the court found that Southgate acted with reasonable cause and in good faith, however, it rejected the imposition of penalties. On October 1, 2009, the court issued a final judgment. Southgate appealed the disallowance of the partnership losses, and the Government cross-appealed.

STATEMENT OF FACTS

A. The Southgate Investment

1. *Beal and Montgomery*. D. Andrew Beal ("Beal") is the founder, CEO, and 100% shareholder of Beal Financial Corporation and its subsidiary, Beal Bank, which in turn owns Beal Capital Markets (collectively, the "Bank"). R.15258/FF-¶1.[1] For over 20 years, Beal and the Bank have had success purchasing debt and equity positions in distressed assets, including portfolios of non-performing loans. R.15259/FF-¶3.

Thomas Montgomery ("Montgomery") is an accountant and investment professional whom Beal Capital Markets hired to identify emerging capital markets for potential investment, particularly in distressed debt and other assets

[1] "R." indicates a page of the record on appeal; "FF-¶" and "COL-" further specify paragraphs of the court's findings of fact and pages of its conclusions of law, respectively.

that reflect "market disconnect[s]." R.15259-15260/FF-¶¶7-8. Investment decisions in such markets often have to be made on very short notice. R.15260/FF-¶9.

2. *The Growth of the Chinese Non-Performing Loan Market.* In 1999 and 2000, China's four primary state-owned commercial banks were saddled with large amounts of non-performing loans. R.15263-15264/FF-¶¶16-18. To assume and resolve these loans, the Chinese government established four asset management companies, including China Cinda ("Cinda"). R.15264/FF-¶19. The companies were given unprecedented "super powers," including the authority to restructure debt, to pursue collection litigation against debtors, to toll limitations periods, and, most importantly, to compromise loan terms, which was otherwise impermissible. *Id*. As required by Chinese law, Cinda bought these loans at full face value, including accrued but unpaid interest. R.15268/FF-¶31. By the end of 2000, Cinda had acquired approximately 373 billion Chinese Yuan (approximately $45 billion U.S.) of loans. *Id.*

3. *Montgomery Investigates Chinese Loan Opportunities.* In early 2002, Montgomery identified the Chinese loan market as a potential investment opportunity. R.15273/FF-¶¶47-48. Between 2000 and 2002, that market had attracted many Western investors who, having had success investing in loans elsewhere in Asia, saw great possibilities in China. R.15271/FF-¶41. Reports of

early profits earned by foreign investors, including Goldman Sachs and Morgan Stanley, stoked such enthusiasm. R.15272/FF-¶44.

Montgomery concluded that Chinese loans were an attractive opportunity because the Chinese currency was undervalued, the Chinese economy was growing rapidly, and the Chinese government was actively seeking foreign investment as part of a bid to join the World Trade Organization. R.15276-15277/FF-¶¶56-58. Leading investment authorities shared Montgomery's view. *Id*.

During his first due diligence trip to China in July 2002, Montgomery determined that unsecured Chinese loans, which could be acquired for less than half the price of secured loans, were the better investment. R.15277/FF-¶59. Montgomery also consulted De Castro, West, Chodorow, Glickfeld & Nass, Inc. ("De Castro"), a U.S. law firm, about the possible tax consequences of a Chinese loan investment. R.15274-15275/FF-¶¶50-52.

Montgomery presented the results of his initial due diligence to Beal. Beal informed Montgomery that, because of banking regulations and other Bank investments, the Bank would not do the deal. R.15278/FF-¶60. In July 2002, Montgomery decided to pursue the opportunity through his own company, Montgomery Capital Advisors ("MCA"). R.15278-15279/FF-¶¶61-62. Although Montgomery was uncertain whether Beal would invest if Montgomery succeeded in putting together a deal, Montgomery "was confident he could find another investor." R.15279/FF-¶63.

4. *Southgate's Acquisition of Chinese Loans*. Montgomery again traveled to China and "spent a significant amount of time and money performing due diligence on loans held by Cinda." R.15280/FF-¶71. He identified a portfolio of approximately 24,000 "severely distressed," non-performing loans (the "NPLs") with a face value of approximately $1.145 billion. R.15280-15281/FF-¶¶72-73. Montgomery concluded that recovering at least 1-3% of the NPLs' face value was realistic, as was acquiring the loans at a price that would leave room for substantial profit. R.15271/FF-¶76. In a contemporaneous e-mail, one De Castro attorney described the deal as having great profit potential "regardless of potential tax benefits." R.15281/FF-¶74. After half a dozen meetings, Montgomery negotiated a purchase price of 1.7% of the face value of the NPLs. R.15281/FF-¶78.

To ensure the application of American law, Montgomery and Cinda agreed to form a pair of American companies through which they would effectuate the NPL acquisition. R.15282, 15301-15303/FF-¶¶80, 148-156. On July 31, 2002, Cinda formed Eastgate, a wholly owned Delaware LLC. Cinda contributed the NPLs, with an outstanding balance of approximately $1.145 billion, to Eastgate on August 1, 2002. R15282-15283/FF-¶¶81-85.

Also on July 31, MCA and Eastgate formed a second Delaware LLC, Southgate. R.15283/FF-¶86. On August 1, pursuant to a contribution agreement among Eastgate, MCA, and Southgate, Eastgate contributed the NPLs to Southgate in exchange for a 99% membership interest in Southgate. Eastgate was credited with an initial capital account balance of $19,420,000. R.15283/FF-¶87. MCA contributed approximately $196,000 in cash and notes in exchange for the remaining 1%. R.15283/FF-¶89. MCA was to manage the partnership, in return receiving $1,000 per month, plus 10% of Southgate's profits after the members recovered their initial capital contributions, with interest. R.15283-15284/FF-¶¶89, 92. MCA also agreed to pay an $8.5 million fee for Deutsche Bank's services as a placement agent. R.15283-15284/FF-¶¶90-91.

On August 1, Cinda entered into a servicing agreement with Southgate by which Cinda agreed to service the NPLs for the next three years, in return for a fee based on collections and other proceeds. R.15284-15285/FF-¶¶94-96. It was standard practice for foreign investors in Chinese loans to retain the selling company in a servicing capacity. R.15286/FF-¶¶98-99. Montgomery believed that Cinda was the best choice given its geographic reach, "super powers," perceived incentive to maximize collections, and "aggressive" pursuit of collections on other loan portfolios. R.15285-15286/FF-¶¶97-99.

5. *Southgate's Continued Due Diligence*. Montgomery continued to conduct due diligence on the NPLs. R.15288/FF-¶¶103-104. Zhongyu, a Chinese valuation firm, sampled the loans and estimated the portfolio was worth between 3.9% and 9.76% of face value. R15288-15289/FF-¶¶105-106. Haiwen & Partners, a Chinese law firm, opined favorably on the NPLs' enforceability. R.15291-15292/FF-¶¶115-119. Sinobridge, a Chinese law firm representing Cinda, provided a similar opinion. R.15292/FF-¶¶120-121.

6. *Beal Invests in Southgate*. Until this point, there was no certainty that Beal would invest in Southgate. R.15299/FF-¶141. At the end of August, however, Beal decided to invest, concluding that Southgate "posed significant profit potential." R.15298-15299/FF-¶¶138-141.

On August 31, 2002, Beal (acting through Martel Associates LLC, a Delaware LLC wholly owned by Beal), purchased 90% of Eastgate's interest in Southgate for $19,407,000. R.15298/FF-¶¶139-140. Martel was admitted as an 89.1% member in Southgate. R.15298/FF-¶140. Cinda retained a 9.9% interest in Southgate, and Montgomery owned 1%. *Id*.

7. *Losses.* The Chinese loan market in general, and the NPLs held by Southgate in particular, proved to be far less profitable than expected. R.15315/FF-¶197. Among other factors, Cinda's shortcomings as servicer—which

Montgomery could not have recognized at the time Southgate acquired the NPLs—led to weak collections. R.15315/FF-¶¶195-197.

During the second half of 2002 (the tax year relevant to this appeal), Southgate sold to third parties a portion of the NPLs with a face amount of approximately $253 million plus approximately $43 million in accrued but unpaid interest. R.15310/FF-¶181. After payment of servicing fees and costs, Southgate's net recovery on its 2002 NPL sales was $2.163 million. R.15311/FF-¶184. Thus, for 2002, Southgate's losses totaled approximately $294 million, of which $292 million were "built-in" losses[2] (tied to the face amount and accrued interest when Cinda transferred the NPLs to Southgate) and $2.01 million were post-contribution losses (*i.e.*, interest that had accrued on the NPLs after contribution to Southgate). R.15311/FF-¶184.[3]

8. *Beal's Additional Contribution to Southgate*. In late 2002, Beal made an additional capital contribution to Southgate. Beal did so by contributing a portfolio of Government National Mortgage Association securities ("GNMAs") with a fair market value of approximately $180 million, R.15318/FF-¶¶208, which were subject to a "repo" transaction with UBS PaineWebber. The effect of the

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[2] When a partner contributes property with a tax basis that exceeds its fair market value, that property has what is called a "built-in loss." 26 C.F.R. § 1.704-3(a)(3)(i), (ii).

[3] The formation of Southgate and the acquisition, servicing, and 2002 sale of a portion of the NPLs are referred to as the "Southgate-NPL Transactions."

repo transaction was to use the GNMAs as security for a cash loan from UBS to Martel in the amount of $162 million. R.15318/FF-¶209.[4] Beal absolutely and unconditionally guaranteed the loan and thereby assumed personal liability for this $162 million loan obligation. R.15319/FF-¶210.

