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

BRIEF FOR THE APPELLEE/CROSS-APPELLANT

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STATEMENT REGARDING ORAL ARGUMENT

Counsel for the United States believe that oral argument should be heard in this case because of the importance of the legal issues.

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Acronym Glossary

As used herein:

"AMC" refers to China's Asset Management Companies

"FPAA" refers to final partnership administrative adjustment

"GNMA" refers to Government National Mortgage Association securities

"LSA" refers to the loan servicing agreement

"MCA" refers to Montgomery Capital Advisers, LLC

"NPL" refers to non-performing loan

JURISDICTIONAL STATEMENT

This case is an action for judicial review of a notice of final partnership administrative adjustment (FPAA) issued by the Internal Revenue Service to Southgate Master Fund, LLC (a partnership for tax purposes) for tax year 2002. *See* 26 U.S.C. § 6226.[1] District courts have jurisdiction over § 6226 actions. 28 U.S.C. § 1346(e).

Final judgment was rendered on October 1, 2009, disposing of all the parties' claims. Southgate's notice of appeal was filed on November 25, 2009, within the 60 days allowed by Fed. R. App. P. 4(a)(1)(B). The Government's cross-appeal was filed on December 3, 2009, within the 14 days allowed by Fed. R. App. P. 4(a)(3). This Court has jurisdiction over both appeals. 28 U.S.C. § 1291.

STATEMENT OF THE ISSUES

This appeal involves a tax shelter acquired by Andrew Beal in order to obtain $1 billion in losses to offset an equal amount of unrelated income. The shelter consisted of several pre-planned, interdependent transactions. First, Beal and one of his advisors

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[1] All "§" references are to the Internal Revenue Code (26 U.S.C.), as in effect in 2002. "R" refers to the paginated appellate record. "Ex" refers to the trial exhibits.

(Thomas Montgomery) located a foreign entity (Cinda) that owned property with built-in losses exceeding $1 billion. Beal and Montgomery understood that the shelter required that the parties utilize the partnership form. Therefore, Cinda and Montgomery formed a “partnership,” and Cinda contributed the built-in-loss property to the partnership. Beal then purchased the bulk of Cinda’s partnership interest, which, under Beal and Montgomery’s interpretation of the Code’s partnership provisions, resulted in the allocation of the bulk of the built-in losses to Beal. Beal then “contributed” property to the partnership for the purpose of increasing his basis therein so as to be able to utilize the losses which were triggered when the partnership sold the built-in-loss property.

Issue related to Southgate’s appeal:

1. Whether the District Court correctly disallowed the partnership’s losses because, alternatively: (a) the “partnership” was a sham, or (b) the pre-planned “partnership” transactions were in substance a sale.

Issue related to the Government's cross-appeal:

2. Whether the District Court erred in determining that accuracy-related penalties did not apply to a sham partnership that was used to generate over $1 billion in tax losses based on a $19.4 million investment.

STATEMENT OF THE CASE

The IRS issued Southgate an FPAA, disallowing Southgate's claimed losses and imposing accuracy-related penalties. After a trial, the District Court held that Southgate's claimed losses were properly disallowed under alternative, fact-specific judicial doctrines, and that penalties were not applicable. Both parties have appealed.

STATEMENT OF THE FACTS

The following facts are summarized from the District Court's opinion and the documents cited therein.

A. Background: The DAD shelter

This case concerns a tax shelter referred to as the "distressed asset/debt ('DAD')" transaction in which a taxpayer seeks to acquire a large built-in loss to shelter unrelated income. (R15372.) In this shelter, a foreign (or other tax-indifferent) entity contributes distressed

assets (*i.e.*, property in which the asset's basis grossly exceeds its value, thus producing a large built-in loss) to a partnership. Shortly thereafter, a U.S. taxpayer purchases the foreign entity's partnership interest (or a portion thereof). The partnership then sells the distressed assets and realizes an enormous tax loss. The vast majority of the loss is passed through to the U.S. taxpayer, who uses it to offset unrelated U.S. income. In this manner, an economic loss incurred by the foreign entity is separated from the tax loss (which the foreign entity cannot use), which is claimed by a U.S. taxpayer who incurred no or minimal economic loss. IRS, Coordinated Issue Paper — Distressed Asset/Debt Tax Shelter (April 2007) (available at www.irs.gov).

Under the Code's partnership rules, if a partnership sells an asset with a built-in loss, that loss cannot be shared with all the partners but is instead allocated to the partner that contributed the asset. (R15379-15380.) In that way, the Code prevents one taxpayer from transferring its tax benefits to another taxpayer. Under the rules in existence in 2002 when Southgate was created, however, if a partner transfers his partnership interest to a new partner before the asset is sold, then the built-in loss may be allocated to the transferee partner. § 704(c); Treas.

Reg. § 1.704-3(a)(7). In 2004, Congress amended the partnership rules in order to prevent taxpayers from shifting built-in losses from tax indifferent parties to U.S. taxpayers through the use of a partnership. American Jobs Creation Act, Pub. L. 108-357, § 833. After the amendments, built-in losses may be taken into account only by the contributing partner, except for very limited amounts (less than $250,000).

B. Beal's first DAD shelter

From 2002-2004, Andrew Beal entered into four DAD shelters using four separate partnerships. (R15330,15389.) This case involves his first DAD transaction, by which he claimed $1 billion in tax losses on his personal income tax returns for 2002-2004 based on an economic loss of approximately $10 million (excluding transaction costs). (R15258.)

Beal is a highly sophisticated, experienced banker who specializes in investing in distressed debt. (R15258-15259.) In 2001, he hired his tax accountant, Thomas Montgomery, to assist him in identifying potential investments. (R15259-15260.) As he completed one such deal in early 2002, Montgomery realized that a distressed-debt investment

could be used to generate tax benefits. (R15261-15262.) Accordingly, he contacted tax attorneys at the De Castro law firm, who provided him and Beal advice on how to use the DAD partnership structure to generate substantial tax benefits. (R15274.)

1. The tax plan

From May through August 2002, De Castro worked with Beal and Montgomery to develop a plan to implement the DAD strategy. (R15340.) De Castro emphasized that they had "to use a partnership to transfer the loss because the debt maintains its high basis when contributed to the partnership and the loss is transferred under the § 704(c) regulations." (R15275, Ex64.) De Castro recommended that they use foreign debt instead of domestic debt because U.S. debt "could expose the strategy to numerous people with potential contact with tax authorities" and "could provide a trail to you." (R15275.)

They decided to use Chinese non-performing loans (NPLs). For many years, Chinese state-owned banks had generated large numbers of NPLs by "loaning" money to state-owned enterprises without any reasonable expectation of repayment. (R15263-15264.) In 1999, China created four state-owned Asset Management Companies (AMC) to

assist the failing banks. (R15264.) The AMCs were required by law to buy the banks' NPLs at face value even though they were worth far less than that amount. (R15265.) One of the AMCs, Cinda, provided the NPLs for the transaction at issue. The specific loans that Montgomery planned to acquire from Cinda were classified as "lowest priority loan," which meant that there was (as he was told) "little hope to get the loans paid back." (R15290.)

Before the transaction was implemented, De Castro provided Montgomery and Beal several memoranda detailing the tax strategy. (R15275.) In a memorandum dated July 8, 2002, De Castro outlined the steps that would be required for Beal to obtain and utilize foreign built-in losses:

- Chinese debt-holder transfers debt to single-member Delaware LLC;
- Chinese LLC and Montgomery form 2-member Investment LLC (a partnership for tax purposes) whereby Chinese LLC transfers debt to partnership in exchange for 99-percent interest and Montgomery obtains 1-percent interest;

- after a "Seasoning Period," Chinese LLC sells 90-percent of its partnership interest to a U.S. investor;
- U.S. investor builds basis in the partnership so that he is able to claim the partnership's losses on his individual tax return;[2]
- as U.S. investor builds basis by contributing property to partnership, Chinese LLC "does not contribute any additional capital, and its percentage interest is diluted to near zero"; and
- the built-in loss is triggered by selling the debt.

(Ex76.) Those exact steps were followed in setting up Beal's subsequent DAD shelters. (R15318, Ex40.)

De Castro emphasized that the tax strategy precluded Beal from committing to the investment until after the partnership was formed, explaining that the "tax benefit depends on a pre-existing partnership structure[;] the tax benefit to Andy depends on Tom's independence in finding the debt (and partnering with the current holder)." (R15391, Ex117 at 3.) Accordingly, Beal informed Montgomery that he was

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[2] A partner's distributive share of partnership losses is allowed only to the extent of the partner's adjusted basis in his partnership interest. § 704(d).

interested in investing in the NPLs, but did not make a binding commitment to do so before joining the pre-existing partnership that Montgomery set up. (R15278-15279.) Weeks before the partnership was formed, Beal decided that he was interested in acquiring Chinese debt with a face value (basis) of approximately $1 billion, and De Castro advised that such an acquisition would generate "$400 million" in tax benefits. (R15274,15281, Ex34.)

Acquiring NPLs was consistent with Beal's core business, but the structure of the Southgate transaction was far different from that used in his previous international acquisitions. (R15300.) In prior deals, Beal purchased NPLs directly from the foreign seller. (R15300.) Although he could have purchased the Chinese NPLs from an AMC, as other Chinese-NPL investors had done, he used the partnership structure in order to obtain Cinda's built-in losses. (R15271-15274,15391.)

