No. 09-11166

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

SOUTHGATE MASTER FUND, LLC, by and through
MONTGOMERY CAPITAL ADVISORS, LLC, its Tax Matters Partner,

Plaintiff-Appellant/Cross-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee/Cross-Appellant.

ON APPEAL FROM THE JUDGMENT AND ORDER
OF THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS

REPLY BRIEF FOR THE APPELLEE/CROSS-APPELLANT

JOHN A. DiCICCO
Acting Assistant Attorney General

GILBERT S. ROTHENBERG
Acting Deputy Assistant Attorney General

KENNETH L. GREENE (202) 514-3573
JUDITH A. HAGLEY (202) 514-8126
Attorneys
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Of Counsel:

JAMES T. JACKS
United States Attorney

TABLE OF CONTENTS

Page

Table of contents i
Table of authorities iii
Acronym Glossary vi
Introduction 1
Argument:

A. Southgate has failed to demonstrate that the De Castro and Coscia opinions complied with Treasury Regulation § 1.6664-4(c)(1)'s minimum requirements 5

1. The District Court's findings and the record evidence demonstrate that the opinions' assumptions were incorrect, and that Beal and Montgomery should have known that they were incorrect 7

a. Partnership-structure assumptions 8

b. GNMA/basis-build transaction assumptions 15

c. Assumptions that profit — not tax — motivated the NPL acquisition 18

2. Subjective belief is not the standard for evaluating the assumptions 20

B. Southgate cannot justify Beal's failure to follow his attorneys' advice regarding the GNMAs 21

Pages

C. Compliance with a “literal — if narrow — reading” of “black-letter law” cannot immunize Beal from the Code’s mandatory accuracy-related penalties, as the District Court erroneously held, particularly given that Beal was specifically advised that the claimed tax benefits would be disallowed if (as here) the partnership violated well-settled judicial tax doctrines . . 24

D. Southgate has failed to demonstrate that none of the mandatory accuracy-related penalties apply to Beal’s attempt to shelter $1 billion through a sham partnership 29

1. Valuation-misstatement penalty 29

2. Substantial-understatement penalty 34

3. Negligence penalty 35

Conclusion 38

Regulatory Addendum 39

Certificate of service 42

Certificate of compliance 43

Pages

TABLE OF AUTHORITIES

Cases:

Alamo Nat'l Bank v. Commissioner, 95 F.2d 622 (5th Cir. 1938). 5

American Boat Co. v. United States, 583 F.3d 471 (7th Cir. 2009). 8, 21

Auer v. Robbins, 519 U.S. 452 (1997). 32

Barlow v. Commissioner, 301 F.3d 714 (6th Cir. 2002). 37

CM Holdings, Inc. In re, 301 F.3d 96 (3d Cir. 2002). 24, 25

Clearmeadow Investments, LLC v. United States, 87 Fed. Cl. 509 (2009). 32

Commissioner v. Culbertson, 337 U.S. 733 (1949). 9

Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001). 19

Conway v. United States, 326 F.3d 1268 (Fed. Cir. 2003). 36

Enbridge Energy Co. v. United States, 553 F. Supp. 2d 716 (S.D. Tex. 2008), *aff'd by unpublished opinion*, 354 Fed. Appx. 15 (5th Cir. 2009).. 24

Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990) 29-31, 33

InterTAN, Inc. v. Commissioner, 87 T.C.M. (CCH) 767, *aff'd*, 117 Fed. Appx. 348 (5th Cir. 2004) 22

Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954). 11

Keller v. Commissioner, 556 F.3d 1056 (9th Cir. 2009). 32, 33

Long-Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd by summary order*, 150 Fed. Appx. 40 (2d Cir. 2005). 6, 24, 27, 28, 34

Mayer Brown LLP v. IRS, 562 F.3d 1190 (2009).. 37

Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967 (2005) 30, 33

Pages

Cases (continued):

Neonatology Assocs. v. Commissioner, 299 F.3d 221
(3d Cir. 2002) 36
Sala v. United States, __ F.3d __, No. 08-1333, 2010 WL
2872368 (10th Cir. July 23, 2010) 19, 20
Santa Monica Pictures, LLC v. Commissioner,
89 T.C.M. (CCH) 1157 (2005) 6, 27-28, 34
Stobie Creek Investments v. United States, No. 2008-5190,
__ F.3d __, 2010 WL 2331155
(Fed. Cir. June 11, 2010) 8, 24
United States v. Boyle, 469 U.S. 241 (1985) 2

Statutes:

Internal Revenue Code of 1986 (26 U.S.C.):

§ 475 34
§ 704 25
§ 6662 1

Miscellaneous:

56 Fed. Reg. 8943-01 (March 4, 1991) 29
56 Fed. Reg. 67492-01 (Dec. 31, 1991) 29
S. Rep. No. 97-494 (1982) 3, 4
Treas. Reg. (26 C.F.R.):

§ 1.701-2 34
§ 1.704-3(a)(7) 25
§ 1.704-3(a)(10) 26
§ 1.6662-3(b)(1)(ii) 36

Pages

Miscellaneous (continued):

Treas. Reg. (26 C.F.R.):

§ 1.6662-5(d) 30, 31, 33
§ 1.6662-5(g) 29-31, 33
§ 1.6664-4(b)(1) 22
§ 1.6664-4(c)(1) 2, 3, 5, 8
§ 1.6664-4(c)(1)(ii) 6, 20

U.S. Treas. Dep't, Office of Tax Policy, *Penalty and Interest Provisions of the Internal Revenue Code* (1999) 37

Acronym Glossary

As used herein:

"AMC" refers to China's Asset Management Companies

"GNMA" refers to Government National Mortgage Association securities

"LSA" refers to the loan servicing agreement

"NPL" refers to non-performing loan

INTRODUCTION

This case concerns a partnership-basis-inflating tax shelter entered into by taxpayer Andrew Beal in order to produce staggering ordinary losses exceeding $1 billion that were — as his counsel admitted — “suffered by someone other than Mr. Beal” (R87) and used to shelter Beal’s unrelated income from his successful bank (Ex403). The scheme manipulates the partnership rules in an attempt to transfer high-basis/low-value assets, here non-performing loans (NPLs), from an entity that cannot use the built-in loss to a taxpayer who can. While claiming $1 billion of those artificial losses through Southgate, Beal and his advisors replicated the scheme through three separate partnerships in order to stockpile billions in losses for Beal’s future use. (R805-813,1854.) The District Court disallowed the $295 million loss claimed by Southgate in 2002 (Ex60), finding (under alternative fact-specific rulings) that Southgate had not acquired Cinda’s carryover basis in the NPLs and thus had misstated the basis of the assets sold by over $1 billion. (R15399.)