Beal contributed the GNMAs to Southgate by contributing the GNMAs to Martel, having Martel enter into the repo transaction, and then contributing his sole membership interest in Martel to Southgate, so that Southgate owned Martel as a wholly owned LLC,[5] a structure that allowed Beal to retain control over the $180 million portfolio on which he was personally liable.[6]

Southgate's and Martel's operating agreements were amended to reflect the new structure. R.15321/FF-¶223. Beal remained the sole manager of Martel, with the right to receive periodic interest payments from the GNMAs, R.15322/FF-¶225; upon distribution of the GNMAs, however, any post-contribution

[4] "Repo" (or "repurchase") transactions are loans in which one party sells securities to the counterparty but agrees to repurchase the same securities at a later date for the same sale price, plus interest. Repos are commonly used with government-backed securities due to certain regulatory requirements. R.15336/FF-¶271.

[5] Since Martel is a single-member LLC, it is disregarded as an entity for tax purposes, and Southgate is treated as owning all of Martel's assets and liabilities. 26 C.F.R. § 301.7701-(3)(b)(1).

[6] Before Beal contributed Martel to Southgate, Martel distributed to Beal the cash from the repo transaction and the 90% interest in Southgate. The Martel restructure, GNMA contribution, and UBS-repo transactions will be referred to collectively as the "GNMA-Martel Transactions."

appreciation in their value was allocable among Southgate's partners in accordance with their percentage interests. R.15323/FF-¶¶227-228.

Although one purpose of the GNMA-Martel Transactions was to permit Beal to recognize his portion of Southgate's losses on his personal return, the GNMA-Martel Transactions also served non-tax business purposes. As discussed above, the partnership and its partners stood to share in the appreciation of the GNMAs; the Government's expert witness opined that this opportunity was worth as much as $13 million. R.15326/FF-¶236. The GNMA-Martel Transactions also diversified Southgate's investment portfolio and created additional net equity for Southgate. R.15336-15336/FF-¶¶272-274.

9. *Tax Consequences*. A partnership is generally treated as an entity separate from its partners for purposes of determining its income, gains, deductions, and losses. 26 U.S.C. §§ 702-704; McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶1.02[3] (4th ed. 2009). The amount of a partnership's gain or loss from the sale of partnership assets is the difference between the sales price and the partnership's "basis" in the assets sold. 26 U.S.C. §§ 1001, 1011. Where, as here, the assets were acquired by the partnership (Southgate) from a partner (Cinda, through Eastgate) as a capital contribution, the partnership's basis in the assets is the same as the contributing partner's basis. 26 U.S.C. § 722. The partnership's basis is commonly referred to as "inside basis."

Following these rules, Southgate reported on its partnership income tax return the $294,861,591 in losses it incurred on the 2002 NPL sales, of which $292,849,721 were built-in losses. R.15348/FF-¶325.

The amount of allocated partnership loss that a partner may deduct on his personal return is limited to his basis in his partnership interest, 26 U.S.C. § 704(d)—commonly referred to as "outside basis." That outside basis includes initial and subsequent contributions of assets to partnership capital. As of December 25, 2002, Beal's outside basis in Southgate was the cost of his initial investment, $28.5 million, R.15316/FF-¶201, and he had been allocated 90% of Southgate's built-in losses, or $263,564,749, as required by 26 U.S.C. § 704(c)(3) and 26 C.F.R. § 1.704-3(a)(7). R.15349/FF-¶326.

The GNMA-Martel Transactions increased his outside basis in Southgate by $180 million (the $18 million net value of the contributed GNMAs plus Beal's guarantee of Martel's $162 million repo liability)[7] and therefore entitled him to claim on his personal return a larger portion of his allocated share of Southgate's

[7] In addition to relatively minor amounts not in dispute, the increase in Beal's outside basis in Southgate is more precisely calculated as follows: *increase* of $180,558,175, R.15323/FF-¶229; *see* 26 U.S.C. §§ 722, 723; *minus* $162 million related to Southgate's assumption of the loan, R.15324/FF-¶230; *see* 26 U.S.C. §§ 752(b), (c), 733; 26 C.F.R. § 1.752-1(e)); *plus* $162 million increase in Beal's share of Southgate's liabilities by guaranteeing the loan, R.15324/FF-¶230; 26 U.S.C. § 752(a). Thus, the fact that the repo transaction involves a loan has no net effect on the increase in Beal's outside basis in Southgate. 26 C.F.R. § 1.752-1(f).

2002 tax losses. R.15323-15324/FF-¶¶229-232. Detailed opinions prepared by De Castro and an accounting firm concluded that those transactions appropriately increased Beal's outside basis, and further opined that those tax consequences were more likely than not to "be upheld if challenged by the IRS." R.15340, 15343/FF-¶¶288, 300.

Accordingly, Beal's personal 2002 tax return reported an ordinary loss deduction of approximately $216 million arising from his interest in Southgate. R.15347/FF-¶318.[8] Beal realized offsetting gains in 2006 and 2007. R.15349/FF-¶328. In October 2006, the IRS issued the FPAA to Southgate.

B. District Court Proceedings

1. *Findings of Fact*. After a fifteen-day bench trial, the district court made extensive factual findings. The court found that "Cinda's tax basis in the NPLs immediately prior to their contribution to Eastgate was . . . $1,379,780,386." R.15282/FF-¶84. "Upon Cinda's contribution of the NPLs to Eastgate, Eastgate's tax basis in the NPLs was equal to Cinda's." R.15282/FF-¶85. After the NPLs

[8] The $216 million loss deduction reflects a $6 million discrepancy for the fair market value of the GNMAs. R.15347/FF-¶319. The deduction should be $210 million (the total of the $28.5 million initial investment, the $180,558,175 GNMA contribution, and a $500,000 note). The district court's opinion makes two passing (mistaken) references to Southgate's claiming "capital" losses, as opposed to "ordinary" losses. That error appears to be the inadvertent result of the court's borrowing language from an opinion which it would later cite explicitly. *Compare* R.15257 ("although Southgate's claimed capital loss appeared to fall within the literal terms of the statute") *and* R.15415 ("although Southgate's claimed capital loss appeared to fall within the literal terms of the statute") *with Coltec Indus. v. United States*, 454 F.3d 1340, 1343 (Fed. Cir. 2006) ("although Coltec's claimed capital loss fell within the literal terms of the statute").

were contributed, "Southgate's initial tax basis in the NPLs was equal to Eastgate's"—*i.e.*, $1,379,780,386. R.15283/FF-¶88. Cinda had received a capital account credit of $19 million for its contribution of the NPLs. R.15348/FF-¶320. "Therefore, a built-in loss of $1.360 billion existed at the time the NPLs were contributed to Southgate." R.15348/FF-¶320. The court also found that "26 U.S.C. § 704(c) and [26 C.F.R] § 1.704-3(a)(7) required that 90 percent of the built-in loss be allocated to Beal" because of his purchase of 90% of Eastgate's partnership interest. R.15348/FF-¶322. That built-in loss, the Court found, was "properly allocated" to Beal, and Beal had to either leave the loss "suspended" inside Southgate for "future years or increase his outside basis in the Southgate partnership . . . to utilize the losses more fully in 2002." R.15316/FF-¶202.

The court found that Southgate's NPL investment was a profit-driven transaction with legitimate business purposes. The investment "fit within Beal's and Montgomery's core business," R.15300/FF-¶145, and Beal himself believed "that Southgate posed significant profit potential," R.15298/FF-¶138. The court specifically found that Beal and Montgomery "believed that they could earn a profit from the NPLs, and ***they would have done this deal regardless of whether or not it had any tax benefits***." R.15300/FF-¶145 (double emphasis added).

The court found that there were business reasons for Cinda's creation of Eastgate—specifically, to ensure that American law applied to the Southgate-NPL

Transactions but that Cinda did not subject itself to other, unknown liabilities under American law. R.15301/FF-¶¶148-149. Eastgate's creation also "confirmed that Cinda had the right and ability to contribute the NPLs to a United States entity." R.15301/FF-¶150.

The court expressly found that "the formation of Southgate was important" for business reasons. R.15301/FF-¶151. Utilizing an American partnership avoided entanglement with Chinese regulators, R.15301-15302/FF-¶¶151-152, facilitated currency exchange, R.15302/FF-¶152, and furthered Cinda's business objective of improving its balance sheet, R.15303/FF-¶156.

The court also found that Montgomery made great efforts to increase the profitability of the investment. Montgomery "negotiated an acquisition price . . . that afforded an investor an opportunity to turn a profit." R.15302/FF-¶154. Montgomery structured the transactions to ensure that Cinda could not "cherry pick[]" potentially valuable loans out of the portfolio. R.15303/FF-¶155. Montgomery completed extensive due diligence analyzing the loans, "consistent with what other investors were doing in the same time period," which evidenced "Southgate's genuine expectation of making some profit on the transaction." R.15293/FF-¶122. And Southgate reasonably relied on Zhongyu's, Haiwen's, and Sinobridge's respective analyses. R.15289, 15292/FF-¶¶110, 121.

The court also found that Beal's contribution of assets to Southgate through the "Martel Restructure and GNMA Repo transactions had some economic substance, as all of Southgate's partners had a reasonable possibility of profiting from the GNMAs after their contribution." R.15325/FF-¶235. That was because any post-contribution gains from the GNMAs were to be allocated to the partners' capital accounts. R.15326/FF-¶239. Although the "structure of the transactions served some legitimate business purposes," R.15336/FF-¶271, the court also found that the contribution of the GNMAs was primarily motivated by tax considerations, based on the court's conclusion that "Beal personally received all of the potential benefits, and retained all of the risks, of the GNMA repo transaction." R.15329-15330/FF-¶¶248-250.