2. Beal and Montgomery implement the tax plan

Pursuant to De Castro's plan, the parties took the following steps:

- on July 18, 2002, Montgomery formed a single-member LLC (MCA);

- on July 31, 2002, Cinda formed a single-member Delaware LLC (Eastgate) and contributed to Eastgate NPLs with a carryover basis exceeding $1.1 billion;
- on that same day, MCA and Eastgate formed Southgate whereby Eastgate contributed its NPLs[3] (valued by the parties at $19.4 million) in exchange for a 99-percent membership interest;[4]
- a few weeks later, on August 30, 2002, Beal (through his single-member LLC, Martel) acquired an interest in Southgate by purchasing 90 percent of Eastgate's 99-percent membership interest for $19.4 million;
- in December 2002, Beal "built" his basis in Southgate; and
- before 2002 year-end, some NPLs were sold in order to generate a loss that Beal could claim on his 2002 income tax return.

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[3] To obtain Cinda's NPLs, Montgomery had to agree to pay an $8.5 million fee to Cinda's sourcing agent, Deutsche Bank. Montgomery anticipated that the fee would be paid by Beal (or another investor). (R15283-15284.)

[4] Southgate entered into a Contribution Agreement with Eastgate, in which Eastgate made certain representations and warranties regarding the NPLs' tax attributes. (R15282.) Southgate also entered into a three-year loan servicing agreement (LSA) with Cinda, pursuant to which Cinda would service the NPLs in exchange for 25 percent of net collections after expenses. (R15284.)

(R15279,15282-15284,15298-15299,15308-15309,15316-15324.) *See* Ex781 (chart depicting transaction).

Although Cinda agreed to transfer its NPLs to a partnership to support Beal's tax strategy, it sought "immediate liquidity" for those assets. (R15306.) On August 1, 2002, it transferred NPLs valued by the parties at $19.4 million to Southgate, and four weeks later, on August 30, 2002, it sold 90 percent of its Southgate interest to Beal for $19.4 million, thus receiving "immediate liquidity" for its NPLs. (R15283,15298,15306.) In an "approval notice" relating to Cinda's handling of the Southgate NPLs, Chinese regulators observed that the "transaction structure" required Cinda to retain a small interest in Southgate "symbolically." (R15357, Ex608.)

3. GNMA/basis-build transaction

As noted above, the tax strategy also required Beal to increase or "build" his basis in the partnership because (as De Castro advised him) he could only deduct the losses on his individual tax return to the extent of his partnership basis. (R15275,15316.) Montgomery and De Castro began planning the basis-build in June 2002. (R15316.)

Beal decided to attempt to build his basis in Southgate by contributing a valuable asset to Southgate in a manner that allowed him to retain the asset's economic benefits. (R15316-15330.) To implement this plan, on December 27, 2002, Beal contributed government-guaranteed securities (GNMAs) worth $180 million to Martel (Beal's single-member LLC). (R15318.) Martel, in turn, used the securities as collateral to borrow $162 million from UBS PaineWebber, Inc. (the so-called "repo" transaction), and then distributed those funds to Beal. (R15318-15319.) Beal then transferred $162 million to his bank (Beal Bank) as a capital infusion. (R15319.)

On December 31, 2002, Martel distributed its interest in Southgate to Beal, and Beal contributed his interest in Martel to Southgate, thereby contributing the GNMAs to Southgate. (R15320-15321.) That contribution diluted Eastgate's partnership interest from 10 percent to 5 percent. (R15321.)

Beal amended Southgate's Operating Agreement to maintain total control over the GNMAs. (R15321-15323.) He reserved for himself essentially all of the GNMAs' value by retaining (i) the right to direct and use the $162 million loan proceeds that the GNMAs

collateralized; (ii) the GNMAs' net interest income; and (iii) the GNMAs' built-in gain. (R15322-15323.) Although the Agreement provided that the Southgate partners could share in any post-contribution gains or losses (the likely value of which was $100,000-$700,000), it also provided Beal control over whether those gains were realized and permitted Southgate to distribute the GNMAs to Beal without having to make any distributions to the other Southgate members. (R15322-15323,15326.) Accordingly, the GNMA/basis-build transaction did not expand Southgate's equity base. (R15330.)

Beal's tax advisors warned him and Montgomery that there was a "a substantial risk that the IRS could successfully attack the contribution of Martel" to Southgate if Beal received the loan proceeds and reserved all net interest income from the GNMAs. (R15318, Ex42 at 2.) Beal disregarded his lawyers' warnings. (R15323.)

After the GNMA/basis-build transaction, Beal took the position that he contributed an additional $180 million to Southgate, which theoretically allowed him to utilize a corresponding amount of the Southgate losses that had been allocated to him for 2002. (R15324.)

C. Southgate's tax and economic results

Southgate ultimately generated over $1 billion in tax losses for Beal. After Beal acquired his Southgate interest, he and Montgomery worked on determining how best to trigger the NPLs' built-in losses. (R15308.) They were advised by De Castro "to trigger the loss through a sale for some cash rather than to write off the debt." (R15308.) Following this tax advice, Montgomery instructed Cinda to sell 20-25 percent of the NPLs by the end of 2002, approximately $250 million (face value), an amount "dictated" by the income Beal wanted to "shelter" in 2002. (R15308-15310.) By 2004, Beal had claimed $1 billion in Southgate losses on his individual return. (R15258.)

Southgate did not generate any economic profit. Beal paid $19.4 million for his Southgate interest, and ultimately received approximately $10 million on the NPL sales (after paying Cinda its servicing fee), resulting in a $10 million economic loss (without regard to transaction costs). (R15258,15316.)

The NPLs were an unprofitable acquisition in part because Cinda serviced Southgate's NPLs poorly. (R15313.) When Southgate complained to Cinda about its poor servicing efforts, Cinda threatened

to disclose the Southgate tax shelter to the IRS. (R15314.) Cinda's threat prompted Southgate to apologize to Cinda. (R15314-15315.) Although Cinda's collection services remained unsatisfactory, Montgomery and Beal nevertheless entered into another "partnership" with Cinda (Pinnacle) in 2003 to generate more DAD-strategy tax benefits for Beal using a new partnership vehicle. (R15311,15313.)

In October 2006, the IRS issued an FPAA to Southgate, disallowing Southgate's claimed losses and imposing accuracy-related penalties. (R15352.)

D. District Court's opinion

The District Court held that the IRS had properly disallowed Southgate's claimed losses from the NPL sales. (R15379-15397.) The court rejected Southgate's claim that compliance with the literal language of the Code and related regulations precluded the court from disallowing the losses under one of the judicial doctrines developed to prevent abusive tax transactions. (R15379-15383.)

The court first addressed the economic-substance doctrine, and, in doing so, analyzed separately the NPL acquisition and the GNMA contribution. (R15386.) The court determined that, when viewed

alone, the NPL acquisition satisfied the economic-substance test because Southgate expected "some profit" from the NPLs. (R15387.) The court determined that the "underlying" GNMA/basis-build transaction, in contrast, "had no discernible economic substance," finding that "Southgate did not have a reasonable possibility of profit[ing]" from the GNMAs, and that there was no "valid business purpose for this 'basis-build' transaction other than the tax benefits obtained by Beal." (R15388-15389.) Although the court found that Southgate's partners could profit if the GNMAs were sold for a gain (R15337), the court further found that such profit potential was "illusory" because Beal controlled whether the GNMAs were sold and had the "option to distribute Martel's assets to himself, to the exclusion of Southgate and its other members" (R15326,15330). Finding that "Beal never intended to share any potential gains or losses from the GNMAs with the other partners in Southgate," the court concluded that Southgate's "proffered reasons for the deal read like afterthoughts designed to disguise the true purpose." (R15389.)

The court next addressed the sham-partnership doctrine, pursuant to which a partnership that lacks substance will be

disregarded even if the partnership engages in genuine business activity. (R15390.) The court stated that a partnership lacks substance if the partners did not really intend to join together for the purpose of carrying on a business and sharing in the gains and losses of that business. (R15390 (citing *Commissioner v. Culbertson*, 337 U.S. 733 (1949)).) In this regard, the court noted that using the partnership structure was part of a pre-planned tax strategy, and that Montgomery admitted that Beal could have purchased the NPLs directly without using the partnership. (R15391.) The court also relied on its prior finding that the "underlying" GNMA "contribution" lacked economic substance, demonstrating that the purported Southgate partners did not intend to share gains and losses as real partners. (R15393-15394.) The court rejected Southgate's "attempts to imbue the partnership with legitimacy," including its contention that there were tax-independent reasons for forming the partnership. (R15392-15393.) Although the court concluded that the NPL acquisition, when viewed in isolation, had economic substance, and thus was "not a sham per se," the court found that "the partnership structure was a sham." (R15393-15394,15397.)

Finally, the court addressed the substance-over-form and step-transaction doctrines. Under those doctrines, courts examine a transaction's formal steps and determine whether the transaction's form reflects its true substance, and whether the form effectuates — or thwarts — Congressional intent. (R15394-15396.) The Government had argued that the formal steps of the DAD shelter should be collapsed to reveal the transaction's substance, which was Beal's purchase of the NPLs from Cinda. (R15396.) The court agreed, holding that the transaction "elevate[d] form over substance," and "that the partnership structure was a sham."[5] (R15397.)

Thus, under the alternative judicial doctrines, the court determined that Southgate had misstated its basis in the NPLs by over $1 billion.[6] (R15399.)