The District Court nevertheless concluded that Beal was not liable for I.R.C. § 6662’s mandatory accuracy-related penalties (including a penalty specifically designed for basis misstatements), because the court determined that Southgate and its managing partners, Thomas Montgomery and Beal, had reasonable cause for making the $1 billion basis misstatement. In our opening brief, we demonstrated that the court's reasonable-cause determination is wrong as a matter of law, because it (i) failed to require Southgate to prove that the De Castro and Coscia tax opinions satisfied Treasury Regulation § 1.6664-4(c)(1), (ii) disregarded the fact that Beal did not follow his attorneys' advice regarding the GNMA/basis-build transaction, and (iii) assumed that compliance with a narrow reading of the technical rules precludes imposition of penalties on a scheme that violates the sham-partnership and substance-over-form/step-transaction doctrines.

In its answering brief (at 49), Southgate seeks to immunize the District Court's reasonable-cause determination from scrutiny by this Court by framing the issues on appeal as factual questions. That attempt is unavailing. As noted in our opening brief (at 73), "what elements must be present to constitute 'reasonable cause' is a question of law." *United States v. Boyle*, 469 U.S. 241, 249 n.8 (1985) (emphasis omitted). To reverse the District Court's reasonable-cause determination, this Court need not (as Southgate erroneously claims (Br. 49-50)) find that any particular finding of fact was clearly erroneous, because (i) the District Court did not find (as Treasury Regulation § 1.6664-4(c)(1) requires) that Beal and Montgomery had no reason to know that the De Castro and Coscia opinions' factual assumptions were inaccurate, and (ii) the District Court did not find that Beal followed De Castro's advice regarding the GNMA/basis-build transaction. But, under any standard of review, the District Court's ruling that reasonable cause can be supported by tax opinions based on false posited facts or advice that was ignored is erroneous, as is its ruling that the mandatory accuracy-related penalties do not (by their terms) apply to Southgate's $1 billion basis misstatement.

Before turning to those arguments, it bears reiterating (because Southgate totally ignores the point) that accuracy-related penalties play a critical role in our self-assessing tax system. Congress designed those penalties for the specific purpose of deterring taxpayers like Beal from playing the "audit lottery" by providing a "downside risk" to tax-avoidance schemes. S. Rep. No. 97-494, at 272-273 (1982). As the Senate Report explained, without accuracy-related penalties, "taxpayers are not exposed to any downside risk in taking highly questionable positions on their tax returns since even resolution of the issue against the taxpayer will require only payment of the tax that should have been paid in the first instance with interest to reflect the cost of the 'borrowing.' . . . Thus, in the event that the questionable position is not detected, the taxpayer will have achieved an absolute reduction in tax without cost or risk." *Id.* Indeed, without penalties, taxpayers — particularly financially savvy taxpayers like Beal — can underpay their taxes, invest that unauthorized Government loan, and, if caught by the IRS, repay the loan with interest and still turn a profit on their tax-avoidance scheme.

This case highlights the need for penalties as a deterrent to taxpayers willing to enter into risky tax-shelter transactions. As the court found, Beal had a "past practice" of trying to "shelter most" of his income, and attempted to use not one, but four, "Chinese NPL tax shelter" partnerships to shelter $4 billion more. (R15308,15314,15389.) Without penalties, there is no reason for Beal to change his tax-sheltering "practice" (R15308). If Beal gets caught, then he merely has to return the money to the U.S. Treasury, and until he is forced to do so, can use the millions in tax that he has avoided as an unauthorized Government loan. If he does not get caught, which — as the $365 billion tax gap demonstrates — happens all too frequently, then he has successfully played the audit lottery at the expense of his fellow taxpayers who must shoulder the share of the nation's revenue needs that Beal has shirked. *See Alamo Nat'l Bank v. Commissioner*, 95 F.2d 622, 623 (5th Cir. 1938) (IRS "in effect represents the interests of all other taxpayers who must bear what the particular taxpayer unjustly escapes"). Although, as the District Court pointed out, Beal is a "noted gambler" (R15414), where (as here) he gambles with the tax laws, he does so with other people's money. In order to protect law-abiding taxpayers, and deter future tax avoidance by Beal and other similar investors, the District Court's penalty ruling should be reversed.

ARGUMENT

A. Southgate has failed to demonstrate that the De Castro and Coscia opinions complied with Treasury Regulation § 1.6664-4(c)(1)'s minimum requirements

In our opening brief (at 84-87), we demonstrated that the De Castro and Coscia tax opinions upon which Southgate relies for reasonable cause fail to satisfy Treasury Regulation § 1.6664-4(c)(1)'s minimum requirements, and that, for this reason alone, neither Southgate, Beal, nor Montgomery could reasonably rely on such advice. In order for advice to support a reasonable-cause defense, the taxpayer "must" (among other things) demonstrate that the advice was not "based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purpose for entering into a transaction or for structuring a transaction in a particular manner." Treas. Reg. § 1.6664-4(c)(1)(ii). If the advice fails to satisfy these minimum threshold requirements, then the taxpayer cannot — as a matter of law — rely on that advice to support a reasonable-cause defense.

Every other court that has addressed this type of partnership-basis-inflating scheme has determined that penalties apply, and, in doing so, has rejected reliance on tax opinions containing false assumptions. *Long-Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 206, 209 (D. Conn. 2004), *aff'd by summary order*, 150 Fed. Appx. 40 (2d Cir. 2005); *Santa Monica Pictures, LLC v. Commissioner*, 89 T.C.M. (CCH) 1157, 1233 (2005). Like the tax opinions rejected by those courts, the opinions here violate the reasonable-cause regulation because they contain factual assumptions that Beal and Montgomery knew or should have known were false, including false assumptions regarding (i) the use of the partnership structure to invest in NPLs, (ii) the GNMA/basis-build transaction, and (iii) Southgate's profit potential as compared to the expected tax benefits. *See* Gov't Br. 85-86.

In response, Southgate contends (i) that the District Court found that the assumptions were correct (Br. 52), and (ii) that Beal and Montgomery subjectively "believed" them to be correct (Br. 51-52). The first contention is wrong, and the second contention is irrelevant.