The court also made findings of fact relevant to three alternative "basis-killer" arguments advanced by the Government (each of which the court rejected). With respect to the Government's attempt to recover penalties, the court specifically found that "Southgate and its members reasonably relied in good faith on the oral and written advice" of De Castro and the accounting firm "regarding the transactions at issue." R.15344/FF-¶305. It further found that "Beal did not 'shop' for an opinion that justified his tax position." R.15338/FF-¶278. The opinions analyzed the relevant arguments and authorities, R.15345/FF-¶¶311-312, and "met applicable professional standards," R.15344-15345/FF-¶¶308-309. "It was therefore reasonable for Beal and Southgate to rely on the . . . opinions" in claiming the NPL losses on their returns. R.15346/FF-¶313.

2. *Conclusions of Law.* The court first held that Southgate incurred losses on the sale of the NPLs and properly allocated those losses among its partners in accordance with the "literal" terms of 26 U.S.C. § 704(c) and the accompanying regulations. R.15383/COL-127. The court concluded that: by the express terms of those provisions, Cinda's basis in the NPLs was what it paid for them plus accrued interest (totaling approximately $1.38 billion); Cinda's basis flowed through to Eastgate and then to Southgate; Southgate incurred a loss equal to the difference between its basis and the amount it received from the NPL sales; and Beal was entitled to 90% of the built-in losses on the NPLs by virtue of his purchase of 90% of Eastgate's interest in Southgate. R.15379-15383/COL-123-127.

The court concluded, however, that compliance with the terms of the statute and implementing regulations did not justify the resulting tax consequences. The court pointed to 2004 amendments to Section 704(c)—two years after the tax year in question—that capped at $250,000 the allocation of built-in losses to a taxpayer who acquires a partner's interest. According to the district court, those amendments did not necessarily signal an intent to *change* the law. Rather, the court held, it "is just as likely . . . that Congress was trying to close a loophole that never really existed." R.15381/COL-125. As support for that conclusion, the district court relied on a statement in the House Committee Report for the 2004 amendments acknowledging that "the partnership rules currently allow for the inappropriate transfer of losses among partners." R.15381/COL-125 (quoting H.R. Rep. No. 108-548(I), 2004 WL 1380512, at *281-283 (2004)). The court read that to mean that "Congress may have simply clarified [in the 2004 amendments] its intention of preventing inappropriate transfers, something it intended even prior to 2004." R.15382/COL-126. The district court did not address the fact that, even after the 2004 amendments, the statute expressly *permitted* loss transfers of up to $250,000. The court ultimately concluded that Southgate's application of Section 704(c) "attribute[d] to Congress a motive it did not clearly express." R.15383/COL-127.

The district court thus proceeded to "apply the so-called judicial doctrines"—"economic substance, sham partnership, and substance over form"—to determine whether compliance with the literal text of the statute was sufficient to justify the tax treatment of Southgate's losses. R.15382-15383/COL-126-127. Holding that the "transaction in question here must be divided for purposes of economic substance analysis," the court looked first at the Southgate partnership itself, then at Beal's contributions to the partnership. R.15386/COL-130.

With respect to the former, the court concluded that the formation and operation of Southgate, and its transactions involving the NPLs, satisfied the criteria set forth in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), and *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009). R.15386/COL-130. Consistent with its detailed factual findings, the court concluded that Southgate was established for non-tax business reasons and that the Southgate-NPL Transactions were profit-motivated. R.15387/COL-131.

The court rejected, however, Beal's attempt to increase his outside basis in Southgate (and thus his ability to claim his share of the NPL losses on his personal return) by contributing the GNMA portfolio to Southgate. Asserting that Beal had "effectively reserved for himself all guaranteed income streams from the GNMAs and sole discretion to award gains or losses from the securities to the partnership" (notwithstanding its factual finding that "all of Southgate's partners had a reasonable possibility of profiting from the GNMAs," R.15325/FF-¶235), the court concluded that the contribution "lacked economic substance" and must be disregarded. R.15389-15390/COL-133-134.

The court further held that Beal's contribution of assets to Southgate retroactively infected *all* of the *partnership's* previously incurred NPL losses under the "sham partnership" and "substance over form" doctrines. With respect to the former, the court held that "[a]lthough the Southgate transaction was not a sham per se . . . the underlying [GNMA-Martel Transactions] were nothing more than a sham to gain tax benefits for Beal." R.15393/COL-137. Addressing the "substance over form" doctrine, the court concluded that, because of Beal's GNMA contribution, the substance of the transactions as a whole did not survive judicial scrutiny. R.15397/COL-141.

The court ultimately held that "the Government's adjustments to Southgate's 2002 tax return are correct." R.15415/COL-159. Separately, the Court rejected the Government's NPL-related basis-killer arguments, and all attempts to impose penalties.

3. *The Judgment.* The court ordered the parties to submit a proposed judgment. R.15415/COL-159.

Southgate observed that the court had concluded that the partnership as a whole had economic substance and had taken issue only with Beal's attempt to contribute more assets to the partnership. R.15416. Southgate therefore proposed a judgment that would have invalidated the $180,558,175 of *Beal's* outside basis from the GNMA-Martel Transactions (and thus his claimed deductions up to that amount) but that otherwise left *Southgate's* losses intact. R.15437. Southgate also requested that the court clarify two passages in its opinion: first, the paragraph in which the court stated "that Southgate's basis is $19.4 million rather than the $1.1 billion claimed," R.15432 (quoting R.15399/COL-143); second, the statement that "the Government's adjustments to Southgate's 2002 tax return are correct," R.15433 (quoting R.15415/COL-159) without limiting it to Beal's outside basis.

The Government argued that—notwithstanding the court's findings that Southgate had economic substance before the GNMA-Martel Transactions—the court had retroactively invalidated the whole partnership. R.15447. The Government also requested that the court "amend[]" its statement "'that Southgate's basis is $19.4 million rather than the $1.1 billion claimed,'" arguing that if Southgate were truly a sham partnership it should have a basis of zero. R.15453.

The court denied both parties' requests for clarification, and on October 1, 2009, issued a judgment "conclud[ing] that the Government's adjustments to Southgate Master Fund, LLC's 2002 tax return as set forth in the Notice of Final Partnership Administrative Adjustment issued on October 13, 2006, are correct." R.15466.

SUMMARY OF ARGUMENT

The district court correctly made numerous factual findings that Southgate was a valid, profit-seeking partnership. The district court further found that Beal properly acquired his interest in Southgate for legitimate business reasons, and that Southgate incurred real losses in its disposition of the NPLs in 2002. But the district court erred in holding that those findings did not compel the legal conclusion that Southgate had properly allocated those losses to its partners under Section 704(c); that Beal's *subsequent* capital contribution to Southgate (which the court deemed defective) retroactively invalidated the partnership; and that Beal's contribution was deficient. Each of those legal holdings reflects an independent reversible error.

I. As it existed in 2002, Section 704(c) *required* that, when a built-in loss is realized through the sale or other disposition of an asset, it must be allocated to the contributing partner. The statute further required that, because Beal purchased 90% of Eastgate's interest in Southgate, 90% of the built-in loss *must* be allocated to Beal. Congress made that deliberate choice when enacting Section 704(c)(3) in 1989. The district court therefore erred in holding that Southgate's allocation of losses to Beal did not reflect the clear intent of Congress.

The district court also misread the 2004 amendments to Section 704(c) as suggesting that the statute had never contemplated this tax treatment. To the contrary, the House Report acknowledged that the law in place in 2002 "currently allow[ed]" for the transfer of built-in losses to successor partners, and expressly stated that the amendments sought only to "limit[]" such transfers. Indeed, the district court failed to confront the fact that the 2004 amendments "preserve[d]" the ability to transfer up to $250,000 in built-in losses to a successor partner. All of that belies the district court's conclusion that the 2004 amendments indicated that Southgate's allocation of losses might have been just a "loophole" in the statutory scheme.

The district court was thus wrong to conclude that Southgate was in mere "literal" compliance with Section 704(c), allowing it to invoke the so-called "judicial doctrines" to evaluate whether the tax consequences complied with congressional intent. As the Supreme Court has recognized, statutory interpretation begins and ends with the text's plain meaning—even in tax cases, and even where the IRS contends that the result would give a taxpayer a "windfall."

II. Even if the district properly invoked the "judicial doctrines," the trial court erred in holding that a defective capital contribution by one partner, some four months later, could retroactively render the entire partnership a "sham." The court's findings that Southgate had economic substance compelled by business or regulatory realities; was imbued with tax-independent considerations; and was not shaped totally by tax-avoidance features precisely track the factors this Court uses to determine whether a transaction has economic substance. *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009). Once those criteria for economic substance are met, "a transaction must be honored as legitimate for tax purposes." *Id.* at 544.

Klamath also holds that the economic substance doctrine applies only to "the particular transaction that gives rise to the tax benefit." *Id.* at 545. The district court initially followed that principle, concluding that the Southgate-NPL Transactions and the GNMA-Martel Transactions "must be divided for purposes of economic substance analysis." But the court then jettisoned that principle by allowing perceived defects in the latter transactions to invalidate the former (and, indeed, all of Southgate). The GNMA-Martel Transactions were not the transactions that gave rise to Southgate's tax benefit. The tax benefits that arose at the partnership level are derived from the losses on Southgate's NPL sales; the GNMA-Martel Transactions relate only to the outside basis of one partner.

The district court's "sham partnership" analysis was unprecedented. The district court pointed to no authority holding that a subsequent flawed capital contribution by one partner could infect a valid, profit-seeking partnership *ab initio*. Had the court applied recognized tests for whether an entity is a "sham," Southgate would have passed by a wide margin.

III. In any event, Beal's contribution of the GNMAs to Southgate was a valid capital contribution. The district court correctly found that the GNMA-Martel Transactions "allowed Southgate's partners to share in any gain or loss from the market value of the GNMAs in the event of a sales transaction"; that the value of this opportunity to Southgate's partners could have been as high as $13 million; and that the transactions altered the legal relations of Southgate's partners. As a matter of law, that is more than sufficient to imbue a transaction with economic substance and to require that it be respected for tax purposes.

