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/CROSS-APPELLEE'S RESPONSE AND REPLY BRIEF

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TABLE OF CONTENTS

TABLE OF CONTENTS–cont'd

TABLE OF CONTENTS–cont'd

INDEX OF AUTHORITIES

Page(s)

CASES

INDEX OF AUTHORITIES-cont'd

Page(s)

INDEX OF AUTHORITIES-cont'd

Page(s)

INDEX OF AUTHORITIES-cont'd

Page(s)

STATUTES

MISCELLANEOUS

INDEX OF AUTHORITIES-cont'd

Page(s)

REGULATIONS

LEGISLATIVE MATERIALS

SUMMARY OF ARGUMENT

The government's brief tells a good story, but it is not the story the trier of fact found to be true after a lengthy trial. Apparently believing that the *judgment* it won below entitles it to use the same *version of the facts* it sought to prove below, the government provides a simple narrative: Southgate was a "DAD shelter," it argues, and therefore (i) the government need not grapple with the text and intent of the statute at the heart of this case, 26 U.S.C. §704(c); (ii) Southgate must be a sham partnership that lacked economic substance; (iii) the district court was clearly erroneous in finding that Beal and Montgomery acted in good faith and were not subject to penalties. But the premise of those arguments—that Southgate was bad from the start—is demonstrably false.

Southgate was *not* a "DAD shelter," and the district court *never found that it was*. To the contrary, the court found as fact that Southgate was formed for legitimate business purposes; that Beal and Montgomery tried to make the partnership profitable; and that they were motivated by the investment's significant profit potential—so much so that "*they would have done this deal regardless of whether or not it had any tax benefits.*" The government does not refute these factual findings, nor could it. The government simply ignores them, trying to substitute evidence and inferences it *unsuccessfully* urged upon the district court. The government also relies heavily on decisions in which courts made the kinds of

factual findings the government wishes had been made here, but the stark contrast between those cases and this one only demonstrates why the government's arguments are fundamentally flawed. In short, the government's brief rests largely on the fiction that the 15-day trial in this case—and the 402 findings of fact it yielded—never happened.

Stripped of its distortions, the government's brief has almost nothing to say about the three legal errors identified in our opening brief. The government has no answer to the overwhelming evidence that Congress fully intended Section 704(c) to require the tax treatment at issue. Instead, the government mischaracterizes our argument, assumes the conclusion it hopes to prove (that Southgate was an improper tax shelter), and then retreats to invoking the judicial doctrines without offering any plausible explanation of why they should apply in the first place.

The government's defense of the district court's application of those doctrines is largely an exercise in denial. The government insists that the court did not find that Southgate had economic substance or that it was retroactively invalidated by a single partner's purportedly defective capital contribution months later—never mind that the court's opinion states explicitly that "Southgate Itself had Economic Substance," but that "the Martel/GNMA Repo transaction resulted in a sham partnership." What is more, the government ignores the factual findings that confirm the court meant precisely what it said. When the government

(reluctantly) tries to defend the court's retroactive-infection theory, it has no response to Fifth Circuit precedent holding that a defective transaction is simply disregarded, not used to invalidate an entire partnership. The government then attempts to compare this case to decisions involving actual sham partnerships, but those decisions illustrate precisely why Southgate *is not* a sham.

Thus, the district court was wrong to invalidate Southgate, even if the GNMA-Martel Transactions were flawed. But the government also cannot defend the court's invalidation of the GNMA-Martel Transactions. It again ignores the court's factual findings—that the transactions "had some economic substance" and "allowed Southgate's partners to share in any gain or loss from the market value of the GNMAs." And it again resorts to mischaracterizing our legal argument: We argued plainly that no business purpose is required for a capital contribution, and the government's only response is the absurd claim that we concede the opposite.

The government's cross-appeal need not long detain this Court. All penalties are inapplicable unless the government can prove that the district court was clearly erroneous in finding as fact that Southgate and its members acted reasonably and in good faith. The government comes nowhere close to carrying that burden. Indeed, the government just ignores further findings that support the court's determination, relying instead on inaccurate recitations of the trial record and evidentiary inferences the court explicitly rejected. Even if the government

could overcome that hurdle, each argument for penalties fails for independent reasons.

ARGUMENT

I. SOUTHGATE'S ALLOCATION OF LOSSES WAS LAWFUL

A. The Transaction Complied With The Text And Intent Of Section 704(c).

The government knows that 26 U.S.C. §704(c) lies at the heart of this case, but it mentions the statute only twice. Gov't Br. 4, 26. That omission is revealing: The government does not and cannot defend the district court's flawed statutory analysis, which led the court to second-guess the tax treatment at issue under "the so-called judicial doctrines." R.15382/COL-126.

It is undisputed that Section 704(c) required the allocation of 90% of the NPLs' built-in losses to Beal. Therefore, the district court recognized, the judicial doctrines could apply *only* if Southgate's compliance with Section 704(c) yielded a result "that Congress [had not] anticipated." R.15380/COL-124. The overwhelming evidence that Southgate's allocation of built-in losses was the *intended result* of deliberate choices by Congress is set forth in our opening brief (at 26-33), but unanswered by the government. So if the government does not dispute that Southgate complied with the text of the statute, Gov't Br. 4, and it does not dispute that the judicial doctrines "cannot trump the plainly expressed intent of the legislature," *Horn v. Comm'r*, 968 F.2d 1229, 1231 (D.C. Cir. 1992);

see Gov't Br. 25-26, how can it avoid responding to the evidence demonstrating that Section 704(c) was *intended* to operate precisely as it did here?

The government's solution is to mischaracterize our argument, saying that we "attemp[t] to avoid th[e district court's] findings by arguing that the transaction's form complied with the literal language of the Code's partnership rules." Gov't Br. at 24. Our opening brief, however, explained at length that the Southgate transaction complied with the statute's "intent" as well as its text, Southgate Br. 27, 31; that this result was "not an accident or a loophole," *id*. at 31; and that the district court therefore erred in disparaging the allocation of built-in losses to Beal "as compliant only with the 'literal' or 'facial' terms of the statute, not with Congress's clear intent," *id*. at 34. We did not rely on mere "literal" compliance.

The government nonetheless argues that allocation of large built-in losses to transferee partners was illegal all along, a result it tries to derive from *Knetsch v. United States*, 364 U.S. 361 (1960). Gov't Br. 26-27. But the government again mischaracterizes our argument: Unlike the taxpayer in *Knetsch*, 364 U.S. at 367, Southgate does not contend that the loss-allocation was intended "merely because [it] predates" the statutory amendment, Gov't Br. 27. Rather, as explained above, our argument is that the 2004 amendment reflects a *change* in Congress's

treatment of built-in losses by, for the first time, limiting allocation to transferee partners to $250,000.

Indeed, *Knetsch* proves our point: The Court concluded that the statute at issue there was the latest in a string of provisions disallowing a type of interest-expense deduction. 364 U.S. at 367-368. But the history of Section 704(c) is just the opposite. As explained in our opening brief (at 31-33), the 2004 amendments limiting the allocation of built-in losses to transferee partners did not "simply . . . expand the application of the policy" previously pursued by the statute. 364 U.S. at 368. The amendments partially *changed* that policy, while preserving it for smaller amounts.

The government's assertion that "prior to the 2004 amendments to §704(c), transactions *devoid of substance* that were *designed to exploit* the partnership rules were [not] exempt from the judicial doctrines," Gov't Br. 26-27 (emphasis added), reflects the government's circular logic. It claims that Southgate should be punished for complying with Section 704(c) because it was allegedly a "partnership-basis-inflating shelter." *Id*. at 30. But its only evidence that the partnership was a "shelter" appears to be Southgate's compliance with Section 704(c). In any event, the government acknowledges that the district court held that "the NPL acquisition had economic substance," *id*. at 38 n.13, so this is indisputably *not* a "transaction[] devoid of substance," *id*. at 26.

B. The Government Would Render Section 704(c) A Nullity.

At bottom, the government's arguments reflect simply the IRS's hostility to Congress's choices in passing and amending Section 704(c). The government emphasizes the size of the deductions, suggesting that allocation of built-in losses to a transferee partner is illegitimate when losses are large. Gov't Br. 24, 29. Under that view, even *before* Congress capped transferred losses at $250,000, there was always a cap on losses under Section 704(c), but the size of the cap was determined *ad hoc* by the IRS's decision to invoke the judicial doctrines.

At other times, the government appears to suggest that any built-in-loss allocation to a transferee partner is illegitimate. For example, it complains that the NPLs' depreciation was originally "suffered by someone other than Mr. Beal." Gov't Br. 24 (internal quotation marks omitted). But this is true of every such allocation under Section 704(c).

The IRS is repeating the error it committed in *Horn v. Commissioner*. There, the D.C. Circuit rejected the IRS's attempt to apply the economic substance doctrine to an "option-straddle transaction" that otherwise complied with the tax laws. 968 F.2d at 1231 (internal quotation marks omitted). The court held that, "[a]lthough useful in determining congressional intent and in avoiding results unintended by tax code provisions, the [economic substance] doctrine *cannot*

trump the plainly expressed intent of the legislature." *Id*. (emphasis added). It continued:

> [A]fter reading the statute and the legislative history, we began with the question, "if [the statute] does not authorize the deduction claimed here, what is its purpose?" . . . [W]e can find no satisfactory answer to that question. . . . [T]o construe the section as . . . the Commissioner do[es] would read it completely out of existence.

Id. at 1234. Similarly, if Section 704(c) did not require the built-in loss to be allocated to Beal when he purchased his interest in the partnership, when *does* it apply?

If, as the government claims, Section 704(c) was not intended to apply to the Southgate-NPL investment, it must be because there was: (1) an unstated dollar limit on loss-transfers even before 2004; or (2) no case where Section 704(c) applied at all.