1. The District Court's findings and the record evidence demonstrate that the opinions' assumptions were incorrect, and that Beal and Montgomery should have known that they were incorrect

The District Court did not find that any of the assumptions in the De Castro and Coscia opinions were correct. Indeed, the court did not even address any specific assumption in those opinions. Although the court concluded that the opinions were not based on unreasonable assumptions (R15345), the court did so after opining whether De Castro and Coscia — not Beal and Montgomery — knew or had reason to know that any of the opinions' assumptions were inaccurate. (R15340,15342.) The proper focus of the reasonable-cause inquiry, however, is on the taxpayer's "perspective," not that of his attorney. *American Boat Co. v. United States*, 583 F.3d 471, 484 (7th Cir. 2009); Treas. Reg. § 1.6664-4(c)(1). What the court should have asked — and failed to ask — was whether Beal and Montgomery knew or had reason to know that the opinions' factual assumptions were inaccurate. If the court had conducted the proper inquiry, it would have concluded — based on its findings and the record evidence — that the opinions contain assumptions that Beal and Montgomery knew or should have known were false.[1]

a. Partnership-structure assumptions.

The De Castro and Coscia opinions informed Beal and Montgomery that the partnership structure would be disregarded

[1] Southgate's reliance (Br. 53) on "an expert witness who opined on the quality" of the opinions is misplaced. An expert's evaluation is irrelevant where — as here — the opinion is based on facts known by the taxpayer to be "false." *Stobie Creek Investments v. United States*, __ F.3d __, No. 2008-5190, 2010 WL 2331155, *15 (Fed. Cir. June 11, 2010).

unless they could satisfy the "critical" test set out in *Commissioner v. Culbertson*, 337 U.S. 733 (1949), and demonstrate that "the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both." (Ex61 at 64-65; *accord* Ex8 at 26.) Both opinions assumed that the partnership was formed for that business purpose. (Ex8 at 26-27,85, Ex61 at 40,62,65.) The District Court, however, never found that the parties had formed Southgate to jointly conduct a business and share in its profits and losses. On the contrary, the court found that the "partnership structure was a sham" (R15397), and made several other findings that demonstrate that Beal and Montgomery knew or should have known that the opinions' assumptions regarding the partnership structure were inaccurate:

- Beal and Montgomery had been advised by De Castro that "Beal had to join a preexisting partnership structure to be able to generate a large tax loss on the Chinese NPLs that Beal could claim on his personal tax returns" (R15391; *accord* R15274);

- Montgomery was "well aware" that other U.S. investors had purchased Chinese NPLs without using the partnership structure (R15271-15273);
- Montgomery admitted that Beal could have purchased the NPLs directly without using the partnership (R15391);
- in prior investments, Beal had purchased NPLs without partnering with the foreign seller (R15300);
- "Beal never intended to share any potential gains or losses from the GNMAs with the other partners in Southgate" (R15389);
- Montgomery began planning the basis-build transaction *before* Southgate was formed (R15275,15316);
- Cinda sought "immediate liquidity" for its NPLs, not a shared investment (R15306), as Montgomery knew (R482); and
- the Cinda-Southgate loan servicing agreement (LSA) — not the Southgate partnership agreement — "allowed Montgomery to achieve the essential benefits of partnering with a Chinese entity" (R15304), and the LSA "explicitly disavows any partnership relationship" (R15305).

In addition, the District Court cited correspondence between De Castro, Montgomery, and Beal (R15275,15281,15308,15318,15340) that makes clear (i) that Beal and Montgomery knew that each step in the DAD partnership scheme was part of a pre-arranged tax strategy — planned before Southgate's formation — to reach the end result of transferring Cinda's built-in losses to Beal (Ex34,Ex39-42,Ex63-67, Ex116-117), and (ii) that Beal and Montgomery formed Southgate with the intention of "dilut[ing]" Cinda's partnership interest to "zero" (Ex76 at 3).[2] Those documents highlight the fact that, even if Beal and Montgomery had a business purpose for investing in NPLs, they knew that they were using the partnership structure for tax purposes. Given

[2] That the court found that Montgomery was not "certain" that Beal would join Southgate (R15279) does not mean (as Southgate suggests (Br. 35,54-55)) that the court found that the parties were not acting pursuant to a pre-arranged tax strategy. As the court found, Montgomery and De Castro anticipated that Beal would join Southgate, and began planning how to report the losses on his tax return and build his basis in Southgate even before the partnership was formed. (R15274-15275,15279,15316.) But, even if the court "failed to find explicitly that" the steps setting up the DAD shelter were part of a prearranged plan, "its findings and opinion impliedly concede that to have been the case, and the evidence is clearly to that effect." *Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685, 689 (5th Cir. 1954).

the court's findings and the documentary evidence cited by the court, the District Court should have concluded that Southgate lacked reasonable cause for reporting tax losses premised on the partnership's validity.

In response, Southgate contends that the District Court made other findings that validate the opinions' assumptions regarding the partnership structure. That contention is incorrect. That the NPL acquisition "fit within Beal's and Montgomery's core business" (as the court found (R15300) and Southgate notes (Br. 50)) means only that the court found that the NPL acquisition had a business purpose, not that the partnership structure had a business purpose. De Castro had specifically warned Beal and Montgomery about that distinction, emphasizing that it "is not sufficient that the partnership itself 'conducts business activities'" that were profitable; rather, the partnership structure itself needed a "nontax business purpose." (Ex61 at 65-66 (citation omitted).) *See* Ex8 at 95,102n.143 (Coscia provides similar advice).

Similarly, the court's statement that the "formation of Southgate was important in several respects" (R15301-15302) cannot bear the weight that Southgate places on it (Br. 50). None of the business objectives cited by the court demonstrate that the parties formed Southgate to conduct jointly a business and share profits and losses, or provide a specific, non-tax reason for using the partnership structure. *See* Gov't Br. 54-58. Moreover, each objective was consistent with the court's recharacterizing the "partnership" steps as a direct sale of NPLs under the step-transaction doctrine. And the court's findings that Cinda sought "immediate liquidity" for its NPLs (R15306), and that "Beal never intended to share any potential gains or losses from the GNMAs with the other partners in Southgate" (R15389) establish that Beal and Montgomery must have known that the opinions wrongly assumed that the "partners join[ed] together to conduct a business and share the profits and losses" (Ex61 at 65; *accord* Ex8 at 26).