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[5] Having disregarded the partnership under the sham-partnership and substance-over-form doctrines, the court did not address the Government's alternative arguments that Southgate's claimed losses should be (i) disallowed under Treas. Reg. § 1.701-2, or (ii) recharacterized as capital (rather than ordinary) losses. (R14625-14626,15067-15068,15391-15392.)

[6] The court rejected the Government's technical arguments related to Cinda's basis in the NPLs. (R15398-15404.) Those fact-

(continued...)

The court next addressed whether accuracy-related penalties, including a penalty designed to deter basis misstatements, applied to Southgate's $1 billion basis misstatement. The court concluded that the penalties did not apply, and, that even if they did, Southgate had reasonable cause for making its $1 billion basis misstatement. (R15404-15414.) In this regard, the court found that Southgate reasonably relied on tax opinions issued by De Castro and the Coscia accounting firm. (R15346.)

The court directed the parties to submit a proposed judgment. (R15415.)

E. Proceedings concerning the judgment

The parties agreed that the judgment should indicate that penalties were not warranted, but disagreed as to what the judgment should say about the tax — *i.e.*, whether all of the FPAA's adjustments to Southgate's tax return were correct, including the disallowance of the claimed losses (as the Government proposed (R15444)), or only

[6](...continued)
specific rulings are not challenged on appeal.

those adjustments related to Beal's GNMA "contribution" (as Southgate proposed (R15437-15438)).

In support of its proposed judgment, Southgate asked the court to "clarif[y]" (i) that Southgate was a legitimate partnership that could, in substance, acquire Cinda's built-in losses and allocate them to Beal, and (ii) that only Beal's attempt to increase his basis in Southgate through the GNMA/basis-build transaction had been disallowed by the court. (R15419-15434.)

In response, the Government stated that the court had not found that the partnership was legitimate at any point in time, but had instead disregarded the Southgate partnership under both its sham-partnership and substance-over-form rulings. As the Government explained, disregarding the partnership eliminates the attempted transfer of Cinda's built-in losses, and supports the court's ultimate holding that Southgate's "'reported loss was invalid'" and that "'the Government's adjustments to Southgate's 2002 tax return are correct.'" (R15445-15454 (quoting R15257,15415).)

The District Court adopted the Government's proposed judgment. (R15466.)

SUMMARY OF ARGUMENT

In 2002, Beal entered into an elaborate arrangement that was designed to create for him a large paper loss exceeding $1 billion that he would use to shelter unrelated ordinary income. The scheme involved the formation of a putative partnership between Beal, his tax accountant, and a foreign entity (Cinda) that was not subject to U.S. taxation, and the manipulation of the Code's partnership rules. The District Court properly rejected Beal's attempt to use a "partnership" to acquire Cinda's $1 billion built-in losses. The court erred, however, in determining that accuracy-related penalties did not apply to Southgate's $1 billion basis misstatement. Two other courts have addressed similar partnership-basis-inflating shelters, and both agreed that the shelter violated well-settled judicial doctrines, and that the basis-misstatement penalty applied. No court has upheld this scheme.

1. a. The record fully supports the court's findings that the Southgate "partnership" was a sham, and that the GNMA/basis-build transaction lacked economic substance. The partnership form was utilized for tax purposes, the purported partners candidly referred to the NPL acquisition as a sale (not a partnership contribution), and the

sham GNMA/basis-build transaction evidenced that the "partners" did not truly intend to join together to share in gains and losses. Southgate has failed to identify any error — let alone clear error — in the court's findings. Southgate's contention that the court concluded that Southgate was a valid partnership, and then "retroactively" invalidated the partnership because of Beal's sham GNMA/basis-build transaction, mischaracterizes the court's decision and conflates the NPL acquisition (which the court found, when viewed in isolation, had economic substance) with the Southgate partnership (which the court found was a sham).

b. The record also supports the court's finding that the "partnership" should be disregarded under substance-over-form principles. The partnership transactions occurred pursuant to a pre-arranged tax plan that contemplated transferring Cinda's built-in losses to Beal through a series of contrived contributions and transfers. Those transactions should be disregarded, and the case should be treated as if Cinda had sold the NPLs directly to Beal. Southgate has failed to allege — let alone demonstrate — any error in the court's well-supported substance-over-form ruling.

2. Penalties apply to Beal's attempt to use a sham partnership to acquire $1 billion in tax losses by importing to the United States economic losses incurred by the Chinese government. That Beal's shelter comported with a literal reading of the Code cannot — as the District Court held — immunize him from penalties; most tax shelters are designed to comply with the black-letter law. And Beal's purported reliance on penalty-protection advice he received from his tax advisors is unreasonable, because the advice was based on assumptions that Beal should have known were untrue, and was in important respects ignored by Beal.

ARGUMENT

I

The District Court correctly concluded that Southgate was not a genuine partnership

Standard of Review

The District Court's conclusion that the "partnership" should be "disregarded for tax purposes" is reviewed under the "clearly erroneous" standard. *Merryman v. Commissioner*, 873 F.2d 879, 879 (5th Cir. 1989).

A. Introduction

This case concerns a basis-inflating tax shelter entered into by taxpayer 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 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 $1 billion carryover basis in the NPLs and thus had misstated the basis of the assets sold. (R15399.)

Southgate attempts to avoid those findings by arguing (Br. 26-36) that the transaction's form complied with the literal language of the Code's partnership rules. That argument is unavailing. It is well

settled that the substance of a transaction, rather than its form, controls the tax consequences of that transaction. *E.g., Gregory v. Helvering*, 293 U.S. 465 (1935). That principle "is no schoolboy's rule; it is the cornerstone of sound taxation . . . . 'Tax law deals in economic realities, not legal abstractions.'" *Estate of Weinert v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961) (citation omitted). Even if a transaction complies with the "literal" tax rules, courts properly disregard the claimed tax benefits if the transaction runs afoul of the economic-substance, substance-over-form, or similar judicial doctrines designed to prevent abuse of the tax laws. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1352 (Fed. Cir. 2006). *See Klamath Strategic Invest. Fund v. United States*, 568 F.3d 537, 545-546 (5th Cir. 2009) (disallowing tax shelter that purportedly complied with partnership rules because it lacked economic substance).

As the Supreme Court has directed, to demonstrate that tax planning is legitimate and not (as here) abusive, taxpayers must establish that "'what was done, apart from the tax motive, was the thing which the statute intended.'" *Knetsch v. United States*, 364 U.S. 361, 365 (1960) (citation omitted). This principle is particularly

important in the area of partnership tax law because "[m]any tax shelter schemes using partnerships are structured to exploit the entity nature of partnerships." 4 Bittker & Lokken, *Federal Taxation of Income, Estates & Gifts*, at 86-5 (3d ed. 2003).

Southgate has not — and cannot — demonstrate that its DAD scheme implements Congressional intent. Rejecting a similar partnership-basis-inflating shelter, the Tax Court has held that Congress did not intend the Code's partnership rules to be used "merely as a vehicle to transfer built-in losses from a tax-indifferent party to an interested purchaser pursuant to a prearranged plan." *Santa Monica Pictures, LLC v. Commissioner*, 89 T.C.M. (CCH) 1157, 1229 (2005). In *Santa Monica*, the court expressly rejected the argument (repeated by Southgate (Br. 23, 36)) that the "transfer of tax basis" at issue in the DAD shelter implements "Congressional Intent" and was "contemplated and, in fact, prescribed under section 704(c)." *Id.* at 1215.

Nor does it follow (as Southgate contends (Br. 31-33)) that prior to the 2004 amendments to § 704(c), transactions devoid of substance that were designed to exploit the partnership rules were exempt from the

judicial doctrines. Indeed, the Supreme Court long ago laid that notion to rest. *Knetsch*, 364 U.S. at 367-368 (prospective change in statute disallowing certain interest deductions created no inference that Congress intended to bless sham interest transactions entered into before amendment's effective date). A transaction cannot avoid scrutiny under the judicial doctrines merely because the transaction predates a statute targeting the specific abuse, as the District Court correctly recognized (R15381-15382). Because virtually any taxpayer could have entered into a "partnership" arrangement with a tax-indifferent entity holding large built-in-losses similar to the one at issue here, the abusive potential of such schemes (prior to the 2004 amendments) is obvious. The judicial tax doctrines were designed to address such situations out of recognition that "[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every device" crafted to avoid tax. *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505, 513 (D.C. Cir. 2000) (rejecting shelter that complied with partnership rules). Indeed, Beal himself was able to replicate this basis-inflating shelter three times simply by creating multiple partnerships to purchase more losses incurred by the Chinese

government and thereby stockpile over $4 billion in artificial losses to shelter future income.[7] (R805-813,15389.)

The legislative history cited by Southgate hardly establishes that, absent the enactment of the 2004 amendments, the DAD tax shelters were untouchable. On the contrary, that history demonstrates that Congress was amending the partnership rules because it had learned that partnerships were being created to "aid tax-shelter transactions" by using the then-existing partnership rules to facilitate "the inappropriate transfer of losses among partners." H.R. Rep. No. 108-548, at 283 (2004). There is no evidence that Congress intended taxpayers to claim "inappropriate" tax benefits prior to 2004. Indeed, Southgate's contrary suggestion conflicts with Montgomery's admission that the transaction provided tax benefits that Congress did not intend

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[7] Congress has repeatedly recognized the crucial role that the judicial doctrines play in disallowing abusive tax shelters before Congress stamps them out with legislation. *E.g.*, Joint Committee on Taxation, *Report of Investigation of Enron Corporation* (JCS-3-03) 128 (2003); H.R. Rep. No. 111-443, at 295 (2010). *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), and the related cases cited by Southgate (Br. 34-35) are not to the contrary. The tax benefits at issue here were not rejected (as Southgate contends (Br. 34)) because they were "unpalatable," but because they did not comply with well-established judicial doctrines.

to bestow on taxpayers. In this regard, Montgomery conceded that he took steps to avoid "an audit or a scrutiny of the transaction," because he knew that if the transaction were uncovered, Congress "would eventually change the law, which they did."[8] (R352-353.) Thus, the legislative history establishes that Congress recognized this kind of transaction as abusive and intended definitively to put an end to it — but does not show that Congress thought the abusive result was countenanced under prior law.