Whether to impose such limitations, however, is a quintessential policy choice. It was up to Congress to change the law if it proved problematic, up to Congress to determine what kind of change was necessary, and up to Congress to decide whether to make that change retroactive. *Horn*, 968 F.2d at 1234. Congress enacted a statutory scheme for partnership taxation that is far simpler than what the IRS might prefer. But Congress's choices—not the IRS's policy concerns—are controlling.

That is the clear lesson of *Gitlitz v. Commissioner,* 531 U.S. 206 (2001), which the government brushes aside in a conclusory footnote. Gov't Br. 28 n.7. There, the Supreme Court concluded that discharge-of-indebtedness income could be passed through to a shareholder of an S-corporation, but also passed through before "the reduction of the S corporation's tax attributes." 531 U.S. at 217. The court of appeals had rejected that statutory reading because "shareholders would receive a windfall. Not only would shareholders avoid taxation on the corporation's discharged debt, they would also receive an upward basis adjustment, thereby permitting them to report a larger capital loss from the sale of their stock." 182 F.3d 1143, 1147 (10th Cir. 1999). In response to this complaint that "shareholders would wrongly experience a 'double windfall,'" however, the Supreme Court issued a definitive rejoinder: "Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." 531 U.S. at 219-220. Likewise, the IRS's apparent belief that allocation of built-in losses to transferee partners under Section 704(c) is bad policy—such that a valid, profit-seeking partnership can be transmuted into a sham simply because it reports its losses as required by the statute—is irrelevant.

C. Southgate Is Not A "'Distressed Asset Debt' Shelter."

The government repeatedly calls Southgate a "DAD shelter." Gov't Br. 3-6, 18, 26, 28, 32. But the district court certainly never found that Southgate was a

"DAD" shelter, despite the government's repeated use of that label in its proposed findings of fact and trial briefing. R.14549; R.14637; R.14654; R.15372/COL-116. And the ultimate question is whether *this Court* determines that Southgate had economic substance on the basis of the facts found at trial—not whether the IRS has decided to categorize it with other transactions it dislikes. Thus, this Court should reject the government's invocation of trial court cases in which it prevailed against so-called DAD shelters. Gov't Br. 30-31 (citing *Santa Monica Pictures v. Comm'r*, T.C. Memo. 2005-104, 2005 WL 1111792, and *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004)). Indeed, those cases bear no meaningful resemblance to Southgate.

In *Santa Monica Pictures*, a group of taxpayers formed a putative partnership with a group of banks, which contributed more than $1 billion in high-basis debt and stock in a largely worthless holding company. T.C. Memo. 2005-104, 2005 WL 1111792, at *1-*2. The banks exited the partnership within a few weeks, leaving the taxpayers with huge potential tax losses that they attempted to claim under Section 704(c). *Id.* The tax court rejected this "formalistic compliance with [the] statutory provisions" on the ground that the partnership was "transitory" and "depended upon the banks' withdrawing from the very partnership they purported to join." *Id.* at *78-*80. The court further found that, despite their claims, "the [taxpayers] and the banks did not intend to partner with one another in

any film distribution business." *Id.* at *53. "Neither of th[e taxpayers] had any experience in running" one, *id*. at *45, the parties had not attempted to protect their distribution rights in the films, and many of the physical copies "d[id] not exist" or were in "suspect" condition. *Id*. at *45-*50.

For Southgate, the opposite is true on *every point*—and the district court so found as fact. The partnership was not transitory: Even after selling the bulk of its interest to Beal, Cinda/Eastgate remained a member of Southgate, R.15298-15299, 15300/FF-¶¶140, 144, and spent years servicing the NPLs, R.15284-15285/FF-¶¶94-95. Beal and Montgomery had extensive experience investing in distressed loans, R.15259-15260/FF-¶¶3, 7-8, and engaged in extensive due diligence, R.15294/FF-¶125. Most importantly, Beal and Montgomery "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.

Similarly, *Long Term Capital Holdings v. United States* involved a transaction found—as fact—to have no chance of a profit and no business purpose, and to be a prearranged scheme with *no* purpose other than obtaining tax benefits. On the basis of many findings of fact, the district court found no possibility of a profit. 330 F. Supp. 2d at 175-176. It also found that "Long Term entered into the . . . transaction without any business purpose other than tax avoidance," *id*. at 190, and that it was marketed "not as an investment but as a tax product," *id*. at 187.

Southgate, in contrast, "showed a reasonable possibility of profit." R.15289-15290/FF-¶110. The district court further found that Southgate "reasonably relied on" an estimate that it could recover a profit of over $83 million on the NPLs, R.15289-15290/FF-¶¶109-110—almost quadrupling Beal's original investment.

In sum, both cases the government cites are decisions from trial courts that made a series of factual findings about the inherent unprofitability of the transactions and the total absence of any business purpose. But here the district court found that Southgate's "members entered into the NPL investment for legitimate purposes with a reasonable possibility of making a profit." R.15306/FF-¶167; *see also* R.15300/FF-¶145. *Long Term Capital* and *Santa Monica Pictures* thus illustrate what a real DAD tax shelter looks like, and it doesn't look like Southgate.[1]

Indeed, the IRS has elsewhere *acknowledged* that Southgate does not neatly fit its definition of a "distressed asset" shelter, recognizing that: Beal was a professional "experienced in the distressed debt business"; the NPLs "were of better quality than the debt involved in the typical DAD (or DAT) case"; Southgate

[1] In its pretrial memorandum, the government promised to prove that the Southgate transaction did not have "a reasonable possibility of earning an economic profit" and "would make no sense to any prudent businessman motivated by objectives other than tax savings." R.12603-12604. But the government lost on these (and numerous other) factual issues. *See* R.15289-15290/FF-¶110 (reasonable possibility of profit); R.15300/FF-¶145 (Beal and Montgomery "would have done this deal regardless of . . . any tax benefits"). It is as if the government has forgotten about the trial.

"was able to sell some of the NPLs"; and Cinda "was better placed to collect on the debt than the collection agents in DAT cases." IRS, Coordinated Issue Paper, Distressed Asset Trust (DAT) Tax Shelters, at 15 n.34 (LMSB4-0210-008, Mar. 23 2010). The IRS cannot credibly change its tune just to further its goal in this litigation.

Engaging in still more name-calling, the government refers to other tax disputes between Beal and the IRS. Gov't Br. 24, 27-28, 32 & n.10. This is plainly improper. None of these cases has been adjudicated, and they speak to nothing but the government's enforcement priorities. In any event, the government's accusations are contradicted by the district court's finding that Beal acted "in good faith," R.15344/FF-¶305, and its recognition that while "Beal is an aggressive risk-taker . . . he plays the game above board," R.15414/COL-158.

II. SOUTHGATE WAS A VALID PARTNERSHIP THAT SHOULD NOT BE DISREGARDED UNDER ANY JUDICIAL DOCTRINE

As explained above, the district court erred in applying the judicial doctrines to the Southgate transaction at all. But it made just as grave an error in *how* it applied those doctrines, concluding that the putative invalidity of a capital contribution months later could retroactively invalidate the entire partnership. To defend that result, the government distorts the standard of review, denies that the court even made such a ruling, argues that Southgate was a sham partnership

anyway, and (finally) claims that the district court articulated an alternative basis for its holding. None of those arguments has merit.

A. The Government Mischaracterizes The Standard Of Review And The Posture Of The Case.

Eager to shield the district court's retroactive-infection holding from review, the government tries to recharacterize legal rulings as questions of fact—either by misstating the standard of review or by simply asserting that the district court made factual findings that it plainly did not. Gov't Br. 23, 35. That attempt must fail.

The government claims that "[t]he District Court's conclusion that the 'partnership' should be 'disregarded for tax purposes' is reviewed under the 'clearly erroneous' standard." Gov't Br. 23 (quoting *Merryman v. Comm'r*, 873 F.2d 879, 879 (5th Cir. 1989)). But *Merryman* does not depart from the long-settled rule, reiterated by this Court in *Compaq v. Commissioner*, that "legal conclusions that transactions are shams in substance are reviewed de novo." 277 F.3d 778, 780-781 (5th Cir. 2001) (internal quotation marks and alterations omitted); *see also Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978) ("The general characterization of a transaction for tax purposes is a question of law."). The government has elsewhere acknowledged that standard. *E.g.*, U.S. Br. at 22, *Sala v. United States*, No. 08-1333 (10th Cir. Mar. 6, 2009) ("The proper application of the economic substance doctrine presents a question of law that this Court reviews *de novo*.").

Indeed, *Merryman* cannot possibly support the government's bid for clear-error review. That decision expressly acknowledged that "[t]he petitioning taxpayers in the instant case agree[d] with the law applied by the Tax Court but disagree[d] with the court's factual findings," and applied the clearly erroneous standard for that reason only. 873 F.2d at 881. In contrast, Southgate does not dispute the district court's findings of fact about why the partnership was formed, which favor Southgate. Instead, Southgate challenges the district court's mistaken legal conclusion that a subsequent capital contribution that is deemed defective can retroactively invalidate an otherwise valid partnership.[2]

The government misrepresents not only the *standard* of review but also *what determinations* are on review. Southgate prevailed on nearly every finding of fact. But the government repeatedly tries to recharacterize any legal issue on which it prevailed as "factual," and thus demands deferential review. For example, it refers to "the District Court's factual determination that the putative partnership . . . was a sham," Gov't Br. 35, when literally *all* of the court's sham-partnership determinations were in its conclusions of law, not its findings of fact. And it tries to bolster these mislabeled assertions by repeatedly citing evidence it *failed* to persuade the district court to credit. *Infra* pp. 24-27. It does not work that way.

[2] We separately dispute the district court's legal conclusions about the GNMA-Martel Transactions. Southgate Br. 50-59; *infra* pp. 39-47.

B. Southgate Itself Had Economic Substance.

1. The District Court Explicitly Held That "Southgate Itself had Economic Substance."

The district court explicitly (and correctly) held that "Southgate Itself had Economic Substance." R.15386/COL-130. The government claims that in doing so the court did not *really mean* to refer to "Southgate Itself," but rather to the NPLs alone. Indeed, the government claims that the district court did not "find that Southgate was a valid partnership" or that "the partnership structure" was "legitimate." *Id*. at 51. Not so.