The testimony cited by Southgate (Br. 51 (citing R458 and R3588)) is not to the contrary. Beal's testimony that Montgomery had "been able to purchase a large portfolio at about half of what they had been marketing it for" (R3588) does not evidence any business purpose for the partnership structure. On the contrary, it supports the alternative step-transaction ruling that the NPL acquisition in substance was a “purchase,” not a partnering. Similarly, Beal’s and Montgomery’s testimony about having a business purpose for Cinda’s role as loan “servicer” (R3588, R458), does not evidence a business purpose for Cinda’s role as Southgate “partner.” As noted above, the Southgate-Cinda LSA expressly disavowed any partnership relationship, and Montgomery was “well aware” that other U.S. investors had engaged Chinese AMCs as servicers without partnering with them, as the District Court found. (R15271-15273,15286,15305.) Finally, Montgomery’s testimony (R458) that he wanted to “lock in the portfolio” does not evidence a business purpose for the partnership, because there was no testimony or finding that a “partnership” was necessary to lock in the NPLs, as opposed to any other type of contractual agreement regarding the NPLs. And, in fact, Montgomery entered into such an agreement with Deutsche Bank (Cinda’s exclusive sourcing agent for its NPLs) on the same day that he formed Southgate. (Ex359, R15270,15279.) Pursuant to that agreement, Montgomery paid Deutsche Bank $50,000 as a “placement fee” to lock in Cinda’s NPL “Assets,” and promised to pay a future fee (calculated as a percentage of those locked-in Assets) once Montgomery secured an investor to purchase the Assets.[3] (Ex359, R15283-15284.) Indeed, before entering that agreement, Montgomery had informed Deutsche Bank that he and Beal were looking to Deutsche Bank to "lock and engage on the billion deal." (Ex33 at SGDB000000178,SGDB000000184.) Overlaying a partnership structure onto Montgomery's contractual arrangement with Deutsche Bank was necessary to lock in the tax benefits, not the NPLs.[4]

In sum, neither the findings nor the testimony cited by Southgate demonstrate that Beal and Montgomery reasonably viewed the partnership structure to be anything other than a sham.

b. GNMA/basis-build transaction assumptions

The District Court's findings also demonstrate that Beal and Montgomery knew or should have known that the opinions' assumptions regarding the GNMA/basis-build transaction were inaccurate. The opinions assumed that Beal contributed the GNMAs to

[3] The agreement referred to Cinda as the "Seller" of the Assets. (Ex359.)

[4] Moreover, locking in specific NPLs in no way evidences that the parties joined together to share profits and losses — it merely evidences that Montgomery sought to ensure that he and Beal actually acquired the assets that they, in substance, purchased from Cinda.

Southgate for the business purpose of allowing “Southgate to diversify its investment portfolio.” (Ex8 at 22; *accord* Ex61 at 31.) The court, however, found that (i) Beal contributed the GNMAs to Southgate pursuant to a tax plan — crafted weeks before Southgate’s formation — to increase Beal’s outside basis and thereby allow him to utilize the NPLs’ built-in-losses (R15316), and (ii) there “was no substantive non-tax economic reason” for the GNMA/basis-build transaction (R15329).

In response, Southgate contends (Br. 51-52) that the District Court found that Beal and Montgomery planned the GNMA/basis-build transaction in order to diversify Southgate’s assets. Far from making such a finding, however, the court expressly rejected Southgate’s diversification proposition as one of several fabricated “post-hoc rationales” (R15335) that did not “amount to substantive business purposes” (R15329). As the court explained (and Southgate ignores), Southgate “did not establish any valid business purpose for this ‘basis-build’ transaction other than the tax benefits obtained by Beal. The proffered reasons for the deal read like afterthoughts designed to disguise the true purpose.” (R15389.) That Beal and Montgomery should have known that the diversification assumption was incorrect is not only supported by the court's findings, it also is highlighted by Montgomery's April 2003 correspondence with Coscia regarding the "missing bus[iness] purpose" for the December 2002 GNMA/basis-build transaction. (Ex380.)

Beal and Montgomery also should have known the falsity of the related assumption that "no partner has in substantial part retained the benefits and burdens of ownership of the contributed property" (Ex8 at 82). As the District Court found, "Beal relinquished nothing of economic value" in the GNMA/basis-build transaction. (R15329.) Although Southgate points (Br. 52) to the court's finding (R15337) that the Southgate partners could potentially benefit if the GNMAs were sold, Southgate ignores the court's further finding that Beal controlled whether the GNMAs were sold (R15326). Moreover, that theoretical potential benefit would not be "substantial," because Beal retained the vast bulk of the GNMAs' value, including the net interest income. (R15322-15323.) *See* Gov't Br. at 12-13,42-43. As the court found, the *de minimis* amount of any post-contribution gain that Southgate theoretically could enjoy was "likely" to be only $100,000-$700,000

(R15326), not $13 million (as Southgate claims (Br. 41)).[5] Therefore, given that Beal expressly retained essentially all of the GNMAs' $180 million value, the assumption that Beal did not retain "in substantial part" the GNMAs' benefits is clearly false.

c. Assumptions that profit — not tax — motivated the NPL acquisition

Finally, Southgate has failed to demonstrate that it had no reason to doubt the accuracy of the opinions' assumptions that profit — not tax — motivated the NPL acquisition, and that Southgate's profit potential was substantial. The Coscia opinion assumed that "the main purpose of the investment in Southgate was for profit." (Ex8 at 65.) That assumption, however, is not supported by any finding, and conflicts with the finding that Beal backed away from complaining about Cinda's servicing efforts when Cinda threatened to report the Southgate shelter to the IRS. (R15314-15315.) *See also* R15289,15311; Mont. Dep. 85. That Beal chose pursuing the $400 million tax benefit over protecting

[5] The "13 million" cited by Southgate is an expert witness's hypothetical valuation premised on Beal not retaining the GNMAs' interest income. (R2713-2716.) As Beal and Montgomery knew — and the court found — that premise was incorrect. (R15323.)

the potential economic profit (which Montgomery quantified as $19 million (R842-844))[6] demonstrates that he should have known that the main purpose of the NPL acquisition was tax, not profit, and that therefore Coscia's contrary assumption was incorrect. Indeed, Southgate does not even challenge (Br. 52) our contention that Beal knew that Coscia's assumption was false.

Ignoring Coscia's false assumption, Southgate contends (Br. 52) that De Castro did not assume that Southgate's profit potential was "substantial." That contention is incorrect. De Castro's opinion expressly warned Beal that "a merely incidental profit motive is not sufficient" to give a transaction economic substance, but concluded that Beal's transaction "should be respected for tax purposes" because it "had substantial non-tax business purposes."[7] (Ex61 at 58.) De Castro

[6] Southgate's claim (Br. 59) that it expected to make an "$83 million" profit conflicts with Montgomery's trial testimony, and finds no support in the court's opinion. The court made no finding as to the amount of profit that Southgate expected to make — other than to characterize it as "some" (R15387).