STANDARD OF REVIEW

On appeal from a bench trial, the district court's findings of fact are reviewed for clear error and legal issues are reviewed *de novo*. *Klamath*, 568 F.3d at 543. The district court's interpretation of a statute and its characterization of a transaction for tax purposes are questions of law subject to *de novo* review, but the facts from which that characterization is made are reviewed for clear error. *Id*. Mixed questions of law and fact are reviewed *de novo*. *Compaq Computer Corp. v*. *Comm'r*, 277 F.3d 778, 780 (5th Cir. 2001).

ARGUMENT

I. SOUTHGATE'S ALLOCATION OF LOSSES WAS PERMITTED—AND REQUIRED—BY LAW.

The district court correctly found that the Southgate-NPL Transactions had economic substance and that Southgate was a legitimate, profit-seeking enterprise. As explained above, *supra* pp. 14-16, 20, and discussed below in further detail, *infra* pp. 37-40, that conclusion was compelled by the court's extensive factual findings. In short, the court found that the Southgate partnership and NPL transactions posed a "reasonable possibility of making a profit," R.15306/FF-¶167, and that Montgomery and Beal "believed that they could earn a profit from the

NPLs, and . . . would have done this deal regardless of whether or not it had any tax benefits," R.15300/FF-¶145.

Nevertheless, the district court ultimately invalidated Southgate's deduction of the NPL losses. The court began by concluding that Southgate's tax treatment relied on a "loophole" that was "not clearly express[ed]" by Congress. R.15381-15383/COL-125-127. The district court was flat wrong; not only was Southgate's deduction of the losses resulting from disposition of the NPLs contemplated by the relevant statutes and regulations, this tax treatment was the direct, foreseeable, and logical consequence of a specific congressional choice.

A. Southgate Complied With The Text And Intent Of 26 U.S.C. § 704(c) And Its Implementing Regulations.[9]

When a built-in loss is recognized through the sale or other disposition of a partnership asset, 26 U.S.C. § 704(c) provides the rule for how to allocate that loss among the partners.[10] The loss must generally be allocated back to the partner who initially contributed the asset. *See* 26 U.S.C. § 704(c)(1). When the contributing partner has sold or transferred his partnership interest before the loss is recognized, that loss must go somewhere—that is, it must be allocated either to the other partners or to the successor partner who acquires the contributing partner's interest.

[9] Unless otherwise noted, references are to the statutes and regulations in place in 2002.

[10] Although Southgate is an LLC, it is classified as a partnership for tax purposes. 26 U.S.C. § 761(a).

The statute answers that question explicitly: "[a]ny reference . . . to the contributing partner *shall* be treated as including a reference to any successor of such partner." 26 U.S.C. § 704(c)(3) (emphasis added). Thus, the successor partner is *required* to step into the shoes of the original contributing partner for this purpose. That treatment is confirmed by agency regulations. 26 C.F.R. § 1.704-3(a)(7) ("If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.").

Application of these provisions to Southgate is straightforward. Cinda (via Eastgate) contributed the NPLs to Southgate with a built-in loss of $1.36 billion. Southgate recognized $292 million of that built-in loss on its sales of a portion of the NPL portfolio later in 2002. *Supra* pp. 10, 12-13; R.15348/FF-¶325. If Cinda had continued to hold its full partnership interest in Southgate, Section 704(c)(1) would have required that the entire built-in loss be allocated to Cinda as the contributing partner. However, when Beal purchased his 90% interest in Southgate from Cinda, he was required to step into Cinda's shoes and was allocated 90% of Cinda's built-in loss under Section 704(c)(3) and 26 C.F.R § 1.704-3(a)(7). Thus, the law mandated that 90% of Southgate's built-in loss recognized in 2002, or $263,564,749, be allocated to Beal.[11]

The district court initially recognized that this allocation of losses was required by Section 704(c) and the Treasury Regulations. R.15348/FF-¶322 ("Because Beal purchased 90 percent of Cinda's partnership interest on August 30, 2002, 26 U.S.C. § 704(c) and [26 C.F.R] § 1.704-3(a)(7) required that 90 percent of the built-in loss be allocated to Beal."). But it ultimately held that this allocation was an unintended consequence of the law: "Although Plaintiff appears to have relied on a literal interpretation of the statutory language as it existed prior to the 2004 amendments, the Court is unwilling to attribute to Congress a motive it did not clearly express." R.15382-15383/COL-126-127.

The long history of Section 704(c) belies the court's skepticism; indeed, Congress specifically chose to authorize the very "loss transfer" that the court here disparaged. In 1954, Congress enacted the first comprehensive statutory scheme for the tax treatment of partnerships and partners. In establishing those new provisions, Congress's "principal objectives" were "simplicity, flexibility, and equity as between partners." H.R. Rep. No. 83-1337 at 65 (1954). At the time, Congress provided two alternative methods of calculating pre-contribution

[11] An additional $1.9 million in post-contribution losses were allocated to Beal and properly reported on Southgate's 2002 tax return. R.15349/FF-¶327. Section 704(c) does not apply to these losses.

partnership gains and losses: The gain or loss could be allocated to the partners in accordance with their relative interests in the partnership, *see* Internal Revenue Code of 1954, Pub. L. No. 83-591, § 704(c)(1), *or* partners could elect to allocate the pre-contribution gain or loss solely to the contributing partner. Pub. L. No. 83-591, § 704(c)(2).

In 1984, Congress revisited the rule and made the second option *mandatory*, requiring that pre-contribution "built-in" gain or loss be allocated to the contributing partner. Pub. L. No. 98-369, § 71 (amending Section 704(c)). At the time, Congress also identified a related problem—what to do if the contributing partner's interest is transferred before a gain or loss is recognized.[12] After initially leaving the issue unresolved, in 1989 Congress provided a crystal-clear answer by enacting Section 704(c)(3): Successors must stand in the contributing partner's shoes. Pub. L. No. 101-239, § 7642.[13] That result was echoed by 26 C.F.R § 1.704-3(a)(7), which states that a taxpayer "must" allocate built-in losses as

[12] *See* H.R. Rep. No. 98-861 at 857 (1984) (noting that certain situations were "not addressed" by the amendments, "including those contributions of . . . property which [were] not disposed of prior to the contributing partner's disposition of his partnership interest").

[13] *See also* H.R. Rep. No. 101-247 at 1357 (1989); S. Rep. No. 101-56 at 197 (1989) ("The bill provides that the term contributing partner includes successor partners. Thus, for example, if the partner who originally contributed property to the partnership sells his interest to a successor partner, the successor is treated as recognizing gain or loss under the provision when the contributed property is distributed to the other partners.").

Southgate did here. It is undisputed that those provisions were in force in 2002, the relevant year for Southgate.

The treatment of successors is thus not an accident or a loophole. Rather, it is an important and deliberate component of the statutory scheme *directing* the tax treatment at issue here. Contrary to the district court's assertion, Congress expressed its intent very "clearly."

B. The 2004 Amendments Confirm This Treatment.

The district court concluded that the 2004 amendments to Section 704(c) made clear that what Southgate did for tax year 2002 was impermissible. The district court had it exactly backward.

The 2004 amendments imposed a cap on transferred losses, effectively acknowledging that Southgate had correctly allocated its built-in losses in prior years. The amendments, which apply only to partnership contributions occurring after October 22, 2004, reversed the rule requiring a transferee partner to step into the shoes of a contributing partner, but *only if* the built-in loss exceeds $250,000 at the time of the transfer. Pub. L. No. 108-357, § 833(a) (adding 26 U.S.C. § 704(c)(1)(C)). Losses of less than $250,000 may still be transferred. Pub. L. No. 108-357, § 833(b) (amending 26 U.S.C. § 743).

The district court nevertheless claimed that "[i]t is just as likely, however, that Congress was trying to close a loophole that never really existed."

R.15381/COL-125. The court reasoned that "the amendment changed Section 704 to require the allocation of built-in losses to the contributing partner rather than other partners. In doing so, Congress may have simply clarified its intention of preventing inappropriate transfers, something it intended even prior to 2004." R.15381-15382/COL-125-126. That cannot be right. As explained above, the treatment of successor partners under Section 704(c) is the direct and intended effect of a deliberate statutory choice. Moreover, if Congress regarded a successor's retention of built-in loss as improper under existing law, its decision to continue to permit retention of less than $250,000 would be nonsensical. Tellingly, the district court did not mention that such loss transfers are still permitted under the amended statute.

The legislative history of the 2004 amendments further demonstrates that the version of Section 704(c) in force in 2002 meant what it said. The House Report's description of the prior version leaves no room for doubt:

> If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner. [26 C.F.R.] § 1.704-3(a)(7). . . . *Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.*

H.R. Rep. 108-548(I), 2004 WL 1380512 at *281-283 (2004) (the "House Report") (emphasis added).[14] Congress clearly intended the 2004 amendments to *change* the existing law regarding allocation of partnership items:

> The Committee believes that the partnership rules *currently allow* for the inappropriate transfer of losses among partners. This has allowed partnerships to be created and used to aid tax-shelter transactions. The bill *limits* the ability to transfer losses among partners, while *preserving* the simplification aspects of the current partnership rules for transactions involving smaller amounts.

H.R. Rep. 108-548(I), 2004 WL 1380512 at *281-283 (2004) (emphases added).