That the 2004 amendments permit legitimate partnerships to transfer $250,000 in built-in gains or losses between real partners does not mean that Congress intended sham partnerships to transfer billions in built-in losses from tax-exempt partners to tax-avoiding partners, as Southgate suggests (Br. 31-33). The provision permitting this limited transfer would — like all Code provisions — apply only to partnerships and transactions that had economic substance, and was

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[8] To avoid detection, Montgomery rejected DAD promoters that had participated "in numerous other distressed debt transactions in recent years (that gave rise to substantial tax benefits)." (Ex65 at 2.) And he told De Castro that he did not want to "expose the strategy to numerous people with potential contact with tax authorities" so as to avoid "a trail." (Ex64 at 2.)

enacted so that real partners could avoid difficult valuation questions "for transactions involving smaller amounts" (*i.e.*, property worth less than $250,000). H.R. Rep. No. 108-548, at 283.

Indeed, the two courts that have addressed similar partnership-basis-inflating shelters have both concluded that the shelter's losses were not "required" by Congress — as Southgate contends (Br. 23) — and rejected the losses by applying judicial doctrines. *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); *Santa Monica*, 89 T.C.M. (CCH) 1157. In *Long-Term Capital*, a foreign corporation (OTC) contributed to a partnership a high-basis/low-value asset in exchange for a partnership interest. OTC subsequently sold its partnership interest to Long-Term, which then had the partnership sell the asset for an enormous loss that was allocated to Long-Term under the Code's partnership-loss-allocation rules. The court disallowed the loss, finding (among other things) that the purported partnering must be recast as a sale under the step-transaction doctrine. 330 F. Supp. 2d at 128. Similarly, in *Santa Monica*, another foreign taxpayer (Credit Lyonnais) contributed to a partnership distressed debt in exchange for

a partnership interest. Credit Lyonnais subsequently sold its partnership interest to the taxpayer, who then had the partnership sell the debt for an enormous loss that was allocated to the taxpayer under the Code's partnership-loss-allocation rules. The Tax Court disallowed the loss, finding (among other things) that the purported partnering must be recast as a sale under the step-transaction doctrine. 89 T.C.M. (CCH) at 1216. Both cases rejected the attempt to transfer built-in losses even though the transfer occurred before the 2004 amendments. *See id.* at 1188-1189 n.81. Southgate has not cited — and we have not found — any case upholding this type of tax scheme.

Finally, Southgate's suggestion (Br. 50) that "Beal's utilization of the [$1 billion ordinary tax] losses would be offset by future gains" is both irrelevant and disingenuous. Whether temporary or permanent, tax benefits resulting from sham transactions are not permitted. *E.g., Gardner v. Commissioner*, 954 F.2d 836, 837-838 (2d Cir. 1992). And even if Beal were to report future gains from Southgate — which he has not done[9] — those gains would be taxed at the lower capital-gains rate.

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[9] The court found (R15349) that Beal "realized" almost $1 billion (continued...)

The difference between the ordinary-income and capital-gains tax rates produces $260 million in permanent tax savings (an amount that does not reflect the time-value of money). (Ex805, R2889-2891.) As Beal's attorneys informed him, even if capital gains were triggered in the future, and were not sheltered through another device, the Southgate strategy "would still involve a tax benefit to Andy [Beal], whose ordinary income will have been offset by Southgate loss and converted into this deferred capital gain." (Ex39 at 3.) And, as noted above, Beal has been stockpiling billions in artificial tax losses from three other DAD shelters which he could use to shelter the deferred capital-gains tax from his first DAD transaction.[10]

As demonstrated below, the District Court correctly determined that Southgate must be disregarded because it found (i) that Southgate

[9](...continued)
in capital gains in 2007. Beal did not, however, recognize those gains by reporting them on his 2007 tax return, and paying the tax that was due. Instead, the return contains an attachment stating that, if his DAD shelter is upheld by the courts, then he will recognize the gain by filing an amended return. (Ex769.)

[10] During this same time period, Beal also purchased a Son-of-BOSS shelter and claimed a $200 million loss on a net $2.5 million investment. (R634-635.) That shelter is being litigated. *Bemont Investments, LLC v. United States*, No. 4:07-cv-00009 (E.D. Tex.).

was a sham partnership, and, alternatively, (ii) that the partnership transactions should be recharacterized under substance-over-form principles as a direct sale of the NPLs. These alternative findings, far from being clearly erroneous, are amply supported by the record, and therefore should not be disturbed on appeal. In addition, this Court could affirm the District Court's disallowance of the losses on the basis that the NPL acquisition lacked economic substance.

B. Southgate was a sham partnership

The Supreme Court held more than 60 years ago that the appropriate standard for determining whether a genuine partnership has been formed for federal tax purposes is whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Culbertson*, 337 U.S. at 742; *accord Bayou Verret Co. v. Commissioner*, 450 F.2d 850, 863 (5th Cir. 1971) (quoting *Culbertson*). That standard implements the purpose underlying the partnership tax rules.

If a taxpayer's use of the partnership form does not satisfy that standard, then the partnership will be disregarded for tax purposes even if it engaged in transactions that had economic substance, as the

District Court correctly noted (R15390). *See Culbertson*, 337 U.S. at 748 (partnership's engagement in genuine cattle business did not preclude sham-partnership inquiry); *Merryman*, 873 F.2d at 880-881 (partnership was a "sham" even though its activities "had economic substance");[11] *ASA*, 201 F.3d at 516 (same); *Andantech LLC v. Commissioner*, 331 F.3d 972, 980 (D.C. Cir. 2003) (same). Applying the *Culbertson* standard to the record here, the District Court correctly determined that Southgate was a sham partnership.[12] (R15390,15394.)

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[11] Although *Merryman* did not cite *Culbertson*, its analysis was similar, examining all the circumstances surrounding the partnership and determining that the partnership was a sham even though it engaged in profitable business activities.

[12] On appeal, Southgate ignores the District Court's reliance on *Culbertson* and contends (Br. 47) that the "only 'sham partnership' criteria recognized by the courts are those established by *Moline Properties v. Commissioner*, 319 U.S. 436, 438-439 (1943)." That contention is not only incorrect (as demonstrated below in Section I.B.3), but it was not properly preserved. In the District Court, Southgate expressly conceded that *Culbertson* provided the appropriate test for determining whether a partnership should be respected for tax purposes (R12088), and did not even cite *Moline* (let alone endorse it as the standard to be applied here). Moreover, both tax opinions upon which Southgate relies for penalty protection cite *Culbertson* for the sham-partnership standard. (Ex8 at 26, Ex61 at 17.)

1. The findings and the record evidence fully support the District Court's conclusion that Southgate was a sham partnership

To determine whether the parties truly intended to join a genuine partnership, courts examine the parties' "agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent." *Culbertson*, 337 U.S. at 742. The record amply supports the District Court's factual determination that the putative partnership between Cinda, Beal, and Montgomery (through their single-member LLCs) was a sham.

a. The partnership form was utilized for tax purposes

There was no substantial non-tax business purpose for using the partnership structure to invest in NPLs. As the court found, in prior NPL acquisitions, Beal purchased the NPLs directly and not by entering into partnerships with the NPL owners. (R15300, Montgomery Deposition 304-305.) And, as the court further found,

other U.S. investors had purchased Chinese NPLs from an AMC, and Montgomery conceded "that either Beal or Martel could have purchased the Southgate NPL Portfolio directly without using [a partnership] structure." (R494,15271-15272,15391.) *See Boca Investerings Partnership v. United States*, 314 F.3d 625, 631-632 (D.C. Cir. 2003) (partnership was a sham where taxpayer could have invested in asset without using partnership structure); *ASA*, 201 F.3d at 516 (same).

Far from being compelled by business or regulatory realities, the partnership structure was devised by Beal's tax advisors and was a critical prerequisite for the $1 billion tax loss that Beal sought to obtain. (R15274, Ex64.) As the court explained, "De Castro advised Beal and Montgomery 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, Ex117.) *See Enbridge Energy Co. v. United States*, 553 F. Supp. 2d 716, 731 (S.D. Tex. 2008) (partnership is a "sham" where partnership is "part of a preconceived [tax] plan"), *aff'd by unpublished opinion*, 354 Fed. Appx. 15 (5th Cir. 2009). As the De Castro paper trail makes clear, the "partnership" was part of a preconceived plan to support the DAD

strategy of generating a $400 million tax benefit, which dwarfed any possible profit potential. (Ex34, Ex40, Ex64, Ex117, Ex786.) *See ASA*, 201 F.3d at 513 (partnership is a sham where "interest in any potential gain from the partnership's investments was in its view at all times dwarfed by its interest in the tax benefit").

b. The "partners" did not view the partnership as genuine

In light of the fact that the partnership structure was selected solely for tax purposes, it is not surprising that there is evidence indicating that the purported partners did not view the partnership as genuine, as the Government's experts concluded. (R2621-2625,2897-2901, Ex633 at 25-26, Ex641 at § 11.) *See ASA*, 201 F.3d at 509 (relying on evidence that purported partner did not view partnership as genuine). In correspondence with third parties, Cinda represented that it had "sold" the NPLs to a foreign investor — not contributed them to a partnership — and characterized its Southgate interest as merely "symbolic[ ]." (Ex606, Ex608, R2897-2898.) When Cinda publicly announced the Southgate deal in September 2002, it referred to the transaction as a "package sale of bad loans." (Ex672, R1400.)