[7] Although a "reasonable possibility of profit" can demonstrate that a transaction has economic substance, *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 788 (5th Cir. 2001), profit potential is not

(continued...)

further noted that pending legislation would require a transaction's "profit potential" to be "substantial" compared to "the expected tax benefits," and then assumed that "the Transactions would have economic substance even under" the "proposed" legislation. (Ex61 at 63-64.) That assumption is inaccurate, as Beal and Montgomery well knew, because the scheme's expected $400 million tax benefit dwarfed the $19 million that Montgomery claimed they expected to make. (R842-844, Ex34.)

2. Subjective belief is not the standard for evaluating the assumptions

Unable to demonstrate that it had no reason to know that the opinions contained inaccurate assumptions, Southgate instead contends (Br. 51-52) that Beal and Montgomery "*believe[d*]" the assumptions to be true. That contention misstates the applicable standard, which is whether the assumption is one "which the taxpayer knows, or has reason to know, is unlikely to be true." Treas. Reg. § 1.6664-4(c)(1)(ii).

[7](...continued)
reasonable where the "expected tax benefit dwarfs any potential gain" from the transaction, *Sala v. United States*, __ F.3d __, No. 08-1333, 2010 WL 2872368, *5 (10th Cir. July 23, 2010).

In this regard, *American Boat* does not (as Southgate suggests (Br. 51)) support its erroneous "believe" standard. As the Seventh Circuit made clear, "the focus is on what [taxpayer] knew or *should have known* at the time he obtained the opinion letter." 583 F.3d at 485 (emphasis added). Beal and Montgomery cannot simply close their eyes to the objective evidence, and profess their subjective belief that the factual statements in the opinions were accurate. They must — as a regulatory prerequisite for the reasonable-cause defense — demonstrate that they did not know or have any reason to know that the assumptions were unlikely. Their failure to do so precludes Southgate's reasonable-cause defense.

B. Southgate cannot justify Beal's failure to follow his attorneys' advice regarding the GNMAs

In our opening brief (at 87-88), we demonstrated that a critical element of reasonable cause is a taxpayer's honest effort to assess his proper tax liability, and that Beal's failure to follow his attorneys' advice regarding the GNMAs negates any claim that he made an honest effort. In particular, Beal disregarded his lawyers' advice that he should not, when "contributing" the GNMAs to Southgate, retain the

$162 million loan proceeds from the GNMA/basis-build transaction and reserve all the GNMAs' interest income. (R15318,15323, Ex42 at 1-2.) And Beal did so despite his advisors' explicit warnings that the partnership itself — not just the GNMA "contribution" — could be viewed as a sham if the other partners did not share substantially in the "contributed" GNMAs. *E.g.*, Ex39 at 1 (warning that "aggressive basis-building strategies" could "taint" the entire partnership); Ex61 at 18 (De Castro opinion's conclusion that partnership is genuine premised on validity of GNMA/basis-build transaction). Beal's disregard of this critical advice undermines his claim that he made an honest effort to assess his proper tax liability. Treas. Reg. § 1.6664-4(b)(1); *InterTAN, Inc. v. Commissioner*, 87 T.C.M. (CCH) 767, 776-777, *aff'd*, 117 Fed. Appx. 348 (5th Cir. 2004).

In response, Southgate does not challenge the legal principle that failure to follow an attorney's advice negates reasonable cause. Instead, Southgate contends (Br. 47) that the District Court found that Beal and Southgate "followed the advice they received." That contention is incorrect. The court did not — and could not — find that De Castro's advice regarding the GNMA/basis-build transaction was followed. Rather, the court found that Beal in fact did exactly what his lawyers had advised against — he received the $162 million in loan proceeds and reserved all GNMA interest income. (R15318-15319,15323.) And, if the court had found that Beal followed his attorneys' advice, that finding would have been clearly erroneous because it conflicted with De Castro's admission that Beal did not heed its advice regarding the GNMA/basis-build transaction (R1762-1763). That Beal "carried out the transactions at issue consistently with" the "descriptions in the De Castro and [Coscia] opinions" (as the court found (R15344)) does not mean that Beal followed De Castro's prior advice (as Southgate contends (Br. 54)). It means only that De Castro and Coscia had accurately described in their final tax opinions the transactions that occurred.

Nor did Beal simply adopt a bona-fide alternative offered by his attorneys, as Southgate erroneously suggests (Br. 54). Rather, he adopted an alternative that De Castro had warned raised "a substantial risk that the IRS could successfully attack the contribution of Martel" (Ex42 at 2), and could "taint" the entire partnership (Ex39 at1). Southgate has failed to explain why it would be reasonable to conclude that a taxpayer was seeking objective advice — not penalty protection — when the taxpayer ignored the actual advice that he received.

C. Compliance with a "literal — if narrow — reading" of "black-letter law" cannot immunize Beal from the Code's mandatory accuracy-related penalties, as the District Court erroneously held, particularly given that Beal was specifically advised that the claimed tax benefits would be disallowed if (as here) the partnership violated well-settled judicial tax doctrines

As explained in our opening brief (at 88), the District Court ultimately concluded that Southgate had reasonable cause because Montgomery and Beal "relied on a literal — if narrow — reading" of the "black-letter law." (R15414.) In response, Southgate makes no attempt to defend the court's rationale, nor could it. That ruling flies in the face of practically every shelter case where penalties have been upheld. *E.g.*, *Enbridge Energy Co. v. United States*, 553 F. Supp. 2d 716 (S.D. Tex. 2008) (applying penalties to Midco shelter, despite compliance with black-letter law), *aff'd by unpublished opinion*, 354 Fed. Appx. 15 (5th Cir. 2009); *Stobie Creek*, 2010 WL 2331155 (same; Son-of-BOSS shelter); *Long-Term Capital*, 330 F. Supp. 2d 122 (same; partnership-basis-inflating shelter); *In re CM Holdings, Inc.*, 301 F.3d 96, 102, 108

(3d Cir. 2002) (applying penalties regardless of "taxpayers' formal compliance with the Code"). It also creates dangerous precedent because almost every tax shelter is designed to comply with a literal reading of the Internal Revenue Code and Treasury Regulations, and any tax professional can issue an opinion providing that the shelter complies with such black-letter law.