The district court emphasized that the House Report described such transfers as "*inappropriate*." R.15381/COL-125 (quoting H.R. Rep. 108-548(I)) (emphasis in original). But that reflects only the reason why Congress wanted to *change* the law. Moreover, the district court overlooked that report's comment that built-in-loss transfers were "currently allow[ed]" under the law. And the district court likewise ignored Congress's decision to "preserv[e]" the transfer of losses of less than $250,000. One can "preserve" only what already exists.

C. The Inquiry Should End There.

The district court correctly found that the Southgate-NPL Transactions had economic substance and that Southgate was a legitimate, profit-seeking enterprise.

[14] *See also* H.R. Conf. Rep. 108-755, 150 Cong. Rec. H8411-01, 2004 WL 2335174 at *1673-1674 (2004) (same); The General Explanation of Tax Legislation Enacted in the 108th Congress (2005), JCS-5-05 No. 32, 2005 WL 5783636 at 36-37 (IRS May 2005) (same).

By enacting Section 704(c)(3), Congress explicitly chose to require that built-in losses be allocated to the successor partner. The meaning of the pre-2004 Section 704(c), and its application to Southgate, is therefore clear: Beal, the transferee partner, steps into shoes of Cinda/Eastgate with respect to 90% of the built-in losses relating to the NPLs.

The district court was therefore wrong in disparaging the transfer of Cinda's share of built-in losses to Beal as compliant only with the "literal" or "facial" terms of the statute, not with Congress's clear intent. That erroneous conclusion led the court to hold that "compliance with statutory language does not preclude it from applying the judicial doctrines to the transaction in question." R.15383/COL-127. The court held that it was authorized to ignore Southgate's compliance with the text of Section 704(c) in the name of "the judicial doctrines of economic substance, sham partnership, and substance over form." R.15383/COL-127. Not so.

Federal courts may not ignore "plain text" simply because it yields a result the government deems unpalatable—even in tax cases. *Gitlitz v. Comm'r*, 531 U.S. 206 (2001), is instructive. There, in the face of objections that the statute had been interpreted to provide a "double windfall" to the taxpayer, the Supreme Court held in favor of the taxpayer. The Court explained that, "because the Code's plain text permits the taxpayers here to receive these ['double windfall'] benefits, we need not address this policy concern." *Id.* at 220; *see also, e.g., Vainisi v. Comm'r*,

___ F.3d ___, No. 09-3314, 2010 WL 935751, at *5 (7th Cir. Mar. 17, 2010) (reversing Tax Court and holding that "[t]he privileges may be anomalous or even unintended . . . . But we cannot rewrite statutes and regulations merely because we think they imperfectly express congressional intent or wise social policy."); *Comm'r v. Korell*, 339 U.S. 619, 625 (1950) ("[W]e cannot reject the clear and precise avenue of expression actually adopted by the Congress because in a particular case we may know . . . that the public revenues would be maximized by adopting another statutory path.").

The purpose of the judicial doctrines is to close *unintended* loopholes in the tax code—*i.e.*, to prevent abusive tax treatments at the outermost margins of what may fall within a literal reading of the law. In upholding the constitutionality of the economic substance doctrine on separation-of-powers grounds, for example, the Federal Circuit explained that, "[f]rom its inception, the economic substance doctrine has been used to *prevent taxpayers from subverting the legislative purpose* of the tax code." *Coltec Indus. v. United States*, 454 F.3d 1340, 1353 (Fed. Cir. 2006) (emphasis added). The touchstone of the doctrine is "subver[sion]" of the statute. It cannot be used to invalidate a transaction that lies at the core of what the law not only contemplates, but also *requires*. Similarly, the Seventh Circuit has defended the economic substance doctrine as a method of stopping those "trying to take advantage of a loophole *inadvertently* created by the framers of the tax code;

in closing such loopholes the courts [can] not rightly be accused of having disregarded congressional intent or overreached." *Yosha v. Comm'r*, 861 F.2d 494, 498 (7th Cir. 1988) (emphasis in original).

The district court recognized as much—at least initially. *E.g.*, R.15383/COL-127 ("The economic substance doctrine allows courts to enforce the legislative purpose of the Internal Revenue Code."); *id*. ("'The doctrine of economic substance becomes applicable . . . where a taxpayer seeks to claim tax benefits, unintended by Congress.'") (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)). But its flawed understanding of Section 704(c)—and the resulting conclusion that "loss transfer" was an unintended loophole in the statute's operation—prevented it from reaching the correct conclusion. Because Section 704(c) and the implementing regulations in effect in 2002 contemplated and required the allocation of losses recognized in the Southgate-NPL Transactions, the district court had no authority to doubt that legal command.

II. THE DISTRICT COURT CORRECTLY FOUND THAT SOUTHGATE WAS A VALID, PROFIT-SEEKING PARTNERSHIP BUT ERRED IN HOLDING THAT IT COULD BE RETROACTIVELY INVALIDATED BY THE PUTATIVELY DEFICIENT GNMA-MARTEL TRANSACTIONS

The district court concluded that—even though Southgate had "facially complied" with the plain language of Section 704(c) and 26 C.F.R § 1.704-3(a)(7), and had "properly allocated" the losses arising out of its 2002 sale of NPLs among its members, R.15316/FF-¶202—the court could "apply the so-called judicial doctrines" to decide whether to uphold Southgate's claimed losses. R.15382/COL-126. As explained above, that conclusion was wrong.

Yet the court committed an even graver mistake when attempting to apply those doctrines. It started out by correctly holding that "Southgate Itself Had Economic Substance," R.15386/COL-130, an inescapable conclusion from the court's findings of fact. But its decision then went astray: The court relied on its skepticism of the *subsequent* GNMA-Martel Transactions (by Beal alone) to invalidate the entire partnership for tax purposes. This was unprecedented and wrong. Even if the GNMA-Martel Transactions were flawed,[15] the court should have simply disregarded them. There was no basis for instead allowing them retroactively to infect the entire Southgate partnership or the distinct Southgate-NPL Transactions.

A. The District Court Correctly Determined That Southgate Itself Had Economic Substance.

As this Court explained in *Klamath*, where a "genuine multiple-party transaction with economic substance . . . is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the

[15] As we explain in Part III, the GNMA-Martel Transactions were not deficient.

Government should honor the allocation of rights and duties effectuated by the parties." 568 F.3d at 543 (*citing Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978)); *see also Compaq*, 277 F.3d at 786 (holding that evidence of economic substance exists "where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests") (quoting *ACM P'ship v. Comm'r*, 157 F.3d 231, 248 n.31 (3d Cir. 1998)).

Applying these factors, the district court correctly held that "Southgate Itself Had Economic Substance." R.15386/COL-130. It explained that "the Southgate transaction regarding the Chinese NPLs (1) had economic substance compelled by business or regulatory realities, (2) was imbued with tax-independent considerations, and (3) was not shaped totally by tax-avoidance features." R.15386-15387/COL-130-131.

That conclusion was compelled by the district court's findings of fact. As set forth at length in the court's opinion:

- The transactions were imbued with real business purposes and presented a "reasonable possibility of making a profit." R.15306/FF-¶167. The acquisition of the NPL portfolio fell within Montgomery and Beal's core business of investing in distressed assets. R.15300/FF-¶145.

- Montgomery took all of the pre-transaction steps necessary to put Southgate in a position to succeed, including securing a loan portfolio from Cinda that met established investment criteria; locking in the portfolio to ensure that Cinda did not "cherry-pick[]" the best loans; negotiating a price that would enable an investor to earn a profit; entering into an agreement that incentivized Cinda to maximize collections; and hiring Chinese firms to conduct due diligence and assess potential recoveries. R.15288/FF-¶¶103-104. The district court recognized that Southgate's due diligence efforts actually "went beyond what is often done in this type of transaction," and evidenced a "genuine expectation" of making a profit. R.15293, 15294/FF-¶¶122, 125.

- Once Southgate acquired the NPLs, it expended "significant effort" to maximize collections, and its collections plan was reasonable. R.15306-15307/FF-¶¶169-171. Southgate's sales of the NPLs were negotiated with unrelated third parties and then submitted to a public auction process to reduce the risk of fraud and ensure arm's-length transactions. R.15309/FF-¶¶177-178.

- Montgomery and Beal "believed that they could earn a profit from the NPLs, and . . . would have done this deal ***regardless of whether or not it had any tax benefits***." R.15300/FF-¶145 (double emphasis added). Indeed, Montgomery was not allocated *any* tax benefits from the built-in losses in the Southgate-NPL Transactions. R.15349/FF-¶329. Rather, Montgomery had long-term plans, and hoped to "become an expert" and "develop a tremendous amount of knowledge about China and then do multiple transactions going forward." R.15301/FF-¶147.

Not only did the district court conclude that the Southgate-NPL Transactions as a whole had economic substance and profit potential, but it also found that *each step* of the transactions was imbued with tax-independent business considerations.

- Creating Eastgate, a Delaware LLC, to act as Cinda's investment vehicle "provided Cinda with a layer of liability protection with respect to the NPLs, its dealings with [Montgomery], and its participation in a joint venture," R.15301/FF-¶148, and confirmed that Cinda could transfer the loans to a United States entity subject to domestic regulation. R.15301/FF-¶¶149-150.

- Establishing and transferring the loans to Southgate avoided onerous legal and regulatory requirements for forming a foreign entity in China and allowed for easier conversion of Chinese Yuan into U.S. dollars. R.15302/FF-¶152.

- Engaging Cinda to service the loans allowed Southgate to: comport with Chinese law, which severely restricts who can collect debt; service a geographically diffuse portfolio of loans—Cinda had branches in all 15 provinces where the NPL debtors were located; maintain influence in the Chinese courts; and perhaps most critically, employ Cinda's "super powers" for collections. R.15304/FF-¶159.

- Using Martel to acquire an interest in Eastgate (instead of buying an interest directly in Southgate) allowed Beal to "get representations and warranties directly from Cinda" and "provided Cinda with immediate liquidity," R.15306/FF-¶¶165-166.