The district court first explained how "the transaction in question here must be divided for purposes of economic substance analysis," and concluded—just before the heading announcing its conclusion that "Southgate Itself had Economic Substance"—that the first step was "to examine the economic substance of ***the partnership*** between Cinda, MCA, and Beal in the Southgate LLC acquisition of the Chinese NPLs." R.15386/COL-130 (double emphasis added). How much more explicit need the court have been?

Only when the court took its "second" step and analyzed "[t]he Martel Restructure/GNMA Repo Transaction," did the court turn around and invalidate Southgate as a whole. R.15386-15390/COL-130-134. That is the retroactive-infection ruling that is challenged on appeal and (as we explain below, *infra* pp. 22, 31-32) that is legally indefensible.

2. The District Court Found Ample Business Purposes For The Southgate Partnership.

Even if the court somehow did not hold that Southgate had economic substance, it was wrong as a matter of law. The legal conclusion that the partnership had economic substance follows necessarily from the court's factual findings (which the government barely challenges). The court found that "Southgate and its members entered into the NPL investment for legitimate purposes with a reasonable possibility of making a profit." R.15306/FF-¶167; *see also* R.15289-15290/FF-¶110; R.15290-15291/FF-¶114; R.15293/FF-¶122; R.15298/FF-¶138; R.15302-15303/FF-¶154; R.15306/FF-¶164. The government claims this is insufficient because "[n]one of [the court's] findings demonstrate . . . that there was a tax-independent business reason for using the partnership structure." Gov't Br. 54-57. But the court made findings on that very point as well.

The court found that "[t]he *formation of Southgate* was important in several respects" unrelated to taxes. R.15301-15302/FF-¶151 (emphasis added). Most importantly, "Southgate was formed with the view that Montgomery would pursue an investor in Southgate on behalf of Cinda—if Beal was not interested, Montgomery believed that he would be able to attract another investor based on his developing skill set in Chinese investments." R.15301/FF-¶151. The court specifically found that "there was no certainty that Beal would invest in Southgate"

before the deal closed. R.15299/FF-¶141. Indeed, Beal angrily "walked out of the August 30 closing" and "agreed to proceed with the transaction" only "after he received additional assurances." R.15299/FF-¶141.

In light of the uncertainty about whether Beal would invest, what was Montgomery to do? As the district court found, Montgomery needed to "'lock-in' all of the loans that met his investment criteria" and "preven[t] Cinda from 'cherry picking' for itself valuable loans discovered during the due diligence process." R.15303/FF-¶155. Montgomery therefore could not simply leave the loans in Cinda's hands until an investor committed to the deal. But, as the government recognizes, he also "could not obtain the NPLs without paying Deutsche Bank $8.5 million," Gov't Br. 65 n.25 (citing R.15283-15284/FF-¶90-¶91), plus paying Cinda $19.4 million for the NPLs themselves. Thus, the court found, Montgomery needed the Southgate partnership as an "investment vehicle," R.15305/FF-¶162, to hold the loans while locating an investor.

Moreover, moving the NPLs to the partnership allowed Montgomery "to confirm Cinda's title to the NPLs and its authority to transfer them," rather than having an investor try to buy them directly in the shadow of legal uncertainty. R.15302/FF-¶153. It also "avoided the difficulties of getting approval for a wholly-owned foreign entity in China," and "allowed for easier conversion of RMB into United States dollars." R.15302/FF-¶152. This was all found as fact by

the district court; the government does not (and cannot) contend that those findings were clearly erroneous.

Contrast these findings with those at issue in the cases on which the government relies, Gov't Br. 36, such as *Boca Investerings Partnership v. United States*, 314 F.3d 625 (D.C. Cir. 2003). There, "the district court never made a finding of fact [regarding] the necessity of [the company]'s acquisition of foreign partners in order to engage in the transactions," or the need for "a partnership with a foreign corporation to invest." *Id*. at 631; *see also ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 516 (D.C. Cir. 2000) (same transaction "without the partnership" would have "far, far lower transactions costs"). Here, the district court made numerous factual findings about the business purposes behind *the Southgate partnership*—not just the NPLs it acquired—and there was no finding that the investment would have had more profit potential if structured differently.

The government contends that there was no need for a partnership because "Beal could have purchased the NPLs directly, as he had done in prior distressed-debt acquisitions. (R.494, 15391.)" Gov't Br. 54; *id*. at 56, 65-66.[3] That claim

[3] Besides flying in the face of the findings of fact, these claims also egregiously mischaracterize the record. The government's citations are to: (1) a page of testimony where Montgomery states that purchasing loans directly from Cinda was "possible" but explains that, "if the investor had bought the loans directly [from] Cinda, they would have had significant business issues," R.494; and (2) a page from the court's Conclusions of Law which simply reiterated what "[t]he Government *contends*," and noted that "[t]he Government *cites* Montgomery's testimony," without ever endorsing those contentions. R.15391/COL-135 (emphasis added).

might make sense if there had been certainty that Beal would invest in the loans; but, as the court found, *there was not*, and Montgomery needed a partnership to hold the loans while he pursued an investor. R.15299, 15301-15302/FF-¶¶141, 151. Unable to dispute those factual findings, the government pretends they do not exist.

3. In Any Event, The Choice Of Entity For A Substantive Transaction Does Not Require A Separate Business Purpose.

These unassailable factual findings render irrelevant the government's argument that a separate business purpose is needed to pursue a business deal through a partnership. But that argument is also legally meritless. A taxpayer need not give a business purpose for rejecting other possible forms for an enterprise.

The government has advanced its sweeping conception of business purpose before—unsuccessfully. In *UPS v. Commissioner*, for example, the Eleventh Circuit rejected the IRS's challenge to UPS's attempt to "avoid paying taxes on [its] lucrative excess-value business [by] restructur[ing] the program as insurance provided by an overseas affiliate." 254 F.3d 1014, 1016 (2001). Responding to the argument that the restructuring had "no business purpose . . . because the excess-value business continued to operate after its reconfiguration much as before," the court held that decisions about how to structure a business cannot be separately analyzed for business purpose:

> For instance, two ways to infuse capital into a corporation, borrowing and sale of equity, have different tax consequences; interest is usually deductible and distributions to equity holders are not. There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a "business purpose." To conclude otherwise would prohibit tax-planning.

Id. at 1019; *see also infra* p. 44 n.11.[4]

That rule makes perfect sense. Taxpayers who pursue real investments must make a range of choices about where, when, and how to do so. For example, one might avoid the corporate form to avoid double-taxation, or locate one's business in a low-tax jurisdiction. If a transaction otherwise passes muster, there is no prohibition on engaging in sound tax planning. "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible." *Estate of McLendon v. Comm'r*, 135 F.3d 1017, 1025 n.16 (5th Cir. 1998) (quoting *Comm'r v. First Security Bank of Utah*, 405 U.S. 394, 398 n.4 (1972)); *see also Frank Lyon*, 435 U.S. at 580 ("The fact that favorable tax consequences were taken into account . . . is no reason for disallowing those consequences."). As the district court found, getting advice from qualified tax lawyers on how to structure an investment—as Beal and Montgomery did from De Castro—is "typical tax planning" and "'everyday lawyering.'" R.15341/FF-¶291.

[4] The cases on which the government relies, in contrast, invalidated tax-driven partnership structures that had forced the taxpayers to *give up huge amounts of money* for no business purpose. *ASA*, 201 F.3d at 516; *Boca*, 314 F.3d at 631.

4. Retroactive-Infection Is Indefensible.

The court's factual findings about the purposes behind Montgomery's use of Southgate as the investment vehicle to acquire the NPLs and its conclusions of law that Southgate had economic substance make clear that it meant what it said: "Southgate Itself had Economic Substance," and was disregarded only because of the court's subsequent rejection of the GNMA-Martel Transactions. R.15386-15388/COL-130-132.

The government is loath to defend the court's real rationale, Gov't Br. 50-53,[5] and for good reason: As explained in our opening brief (at 40-46), that ruling cannot be squared with *Klamath*, which holds that, in "applying the economic substance doctrine, the proper focus is on the *particular* transaction that gives rise to the tax benefit," and that "if a transaction lacks economic substance . . . the *transaction* must be *disregarded*." 568 F.3d 537, 544-545 (5th Cir. 2009) (emphasis added). The government has no answer to this.

C. Southgate Was Not A Sham Partnership.

The government spends most of its brief arguing that the district court held Southgate to be a "sham partnership," Gov't Br. 33-60—an inquiry that largely

[5] The government obliquely defends retroactive-infection in its discussion of the "sham partnership" doctrine at Gov't Br. 53. We explain *infra* pp. 31-32 why that defense is meritless.

replicates the economic substance doctrine. *E.g.*, *ASA*, 201 F.3d at 513. The government again mischaracterizes the court's opinion and misstates the law.

1. The District Court Held That Southgate Was Not A Sham *Per Se*.

For all of the pages the government spends on this issue, it never plainly states what the district court actually said: Southgate was a sham *only* because of the (mistaken) principle of retroactive-infection. The government insists, however, that the court held that Southgate had been a sham all along (presumably even before Beal joined it). Gov't Br. 50. But that is simply not consistent with what the court wrote: "Although the Southgate transaction was *not a sham per se*, it is apparent to the Court that the underlying Martel/GNMA Repo structure was nothing more than a sham to gain tax benefits for Beal." R.15393/COL-137 (emphasis added).[6] After explaining why it thought the GNMA-Martel Transactions were invalid, it concluded that, "[t]aken together, it is apparent that ***the Martel/GNMA Repo transaction resulted in a sham partnership***, and Beal therefore is not entitled to an increase in his outside basis." R.15394/COL-138 (double and triple emphasis added). That is a plain expression of the district

[6] The government attempts to cover up this holding with yet another intentional mischaracterization of the district court's opinion. Gov't Br. 17 ("Although the court concluded that the NPL acquisition, when viewed in isolation, had economic substance, and thus was 'not a sham per se,' . . ."). As shown above, the court *actually* referred to "the Southgate transaction" not "the NPL acquisition." R.15393/COL-137.

court's (erroneous) belief that a faulty attempt to create outside basis through a capital contribution could "result[] in a sham partnership"—*i.e.*, retroactively transform an otherwise valid partnership into a sham.