Similarly, Southgate's agent referred to the NPLs as "the assets we bought from Cinda." (Ex1234, R2895-2896.) Indeed, during candid moments at trial, Montgomery referred to "loans we were buying."[13] (R483.)

c. The "partnership" was not conducted as a genuine joint business, as evidenced by the sham GNMA contribution

The District Court correctly supported its sham-partnership finding with its prior ruling that the "underlying" GNMA/basis-build transaction lacked economic substance. As discussed in detail below, that transaction was a necessary step to the tax shelter.

A transaction is properly disregarded under the economic-substance doctrine if it either (i) lacks economic substance compelled by business or regulatory realities, or (ii) the taxpayer was motivated to

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[13] The District Court's sham-partnership ruling does not create an "absurd" result for Montgomery, as Southgate suggests (Br. 44). When (as here) a partnership is disregarded, the partnership transactions are deemed to have been conducted directly by the purported partners. Thus, Montgomery and Beal are deemed to have purchased the NPLs, and they obtained a cost basis. § 1012. If (as the court held) the NPL acquisition had economic substance, then Montgomery is entitled to deduct any related losses that he can substantiate. *See* Ex814 (Beal reimbursed Montgomery's Southgate expenses and paid him $200,000 for the Southgate deal).

enter the transaction for tax purposes. *Klamath*, 568 F.3d at 544. Here, the court determined that the GNMA/basis-build transaction lacked economic substance, finding that (i) Southgate lacked a reasonable possibility of profiting from Beal's "contribution," and (ii) there was no valid business purpose for the purported contribution other than tax benefits for Beal. (R15388-15390.) Southgate has failed to identify any error — let alone clear error — in either of the court's findings.

i. Southgate had no reasonable expectation of profiting from the GNMAs

The District Court concluded that Southgate lacked a reasonable possibility of profiting from the GNMA/basis-build transaction because Beal effectively reserved for himself all guaranteed income streams from the GNMAs, and had the sole discretion to award gains or losses from the securities to the partnership. (R15326,15389.) That conclusion was supported by the court's findings that "Beal relinquished nothing of economic value," and Southgate received "no economic benefit" through "Beal's alleged contribution" because (i) "Southgate had only a small possibility of realizing an economic

profit from the alleged contribution," and (ii) that small possibility was controlled by Beal who had the economic incentive and contractual right to retain all profit from the GNMAs for himself. (R15328-15330.) As the court explained, the "possibility of Beal exercising his option to allow Southgate to profit from the GNMA transaction — effectively to his own economic detriment — was not a reasonable possibility of profit for Southgate." (R15389.) And, as the court further found, "Southgate's accounting books and records reflect that, from the execution of the GNMA repo transaction in December 2002 through the presentation of evidence, Southgate allocated all income from the GNMAs to Beal, and never recorded any allocation of income from the GNMAs to MCA or Cinda." (R15328.)

The court's findings are fully supported by the record. According to the parties' stipulations and Southgate's Operating Agreement:

- Beal had the "sole discretion" to "direct the use and application" of the $162 million repo-proceeds;
- "[a]ll interest accruing with respect to the GNMAs following the Martel Restructure is to be allocated to Beal";

- Beal had the "absolute right in Beal's sole discretion" (a) to cause Martel to distribute the securities to Beal, or (b) to direct the sale of the GNMAs; and
- if Beal caused Martel to distribute the GNMAs to himself, that distribution would "not give rise to any obligation of Southgate to make any distributions to any other members."

(R14413, Ex602.) Given those severe restrictions, the only realistic way that Southgate could realize any profit from the GNMAs were if the securities appreciated in value and Beal chose to have Martel sell the GNMAs, as the experts for both parties testified. (R2635-2649,3176-3179.) But as Montgomery conceded, it "was within [Beal's] sole discretion to choose whether or not to have Martel sell any of the [GNMAs] to realize a gain" for the partners to share. (R691-693.) Thus, although in form Beal contributed GNMAs to Southgate, and theoretically all the partners had a small chance to profit on them, the practical realities proved otherwise. *See Dow Chem. Co. v. United States*, 435 F.3d 594, 603-604 (6th Cir. 2006) (transaction lacked economic substance where transaction containing formal possibility for gain also "contained features designed to neutralize the taxpayer's

ability to realize [those] gains"). As the court correctly concluded, any "profit" that the partners could experience from the GNMAs was "illusory because Beal retained total control over any transactions that Martel could execute regarding the GNMAs, including any transaction that could generate a gain." (R15394.)

Moreover, putting aside Beal's total control over the GNMAs (which made any profit potential for the partnership illusory), the theoretical opportunity for Beal's Southgate partners to profit from the GNMAs was *de minimis*. Those securities collateralized, and were used to pay off, a $162 million loan from UBS, the proceeds of which were used by Beal Bank, not Southgate. (R872.) Beal retained the GNMAs' built-in gains, and all net interest income from the GNMAs (which amounted to approximately $12 million during the time that Southgate held the GNMAs). (Ex621-623, Ex627-629, Ex642 at 8.) The only GNMA benefit that Beal did not formally reserve for himself was any post-contribution appreciation. The likely value of that benefit was merely $100,000-$700,000, as the Government's expert (Barnhill)

testified (R2708-2709) and the court found (R15326).[14] Such a *de minimis* amount probably does not exceed the related transaction costs, and cannot breathe substance into a purported $180 million contribution.

Indeed, Beal's tax advisors had advised Beal against reserving the $162 million repo-proceeds and the guaranteed net interest payments to himself, warning him that the arrangement may not qualify as a genuine partnership contribution if he structured it as he ultimately did. As De Castro admonished Beal, "if Martel is contributed to Southgate subject to a special allocation to Andy of *all* profit and loss attributable to Martel (*i.e.*, attributable to the repoed GNMAs) this may not safely qualify as a contribution to the Southgate partnership (because none of the other partners would share in the assets contributed, other than in possible appreciation or depreciation in those assets)." (R15318, Ex42 at 1.) De Castro further advised Beal that if

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[14] The "$13 million" valuation cited by Southgate (Br. 12, 51) was based on an unrealistic hypothetical that "assumes that Mr. Beal does not act in his economic self-interest" and allowed Southgate to retain the interest income that Beal (against the advice of his attorneys) had expressly reserved to himself. (R2713-2716.) Neither Barnhill nor the court endorsed that hypothetical as a reasonable possibility. (R2713-2716,15326.)

he reserved all net interest accruing with respect to the GNMAs, then he would be at "substantial risk that the IRS could successfully attack the contribution" as a sham. (Ex42 at 2.) De Castro admitted that Beal did not heed its advice and implemented that risky plan. (R1762-1763.) Southgate cannot complain that the court reached the conclusion that its attorneys had predicted.

Ignoring the factual findings that support the court's conclusion that the GNMA/basis-build transaction lacked economic substance, Southgate contends (Br. 51-53) that the court's conclusion conflicts with other factual findings. That contention lacks merit. Although Beal had the option — theoretically — to permit the Southgate members to share in the GNMAs' appreciation by selling the securities and allocating the gains to each partner (as the court found (R15337) and Southgate emphasizes (Br. 51)), that possibility did not give the transaction economic substance because Beal also had the option to *not* sell the GNMAs (as the court further found (R15326) and Southgate ignores). As the court explained, "Beal never exercised his option to share any gains from the GNMAs with Southgate's other members" (R15328), and "Beal never intended to share any potential gains or losses from the

GNMAs with the other partners in Southgate" (R15389). The court correctly recognized that Beal would not act against his self interest. *See Klamath*, 568 F.3d at 544-545.

Similarly lacking merit is Southgate's contention (Br. 53) that the Southgate partners would benefit if the GNMAs were distributed to Beal because the distribution would "reduce" Beal's membership-interest "percentage" and increase those of his partners. The court did not — and could not — make that finding. Southgate's Operating Agreement clearly provides that partner "Percentage Interests" are "revised" only by "additional capital contributions and withdrawals of Membership Interests," not by distributions.[15] (Ex600 at 5, R2909-2910.) Although the court noted that a distribution could impact the partners' capital accounts[16] (R15327), that finding does not further

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[15] Both before and after the GNMAs were distributed to Beal in 2006, Southgate's returns consistently reported Beal's capital, profit, and loss interests in the partnership as "93.9377%." (R2798-2800, Ex60, Ex220, Ex807.)

[16] Southgate cites no evidence demonstrating that gain or loss was allocated to Cinda's and Montgomery's capital accounts when the GNMAs were distributed to Beal in 2006. Its 2006 financial statements and the expert testimony indicate to the contrary. (Ex625, R2906-2907.)

Southgate's position. Any impact on the capital accounts would (as the court further found) only provide the partners a right to "receive an offsetting distribution upon liquidation" (R15327), and Beal controlled whether such an event would occur. Moreover, any possible impact on the capital accounts would be *de minimis*, as explained above.