Acknowledging the validity of Southgate and the transactions by which it acquired, serviced, and sold the NPLs, the district court found that Southgate had an initial tax basis of $1.38 billion in the NPLs contributed by Cinda to Southgate, that Southgate suffered a $294 million loss on the sale of a portion of those NPLs in 2002, and that 90% of this loss was "properly allocated" to Beal. R.15316/FF-¶¶199-202. Thus, it held, "Southgate Itself had Economic Substance." R.15386/COL-130.

B. The Alleged Invalidity Of The GNMA-Martel Transactions Cannot Retroactively Infect The Economic Substance Of Southgate Or Its NPL Investments.

The district court held that the purported deficiency of the GNMA-Martel Transactions not only reduced the share of Southgate's losses that Beal could claim on his personal return, but also infected the entire partnership—rendering it void *ab initio*. But it gave barely any reason for this surprising result: It simply declared that "it is apparent that the Martel/GNMA Repo transaction resulted in a sham partnership." R.15395/COL-138. It did not explain how a partner's allegedly invalid attempt to add assets to a *valid* partnership could "result[]" in turning that preexisting partnership into a "sham." *Id.*

No explanation was given because none is possible. Even if the GNMA-Martel Transactions lacked economic substance, the consequence would be to disregard them. They cannot retroactively infect the entire partnership and render it a "sham." The district court's holding on this point was unprecedented and unsupportable.

1. <u>The Putative Invalidity Of One Transaction Does Not Infect An Earlier One.</u>

First, this Court has held that, in "applying the economic substance doctrine, the proper focus is on the particular transaction that gives rise to the tax benefit." *Klamath*, 568 F.3d at 545; *see also Coltec*, 454 F.3d at 1357; *James v. Comm'r*, 899 F.2d 905, 910 (10th Cir. 1990). The district court appeared to recognize this premise when it correctly determined that the Southgate-NPL Transactions and the GNMA-Martel Transactions "must be divided for purposes of economic substance analysis." R.15386/COL-130.

Yet the court then undercut its own determination by wrongly using the second transaction to reverse its initial conclusion that the Southgate partnership was valid. The Southgate-NPL Transactions affected the *partnership's* losses. The GNMA-Martel Transactions affected *only one partner's—Beal's—outside basis*, not the partnership's inside basis or its taxable income. 26 U.S.C. §§ 701, 702(a). So any "focus" on the GNMA-Martel Transactions must be limited to "the tax benefit" they provided—namely, increasing Beal's outside basis and the timing of his ability to utilize losses on his personal tax return. Beal's attempt to build outside basis to *utilize* the losses cannot retroactively taint Southgate's *incurrence* of the losses.

Second, and more fundamentally, this Court has also held that "if a transaction lacks economic substance . . . the transaction *must be disregarded*." *Klamath*, 568 F.3d at 544 (emphasis added). That rule is settled across the circuits. *See, e.g.*, *Coltec*, 454 F.3d at 1343 ("the transaction . . . lacked economic substance and therefore must be disregarded for tax purposes"); *In re CM Holdings*, 301 F.3d 96, 102 (3d Cir. 2002) ("[I]f a transaction . . . lacks economic substance it simply is not recognized for federal taxation purposes, for better or for worse.") (internal quotations omitted); *Keeler v. Comm'r*, 243 F.3d 1212, 1215 (10th Cir. 2001) ("[A] cardinal rule of the tax code [is that] transactions lacking economic substance are not recognized for tax purposes."); *Ferguson v. Comm'r*, 29 F.3d 98, 102 (2d Cir. 1994) ("Having concluded that the . . . activities lacked economic substance, those activities must be disregarded for tax purposes.").

Yet the district court did not simply "disregard[]" the GNMA-Martel Transactions. Instead, it used them to reverse its own conclusion that "Southgate Itself Had Economic Substance." R.15386/COL-130. This was inconsistent with *Klamath*'s requirement that "the transaction must be disregarded," 568 F.3d at 544; *see also, e.g.*, *Coltec*, 454 F.3d at 1360 ("When that transaction is disregarded, the basis in the . . . stock is *unaffected* by the [transaction].") (emphasis added). Southgate's losses should have remained with the partnership; Beal and the other partners should be able to deduct their allocated share of those losses in future years if they properly build sufficient outside basis in the partnership. By retroactively invalidating those losses, however, the district court prohibited any possibility of future deductions. That error is reason enough to reverse the decision below.

2. <u>If Affirmed, The Court's Ruling Would Have Absurd Consequences.</u>

The district court's invented retroactive-infection ruling, if allowed to stand, would itself infect many other settled principles of tax law. Courts routinely confront situations where an entity with a legitimate business purpose and a history of other economically substantial transactions participates in a single transaction that is found to lack economic substance. Under the logic of the district court's opinion, that lone transaction should invalidate the entity as a whole. But that is not the law. *See, e.g.*, *Coltec*, 454 F.3d at 1356 (invalidating a transaction that lacked economic substance, but leaving the otherwise legitimate underlying business form intact); *Thompson v. Comm'r*, 631 F.2d 642, 643 (9th Cir. 1980) (recognizing that underlying real estate venture was legitimate despite concluding that a particular transaction by the venture lacked economic substance); *Wells Fargo v. United States*, No. 06-628T, 2010 WL 94544, at *56 (Fed. Cl. Jan. 8, 2010); *Davis v. Comm'r*, 585 F.2d 807, 812 n.8 (6th Cir. 1978) (invalidating specific transaction while upholding underlying entity).

Under the district court's ruling, every entity that engages in a transaction that the IRS might later challenge risks its own existence. If a court found a single transaction invalid under the economic substance doctrine—a doctrine the district court acknowledged to be "murky," R.15384/COL-128—the whole enterprise would be invalidated. That would have intolerable consequences for well-intentioned taxpayers, and it would turn *Coltec* and many other economic substance cases upside-down.

The district court's flawed analysis is further reflected in the tax treatment of Montgomery's share of Southgate's losses. Montgomery was not allocated any of the built-in loss on the NPLs. R.15349/FF-¶329. Rather, "[a] $20,119 loss (post-contribution loss only) was allocated to MCA, and reported on Southgate's 2002 Form 1065." R.15349/FF-¶327. Montgomery lost approximately $85,000 on the Southgate transaction. R.15349/FF-¶329. There is no dispute that Montgomery, through MCA, properly computed and reported his outside basis in Southgate on his 2002 tax returns. Montgomery was entitled to deduct this share of Southgate's losses on his 2002 tax return.

Yet the district court's ruling that the GNMA-Martel Transactions (which relate only to Beal's outside basis) nullify *Southgate as a whole* deprives Montgomery of that right. Nothing in law or logic allows a court to penalize one partner for the purported errors of a second partner on the second partner's *personal* tax returns. *Cf. United States v. Herring*, 492 F.3d 1212, 1218 (11th Cir. 2007) (punishing one actor for another's conduct "would be like telling a student that if he skips school one of his classmates will be punished"), *aff'd*, 129 S. Ct. 695 (2009). Yet that is the consequence of the district court's retroactive-infection ruling.

If affirmed, the district court's ruling would bring chaos to the entire field of partnership taxation—and perhaps elsewhere. Unrelated transactions found to violate the "murky," R.15384/COL-128, economic substance doctrine would cause entire partnerships to evaporate. A single partner's attempt to claim losses improperly on his own personal tax return would penalize his partners as well. If that were the law, one would expect there to be some authority saying so. But the district court identified nothing supporting such a sweeping proposition. On the contrary, the district court's ruling is inconsistent with *Klamath* and countless other cases.

A simple example illustrates the point. Suppose a law firm is in need of new office space. Suppose further that one of the firm's partners agrees to contribute an office building she owns to the partnership—including the right to share in any appreciation in the building's value if it is later sold—but reserves to herself the lease income generated by the building's other tenants. Even if the IRS later successfully challenges that contribution as somehow deficient (which, as we explain below, is a dubious proposition), that cannot retroactively void an otherwise valid law firm partnership. But that is what the district court did here, relying on perceived flaws in Beal's *subsequent* capital contribution to invalidate Southgate *ab initio*.

C. Southgate Would Also Have Satisfied Traditional Sham Partnership Analysis

Having concluded that the Southgate partnership and NPL Transactions had economic substance under *Klamath*, 568 F.3d at 544, the district court should have recognized that "a transaction must be honored as legitimate for tax purposes," *id.*, and therefore that the losses Southgate incurred on NPL sales in 2002 are allowable. In its separate discussion of the "sham partnership" and "substance over form" doctrines, which focused principally on the GNMA-Martel Transactions, the district court's only analysis of Southgate itself was limited to its retroactive-infection ruling and reliance on *Merryman v. Comm'r*, 873 F.2d 879 (5th Cir. 1989). As discussed above, the retroactive-infection ruling was wrong; and *Merryman* neither applied nor even referred to a "sham partnership doctrine," but rather determined the validity of a partnership under the *Frank Lyon* economic substance test. As even the district court recognized, Southgate satisfied the *Frank Lyon* test. *See supra* pp. 37-40.[16]

Nonetheless, it bears emphasizing that even if the district court had conducted a traditional "sham partnership" analysis of Southgate—which it did not—Southgate undoubtedly would have satisfied it. The only "sham partnership" criteria recognized by the courts are those established by *Moline Properties v. Comm'r*, 319 U.S. 436, 438-439 (1943), or 26 U.S.C. § 704(e). Southgate plainly satisfies both.