2. The Facts Found By The District Court Prove That Southgate Was Not A Sham.

Even more egregiously, the government attempts to recharacterize or simply ignore the court's factual findings. For example, the government refers to "the District Court's factual determination that the putative partnership between Cinda, Beal, and Montgomery (through their single-member LLCs) was a sham." Gov't Br. 35. But there was *no such factual determination*. In its *factual* findings, the court repeatedly reaffirmed that the partnership had economic substance and a business purpose. The court invalidated the partnership only (and erroneously) as a conclusion of law.

The court's *actual* factual determinations were that both the investment and the partnership had economic substance and business purpose:

- "Southgate and its members entered into the NPL investment for legitimate purposes with a reasonable possibility of making a profit." R.15306/FF-¶167.
- Southgate "reasonably relied on" an estimate that it could recover up to "$111,798,757" on the NPLs and therefore "showed a reasonable possibility of profit." R.15289-15290/FF-¶¶109-110.
- The partnership structure was "important in several respects," most especially so that "Montgomery [c]ould pursue an investor in Southgate . . . if Beal was not interested." R.15301-15302/FF-¶151; *supra* pp. 17-20.

- The partnership also allowed Montgomery to "'lock-in'" the loan portfolio and "preven[t] Cinda from 'cherry picking'" while pursuing an investor. R.15303/FF-¶155.

- 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.

And the parties' conduct as Southgate partners had economic substance and business purpose as well:

- "Montgomery reasonably chose to partner with Cinda" in servicing the NPLs. R.15304/FF-¶160.

- When Cinda's collection efforts were disappointing, Southgate repeatedly made efforts "to improve collections" by both working with Cinda and ultimately threatening litigation. R.15312-15313/FF-¶¶188-191.

- By giving Cinda a share of the profits from the NPL collections, "Montgomery aligned Cinda's interests with Southgate's" and "help[ed] ensure that Cinda had the working capital and motivation to work the NPL pool." R.15302/FF-¶154.

The contrary claims asserted by the government are not the court's factual findings, but rather citations of *trial evidence* that it could not convince the court to credit, conclusions of law recharacterized as factual, or factual findings that simply do not say what the government claims.

For instance, the government states that "the court's factual findings demonstrate that Beal entered this shelter motivated by the $400 million tax benefit, not any economic profit potential." Gov't Br. 71. It provides eleven purportedly supporting citations in support of this claim—seven of which are not to the court's factual findings at all, but rather to trial evidence. *Id.* (citing R.841-

842, R.964-965, R.1006-1007, R.2735-2736, R.3066-3067, Ex.233, Ex.235). Of the four actual references to factual findings: One is to a finding that *contradicts* the government's claim. *See* R.15300/FF-¶145 (Beal would have done the deal with no tax benefits). One is a finding about a partnership Beal entered into *after* Southgate, and which is not at issue here. R.15311/FF-¶186. And the remaining two plainly do not speak to whether Beal was motivated by profit potential. R.15314-15315/FF-¶194 (Cinda's purported threats); R.15308-15310/FF-¶¶173-180 (timing of the sales). The court's *actual* factual findings repeatedly affirm that Beal and Montgomery were motivated by profit. *E.g.*, R.15276/FF-¶55, R.15300/FF-¶145 (Beal and Montgomery "would have done this deal regardless of whether or not it had any tax benefits").

Similarly, the government repeatedly characterizes the tax advice at issue as improper. Gov't Br. 6-9, 35-37, 63-65. But the district court disagreed. R.15275/FF-¶53. And, in response to a memo about the desirability of keeping a low profile, R.15275/FF-¶54 (which the government trumpets, Gov't Br. 6), the court found that, "[d]espite the tenor of this tax-specific memorandum, Montgomery and Beal evaluated the contemplated transaction *both* for its non-tax economic profitability potential and the domestic tax benefits that could result." R.15276/FF-¶55. Similarly, the government implies that Southgate tried to conceal its activities from an IRS audit. Gov't Br. 14-15, 29, 71. But that is not what the

district court found—it found that memos from De Castro "reflect[ed] Beal's and Montgomery's caution *in light of the extremely high likelihood* of an IRS audit." R.15275/FF-¶52 (emphasis added).

The government claims "that the purported partners did not view the partnership as genuine." Gov't Br. 37-38. But for this remarkable proposition the government simply reiterates its own experts' opinions and cites no factual findings at all—because there are none. Similarly, the government complains that Southgate never distributed any money to Cinda. Gov't Br. 50 n.17. But Cinda received a share of collections when it serviced the loans, R.15302-15303/FF-¶154, and, as Montgomery explained at trial, Cinda was entitled to further distributions from Southgate, but released them to avoid litigation about its shoddy collection practices. R.757-758. In reality, there is not *a single factual finding* suggesting Southgate itself to be a sham.

Indeed, one could hardly tell from reading the government's brief that there was a 15-day trial that produced 402 findings of fact resolving many of the issues the government now raises. If the government thinks those findings were wrong, it should have confronted them and provided this Court with the requisite overwhelming evidence—not a mere conclusory footnote, Gov't Br. 58 n.21—that they were clearly erroneous.

3. *Moline Properties*, Not *Culbertson*, Determines The Validity Of A Partnership—But Southgate Is Plainly A Partnership In Either Event.

The government claims that *Moline Properties v. Comm'r*, 319 U.S. 346 (1943), "involved corporations, not partnerships" and thus "ha[s] no bearing on the question whether parties have formed a genuine partnership for tax purposes." Gov't Br. 58-59 (citing *ASA*, 201 F.3d at 512-513). The government's citation of *ASA* is baffling. In that case, the D.C. Circuit applied *Moline Properties* to a *partnership*, explaining that "[t]he Tax Court has since applied *Moline* to partnership cases." 201 F.3d at 512. Likewise, the Tax Court has held that

> the principles announced in *Moline Properties* . . . appl[y] to whether a partnership will be recognized for Federal tax purposes. When called upon to determine whether or not a particular entity (*i.e.*, a partnership) will be recognized for tax purposes, the courts subsequent to *Moline Properties*, have used a two-prong test—the entity (1) must be created for a business purpose, *or* (2) must carry on a business activity.

Bertoli v. Comm'r, 103 T.C. 501, 511-512 (1994); *see* Southgate Br. 46-48 (analyzing two-prong test).

The government relies instead on *Commissioner v. Culbertson*, 337 U.S. 733 (1949), and even claims that "Southgate expressly conceded [below] that *Culbertson* provided the appropriate test." Gov't Br. 34 n.12. In fact, as Southgate argued to the district court, "in 1951 Congress legislatively limited the test set forth in *Culbertson* . . . and the Government's citation of *Culbertson* is [in]apposite." R.15159 (citing Revenue Act of 1951, Pub. L. No. 82-183, §340(a), *recodified at*

26 U.S.C. §704(e)(1) and *Pflugradt v. United States*, 310 F.2d 412, 415 (7th Cir. 1962) ("The test is no longer whether the parties acted in good faith with a business purpose in joining together to conduct the partnership business. This was the test set forth in *Culbertson . . . before present § 704(e)(1) was part of the Code.*") (emphasis added)). Although Southgate argued in the alternative that "Southgate and its members satisfy [the *Culbertson*] standard," R.15159, that was caution, not waiver.

In any event, it does not matter whether Southgate's validity is tested under *Moline Properties*, *Culbertson*, *Merryman*, or Section 704(e). The government does not dispute that Southgate satisfies *Moline Properties* and Section 704(e). Southgate Br. 47-49. Even if *Culbertson* and *Merryman* apply, the district court's factual findings show that Southgate was not a "sham."

Culbertson asked whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." 337 U.S. at 742. The district court's findings show that Beal and Montgomery acted in good faith and "with a business purpose." They were working within their core business, R.15259-15261/FF-¶¶3, 7-8, and "believed that they could earn a profit from the NPLs." R.15300/FF-¶145. And they "intended to join together," 337 U.S. at 742, for legitimate reasons—Montgomery and Cinda created the partnership while Montgomery identified an investor, and Beal bought into the

partnership once he decided to pursue the investment. R.15301-15302/FF-¶¶151-153. And, as explained above, Southgate's subsequent "conduct of the enterprise" was equally legitimate. Montgomery, Beal, and Cinda continued to pursue profit together for over three years. R.15312-15316/FF-¶¶188-198.

Merryman simply applied the economic substance test set forth in *Frank Lyon*, which Southgate plainly satisfied. Southgate Br. 37-40, 47. But, even if *Merryman* does embody a sham partnership test, it illustrates how different Southgate is from a sham partnership:

- In *Merryman*, the Washburn family already owned the assets it came to hold via the sham partnership. 873 F.2d at 882. Here, by contrast, Cinda, MCA, and Beal first came together in the Southgate-NPL Transactions. R.15279, 15280-15281, 15299/FF-¶¶67, 71-78, 141.

- In *Merryman*, the sham partnership was grossly undercapitalized, with the "paltry sum" of $1,000 used as capital to acquire (by promissory note) an oil rig for $2,250,000. 873 F.2d at 882 & n.2. Here, by contrast, Southgate was fully capitalized to pursue profit on the NPLs, and Cinda received cash for selling its interest in Southgate. R.15283, 15398-15299/FF-¶¶87, 140.