Unable to demonstrate that the GNMA/basis-build transaction had any appreciable beneficial impact on the partnership, Southgate instead relies on the degree of paper shuffling that the transaction entailed, arguing (Br. 54-56) that a transaction has economic substance if it alters in any way the parties' formal legal relations. That argument conflicts with binding case law. *See Knetsch*, 364 U.S. at 365-366 (disallowing deductions generated by transaction with third-party insurance company, even though transaction altered the legal relations between insurer and taxpayer); *Klamath*, 568 F.3d at 541-542, 545 ("loan transactions lacked economic substance," even though transactions altered (as a formal matter) taxpayers' relations with the bank).

ii. There was no valid business purpose for Beal's purported GNMA contribution to Southgate

The court also found that the GNMA/basis-build transaction lacked a valid business purpose, and that Southgate's "proffered reasons for the deal read like afterthoughts designed to disguise the true purpose." (R15389.) That finding is fully supported by the record.

The parties stipulated that Beal entered into the GNMA/basis-build transaction "to increase his outside basis in Southgate." (R14413.) The documentary evidence demonstrates that Montgomery, Beal, and their tax advisors had been planning the basis-build transaction since June 2002 as an integral step in the DAD-shelter strategy. (R15316, Ex65, Ex76.) And the Government's experts reviewed the transaction documents and the relevant books and records, and concluded that there was no business purpose for the GNMA contribution. (R2674-2678,2903-2910.) Indeed, months after the GNMA/basis-build took place, Coscia advised Montgomery that he was still working on the tax opinion because they needed to "beef up the missing bus[iness] purpose" for that transaction. (Ex380, R1112.)

The court did not find — as Southgate contends — that there were "'some non-tax business purposes' behind Beal's contribution of the GNMAs to Southgate" (Br. 58 (quoting R15335)). Rather, the court found that "there were some non-tax business purposes behind the transactions *offered as post-hoc rationales*." (R15335 (emphasis added).) And, as Southgate concedes (Br. 59 n.23), "business purpose 'must be measured at the time of the transaction.'" Southgate has not — and cannot — challenge the court's finding that the alleged business-purpose rationales were only created after the fact, and were not genuine in any event.

Moreover, Southgate's alleged business purpose for the contribution — *i.e.*, to provide equity and diversification for further Chinese NPL acquisitions by Southgate (Br. 59) — conflicts with the court's findings that (i) the GNMA contribution did not expand Southgate's equity base, and (ii) Beal pursued further acquisitions through his subsequent DAD shelters, not through Southgate. (R15330.) With regard to the latter finding, the decision to use subsequent shelters was made *before* the GNMA/basis-build transaction occurred (not *after*, as Southgate suggests (Br. 59 n.23)). In November

2002, a month *before* the GNMA/basis-build transaction, Montgomery and De Castro were planning the "China 2 transaction" and the amount of "debt desired in new LLC." (Ex812.)

Unable to demonstrate a genuine business purpose for the GNMA/basis-build transaction, Southgate wrongly contends (Br. 56) that it need not do so. Southgate concedes (Br. 56) — as it must — that the transaction was subject to the economic-substance doctrine, and this Court has made clear that to pass muster under that doctrine, the transaction must have *both* economic substance *and* a genuine business purpose. *Klamath*, 568 F.3d at 544. The absence of either one of them "will render the transaction void for tax purposes." *Id.*

In sum, the court found that the partnership engaged in the GNMA/basis-build transaction in a manner that benefitted only Beal, and not his Southgate partners. (R15393-15394.) Although Beal purported to contribute GNMAs valued at $180 million to Southgate, in substance, that contribution was illusory and provided the partnership "no economic benefit" because "Beal never intended to share any potential gains or losses" from those securities with his "partners." (R15326-15330,15389; *see* R2635-2649.) Thus, the GNMA/basis-build

transaction clearly demonstrates that the "partners" did not intend to "shar[e] in the profits and losses" of the partnership, as *Culbertson* requires, 337 U.S. at 741.[17]

2. The District Court did not find that Southgate was a valid partnership and thus did not "retroactively" invalidate the partnership, as Southgate contends

Southgate contends (Br. 36-46) that the District Court erred by initially determining that the partnership was "valid," and then "retroactively" invalidating the partnership because the GNMA/basis-build transaction lacked substance. That contention is based on a false premise. The court never found that Southgate was valid; on the contrary, it expressly found that the partnership "was a sham." (R15393.)

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[17] Other findings demonstrate that the partnership did not conduct itself as a genuine partnership, and each is fully supported by the record. Southgate distributed approximately $60 million to Beal, and zero to Beal's "partners." (R2625-2626,15326.) *See Merryman*, 873 F.2d at 883. Cinda never even inquired about partnership distributions. On the contrary, Cinda was interested in "immediate liquidity" for its NPLs, as the court found (R15306), and it acquired that liquidity by selling most of its partnership interest to Beal shortly after joining Southgate. *See* R2621-2626.

Southgate's argument conflates the partnership structure (which the court found to be a sham) with the partnership's NPL acquisition (which the court found to be legitimate). At no point in the opinion did the court find that Southgate was a valid partnership or was formed with the intent to pursue a joint business and to share in profits and losses (as *Culbertson* requires). In this regard, the page of the court's opinion cited by Southgate (Br. 37 (citing R15386)) in support of its argument that the partnership was valid states that "the Court concludes that the Southgate transaction regarding the Chinese NPLs" had economic substance and was a genuine business activity. But as the court correctly emphasized, "taxpayer's selection of the partnership form to conduct business is not automatically respected for tax purposes, *even if the underlying activity was a genuine business activity*." (R15390 (emphasis added).) To hold otherwise would conflict with binding precedent such as *Culbertson* and *Merryman*.[18]

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[18] Throughout its brief (*e.g.*, Br. 37, 40), Southgate repeats one of the opinion's headings — "Southgate Itself Had Economic Substance" — to support the proposition that the court found that the partnership was valid. As the sentence that follows that heading makes clear, however, by "Southgate Itself," the court meant the NPL acquisition, not the partnership structure. (R15386.) Indeed, the text following

(continued...)

Moreover, there was nothing “retroactive” about the court’s analysis of the GNMA/basis-build transaction. Southgate’s attempt to isolate Beal’s basis-build transaction from the rest of the pre-planned tax strategy conflicts with the court’s findings and the documentary evidence. As the court expressly found, the basis-build plan originated in June 2002, *before* Southgate was formed, and was an integral part of the tax strategy from the very beginning. (R15275,15316.) Weeks before Southgate was formed, De Castro discussed with Montgomery how Beal would “need to build outside basis” in the partnership in order to claim the built-in losses on his individual tax return. (Ex65 at 2.) The July 2002 De Castro outline of the DAD strategy included the basis-build transaction as an integral step. (Ex76.) And Beal had been repeatedly warned by his tax advisors that the partnership 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

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[18](...continued)
that heading does not address the reasons for using the partnership structure to acquire NPLs, but rather the separate and distinct question of whether the acquisition had “profit potential.” (R15387.)

18 (De Castro opinion's conclusion that partnership is genuine premised on validity of GNMA/basis-build transaction). Therefore, the GNMA/basis-build transaction was in no way an "unrelated" transaction, as Southgate contends (Br. 45).

Southgate's suggestion (Br. 43-46) that courts cannot base sham-partnership determinations on facts occurring *after* a partnership's formation conflicts with binding authority. *See Culbertson*, 337 U.S. at 742 (relevant factors include validity of parties' "capital contributions" and "conduct of the parties in execution of" partnership agreement); *Merryman*, 873 F.2d at 880, 883 ("sham partnership" determination supported by post-formation facts, including that partnership "never distributed any funds to its partners").[19] Such facts appropriately shed light on what the parties intended when they formed their "partnership." Indeed, notwithstanding that it came second in time, the court properly referred to the GNMA/basis-build transaction as the "underlying" transaction, *i.e.*, the foundation of the shelter. (R15393.)

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[19] *Coltec* and the other economic-substance cases cited by Southgate (Br. 43-44) are not to the contrary, and did not involve (as here) the use of the partnership form to generate tax benefits.

Nor did the court make any fact finding that would make "inescapable" the conclusion that Southgate was a valid partnership, as Southgate contends (Br. 37). In this regard, each fact cited by Southgate (Br. 38-39) in support of the partnership's purported validity relates to whether the NPL acquisition — not the partnership — had economic substance:

- The "NPL portfolio fell within Montgomery and Beal's core business" and had a "reasonable" profit potential.
- Montgomery took steps to ensure the NPL acquisition was successful.
- The collection plan was reasonable.
- Montgomery and Beal "believed that they could earn a profit from the NPLs," and would have done "this deal" without the tax benefits.

None of these findings address the partnership with Cinda. That partnership was unnecessary for the NPL acquisition, because — as Montgomery conceded — Beal could have purchased the NPLs directly, as he had done in prior distressed-debt acquisitions. (R494,15391.)

Southgate further contends (Br. 39-40) that the District Court found that certain steps related to the NPL acquisition were "imbued with tax-independent business considerations." None of those findings demonstrate, however, that there was a tax-independent business reason for using the partnership structure to pursue that acquisition.