Under *Moline Properties*, an entity is to be "respected and maintained" for federal tax purposes if its purpose *at the time of formation* is to conduct business activity, or if the entity carries on business activity after its formation. 319 U.S. at 438-39 (rejecting contention that entity was a sham); *United States v. Creel*, 711

[16] In contrast to Southgate, the partnership at issue in *Merryman* was found to have served no business or economic purpose, as it had no real liabilities, functioned primarily among family members, did not alter the economic positions of its partners, conducted no business dealings other than executing two contracts, owned no property, kept no books or records, and did not hold itself out as being engaged in business. 873 F.2d, at 879-880; *see also Compaq*, 277 F.3d at 787-788 (describing the extreme facts of *Merryman*).

F.2d 575, 578-79 (5th Cir. 1982). *Moline Properties* establishes a two-pronged test, "the first part of which is business purpose, and the second, business activity. Business purpose or business activity are alternative requirements." *Rogers v. Comm'r*, T.C. Memo 1975-289, 1975 WL 2907.

If it is shown *either* that the partners had a legitimate business purpose in creating a business entity *or* that the entity carried on business activities, the entity will not be disregarded as a sham. In *Copeland v. Comm'r*, the Court employed the *Moline Properties* test in holding that an entity was a valid partnership, even in the absence of a profit objective, so long as it engaged in business activities. 290 F.3d 326, 330 (5th Cir. 2002) ("They carried on a financial operation or venture. They are to be treated as partnerships . . . even though the underlying activities of the partnerships lacked a profit objective."); *see also Raymond Pearson Motor Co. v. Comm'r*, 246 F.2d 509, 515 (5th Cir. 1957).

Southgate likewise satisfies these criteria. As discussed above, the district court correctly found that Southgate was formed with a profit objective. R.15300, 15306/FF-¶¶145, 167. It also carried on substantial business activity. Southgate was created legally under an enforceable LLC operating agreement, R.15282-15283/FF-¶¶86, 92, entered into the collection agreements R.15284-15288/FF-¶¶94-102, and conducted activities consistent with its investment purpose, R.15273-15288, 15306-15310/FF-¶¶47-102, 168-183.

Southgate also satisfies the criteria set forth in 26 U.S.C. § 704(e)(1), which sets forth a test for determining a putative partner's status:

> A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

26 U.S.C. § 704(e).[17] Thus, if a person (1) owns (2) a capital interest in (3) a partnership in which capital is a material income-producing factor, then that person is recognized as a partner and must be taxed as one. The court's factual findings make plain that Southgate and its members satisfy each element of the statute. *See* R.15281/FF-¶78 (ownership); R.15324/FF-¶233 (capital interests); R.15283/FF-¶¶87, 89 (capital as material income-producing factor). The IRS has not even contended otherwise.[18]

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[17] Although Section 704(e) is titled "Family Partnerships," it applies to *all* partnerships in which capital is a material income-producing factor. *Evans v. Comm'r*, 447 F.2d 547, 550 (7th Cir. 1971).

[18] The court's putative analysis of the "substance over form" doctrine was even more fleeting. R.15394-15397/COL-138-141. The court observed that it had "already concluded that the Martel/GNMA Repo transaction lacked economic substance and the partnership structure was a sham. It necessarily follows that the substance of the transaction, with Martel as a conduit to facilitate solely tax-based motives, cannot survive judicial scrutiny." R.15397/COL-141. It gave no separate reason for believing that either Southgate or the GNMA-Martel Transactions "elevate[d] form over substance." *Id.*

III. THE DISTRICT COURT ERRED IN CONCLUDING THAT THE GNMA-MARTEL TRANSACTIONS LACKED ECONOMIC SUBSTANCE

The district court correctly recognized that Beal's ability to deduct his share of Southgate's losses was, at bottom, a question of timing. That is, the question was not *whether* Beal could deduct those losses, but *when* he could do so by increasing his outside basis in Southgate. As the district court put it: "Faced with a built-in loss that, while properly allocated to him, exceeded his outside basis in Southgate, Beal either had to leave the losses in excess of his outside basis "suspended" *for future years* or increase his outside basis . . . to utilize the losses more fully *in 2002*." R.15316/FF-¶202 (emphases added). The district court also correctly acknowledged that Beal's utilization of those losses would be offset by future gains, and specifically found that Beal realized such gains in 2006 and 2007. R.15349/FF-¶328.

The district court then concluded, however, that the "Martel/GNMA repo structure was nothing more than a sham to gain tax benefits for Beal." R.15393/COL-137. That conclusion is contradicted by the court's own findings of fact that the GNMA-Martel Transactions *had* economic substance and business purposes apart from providing tax benefits to Beal; the district court also ignored the operation of capital accounting confirmed by Southgate's Operating Agreement and described by the court earlier in its opinion. It is also legally erroneous: The district court faulted the transactions for not having a business purpose, but no such purpose is required for making a capital contribution.

A. The District Court's Conclusion That The GNMA-Martel Transactions Lacked Economic Substance Is Contradicted By Its Findings Of Fact

Because this Court reviews legal conclusions *de novo* while reviewing findings of fact for clear error, the district court's findings of fact control over its conflicting conclusions of law. Those findings of fact establish that the GNMA-Martel Transactions had economic substance under *Frank Lyon* and *Klamath*.

The district court found that "[t]he Martel Restructure and GNMA Repo transactions *had some economic substance*, as all of Southgate's partners had a *reasonable possibility of profiting* from the GNMAs after their contribution." R.15326/FF-¶235 (emphases added). More specifically, the court found that the GNMA-Martel Transactions "allowed Southgate's partners to share in any gain or loss from the market value of the GNMAs in the event of a sales transaction." RR.15337/FF-¶275; *see also* R.15321, 15327/FF-¶¶223, 242. The Government's own expert witness opined that the value of this opportunity to Southgate could be as high as $13,000,000. R.15326/FF-¶236.

"A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit." *Portland Golf Club v. Comm'r*, 497 U.S. 154, 170 n.19 (1990) (quoting *Gefen v.*

Comm'r, 87 T.C. 1471, 1490 (1986)). The entitlement to post-contribution profits alone thus establishes the legitimacy of the GNMA-Martel Transactions for tax purposes. That is because the economic substance doctrine "do[es] not allow the [court] to disregard economic transactions . . . which result in actual, non-tax related changes in economic position." *ACM P'ship*, 157 F.3d at 248 n.31 (quoting *Northern Indiana Pub. Serv. Co. v. Comm'r*, 115 F.3d 506, 510 (7th Cir. 1997)).

Notwithstanding these unambiguous findings concerning the profit potential of the GNMA-Martel Transactions, the district court incorrectly concluded that the transactions "lack[ed] economic substance." R.15389/COL-133. The court attempted to justify this contradictory conclusion by explaining that "Beal effectively reserved for himself all guaranteed income" from the GNMAs before transferring them to Southgate, thus depriving Southgate's other partners of all of the potential benefits of the GNMAs. R.15389/COL-133.[19]

Again, this conclusion contradicts the court's specific factual findings. The court found that, assuming "Beal could distribute the GNMAs to himself, the

[19] The district court appears to have erroneously believed that Beal's reservation to himself of income from the GNMAs (like the coupons on a bond) meant that he had reserved all possibility of profit. As discussed above, post-contribution appreciation in the value of the underlying GNMAs was shared among the partners. The district court also appeared troubled by Beal's reservation of interest income from the GNMAs, but that is hardly an unusual occurrence when dealing with government securities. Suppose, for example, Beal had contributed United States Treasury "strips," which allow investors to "hold and trade the individual interest and principal components of eligible Treasury notes and bonds as separate securities." http://www.treasurydirect.gov/instit/marketables/strips/strips.htm. Beal's contribution of the GNMAs subject to his reservation of the interest income was not meaningfully different.

Southgate Operating Agreement provided that Southgate's other partners *would not be* deprived of their share of the assets." R.15327/FF-¶242 (emphasis added). As the court found, under the Second Amendment to Southgate's Operating Agreement, although Beal had the right to distribute the GNMAs or payments associated with them back to himself, such a distribution would reduce his capital account and percentage interest in Southgate, while increasing Southgate's other partners' capital accounts and percentage interests accordingly. R.15326/FF-¶239. Assuming the GNMAs were distributed when they had a fair market value greater than they had on the day they were contributed to Southgate, Beal would be entitled to a proportionately smaller share of Southgate's other assets (*i.e.*, the NPLs and cash contributed by MCA). R.15327/FF-¶242. Because there was real value in Southgate's "other assets"—*i.e.*, the NPLs—any reduction in Beal's capital account and corresponding increase in Eastgate's and MCA's capital accounts and percentage interests would have had meaningful consequences. Thus, Southgate's other partners would receive either direct gains from the GNMAs or indirect gains via a higher percentage of Southgate's other assets.[20]

[20] The latter finding is reinforced by the court's finding that the Second Amendment to the partnership agreement "expressed the parties' intent that Southgate and its members participate in the gain on the GNMAs through allocation of post-contribution gains and losses based on their interest in Southgate," R.15321/FF-¶223, and that "Southgate properly maintained the members' capital accounts in connection with the [GMNA-Martel Transactions]," R.15325/FF-¶233.

Although the district court concluded that the GNMA-Martel Transactions "fail[] the test set forth in *Frank Lyon* and *Klamath*,"[21] R.15389/COL-133, that conclusion was based entirely on its conclusion that Southgate did not have a "reasonable possibility of profiting" from the GNMA-Martel Transactions. That conclusion conflicts with the court's findings of fact as set forth above. The findings of fact establish that the *Frank Lyon/Klamath* criteria are met.