- In *Merryman*, the sham partnership "waived all warranties on the purchase of this costly piece of machinery." 873 F.2d at 882. Here, by contrast, Southgate's formation allowed Montgomery to "'lock-in'" the portfolio's contents and to obtain "representations and warranties directly from Cinda." R.15303-15304, 15306/FF-¶¶155, 157, 165.

- In *Merryman*, the sham partnership "had no office or employees, paid no salaries, and carried on no other business dealings." 873 F.2d at 883. Here, by contrast, Montgomery made numerous trips to China on behalf of Southgate and hired two full-time employees "to work with Cinda on Southgate collections." R.15206-15307/FF-¶169; *see also* R.15312/FF-¶188.

The district court's findings of fact—as opposed to the assertions in the government's brief—thus make plain that the only way the court could have concluded that Southgate was a sham was through its mistaken retroactive-infection ruling.

4. The GNMA-Martel Transactions Did Not Result In A Sham Transaction.

Despite largely disavowing the retroactive-infection theory, the government argues that "the GNMA/basis-build transaction clearly demonstrates that the 'partners' did not intend to 'shar[e] in the profits and losses' of the partnership," and that under *Culbertson* and *Merryman* the transaction can "appropriately shed light on what the parties intended when they formed their 'partnership.'" *Id*. at 49-50, 53. This is wrong.

Even after the GNMA-Martel Transactions, Cinda retained more than a 5% interest in Southgate, and was therefore entitled to several million dollars in potential profit from the NPLs. R.15321/FF-¶222; *infra* pp. 38-39. It also continued to be doubly incentivized to generate profits by successfully servicing the loans. R.15302-15303/FF-¶154; *supra* p. 27. Montgomery maintained his stake in the enterprise and "was looking long term—he 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.

As explained above, neither *Culbertson* nor *Merryman* applies; but, even if they did, neither case allows an invalid subsequent capital contribution by one partner to infect an entire partnership. The government says that *Culbertson* looked to "parties' 'capital contributions' and 'conduct of the parties in execution of' partnership agreement," Gov't Br. 53, but the Court examined whether a partner had "contributed '*original* capital'" when entering the partnership. 337 U.S. at 743-744 (emphasis added). Even without the GNMA-Martel Transactions, Beal paid millions of dollars for his share of Southgate. R.15298-15299/FF-¶140. The same is doubly true for *Merryman*, which never mentions a post-formation capital contribution.

In any case, even under the government's theory, post-formation facts are relevant only if they "shed light on what the parties intended when they *formed* their partnership." Gov't Br. 53 (emphasis added; internal quotation marks omitted). Once again, numerous findings of fact resolve the question: When Southgate was formed, Beal wasn't sure he would invest. R.15299/FF-¶141. When Beal *did* decide to invest in Southgate, he was motivated by "profit potential," R.15306/FF-¶164—so much so that he (and Montgomery) "would have done this deal regardless of whether or not it had any tax benefits." R.15300/FF-¶145. The government has no response to any of these crucial findings confirming that Southgate was *formed* for entirely legitimate purposes.

D. There Were No Alternative Holdings.

The government also invents an alternative basis for the district court's decision: "As an alternative to its sham-partnership ruling, the [court] applied the substance-over-form doctrine and found that the interrelated series of transactions designed by Beal's tax advisors was in substance a sale of NPLs from Cinda to Beal and not a genuine partnership." Gov't Br. 60; *see also id*. at 61 ("step-transaction doctrine"). Wrong again.

1. The District Court Did Not Make An Alternative Substance-Over-Form Or Step-Transaction Ruling.

Once more, the government misstates the court's holding. In discussing the substance-over-form doctrine, the court recited the government's *arguments* that "Beal himself purchased the NPLs from Cinda," and that the GNMA-Martel Transactions "should be collapsed and treated as if Beal had entered into the repo transaction with UBS," followed by Southgate's responses to those arguments. R.15396-15297/COL-140-141. Then the court offered its own analysis, consisting of a single paragraph:

> Yet by properly collapsing the series of transactions to analyze its substance as a whole, the Court necessarily concludes that the effect was to elevate form over substance. The Court has *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 (citation omitted; emphasis and double emphasis added). Given the reference to "Martel as a conduit," the court was not addressing Southgate, but rather the government's argument that the components of "the Martel/GNMA Repo transaction . . . should be collapsed." R.15396-15397/COL-140-141.

But *whatever* transaction the court was referring to, this is not an *alternate* holding. The court stated that its substance-over-form analysis "necessarily follow[ed]" from its rulings on economic substance and sham partnership. Thus, this ruling explicitly rises or falls with the court's analysis of the other judicial doctrines and need not be separately analyzed on appeal.

2. There Is No Basis For Invalidating Southgate Under Those Doctrines.

In any event, there is no merit to the government's argument. The government repeatedly asserts that the so-called "shelter consisted of several pre-planned, interdependent transactions" to gain tax benefits for Beal. Gov't Br. 1; *see also id*. at 2, 17, 52. The district court found the opposite. Montgomery had presented the NPL opportunity to Beal Bank, which had rejected it because of regulatory concerns, so Montgomery pursued the opportunity independently. R.15278/FF-¶¶60-61. Because Beal saw "how strongly Montgomery believed in the profit potential of the investment opportunity," he told Montgomery in July 2002 "that he did not want to commit time or money to the prospect until

Montgomery had secured a specific deal that Beal could consider." R.15278-1579/FF-¶62. Even then, "Montgomery hoped, *but could not be certain*, that Beal would invest in the Chinese non-performing loans if Montgomery was able to put a deal together." R.15279/FF-¶63 (emphasis added). Montgomery did not present the opportunity to Beal until August 25, 2002, after Southgate's formation on August 1. R.15284, 15298/FF-¶¶94, 138. On August 30, Beal finally invested in Southgate. "Until th[at] point, there was no certainty that [he] would." R.15299/FF-¶141.

In such circumstances, the step-transaction doctrine is inapplicable. *No* case authorizes application of the step-transaction doctrine when the different transactions are independent and there was no pre-ordained end result. *See Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244-1245 (5th Cir. 1983).

The government says that "the correspondence between De Castro, Montgomery, and Beal (cited by the court) makes clear [that] each step in the DAD scheme was part of a pre-arranged tax strategy." Gov't Br. 63 (citations omitted). The district court disagreed. It *found as fact* that there was no prearrangement, and no certainty that Beal would invest in Southgate at all. As for the court's "cit[ations]" to "the correspondence," the court never credited the aspersions the government now casts. Instead, it repeatedly refused to draw a negative inference

from the fact that a memo from a tax advisor would primarily discuss tax. R.15275-15276/FF-¶¶52-53, 55.

The government also relies again on *Long Term Capital*. But there the trial court made a "fact finding" that "the various steps of the . . . transaction were prearranged to ensure . . . tax benefits." 330 F. Supp. 2d at 192. Here, the court made the *opposite* finding that Beal was undecided about whether to invest at all, and almost didn't. R.15299/FF-¶141.

E. Southgate's Losses Are Not Disproportionate.

Finally, in an argument largely unmoored from any of the foregoing analysis, the government urges the Court to adopt a freestanding proportionality principle—that "transactions should be disregarded for tax purposes under the economic-substance doctrine 'in cases where the economic or business purpose of a transaction is relatively insignificant in relation to the comparatively large tax benefits'" Gov't Br. 68 (quoting *Rogers v. United States*, 281 F.3d 1108, 1117 (10th Cir. 2002)); Gov't Br. 68-69 (citing *ACM P'ship v. Comm'r*, 157 F.3d 231, 258 (3d Cir. 1998); *Nevada Partners Fund, LLC v. United States*, No. 06-379, 2010 WL 1795618, at *11 n.22 (S.D. Miss. Apr. 30, 2010)).

The cases the government cites cannot bear such weight. *Nevada Partners* holds that "modest profits relative to substantial tax benefits are insufficient to imbue an *otherwise dubious* transaction with economic substance." 2010 WL

1795618, at *11 n.22 (emphasis added). *ACM Partnership* held that "neither ACM nor any of its partners reasonably anticipated *any* profits." 157 F.3d at 258-259 (emphasis added). And the quoted part of *Rogers* simply paraphrases a law review article that was inapplicable. 281 F.3d at 1117-1118. Moreover, as other courts have recognized, "there is no *per se* rule that tax benefits of a certain size are presumed impossible." *Allison v. United States*, 80 Fed. Cl. 568, 596 (2008) (citing *Durrett v. Comm'r*, 71 F.3d 515 (5th Cir. 1996), and *Chamberlain v. Comm'r*, 66 F.3d 729 (5th Cir. 1995)).

The government notes that "Congress recently has enacted this common-sense principle into law" in a statute codifying the economic substance doctrine. Gov't Br. 69. The government does not even suggest that the new law actually governs, since it "appl[ies] only to transactions entered into [after March 30, 2010]." Pub. L. No. 111-152, §1409(a) (2010). And the government fails to apprehend that the statute actually *confirms* that no such proportionality principle applies here. The Joint Committee on Taxation expressly noted that this Court's decision in *Compaq* requires "a reasonable possibility of profit" *without* the additional gloss of a proportionality requirement. Technical Explanation of The Revenue Provisions On The "Reconciliation Act of 2010," As Amended 145 & n.312 (JCX-18-10, Mar. 21, 2010) [*2010 Joint Committee Report*] (citing *Compaq*, 277 F.3d at 781). Congress's most recent action thus proves that, for pre-March

30, 2010, transactions, this Circuit requires a "reasonable possibility of profit," *not* the new proportionality test.