That Eastgate was created to provide Cinda liability protection and to confirm for Montgomery that Cinda had title to, and could transfer, the NPLs (as the court found (R15301-15302) and Southgate notes (Br. 39)) in no way demonstrates any business purpose for Eastgate partnering with Montgomery and Beal through Southgate. Once the NPLs were transferred to Eastgate, they could have been sold directly to Montgomery and Beal. The further transfer of the NPLs to Southgate was unnecessary to achieve either protection for Cinda or confirmation for Montgomery (but was critical to the tax strategy).

That Montgomery wanted to use a U.S. entity to hold the NPLs to avoid using a foreign entity in China and to allow for easier currency conversions (as the court found (R15302) and Southgate notes (Br. 39-40)) does not demonstrate that Southgate was created for "tax-independent business considerations," as Southgate contends (Br. 39-

40). Those two business objectives could have been achieved by Cinda selling the NPLs to a U.S. entity, and did not require Cinda joining a U.S. partnership (a step that was, again, critical to the tax strategy). As the court further found, other U.S. investors had purchased Chinese NPLs, and Montgomery and Beal could have done the same. (R15271-15272,15391.)

That Montgomery reasonably selected Cinda to service its loans (as the court found (R15304) and Southgate notes (Br. 40)) explains why Montgomery entered into the LSA with Cinda; it does not explain why Montgomery and Beal entered into a partnership with Cinda. As the court found, the LSA — not the Southgate partnership — "allowed Montgomery to achieve the essential benefits of partnering with a Chinese entity"; the LSA retained Cinda's "super powers" related to collections, and "aligned Cinda's interests with Southgate's" by providing Cinda a 25-percent collection fee. (R15302,15304.) But, as the court further found, the LSA "explicitly disavows any partnership relationship between Cinda and Southgate." (R15305; *see* Ex15 at 2.)

Finally, that Beal's purchase of Eastgate's interest in Southgate provided Beal representations and warranties directly from Cinda (as

the court found (R15306) and Southgate notes (Br. 40)) does not explain why Beal entered into a partnership with Cinda. Beal could have obtained representations and warranties directly from Cinda by purchasing the NPLs instead of purchasing Cinda's interest in a partnership holding NPLs. Purchasing Cinda's partnership interest, however, was critical to the DAD tax strategy. If Beal had simply purchased the NPLs, or invested $19.4 million directly in Southgate, he would not have been allocated Cinda's $1 billion built-in loss when the NPLs were sold.[20]

Although the District Court stated that the "formation of Southgate was important in several respects" (R15301-15302), none of the business objectives noted by the court provide a specific, non-tax reason for Southgate's formation, as demonstrated above. And none of the findings cited by Southgate demonstrate that the parties intended

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[20] The representations and warranties that Cinda provided to Beal incorporated the representations and warranties that Cinda provided to Southgate in the Contribution Agreement. (Ex216B at 7.) The court found that it "was reasonable for Southgate to rely on Cinda's representations in the Contribution Agreement." (R15367.) Therefore, purchasing Cinda's partnership interest did not provide Beal any additional assurances regarding the NPLs' attributes than he could have obtained by investing directly in Southgate.

to join together and share profits and losses. Indeed, one of the findings cited by Southgate — that Cinda sought "immediate liquidity" (Br. 40), not a shared investment — is contrary to viewing the partnership as genuine. *See* R482. In short, the court did not find that Southgate was a valid partnership at any point in time, or had been formed for a valid business purpose.[21]

3. Southgate's reliance on *Moline* and § 704(e) is misplaced

Unable to demonstrate that Southgate was formed for a substantial non-tax purpose, Southgate argues (Br. 47-49) that it need not do so under *Moline* and § 704(e). Citing *Moline* for the first time on appeal, Southgate contends (Br. 47) that a partnership formed solely for tax purposes will be respected so long as it "carries on business activity after its formation." *Moline* does not support that proposition.

Moline involved corporations, not partnerships. Thus, *Moline* — and the other corporate cases cited by Southgate — have no bearing on the question whether parties have formed a genuine partnership for tax purposes. *See ASA*, 201 F.3d at 512-513 (rejecting argument that sham

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[21] If the court had made such a finding — which it did not — it would have been clearly erroneous, as demonstrated above.

partnership should be respected under *Moline*); *Saba Partnership v. Commissioner*, 273 F.3d 1135, 1141 (D.C. Cir. 2001) (same).[22] The Supreme Court's opinion in *Culbertson* — issued a few years after *Moline* — confirms that *Moline* is inapposite because the Court did not even cite, much less rely on, *Moline* in determining whether the taxpayers in question had entered into a genuine partnership for federal tax purposes. Indeed, if *Moline*'s business-activity test had been relevant, as Southgate contends, then *Culbertson* and *Merryman* would have been resolved in favor of the taxpayers, since the putative partnerships in those cases were unquestionably engaged in legitimate business activities.

Similarly, § 704(e) does not (as Southgate suggests (Br. 49)) validate sham partnerships. Section 704(e) (entitled "Family Partnerships") provides an objective standard for determining whether

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[22] *Moline* turned on the fact that corporations are separate taxable entities. Partnerships, however, are not separate taxable entities. §§ 701, 702(a). The only partnership cases cited by Southgate — *Copeland v. Commissioner*, 290 F.3d 326 (5th Cir. 2002) and *Raymond Pearson Motor Co. v. Commissioner*, 246 F.2d 509 (5th Cir. 1957) — did not (as Southgate suggests (Br. 48)) cite *Moline*, apply its test, or resolve an issue comparable to that resolved in favor of the Government in cases like *Culbertson*, *Merryman,* or *ASA*.

a particular "person" is a "partner" in an extant partnership. It does not, however, provide any standard for determining whether an arrangement constitutes a genuine partnership, but rather assumes the existence of a genuine partnership, as the regulations and legislative history make clear. Treas. Reg. § 1.704-1(e)(1)(iii) ("donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a *bona fide* transaction, not a mere sham for tax avoidance or evasion purposes"); H.R. Rep. No. 586, at 33 (1951) (same). The statute, therefore, does not apply to sham partnerships — if there is no genuine partnership, there can be no actual partners.

C. The "partnership" was properly recharacterized as a direct sale of NPLs from Cinda to Beal under substance-over-form principles

As an alternative to its sham-partnership ruling, the District 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. (R15394-15397.) In doing so, the court correctly followed the fundamental principle of tax law that the minimization of a tax

liability may not be accomplished through form alone. *E.g., Blueberry Land Co. v. Commissioner*, 361 F.2d 93, 101 (5th Cir. 1966) (recharacterizing taxpayers' sale of mortgages to intermediate corporation, which resold mortgages to savings and loan association, as taxpayers' sale of mortgages to association); *Rogers v. United States*, 281 F.3d 1108, 1127 (10th Cir. 2002) (recharacterizing purported loan and stock-option transaction as stock sale/redemption); *Tribune Co. v. Commissioner*, 125 T.C. 110, 198-199 (2005) (recharacterizing stock merger as a "sale" for cash, although in form taxpayer received stock, not cash). One important subset of the substance-over-form doctrine is the step-transaction doctrine, which disregards for tax purposes a "transparently artificial" step taken by a taxpayer so that "[a] given result at the end of a straight path is not made a different result because reached by following a devious path." *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938). Both doctrines are "particularly pertinent to cases" — as here — "involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result." *Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954).

The substance-over-form doctrine is independent from the economic-substance doctrine. *See Rogers*, 281 F.3d at 1114-1118 (explaining difference between the doctrines). The mere fact that a transaction has a legitimate business purpose and profitability does not mean that the court has to accept the transaction's formal characterization. *E.g., Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966) (recharacterizing stock sale as reorganization even though the transfer of assets had economic substance); *Kuper v. Commissioner*, 533 F.2d 152, 158 (5th Cir. 1976) (recharacterizing transaction even though taxpayer had a "valid business purpose" because the recharacterization "would have accomplished this business objective. A legitimate business goal does not grant taxpayer *carte blanche* to subvert Congressionally mandated tax patterns."); *BB&T Corp. v. United States*, 523 F.3d 461, 471-477 (4th Cir. 2008) (recharacterizing "lease" as a "financing arrangement" and assuming for summary-judgment purposes that transaction had "economic substance"). Thus, the fact that the District Court determined that the NPL acquisition had economic substance did not preclude the court from recharacterizing

the manner in which Beal pursued that acquisition from a partnership to a direct sale.

As noted above, the courts in *Long-Term Capital* and *Santa Monica* both applied the step-transaction doctrine to shelters similar to Beal's DAD scheme and recharacterized a multi-step partnership arrangement as a direct sale. In each case, the court found that the foreign partner's contribution of the built-in-loss asset to the partnership, and subsequent sale of its partnership interest to the taxpayer, were "prearranged parts of a single transaction and therefore must be stepped together." *Long-Term Capital*, 330 F. Supp. 2d at 170-171; *accord Santa Monica*, 89 T.C.M. (CCH) at 1217-1218.

The District Court reached the same conclusion here, and its ruling is fully supported by the evidence.[23] As the correspondence between De Castro, Montgomery, and Beal (cited by the court (*e.g.*, R15275,15281,15308,15318,15340)) makes clear, each step in the DAD scheme was part of a pre-arranged tax strategy — planned before

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[23] Dismissing the court's substance-over-form ruling in a brief footnote (Br. 49 n.18), Southgate has not — and cannot — demonstrate that the substance-over-form and step-transaction doctrines are inapplicable to its pre-arranged tax strategy.