Moreover, the District Court's ruling disregards the fact that Beal's advisors had specifically warned him that compliance with the Code and regulations was insufficient, thus precluding any reasonable reliance by Beal on the technical black-letter law. In this regard, De Castro and Coscia explained that the DAD shelter relied on Treasury Regulation § 1.704-3(a)(7), which provides that if a partner that has contributed built-in-loss property to a partnership transfers his partnership interest, then the built-in-loss should be allocated to the transferee partner.[8] (Ex61 at 37; Ex8 at 70.) But, as De Castro and Coscia both emphasized, notwithstanding that foregoing rule, the

[8] As De Castro's opinion noted, although I.R.C. § 704 did not provide for this allocation, it did not (before the 2004 amendments) expressly "prevent" the shifting of built-in-losses. (Ex61 at 38.)

attempted transfer of built-in losses could be thwarted by other applicable rules and judicial doctrines. (Ex61 at 39-50,64-67, Ex8 at 71,87.) The advisors noted that the regulation itself made clear that the built-in loss could not be transferred if doing so “substantially reduces the present value of the partners aggregate tax liability.” (Ex61 at 37 (citing Treas. Reg. § 1.704-3(a)(10)); Ex8 at 71 (same).) Montgomery and Beal knew that transferring $1 billion in losses from Cinda to Beal would substantially reduce the present value of the partners’ aggregate tax liability and that therefore their tax scheme was outside the intended scope of the regulation.[9] (Ex8 at 13 (Cinda not subject to U.S. taxation).) And De Castro warned them that the tax strategy was risky because the IRS had started to investigate transactions “involving a partnership’s allocation of losses derived from the disposition of distressed debt that had been contributed to the partnership by a foreign partner” (Ex61 at 39), the very scheme at issue here.

[9] As Montgomery conceded, the DAD scheme produced tax benefits that, if discovered by Congress and the Treasury Department, would prompt them to “change the law, which they did.” (R352-353.)

De Castro and Coscia also warned Beal and Montgomery that their partnership scheme could be disallowed if (as pertinent here) it violated the sham-partnership and step-transaction doctrines, despite any compliance with black-letter law. (Ex61 at 39-50,64-67, Ex8 at 72,87.) Indeed, other courts have imposed penalties on analogous partnership-basis-inflating shelters after finding, under the step-transaction doctrine, that a multi-step partnership arrangement was, in substance, a direct sale of the built-in-loss asset. *Long-Term Capital*, 330 F. Supp. 2d at 191-196; *Santa Monica*, 89 T.C.M. (CCH) at 1217-1218.

The District Court disregarded the partnership under the sham-partnership and step-transaction doctrines (R15396-15397), and Southgate has failed to explain why penalties should not likewise be applied here. Southgate attempts (Br. 35-36,54-55) to distinguish those cases based on the court's finding that it was not certain that Beal would join Southgate when the partnership was formed. That finding is legally irrelevant. Certainty that each step in a tax plan will be implemented is not required by the step-transaction doctrine, and was not present in *Long-Term Capital* or *Santa Monica* either. As De

Castro expressly advised, courts have rejected the argument that the step-transaction doctrine requires certainty or a "binding commitment" that each step in a pre-arranged plan would occur. (Ex61 at 42.) Like the taxpayers in *Long-Term Capital* and *Santa Monica*, Beal and Montgomery knew that the arrangement was part of a pre-arranged strategy to shift Cinda's losses to a U.S. taxpayer that everyone expected to be Beal, as the De Castro memoranda cited by the District Court makes clear. (Ex34,Ex39-42,Ex63-67,Ex116-117.) *See* Gov't Br. 6-9,63-64. And part of the plan included having Beal wait to join the pre-existing partnership. (R15391, Ex117 at 3.) In Beal's subsequent DAD shelters, Montgomery again engineered this tax-driven uncertainty by first forming a new partnership with a Chinese entity and then introducing Beal "[l]ater." (Ex812.) That the tax strategy was designed to comport with black-letter law cannot immunize Beal from penalties, just as it did not immunize the taxpayers in *Long-Term Capital* and *Santa Monica*.

D. Southgate has failed to demonstrate that none of the mandatory accuracy-related penalties apply to Beal's attempt to shelter $1 billion through a sham partnership

In our opening brief (at 74-82), we demonstrated that each of the alternative, mandatory accuracy-related penalties imposed by the IRS applied to Beal's basis-inflating DAD shelter. Southgate has failed to identify any error in our analysis.

1. Valuation-misstatement penalty

As previously explained (Gov't Br. 74-76), the Code's penalty for basis misstatements applies to Southgate's $1 billion basis misstatement, and that to the extent that *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990) indicates to the contrary (as the District Court held), that decision's interpretation of the valuation-misstatement penalty had since been abrogated by regulation.[10] *See* Treas. Reg. § 1.6662-5(g) (any misstatement of basis concerning property with a correct basis of "zero" is subject to gross-valuation-misstatement

[10] The regulations were proposed and promulgated in 1991, shortly after *Heasley* was decided, not in 1998 (as Southgate claims (Br. 56)). 56 Fed. Reg. 8943-01 (March 4, 1991) (proposed); 56 Fed. Reg. 67492-01 (Dec. 31, 1991) (final).

penalty); Treas. Reg. § 1.6662-5(d), ex. 3 (gross-valuation-misstatement penalty applies to understatement of tax resulting from total disallowance of depreciation deduction where property's correct basis is zero). In response, Southgate does not — and cannot — challenge the proposition that courts must defer to a subsequently issued regulation, even if it conflicts with the court's prior case law, if (as here) the prior case law had interpreted an ambiguous statute. *See Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 985 (2005). Instead, Southgate contends (Br. 56) that the regulation does not address *Heasley*'s rule that, when a deduction is totally disallowed, the resulting tax underpayment is not attributable to a valuation misstatement. Southgate is mistaken.

To read (as Southgate does) the regulation as not displacing *Heasley*'s total-disallowance rule would render Treasury Regulation § 1.6662-5(g) a nullity. Basis-dependent deductions (like the losses at issue here) will always be totally disallowed if the correct basis is zero. Therefore, if the valuation-misstatement penalty cannot apply whenever a deduction is totally disallowed (as *Heasley* held), then the penalty can never apply if the correct basis is zero. If that were the case, there would be no need for Treasury Regulation § 1.6662-5(g), which addresses how to apply the penalty when the correct basis is zero. The regulation thus clearly envisions that the valuation-misstatement penalty would apply if the correct basis is zero, and clarifies that the gross-valuation-misstatement penalty (rather than the substantial-valuation-misstatement penalty) applies in that circumstance. Treas. Reg. § 1.6662-5(g).