In any event, Beal's profit potential was hardly disproportionate. The district court found that the NPLs were estimated to be worth as much as $111 million, and that "Southgate reasonably relied on" that valuation. R.15289-15290/FF-¶¶109-110.[7] After taking account of the costs of the transaction, Southgate had a potential profit of *more than $83 million*. That can hardly be dismissed as "relatively insignificant." Gov't Br. 68 (internal quotation marks omitted). It is almost *ten times* the $8.5 million fee to Deutsche Bank, which the government wrongly calls "a fee way out of proportion to the expected profit." Gov't Br. 72. And it is surely "substantial in relation to" the $260 million in taxes—stemming from the different tax rates for ordinary income and capital gains—that the government claims are at issue in this case. Gov't Br. 69 (internal quotation marks omitted); Ex.805; R.2889-2890. Indeed, that profit is far more substantial in relation to the tax benefits than the profit upheld in *Compaq*. See 277 F.3d at 780, 787 ($1.9 million potential pre-tax profit; $3.4 million foreign tax

[7] The government asserts that this finding was "factually erroneous" because Zhongyu's estimate was delivered on August 16, after Southgate was formed, but before an investor had joined the partnership. Gov't Br. 68 n.27. But it is entirely sensible to analyze Southgate's "possibility of profit" as of the time that Montgomery found an investor. *See* R.15305/FF-¶162 ("[T]he issuance of the Zhongyu . . . repor[t] shortly after the August 1 closings bolstered Southgate's position as an investment vehicle.").

credit and $20.7 million in capital losses). This Court held that to be "a reasonable possibility of profit," *id.* at 788; it follows *a fortiori* that the $83 million potential profit on Southgate is as well.

Moreover, the district court correctly found that Beal's losses were "only temporary" and—consistent with Section 704(c)—he realized "offsetting gains in 2006 and 2007." R.15349/FF-¶328.[8] Thus, Beal's "net loss" for tax purposes equals Beal's economic loss, and the built-in losses allocated to Beal under Section 704(c) are exactly proportionate to his recaptured gains. *Id*.

At bottom, the government's disproportionality complaint is a smokescreen for the IRS's disagreement with the operation of Section 704(c) and the different tax rates for ordinary income and capital gains. But those decisions belong to Congress, which alone can modify Section 704(c)'s operation (as it did in 2004) and expand or contract the differences in ordinary-income and capital-gains tax rates.

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

The government all but ignores the district court's numerous factual findings that the GNMA-Martel Transactions had real substance and profit potential for all

[8] Remarkably, the government argues that Beal has not recaptured these gains because he has not paid twice—*i.e.*, paid the taxes he will owe if he loses this suit (which he paid before filing) *and* paid the taxes that he will owe if he wins. Gov't Br. 31-32 n.9. As noted above, the district court found otherwise.

of Southgate's partners. Instead, the government resorts to obvious mischaracterizations of the district court's opinion. The government likewise ignores authority—most notably, *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991)—indicating that a partnership capital contribution with economic substance is not subject to a "business-purpose" test at all. Instead, the government advances the demonstrably false assertion that Southgate did not even raise this argument.

A. Under Any Test, The District Court's Factual Findings Compel The Conclusion That The GNMA-Martel Transactions Had Economic Substance.

As detailed in our opening brief (at 51-54), the district court's conclusion that the GNMA-Martel Transactions lacked economic substance cannot be reconciled with its factual findings, including:

- The GNMA-Martel Transactions "had some economic substance, as all of Southgate's partners had a reasonable possibility of profiting from the GNMAs after their contribution," R.15325-15326/FF-¶235.
- 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," R.15337/FF-¶275.
- "Barnhill, the Government's proffered expert on the [GNMA-Martel Transactions] testified that the value to Southgate of the GNMA contribution could be as much as $13 million, although the 'most likely' value was between $100,000 and $700,000," R.15326/FF-¶236.

Unable to dispute these findings, the government instead plays fast and loose with the record, portraying the district court's legal conclusions as factual findings entitled to heightened deference. Most notably, the government argues that

"Southgate has failed to identify any . . . clear error" in the court's "findings" that, because of Beal's "total control" over the GNMAs, Southgate lacked a reasonable possibility of profiting from the GNMA contribution. Gov't Br. 39, 42 (citing R.15388-15390). But Southgate need not show "clear error" because, as discussed in Southgate's opening brief (at 51-53), the district court actually ***found*** that "all of Southgate's partners had a reasonable possibility of profiting from the GNMAs after their contributions," R.15325-15326/FF-¶235, while it ***held*** that the "possibility of Beal exercising his option to allow Southgate to profit from the GNMA transaction . . . was not a reasonable possibility of profit for Southgate." R.15389/COL-133. The former is subject to the clearly erroneous standard. The latter is reviewed *de novo*. In light of the clear conflict between the two, the district court's factual findings should control.

The record fully supports the district court's factual findings. Even the government's own witness identified up to $13 million of profit potential to Southgate arising out of the GNMA contribution. R.15326/FF-¶236.[9] Although the government dismisses this figure as based on an "unrealistic hypothetical" Gov't Br. 43 n.14, the court cited the $13 million figure in its findings of fact with no such qualification. In any event, the "unrealistic hypothetical" is that Beal

[9] Even if the GNMA contribution was worth just $100,000-$700,000 to Southgate, that is more than sufficient to support the court's finding of a reasonable possibility of profit because no proportionality requirement applies here. *Supra* pp. 36-39.

would do something other than distribute the GNMAs to himself if they had appreciated in value. R.2716. Not only is that scenario "realistic," but the government's contrary assertion ignores both (1) the district court's finding that Southgate's other members would share in any gain on the GNMAs via a higher percentage of Southgate's other assets, R.15327-15328/FF-¶242, and (2) Treasury Regulations requiring the same result. *See* 26 C.F.R. §1.704-1(b)(2)(iv)(b), (e).

The government cites "Southgate's Operating Agreement" as evidence that such self-distribution of the appreciated GNMAs would not reduce Beal's membership-interest percentage. Gov't Br. 45. But the Second Amendment to Southgate's Operating Agreement specifically states that any such distribution would "*thereby reduc[e] Beal's capital account in [Southgate]*)." Ex.218E at 4 (emphasis added); R.15322-15323/FF-¶225. When GNMA proceeds were distributed to Beal in 2006, his capital account was reduced accordingly. R.15327/FF-¶241; *see also* R.15325-15326/FF-¶233.

The government's reliance on the district court's conclusion that Beal "never intended to share any potential gains or losses from the GNMAs with the other partners in Southgate," R.15389/COL-133, fares no better. That conclusion cannot be reconciled with the court's factual finding that the Second Amendment "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.15321-15322/FF-¶223. The government tries to bolster its view of Beal's "intent" by claiming that it would be "against [Beal's] self interest" to share any gains in the GNMAs with Southgate's partners. Gov't Br. 45. That argument makes no sense, as it presumes that Beal would ignore potential gains to be realized if the GNMAs appreciated in value solely to avoid having to share profits with Southgate's other members.

Finally, the government erroneously contends that *Estate of Strangi v. Commissioner*, 293 F.3d 279 (5th Cir. 2002), conflicts with "binding caselaw." Gov't Br. 46. That case is entirely consistent with *Knetsch*, which focused on whether the transaction "appreciably affect[ed]" the taxpayer's position, not on simple profit potential. 364 U.S. at 366.

B. Because The GNMA-Martel Transactions Had Economic Substance, No Further Business Purpose Was Required

In any event, no business purpose is required for capital contributions to a partnership. The government's brief harps on purported inadequacies of the De Castro and CGC memos but ignores Southgate's main point that no statute, regulation, or case imposes a business-purpose requirement on a capital contribution. Indeed, the government does not even cite the Supreme Court's decision in *Cottage Savings*, which is irreconcilable with the government's view that a separate business purpose is required for transactions that merely result in the recognition or realization of already incurred losses.

Tellingly, the government points to nothing in the text of the relevant statutes that would impose a business-purpose requirement. Our opening brief explained that those statutes are cast in mandatory terms that make the calculation of a partner's outside basis a matter of mechanical, chronological adjustments without regard to intent. Southgate Br. 56 (quoting 26 U.S.C. §722); *see also* 26 C.F.R. §1.722-1. Likewise, the statutes concerning a partner's recognition of his allocable share of partnership gain or loss for the year are mechanical and focused on timing. Southgate Br. 56-57; *see also* 26 C.F.R. §1.704-1(d)(2). The government does not respond to any of these arguments.[10] *Cf. Boulware v. United States*, 552 U.S. 421, 431 (2008) (addressing similarly phrased statutory provisions regarding corporate distributions and holding that, "[a]s those sections are written, the tax consequences of a 'distribution by a corporation with respect to its stock' depend, not on anyone's purpose . . . but on facts wholly independent of intent").[11]

[10] That failure is all the more striking because other Tax Code provisions include an express business-purpose requirement. *E.g.*, 26 U.S.C. §706(b)(1)(C) (partnership can use a modified tax year "if it establishes, to the satisfaction of the Secretary, a business purpose therefor").

[11] When prospectively codifying the economic substance doctrine, Congress recognized that "certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages," will continue to be exempt from any business-purpose requirement. *2010 Joint Committee Report*, at 142-156. At least one commentator has explained that such exempt transactions include partnership capital contributions. Monte A. Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 127 Tax Notes 291, 298 (Apr. 19, 2010). Thus, any business-purpose requirement under *Klamath* does not apply to partnership capital contributions.

The lack of support for the government's position is particularly glaring given its far-reaching consequences. As the district court found, "increasing basis to enable a taxpayer to utilize losses is a common year-end tax strategy." R.15336/FF-¶270; *see* Ex.1478 (RIA 2002 Tax Planning Guide) (partner anticipating a loss in excess of his basis "can *choose* to take the loss this year [2002] by increasing his basis by the end of the partnership tax year.") (emphasis added); *see also* RIA Tax Planning Guides 2001-2009. The government's rule would turn the tax world on its ear and punish all manner of partnerships for engaging in routine tax planning.