B. The GNMA-Martel Transactions Altered The Legal Relations Of Southgate's Members.

Even if the district court's eventual conclusion that "Southgate did not have a reasonable possibility of profit from" the GNMA-Martel Transactions had been correct, the district court's conclusion that those transactions fail the economic substance test is erroneous. Finding a "reasonable possibility of profit" is not the exclusive means by which a transaction may be found to have economic substance. The economic substance doctrine requires an effect on "the taxpayer's net economic position, *legal relations*, or non-tax business interests." *ACM P'ship*, 157 F.3d at 248 n.31 (emphasis added); *Compaq Computer Corp.*, 277 F.3d at 786; *see also Countryside Ltd. P'ship v. Comm'r*, T.C. Memo 2008-3, 2008 WL 41414 (holding that a transaction that accomplishes a valid business purpose by

[21] Although *Klamath* binds this panel, its interpretation of *Frank Lyon* conflicts with decisions of other circuits, 568 F.3d at 544 (acknowledging disagreement with *Rice's Toyota World v. Comm'r*, 752 F.2d 89 (4th Cir. 1985)), and we reserve the right to request that it be abrogated by this Court *en banc* or by the Supreme Court.

economically altering the positions of the partnership or its partners cannot be disregarded for lack of economic substance even if the transaction was entirely tax motivated). Under Fifth Circuit precedent, that test is satisfied if the transaction in question alters the legal relationships of the parties, which the GNMA-Martel Transactions unquestionably did. *Estate of Strangi v. Comm'r*, 293 F.3d 279 (5th Cir. 2002).

In *Estate of Strangi*, this Court considered whether to disregard a limited partnership created by a decedent two months before his death. This Court affirmed the Tax Court's holding that, even without persuasive proof of a business purpose for the partnership, the objective economic substance of the partnership was "enough . . . to be recognized for federal estate tax purposes." 293 F.3d at 282.[22] Citing *Merryman* and *ACM Partnership*, the Court held that, because the "partnership agreement changed the legal relationships between decedent and his heirs and creditors" and because "[p]otential purchasers of decedent's assets would not disregard the partnership," the family limited partnership had "sufficient substance to be recognized for tax purposes." *Id*. at 282.

Consistent with this Court's conclusions in that case, the district court here found sufficient evidence that the GNMA-Martel Transactions altered the legal

[22] Although *Estate of Strangi* was a federal estate tax case, the Court applied the economic substance doctrine in the same way as in a federal income tax case.

relationships of Southgate's members to support a conclusion that the Transactions satisfy the objective prong of the economic substance test. In addition to the findings of fact set forth above, it is also undisputed that Cinda, MCA, Beal, and Southgate observed the formalities associated with Southgate's separate legal existence.

C. No Business Purpose Is Required For A Capital Contribution, Although The GNMA-Martel Transactions Had Business Purposes Nonetheless.

So long as a capital contribution to a partnership possesses economic substance, no separate business purpose is needed for that contribution. Indeed, the statutes and regulations that govern basis and the recognition of pre-existing tax losses make no mention of such a requirement. Rather, they focus merely on basis as a question of timing—when basis exists (regardless of *why* it exists), losses will be allowed. *See, e.g.*, 26 U.S.C. § 704(d) ("A partner's distributive share of partnership loss . . . *shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership* at the end of the partnership year in which such loss occurred.") (emphasis added); 26 C.F.R. § 1.704-1(d) ("[A]ny loss so disallowed *shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years*, to the extent that the partner's adjusted basis for his partnership interest at the end of such year exceeds zero . . . .") (emphasis added); 26 U.S.C. § 722 (the contributing partner's basis in the partnership "*shall* be the amount of money and the adjusted basis of such property" contributed to the partnership) (emphasis added).

The logic of that proposition is demonstrated by *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991). *Cottage Savings* involved a year-end transaction in which a savings and loan association swapped its interest in a mortgage pool that had incurred losses for another interest of equal value in a different pool. The exchange was intentionally structured to make no change in the taxpayer's accounting books, *id*. at 556-557, but specifically to allow the losses to be "recognized" for tax purposes (and therefore taken as a tax deduction).

The IRS asserted that the swapped loan portfolios could produce deductible losses "only if they differ in economic substance." *Id.* at 562. The Supreme Court rejected that argument, concluding that it was sufficient that the loans "embod[ied] legally distinct entitlements." *Id*. at 566. It then reversed the lower court, which had held that "[w]hat is done for the purpose of tax avoidance must, however, have some business purpose." 890 F.2d 848, 853 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991). Having held real loans that lost value, the taxpayer was not required to show some separate "economic substance" or "business purpose" underlying its attempt to claim those losses on its tax return. 499 U.S. at 567-568. Thus, the Court appreciated that the recognition of those losses was only a timing event that the taxpayer had a right to trigger when he sold them to an unrelated party for a new mortgage pool.

The same principle applies to a capital contribution designed to increase a partner's outside basis. The GNMA-Martel Transactions did not *generate* losses, such that a court could be concerned about whether they were genuine or had been properly incurred by Southgate. Rather, those transactions merely reflected Beal's effort to contribute assets to Southgate, with the obvious consequence of increasing his outside basis in the partnership and thereby allowing him to use the portion of Southgate's losses allocated to him.

Just as a taxpayer might sell certain stocks on December 31 rather than January 1 to make sure that losses fell within a particular tax year—or swap loan portfolios that are indistinguishable for accounting purposes in order to realize a tax loss, *id*. at 556-557—a partner's contribution to the partnership should not be disrespected simply because it might be motivated by a tax, rather than business, purpose. Otherwise, almost any transaction triggering a tax event would be subject to judicial disregard.

Nonetheless, it bears repeating that the district court found that there ***were*** "some non-tax business purposes" behind Beal's contribution of the GNMAs to Southgate. R.15314, 15335-15337/FF-¶¶205, 269-275. In addition to the fact that the GNMA-Martel Transactions allowed Southgate's members to share in any gain or loss from the market value of the GNMAs in the event of a sales transaction or in-kind distribution, the court also specifically found that "the structure of the [GNMA-Martel Transactions] served some legitimate business purposes." R.15336/FF-¶271. The transaction structure met UBS's preferences and was more efficient than other alternatives. *Id*.

The district court found that the GNMA-Martel Transactions resulted in the contribution of $18,558,175 in net equity to Southgate, which could allow the partnership to pursue additional investments in China.[23] The GNMAs also "diversified Southgate's investment portfolio," thereby providing "a potential benefit to Southgate." R.15337/FF-¶273.

IV. THE DISTRICT COURT IMPROPERLY DENIED BEAL APPROXIMATELY $28.5 MILLION IN UNDISPUTED BASIS BY AFFIRMING THE FPAA IN ITS ENTIRETY.

Southgate's position at trial was that, at the end of 2002, Beal's basis in Southgate was approximately $210 million. Although the FPAA challenged all of Beal's basis in Southgate, at trial the Government presented evidence challenging only $180.5 million—the amount related to the GNMA-Martel Transactions. Thus there is no dispute that Beal had approximately $28.5 million in basis in Southgate

[23] The fact that Southgate ultimately did not pursue additional non-performing loan deals is irrelevant. Any business purpose "must be measured at the time of the transaction rather than with 20/20 hindsight." R.15387/COL-131 (citing *Smith v. Comm'r*, 937 F.2d 1089, 1096 (6th Cir. 1991)); *see also Bryant v. Comm'r*, 928 F.2d 745, 749 (6th Cir. 1991). Here, Southgate's experience showed that other investors' past performance in the Chinese market was not indicative of future results.

before the GNMA-Martel Transactions. R.15316/FF-¶201. If this Court determines that Southgate was not a "sham," but that the GNMA-Martel Transactions lacked economic substance, Beal is entitled to deduct his portion of the NPL-related losses up to the amount of his outside basis, or $28.5 million.

CONCLUSION

For the foregoing reasons, the portion of the judgment of the district court that granted judgment in this action for the United States and concluded "that the Government's adjustments to Southgate Master Fund, LLC's 2002 tax return as set forth in the Notice of Final Administrative Adjustment issued on October 13, 2006, are correct" should be reversed.

The Appellants respectfully request this Court vacate the district court's judgment and remand with instructions to enter a judgment that allows all losses and deductions claimed by Southgate and determines that Beal's outside basis in Southgate was approximately $210 million. Alternatively, if the Court determines that the GNMA-Martel Transactions should be disregarded for tax purposes, the case should be remanded for entry of a judgment that eliminates all adjustments in the FPAA except an adjustment disallowing any increase to Beal's outside basis from the GNMA-Martel Transactions.

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Respectfully submitted,

SONNENSCHEIN NATH & ROSENTHAL LLP
By: /s/ M. Todd Welty
M. Todd Welty
2000 McKinney Avenue
Suite 1900
Dallas, TX 75201-1858
Telephone: (214) 259-0953
Facsimile: (214) 259-0910

SONNENSCHEIN NATH & ROSENTHAL LLP
Justin N. Kattan
1221 Avenue of the Americas
New York, NY 10020-1089
Telephone: (212) 768-6923
Facsimile: (212) 768-6800

ROBBINS, RUSSELL, ENGLERT, ORSECK, UNTEREINER & SAUBER LLP
Roy T. Englert, Jr.
Mark T. Stancil
William P. Baude
1801 K Street, NW, Suite 411
Washington, D.C. 20006
Telephone: (202) 775-4500
Facsimile: (202) 775-4510

CHICOINE & HALLETT, P.S.
Darrell D. Hallett
John M. Colvin
Millennium Tower
719 Second Avenue, Suite 425
Seattle, WA 98104
Telephone: (206) 223-0800
Facsimile: (206) 467-8170

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP
Martin D. Ginsburg
Alan S. Kaden
1001 Pennsylvania Avenue, NW
Washington, DC 20004
Telephone: (202) 639-7000
Facsimile: (202) 639-7003

CERTIFICATE OF SERVICE

I certify that on March 31, 2010, 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. 32(a)(7)(B) because this brief contains 13698 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
M. Todd Welty