Although Treasury Regulation § 1.6662-5(g) does not expressly address the attribution question raised by *Heasley*, Example 3 in Treasury Regulation § 1.6662-5(d) does, and thereby demonstrates that the regulation does not merely "solve a basic mathematical problem," as Southgate contends (Br. 56). In that example, a claimed depreciation deduction was totally disallowed because the taxpayer had "fully depreciated" the asset in prior years. That total disallowance caused the property's basis to be adjusted from the $1,250,000 claimed by the taxpayer to the correct basis of zero. The regulation expressly provides that the resulting understatement of tax was "attributable" to a gross-valuation misstatement and that therefore the penalty applied. Treas. Reg. § 1.6662-5(d), ex. 3. Similarly, here, Southgate's claimed $1 billion basis in the NPLs has been reduced to zero under the sham-partnership and step-transaction doctrines, and the disallowed losses (which had been premised on the inaccurate $1 billion basis) are — under the regulation's reasoning — attributable to a gross-valuation misstatement.

The Government's interpretation gives meaning to the entire regulation, and is entitled to deference. *See Auer v. Robbins,* 519 U.S. 452, 461-462 (1997) (agency's interpretation of its own regulation is entitled to "controlling weight," even where agency's interpretation is "in the form of a legal brief"). That the Government's interpretation is reasonable cannot be denied, given that the majority of the circuits agree that the valuation-misstatement penalty applies when a deduction has been totally disallowed and the correct basis is zero. *See* Gov't Br. 76n.33 (listing cases); *Clearmeadow Investments, LLC v. United States*, 87 Fed. Cl. 509, 530-536 (2009) (describing circuit-split). *But see Keller v. Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009). Indeed, in *Keller*, the Ninth Circuit held that prior case law bound it to the rule that the valuation-misstatement penalty does not apply if a tax deduction is totally disallowed, but recognized that the contrary position held by the majority of the circuits is a “sensible method” in that it “cuts off at the pass what might seem to be an anomalous result — allowing a party to avoid tax penalties by engaging in behavior one might suppose would implicate more tax penalties, not fewer.”[11] *Id.*

In sum, given Treasury Regulation § 1.6662-5(d) and § 1.6662-5(g), this Court is no longer bound to follow *Heasley*. Consistent with the applicable regulations, the gross-valuation-misstatement penalty should apply to Southgate’s $1 billion basis misstatement, just as it

[11] Southgate’s reliance (Br. 56) on cases like *Keller* that followed *Heasley* after the regulation was promulgated is misplaced, because they did not address Treasury Regulation §§ 1.6662-5(d), 1.6662-5(g) or the Government’s *Brand X* argument.

applied to similar schemes in *Long-Term Capital* and *Santa Monica*.[12] *See* Gov't Br. 78.

2. Substantial-understatement penalty

In our opening brief (at 79-81), we demonstrated that the District Court erred in determining that Southgate had substantial authority

[12] As previously noted (Gov't Br. 72 n.29), if this Court were to disagree with the District Court's sham-partnership and step-transaction rulings, and affirm the ruling that the NPL acquisition had economic substance, a remand would be necessary to address the Government's alternative arguments for disallowing Southgate's ordinary losses. If the losses were disallowed under Treasury Regulation § 1.701-2 (which the court expressly recognized was a separate basis for disallowing the losses (R15391-15392; *see* R12090-12091)), then Southgate's basis in the NPLs would be adjusted to zero, and the valuation-misstatement penalty would apply. The penalty would not apply, however, under the Government's alternative argument that the ordinary losses should be recharacterized as capital losses. Pursuant to that argument, if (as Southgate argued) the NPLs were not "inventory" under I.R.C. § 475, then the NPL losses were capital, not ordinary. (R14625-14626,15067-15068.) The court determined that the NPLs were not "inventory." (R15360-15367.) Because the Government has not challenged that determination, the losses (if allowed) must be recharacterized as capital losses. Recharacterizing the losses has no impact on Southgate's claimed basis, and, therefore, the valuation-misstatement penalty would not apply. The other penalties, however, would apply, particularly given that Southgate was specifically warned about the inconsistency in arguing that the NPLs were not "inventory" for purposes of § 475 but were "inventory" for purposes of the capital-versus-ordinary-loss rules. (Ex63,Ex380.)

for its $1 billion basis misstatement. As we pointed out (and Southgate has not challenged (Br. 57-59)), the court erroneously relied on the irrelevant fact that one of the Government's technical arguments (*i.e.*, the "Section 482 argument") was a "matter of first impression." Given that the court based its substantial-understatement determination on an irrelevant legal proposition that Southgate does not even attempt to defend, that determination should be reversed.

Moreover, Southgate's reliance (Br. 57) on the case law cited in the De Castro and Coscia opinions is misplaced, because the applicability of that law was premised on numerous factual assumptions that, as demonstrated above, Beal and Montgomery knew were not true. De Castro and Coscia cited no authority — let alone substantial authority — that would support upholding the tax scheme based on the actual facts of this case.

3. Negligence penalty

Finally, in our opening brief (at 81-82), we demonstrated that the negligence penalty applies to any understatement of tax resulting from Southgate's $1 billion basis misstatement. As we explained, a reasonable person would have realized that the tax benefits generated by Beal's DAD shelter were "too good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii). Using a sham partnership, Beal attempted to leverage an out-of-pocket cost of approximately $20 million into a tax-sheltering loss of $1 *billion*. Because the partnership structure lacked all substance, and the tax benefits were astronomical compared to the costs, Beal gambled in the audit lottery at his "peril." *Neonatology Assocs. v. Commissioner*, 299 F.3d 221, 234 (3d Cir. 2002). The negligence penalty has applied where the "tax benefit was almost twice the amount of the investment." *Conway v. United States*, 326 F.3d 1268, 1279 (Fed. Cir. 2003). Here, the tax benefit was more than 50 times the amount of the investment. To deny that such a benefit was too good to be true would be absurd, and Southgate does not even attempt to do so.

Instead, Southgate contends (Br. 59) that Beal had no reason to question his advisors' judgment that he was entitled to that too-good-to-be-true tax benefit. That contention is incorrect. As explained above, the purported "judgment" of his advisors (i) was premised on factual assumptions that Beal and Montgomery — both highly sophisticated business men — knew were false, and (ii) was, in critical respects, disregarded. *See Barlow v. Commissioner*, 301 F.3d 714, 724 (6th Cir. 2002) (applying negligence penalty where taxpayer failed to follow attorney's advice).