Astonishingly, the government does not even cite *Cottage Savings*, in which the Supreme Court upheld the realization of tax losses resulting from two banks' swapping of economically identical loan portfolios. As explained in detail in our opening brief (at 57-58), that transaction (like Beal's contribution of the GNMAs to Southgate) merely involved the timing of the release of recognized losses to a taxpayer. Indeed, *Cottage Savings* presented a harder question, because the transaction that passed muster without a business purpose there *triggered* the loss. Here, the GNMA-Martel Transactions involved only the release of a bona fide loss that had already been incurred (Southgate's NPL-related losses). Tellingly, the

government cannot point to a single case imposing a business-purpose requirement on a partnership capital contribution.[12]

Instead, the government mischaracterizes our argument. The government suggests that "Southgate concedes" that partnership capital contributions are subject to a separate-business-purpose requirement. Gov't Br. 49. That is wrong. As our brief carefully explained, we agree that a capital contribution must have economic reality—*i.e.*, it must affect "'the taxpayer's net economic position, legal relations, or non-tax business interests.'" Southgate Br. 54 (quoting *ACM P'ship*, 157 F.3d at 248 n.31). But we argued at length that "no separate business purpose is needed for that contribution." Southgate Br. 56. The notion that we conceded the opposite is absurd.

Finally, the government argues that the district court did not find any business purposes attendant to the GNMA-Martel Transactions. That is plainly wrong. In addition to finding that Beal and Southgate entered into the GNMA-Martel Transactions "to take advantage of the deferral of taxable income *and accomplish some non-tax business purposes*," R.15317-15318/FF-¶205 (emphasis added), the court's opinion discusses at length no fewer than five business

[12] The only case of which we are aware that even considered the government's position questioned its validity. *See Corum v. United States*, 268 F. Supp. 109, 118 (W.D. Ky. 1967) (declining to decide the issue but observing that "[t]here is nothing in [the statutes] requiring a contribution of money or property by a partner to be made for valid business purposes in order for the contribution to . . . increase the basis of the partners' interest in the partnership").

purposes of the Transactions. R.15335-15337/FF-¶¶269-275. The government does not bother to address them.

IV. THE DISTRICT COURT CORRECTLY DETERMINED THAT PENALTIES ARE INAPPLICABLE

As evidenced by the district court's extensive findings of fact, this is not a case in which wanton disregard for the tax laws merits the imposition of penalties. On the contrary, the court unequivocally found as fact that Southgate acted with reasonable cause and in good faith. The court further found that Beal and Southgate sought advice from qualified professionals, provided them with all relevant information, and followed the advice they received, all in a rigorous effort to report their NPL-related losses correctly. R.15338-15347/FF-¶¶277-316. Those findings are a complete defense to all penalties, and the government cannot even begin to prove that they are clearly erroneous. Imposing penalties on Southgate given those findings would be unprecedented.

The district court also properly followed Fifth Circuit precedent in rejecting valuation misstatement penalties, just as it correctly rejected the government's argument that Southgate's tax position automatically lacked substantial authority simply because the court ultimately held that Southgate was a sham partnership.

A. Southgate Acted In Good Faith And With Reasonable Cause.

1. The District Court Found As Fact That Southgate Acted Reasonably And In Good Faith.

The government pushes any discussion of the good-faith defense to the end of its brief, but it is the only issue the Court needs to resolve to reject all penalties. 26 U.S.C. §6664(c)(1). And resolving it is straightforward. The district court heard testimony from Southgate's members and advisors, judged their credibility, closely reviewed the written tax advice, and emphatically found that Southgate acted in good faith in every respect. Specifically:

- "Southgate and its members, including Beal, disclosed all pertinent facts to De Castro [and CGC] and made no representations or assumptions that it knew or had reason to know were inaccurate." R.15340-15341/FF-¶289, R.15342/FF-¶296.
- "Southgate and its members reasonably relied in good faith on the oral and written advice of De Castro and CGC regarding the transactions at issue." R.15344/FF-¶305; *see also* R.15346/FF-¶313 ("It was therefore reasonable for Beal and Southgate to rely on the De Castro and CGC opinions.").
- "Southgate [and Beal] carried out the transactions at issue consistently with the transactional documents and descriptions in the De Castro and CGC opinions." R.15344/FF-¶¶306-307.

Those findings are more than sufficient. *See Stanford v. Comm'r*, 152 F.3d 450, 460-461 (5th Cir. 1998) ("'[T]he extent of the taxpayer's effort to assess his proper tax liability' is 'generally the most important factor' in determining reasonable cause and good faith. [An a]dditional 'circumstanc[e] . . . includ[es]' . . . reliance on the advice of a professional tax advisor 'if, under all the circumstances, such

reliance was reasonable and the taxpayer acted in good faith.'") (quoting 26 C.F.R. §1.6664-4(b); internal citations and alterations omitted); *Streber v. Comm'r*, 138 F.3d 216, 223 (5th Cir. 1998) (quoting *Heasley v. Comm'r*, 902 F.2d 380, 384-385 (5th Cir. 1990)) (same).

To impose *any* penalties, the government therefore must prove that those findings are clearly erroneous. The government acknowledges as much, Gov't Br. 73 ("Whether the elements that constitute 'reasonable cause' are present in a given situation is a question of fact."),[13] and ultimately offers only the conclusory assertion that, "[t]o the extent the court found" good faith, "those findings are clearly erroneous." Gov't Br. 87 n.37. But the government comes nowhere close to carrying that massive burden. "In order to satisfy this clear error test all that is necessary is that the finding be plausible in light of the record as a whole." *United States v. Edwards*, 303 F.3d 606, 645 (5th Cir. 2002) (internal quotation marks and citation omitted); *see also S Industries v. Centra 2000*, 249 F.3d 625, 627 (7th Cir. 2001) ("We will not reverse a determination for clear error unless it strikes us as wrong with the force of a 5 week old, unrefrigerated, dead fish.").

[13] Cryptically, the government also states that "what elements must be present to constitute 'reasonable cause' is a question of law," Gov't Br. 73, hinting at *de novo* review. But the government never claims (nor could it) that the district court considered the wrong "elements."

2. The Government's Disputes With The Court's Findings Are Meritless.

The government's primary attack on the De Castro and CGC tax opinions is to claim that they relied on "incorrect" assumptions. The government asserts, for example, that the opinions "assumed that Beal and Montgomery had a valid business purpose for using the partnership structure to invest in NPLs," but "[t]hat assumption was incorrect, and Beal and Montgomery should have known it was incorrect." Gov't Br. 85.

But the district court's other factual findings prove that the assumption was true: the partnership structure *did* have a business purpose. The court found that "the Southgate transaction fit within Beal's and Montgomery's core business. They believed that they could earn a profit . . . and they would have done this deal regardless of whether or not it had any tax benefits," and that "[t]he formation of Southgate was important in several respects." R.15300-15302/FF-¶¶145, 151; *supra* pp. 17-20. So the government could not overturn the court's penalty findings without also overturning these further findings (which it does not even attempt). Those findings were also amply supported by Montgomery's testimony at trial, R.372-373; R.181-183; R.201-202; R.220, and confirmed by Osborn's as well. R.1235-1236; R.1247-1248. The district court's decision to credit that evidence is more than "plausible." *Edwards*, 303 F.3d at 645.

The government must further show that Beal and Montgomery did not *believe* that Southgate had a business purpose. *American Boat Co. v. United States*, 583 F.3d 471, 485 (7th Cir. 2009). There was uncontroverted evidence that they did, *e.g.*, R.458; R.3588, which the district court necessarily credited, R.15340-15341/FF-¶¶286, 289. "When a trial judge's finding is based on his decision to credit the testimony of one of two or more witnesses that finding, if not internally inconsistent, can virtually *never* be clear error." *United States v. Brown*, 561 F.3d 420, 434 (5th Cir. 2009) (emphasis added; internal alterations and quotation marks omitted); *see also In re Eldercare Properties*, 568 F.3d 506, 515 (5th Cir. 2009).

The government makes similar arguments about the assumptions surrounding the GNMA-Martel Transactions, claiming that "both [tax] opinions assumed that the GNMA/basis-build transaction had a valid business purpose, and that 'no partner has in substantial part retained the benefits and burdens of ownership of the contributed property.'" Gov't Br. 85-86. The first claim is another mischaracterization; the government does not point to any part of the tax opinions that *assumed* "a valid business purpose" for the GNMA-Martel Transactions. Rather, the cited pages state that the Transactions would diversify Southgate's portfolio, Ex.8 at 22; Ex.61 at 6, and the district court found that

statement to be *true*. R.15337/FF-¶273 ("[T]he Martel Restructure and GNMA Repo transactions diversified Southgate's investment portfolio.").

The second claim—that it was improper to assume that the benefits of the GNMAs were shared—is also wrong. Once again, the court's finding that the assumption was correct cannot be overcome without also overturning its finding 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." R.15337/FF-¶275. The government does not challenge that finding, and ample evidence supports it. R.574; R.2714; R.3173. And the government would further have to prove that Beal and Montgomery could not possibly have believed that assumption. But there was uncontroverted evidence that they did. R.574; R.1916.

And, contrary to the government's assertion, the De Castro opinion did not "assum[e]" that Southgate's "'profit potential' was 'substantial in comparison to the present value of the expected tax benefits.'" Gov't Br. 86 (quoting Ex.61 at 63-64). Rather, the quoted language referred to a Senate bill (ultimately enacted) that defined economic substance for transactions *after* March 2010, and that (as explained above, *supra* pp. 37-38) deliberately *diverged* from existing Fifth Circuit law.

Indeed, the facts proving good faith here are far stronger than those on which the Seventh Circuit upheld that defense in *American Boat*. There the government claimed an opinion letter contained representations that the taxpayer "knew or should have known were false, particularly that the . . . transactions had a nontax business purpose and that [the taxpayer] sought an economic profit." 583 F.3d at 484. The Seventh Circuit noted that "making a profit . . . was unlikely at best," and acknowledged evidence that undercut the taxpayer's purported motivation, but nonetheless deferred to the district court's conclusion that the taxpayer was "a credible witness" who "'thought . . . that he could make some money.'" *Id*. at 484-485.

In the same vein, the district court's findings here concerning the De Castro and CGC tax opinions reflect the court's firsthand assessment of the testimony of Beal, Montgomery, the tax attorneys and accountants who advised them, and an expert witness who opined on the quality of the work. There is no basis for reversing them. *Brown*, 561 F.3d at 434; *Eldercare Properties*, 568 F.3d at 515. In contrast, the tax opinion in *Long Term Capital* failed to discuss any of the facts or legal authorities relevant to the transaction at issue. 330 F. Supp. 2d at 209. Moreover, the court found that the tax opinions ignored important evidence that was "clearly contrary to certain representations" on which King & Spalding relied and that rendered certain assumptions "unreasonable and unsupportable." *Id*. The

district court here found exactly the opposite. R.15345/FF-¶311 ("[The opinions] analyze the relevance and persuasiveness of authorities [and] are not based on unreasonable assumptions.").

The government next claims that Beal "disregarded" De Castro's advice, but that is contravened by the district court's factual findings that "Southgate [and Beal] carried out the transactions at issue consistently with the transactional documents and descriptions in the De Castro and CGC opinions." R. 15344/FF-¶¶306-307. The government presents no evidence that this finding was clearly erroneous.

The government complains that, while the De Castro memo presented a range of ways to execute the GNMA-Martel Transactions, the one Beal ultimately chose was not preferable. This Court, however, has held that

> taxpayers should ordinarily not be held negligent for following *any* of the bona fide alternatives developed by an advisor acquainted with the relevant facts. To find otherwise adds a new requirement to the reliance on counsel defense: not only must the taxpayer show that his advisor discussed how to treat a tax-related transaction, he must also show that the advisor ranked any alternatives hierarchically, and he (the taxpayer) adopted whichever alternative was at the top of the list.

Streber v. Comm'r, 138 F.3d at 221 (emphasis added).

Finally, the government disparages De Castro's work as a pre-arranged plan for "penalty protection." Gov't Br. 87-88. Once again, the government substitutes epithets for evidence. Not only did the district court conclude that there was no

prearranged plan, but it expressly rejected the notion that De Castro acted as "penalty protection" for Southgate, finding instead that De Castro provided "ordinary tax planning work." R.15339/FF-¶282, R.15341/FF-¶291. And, as the court further found, the fact that De Castro's opinions anticipated each and every one of the arguments raised in the FPAA, "and that there are memoranda and draft opinions in which the advisors at both De Castro and CGC are wrestling with the various issues in the FPAA," are "evidence of the *quality* of the opinions rather than evidence of a tax avoidance scheme furthered by these professionals." R.15345-15346/FF-¶312 (emphasis added).

B. Even If Good Faith Were Inapplicable, All Of The Penalties Fail As A Matter Of Law.

1. Valuation Misstatement Penalties Cannot Be Imposed Against Southgate Under Settled Circuit Precedent.

The district court properly rejected the government's attempt to impose a valuation misstatement penalty. That outcome is mandated by this Circuit's established rule that, "[w]henever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." *Heasley*, 902 F.2d at 383. "In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit." *Id.*; *Todd v. Comm'r*, 862 F.2d 540, 543 (5th Cir. 1988); *see* R.15407-15408/COL-151-152.

The government contends that *Heasley* was abrogated by regulations adopted in 1998. Gov't Br. 76-77. But 26 C.F.R. §1.6662-5(d) and §1.6662-5(g) sought only to solve a basic mathematical problem: where the basis in an asset is zero, it is mathematically impossible to calculate a percentage change (because any percentage of zero is still zero). Those regulations provide that when the correct basis is determined to be zero, there is a "gross" valuation misstatement.

And the government never mentions the *first* section of that regulation, which expressly states that the regulations apply only when an "underpayment that is *attributable to* a substantial valuation misstatement." 26 C.F.R. §1.6662-5(a) (emphasis added). *Heasley* addressed the meaning of that very phrase and held that any underpayment in this case is not "attributable to" an erroneous valuation. The regulations do not even purport to address that fundamental premise. Unsurprisingly, this Court and others have continued to apply *Heasley* even after those regulations took effect. *See Weiner v. United States*, 389 F.3d 152, 161 (5th Cir. 2004); *Keller v. Comm'r*, 556 F.3d 1056, 1060-1062 (9th Cir. 2009); *Alpha I, L.P. v. United States*, 84 Fed. Cl. 622, 626-632 (2008).

The government similarly ignores history in trying to distinguish *Heasley*, contending that "[t]he District Court did not totally disallow all tax benefits arising from the NPL acquisition." Gov't Br. 78. But the FPAA stated that Southgate's "claimed losses are *disallowed in full*," Ex.1001 at 8-9 (emphasis added), and the

district court, at the government's urging and over Southgate's objection, entered a judgment stating that "the Government's adjustments to [Southgate's] 2002 return as set forth in the [FPAA] are correct," R.15466. Having invited that result, the government can hardly deny that it happened.[14]

2. Southgate's Position Was Supported By Substantial Authority.

The government claims that the 20% substantial-understatement penalty applies because the district court erred in finding that Southgate had substantial authority for its tax positions. It did not err. Substantial authority exists when the weight of authorities supporting the tax treatment is "substantial in relation to" those "supporting contrary treatment," and is "determined in light of the pertinent facts and circumstances" of the case at hand. 26 C.F.R. §1.6662-4(d)(2), (d)(3)(i). Statutory, regulatory, and decisional authority can serve as substantial authority. 26 C.F.R. §1.6662-4(d)(3)(iii). The De Castro and CGC tax opinions discuss all three categories of authority in exhaustive detail, and make plain that, regardless of how this case is ultimately decided, there was substantial authority in favor of upholding Southgate.

The government does not actually question that fact, responding instead that "it is well settled that taxpayers may not claim tax benefits from transactions that

[14] The government states its "view" that *Heasley* was wrongly decided, Gov't Br. 78 n.34, but that assertion does not make it any less binding. *In re Entringer Bakeries*, 548 F.3d 344, 348 (5th Cir. 2008).

are shams or lack substance." Gov't. Br. 81. But that simply begs the question whether there was substantial authority to think that Southgate would be upheld under the judicial doctrines. There is no automatic rule that a sham-partnership finding warrants penalties.

As the district court recognized, the judicial doctrines are "amorphous, require intensive fact-finding, and generally lack the sort of black-letter multi-part tests that allow definitive answers." R.15410. Thus, this Court has held, so long as "the substantial authority issue turns on evidence going both ways, 'there is substantial authority from a factual standpoint for the taxpayer's position.'" *Streber*, 138 F.3d at 223 (quoting *Osteen v. Comm'r*, 62 F.3d 356, 359 (11th Cir. 1995)). In contrast, "'[*o*]*nly* if there was a record upon which the Government could obtain a reversal under the clearly erroneous standard could it be argued that from an evidentiary standpoint, there was not substantial authority.'" *Id*. (emphasis added).[15] As noted above, *supra* pp. 24-27, the government cannot claim that the evidentiary record was one-sided in its favor, and therefore cannot deny that there was substantial authority in Southgate's favor.[16]

[15] Tellingly, one of the few cases to actually adopt the government's view of substantial authority, *Long Term Capital*, simultaneously *acknowledged* that the Fifth Circuit had already rejected this position. 330 F. Supp. 2d at 204 (criticizing *Streber*).

[16] To the extent Southgate must show that it reasonably believed its tax position was more likely than not the correct one, 26 U.S.C. §6662(d)(2)(C)(i)—despite the district court's ruling to the contrary, R.15408/COL-152—there can be no dispute that the De Castro and CGC opinions

3. Negligence Penalties Are Inapplicable.

Because Southgate satisfies the "substantial authority" standard, negligence penalties cannot be imposed. 26 C.F.R. §1.6662-4(d)(2). Moreover, the government's "'too good to be true'" argument, Gov't Br. 81, is without merit. The district court found that Beal had no reason to question his advisors' judgments regarding the proper tax treatment of Southgate's NPL-related losses. *American Boat*, 583 F.3d at 485 (rejecting government's claim that "a 'too good to be true' transaction should have put [the taxpayer] on notice that something was awry") (internal quotation marks omitted). As we explained above, *supra* pp. 36-39, lawful tax benefits cannot be disallowed simply because they are large, and in this case the potential profits—$83 million—were large as well.

CONCLUSION

The Court should vacate the judgment and remand with instructions to enter a judgment allowing all losses and deductions claimed by Southgate and Beal.[17]

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concluded that there was a greater than 50% likelihood that the IRS would uphold Southgate's tax treatment of its losses. 26 C.F.R. §1.6662-4(g)(4). And, as discussed above, Southgate and its members reasonably relied on those opinions and would have done the deal regardless of the tax consequences. *Supra* pp. 47-55.

[17] This Court should reject the government's urging, Gov't Br. 72 n.29, to remand for reconsideration of its 26 C.F.R. §1.701-2 or capital-loss arguments. The government expressly acknowledged in the joint pretrial order that §1.701-2 "produces the same federal tax result" as the judicial doctrines, R.14449, and has waived any argument that it produces a different result. The capital-loss argument was raised in connection with the government's "basis-killer" argument that "Cinda was not a dealer in securities," R.14625-14626, which the government has abandoned on appeal, Gov't Br. 18-19 n.6.

Alternatively, if the Court concludes that the GNMA-Martel Transactions should be disregarded, the case should be remanded for entry of a judgment: (1) upholding Southgate's reporting and allocation of losses on its 2002 tax return, and (2) allowing Beal's deduction of his allocated share of Southgate's losses in 2002 equal to his outside basis in Southgate, calculated without the GNMA-Martel Transactions.

In any event, the ruling as to penalties should be affirmed.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on July 9, 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. 28.1(e)(2)(A)(i) because this brief contains 14,000 words (as counted by Microsoft Word 2003), excluding the parts of the brief exempted by FED. R. APP. P. 32(a)(7)(B)(iii).

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

/s/ M. Todd Welty
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