By arguing that it should not be penalized for claiming too-good-to-be-true tax benefits from a sham partnership, Southgate — like the District Court — fails to appreciate the importance of mandatory accuracy-related penalties to our self-assessing tax system. As the D.C. Circuit has recently emphasized, "enforcement of the tax laws, a largely self-policed obligation, depends heavily on the personal probity of taxpayers and the *deterrent effect of severe and certain sanctions*." *Mayer Brown LLP v. IRS*, 562 F.3d 1190, 1192-1193 (2009) (emphasis added). Moreover, penalties assure the taxpaying public that all taxpayers are expected to meet their tax obligations, and that those who do not will pay a price. *See* U.S. Treas. Dep't, Office of Tax Policy, *Penalty and Interest Provisions of the Internal Revenue Code* 36 (1999). Applying penalties to Beal's sham-partnership scheme would assure taxpayers who (unlike Beal) do not make a "practice" of "shelter[ing]" their income (R15308) that they were not foolish for avoiding similar schemes.

CONCLUSION

The District Court's judgment should be affirmed with regard to its disallowance of Southgate's losses and reversed with regard to its ruling that penalties were inapplicable.

Respectfully submitted,

JOHN A. DiCICCO
Acting Assistant Attorney General

GILBERT S. ROTHENBERG
Acting Deputy Assistant Attorney General

/s/ Judith A. Hagley

KENNETH L. GREENE
JUDITH A. HAGLEY
Attorneys
Tax Division
Department of Justice

REGULATORY ADDENDUM

Treasury Regulations (26 C.F.R.):

§ 1.6662-5 Substantial and gross valuation misstatements under chapter 1.

(a) *In general*. If any portion of an underpayment, as defined in section 6664(a) and § 1.6664-2, of any income tax imposed under chapter 1 of subtitle A of the Code that is required to be shown on a return is attributable to a substantial valuation misstatement under chapter 1 ("substantial valuation misstatement"), there is added to the tax an amount equal to 20 percent of such portion. Section 6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement under chapter 1 ("gross valuation misstatement"). No penalty under section 6662(b)(3) is imposed, however, on a portion of an underpayment that is attributable to a substantial or gross valuation misstatement unless the aggregate of all portions of the underpayment attributable to substantial or gross valuation misstatements exceeds the applicable dollar limitation ($5,000 or $10,000), as provided in section 6662(e)(2) and paragraphs (b) and (f)(2) of this section. This penalty also does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664-4 applies. There is no disclosure exception to this penalty.

(b) *Dollar limitation*. No penalty may be imposed under section 6662(b)(3) for a taxable year unless the portion of the underpayment for that year that is attributable to substantial or gross valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)). This limitation is applied separately to each taxable year for which there is a substantial or gross valuation misstatement.

* * * * *

(d) *Examples*. The following examples illustrate the provisions of paragraphs (b) and (c) of this section. These examples do not take into account the reasonable cause exception under § 1.6664-4.

* * * * *

Example 3. Corporation V is a C corporation. In 1990, V had a loss of $100,000 without considering depreciation of a particular asset which it had fully depreciated in earlier years. V had a depreciable basis in the asset of zero, but on its 1990 calendar year return erroneously claimed a basis in the asset of $1,250,000 and depreciation of $250,000. V reported a $350,000 loss for the year 1990, and carried back the loss to the 1987 and 1988 tax years. V had reported taxable income of $300,000 in 1987 and $200,000 in 1988, before application of the carryback. The $350,000 carryback eliminated all taxable income for 1987, and $50,000 of the taxable income for 1988. After disallowance of the $250,000 depreciation deduction for 1990, V still had a loss of $100,000. Because there is no underpayment for 1990, no valuation misstatement penalty is imposed for 1990. However, as a result of the 1990 depreciation adjustment, the carryback to 1987 is reduced from $350,000 to $100,000. After absorption of the $100,000 carryback, V has taxable income of $200,000 for 1987. This adjustment results in an underpayment for 1987 that is attributable to the valuation misstatement on the 1990 return. The valuation misstatement for 1990 is a gross valuation misstatement because the correct adjusted basis of the depreciated asset was zero. (See paragraph (e)(2) of this section.) Therefore, the 40 percent penalty rate applies to the 1987 underpayment attributable to the 1990 misstatement, provided that this underpayment exceeds $10,000. The adjustment also results in the elimination of any loss carryback to 1988 resulting in an increase in taxable income for 1988 of $50,000. Assuming the underpayment resulting from this additional $50,000 of income exceeds $10,000, the gross valuation misstatement penalty is imposed on the underpayment for 1988.

(e) *Definitions* —

(1) *Substantial valuation misstatement*. There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 200 percent or more of the correct amount.

(2) *Gross valuation misstatement*. There is a gross valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 400 percent or more of the correct amount.

(3) *Property*. For purposes of this section, the term “property” refers to both tangible and intangible property. Tangible property includes property such as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action.

* * * * *

(g) *Property with a value or adjusted basis of zero*. The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent.

* * * * *

CERTIFICATE OF SERVICE

It is hereby certified that on this 30th day of July, 2010, the foregoing reply brief for the appellee/cross-appellant was filed electronically with the Clerk of the Court using the ECF system. On that same date, seven paper copies were mailed to the Clerk by First Class Mail, and service of this reply brief was made on counsel for the appellant/cross-appellee through this Court's ECF system, and by mailing two copies thereof by First Class Mail to counsel at the address set forth below:

M. Todd Welty, Esquire
Sonnenschein Nath & Rosenthal LLP
2000 McKinney Ave., Suite 1900
Dallas, TX 75201

/s/ Judith A. Hagley

JUDITH A. HAGLEY
Attorney for appellee/cross-appellant

CERTIFICATE OF COMPLIANCE

1. This reply brief complies with the type-volume limitation of Fed. R. App. P. 28.1(e)(2)(C) because:

[X] this brief contains 6,997 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii), or

[ ] this brief uses a monospaced typeface and contains [state the number of] lines of text, 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:

[X] this brief has been prepared in a proportionally spaced typeface using Corel Word Perfect X3 in Century Schoolbook 14 pt. type, or

[ ] this brief has been prepared in a monospaced typeface using [state name and version of word processing program] with [state number of characters per inch and name of type style].

3. The undersigned hereby further certifies that the foregoing brief filed electronically with the Court is in PDF searchable format, that the text of the PDF copy is identical to the text of the paper copy, that the PDF version has been electronically scanned for viruses with the Trend Micro OfficeScan 8.0 antivirus program (copyright 2007) and that, according to the program, no viruses were detected.

/s/ Judith A. Hagley
(s)____
Attorney for appellee/cross-appellant

Dated: July 30, 2010