Southgate was even formed on July 31, 2002 — to reach the end result of transferring Cinda's built-in losses to Beal. (Ex34, Ex39-42, Ex63-67, Ex116-117.) *See* Ex76 (July 8, 2002 De Castro correspondence outlining each interdependent step of the tax plan, including Cinda's transfer of its partnership interest, Beal's basis-build, and the triggering of the tax loss by selling the NPLs).[24] In particular, the correspondence highlights that the partnership structure was selected for tax purposes (Ex 64, Ex117), and that it was planned from the beginning that the Chinese entity would exit the partnership shortly after entering it, leaving behind a small partnership interest that would be "diluted to near zero" (Ex76 at 3). Applying the logic of *Santa Monica* to the facts here, "the parties purposed that [Cinda] should join the partnership so as to withdraw from it. It is this schizophrenic purpose which 'defeats or contradicts the apparent transaction.'" 89 T.C.M. (CCH) at 1191. *See Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1528-1529 (10th Cir. 1991) (courts properly

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[24] Although some of the early De Castro memoranda were addressed to Montgomery, De Castro had been retained by Beal. (Ex76, Ex344, Ex347.)

"ignore acts taken in intermediate steps which the taxpayer has itself undone with subsequent steps").

In substance, Cinda — like the foreign entities in *Long-Term Capital* and *Santa Monica* — sold its NPLs to Beal. Cinda sought "immediate liquidity" for its NPLs (R15306), and it entered the Southgate partnership with the expectation that it would sell that interest to a tax-shelter-seeking investor like Beal.[25] (R482,723-724.) And then four weeks after transferring NPLs valued at $19.4 million to Southgate, Cinda turned around and sold most of its partnership interest to Beal for $19.4 million.[26] The intermediate step of Cinda's partnership contribution should be ignored, and the transaction should

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[25] The fee structure ensured that Cinda would sell its partnership interest. Montgomery could not obtain the NPLs without paying Deutsche Bank $8.5 million. (R15283-15284.) That fee was not due, however, until an investor purchased Cinda's Southgate interest. (R723-724.) The parties formed Southgate with the understanding that Beal (or another investor) would purchase Cinda's interest and pay the $8.5 million fee. (R723-724,15279,15283-15284.) When analyzing the deal before Southgate was formed, the tax advisors assumed that Beal would be the investor. (Ex65 at 2, Ex117.)

[26] In August 2002, Beal provided Cinda $19.2 million in cash and an interest-bearing note for approximately $200,000. (R15299.) In 2008, Cinda formally relinquished the note and its remaining partnership interest for $220,000. (R3043-3046.)

be taxed as if Cinda sold the NPLs directly to Beal, a transaction that Montgomery conceded could have occurred. (R494,15391.) Indeed, recharacterizing the interrelated steps as a "sale" mirrors how the parties candidly viewed the transaction. *See*, above, at pp. 37-38.

That Cinda sold most — but not all — of its partnership interest does not give the "partnership" substance or distinguish this case from *Long-Term Capital* or *Santa Monica*. Cinda's formal retention of a small interest in Southgate was engineered for tax purposes. (Ex41 at 4-5.) As Cinda told its regulators, its retention of a "symbolic[ ]" partnership interest was required by Beal's tax strategy, not economic realities. (Ex608, R15357.) Moreover, the pre-arranged tax scheme envisioned that Beal would ultimately dilute Cinda's retained interest to essentially "zero" by increasing his outside basis by over $1 billion. (Ex76 at 3; *see* Ex604 at 8, R625-626.)

Similarly, that Beal had not formally agreed to purchase Cinda's partnership interest before Southgate was formed does not preclude the court's application of the step-transaction doctrine. This Court has rejected the argument that the doctrine requires a "binding commitment" that each step in a pre-arranged plan would occur. *Sec.*

Indus. Ins. Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983). As this Court explained, to hold otherwise "would effectively permit taxpayers to evade the step transaction doctrine merely by abstaining from formal commitments." *Id.* Here, Beal's delay in joining Southgate was created for tax purposes, and it was understood that Beal would purchase Cinda's partnership interest. (Ex117, Montgomery Deposition 387-388.) Beal selected "a billion dollars" as the amount of built-in losses that would be transferred through the partnership *before* Southgate was formed. (R15274, Ex33.) Moreover, Beal's tax advisors were already drafting their tax opinions *before* Southgate was formed. (R1144-1147,15340-15341, Ex67.) Those penalty-protection opinions would only be necessary if Beal acquired Cinda's partnership interest. Tellingly, in Beal's subsequent DAD shelters, Montgomery would again form a new LLC and then introduce Beal "[l]ater." (Ex812.)

D. Southgate's NPL acquisition lacked economic substance

This Court could affirm the District Court's disallowance of Southgate's losses on the alternative basis that the NPL acquisition itself lacked economic substance, as the Government had argued below.

The court held that the NPL acquisition satisfied the economic-substance doctrine because it found that Southgate expected to make "some profit" when it acquired the NPLs. (R15387.) That finding is legally insufficient to support a ruling that a transaction has economic substance.[27]

"[T]he existence of some potential for profit does not foreclose a finding of no economic substance." *Keeler v. Commissioner*, 243 F.3d 1212, 1219 (10th Cir. 2001). Rather, 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." *Rogers*, 281 F.3d at 1117; *ACM Partnership v. Commissioner*, 157 F.3d 231, 258 (3d Cir. 1998) (same); *Nevada Partners Fund, LLC v. United States*, No. 3:06cv39, 2010 WL 1795618, at *12 n.22 (S.D. Miss. Apr. 30, 2010) (same). As this Court has explained, the fact that a taxpayer may have some business purpose is insufficient to respect a

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[27] The finding is also factually erroneous. The purported profit expectation was based on the Zhongyu valuation of the NPLs (R15289-15291), but that valuation was not received until *after* Southgate acquired the NPLs (R15288). Obviously, the NPLs were acquired for their tax potential, not their profit potential.

transaction's form where the taxpayer "also had larger tax objectives which ultimately controlled [the] specific form of the transactions." *Kuper*, 533 F.2d at 159. Indeed, Congress recently has enacted this common-sense principle into law by providing that a transaction must be disregarded under the economic-substance doctrine unless the taxpayer can demonstrate that a transaction's profit potential "is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1068 (2010) (amending § 7701 of the Code by adding "(o) Clarification of Economic Substance Doctrine"). Beal was expressly warned about this principle by De Castro, which advised that "a merely incidental profit motive is not sufficient" to give a tax-motivated transaction economic substance.[28] (Ex61 at 58.)

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[28] None of the cases cited by the District Court support the proposition that an expectation of "some profit" validates any tax-driven transaction. In *Klamath*, this Court determined that a transaction lacked economic substance because there was "no reasonable possibility of profit." 568 F.3d at 545. It did not hold (as the District Court did) that "some profit" would satisfy the test.

The District Court did not — and could not — find that the NPL acquisition's profit potential was substantial in relation to the expected tax benefits. Although the court found that Southgate expected to make "some profit" when it acquired NPLs, the court did not quantify that term. Montgomery testified that he expected Southgate to make $19 million on the NPL acquisition (although he had not created any contemporaneous documentation to that effect). (R842-844.) Taking that unsubstantiated, self-serving claim to be true, a $19 million profit is insignificant when compared to the scheme's expected $400 million tax benefit. Moreover, the value of the tax losses generated by the NPL sales dwarfed the net cash flows generated by those sales. (Ex785-787.) In 2002, the NPLs generated $83.5 million in tax savings and $2.1 million in cash. In 2003, the NPLs generated $150 million in tax savings and $6 million in cash. And in 2004, the NPLs generated another $150 million in tax savings and $2.4 million in cash. In total, the NPLs generated $383.5 million in tax savings and $10.5 million in cash (which did not even cover the transaction's costs). Given the gross imbalance between the expected tax benefits and the purported

expected profit, Beal's DAD shelter was clearly a tax-motivated transaction. To hold otherwise would defy logic.

Moreover, the court's factual findings demonstrate that Beal entered this shelter motivated by the $400 million tax benefit, not any economic profit potential. When Cinda threatened to report the Southgate shelter to the IRS, Beal and his advisors backed away from complaining about Cinda's servicing efforts. (R964-965,15314-15315, Ex233, Ex235.) Further, even after Cinda revealed itself to be a poor loan servicer, Beal nevertheless entered another transaction with Cinda (R1006-1007,3066-3067), which the court found could only be explained by tax reasons (R15311). As Montgomery admitted, he and Beal thought that Beal would obtain a "billion dollars of tax deductions" "whether or not Cinda did a great job or a lousy job collecting the NPLs." (R841-842.) That Beal purportedly would have invested in Chinese NPLs even without the tax benefits (as the court found (R15300)) does not mean that the transaction would have been conducted in the same way: *e.g.*, ceding almost all control to Cinda over the NPLs, even though Beal typically micro-managed his investments (R2735-2736); selling NPLs to trigger tax losses (R15308-15310), rather

than trying to collect the loans to trigger profits; and paying Deutsche Bank $8.5 million, a fee way out of proportion to the expected profit, but not to the expected tax loss. When Beal had to choose between economic profits or tax benefits in the Southgate transaction, Beal repeatedly chose pursuing the tax benefits over protecting the economic profits. Such decisions are the hallmark of a transaction lacking economic substance.[29]

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[29] If the Court disagrees with the District Court's sham-partnership and substance-over-form conclusions, and affirms its conclusion that the NPL acquisition had economic substance, then the Court would need to remand the case to the District Court to address the Government's alternative arguments for disallowing Southgate's claimed ordinary losses. *See*, above, n.5. The need for a remand moots Southgate's contention (Br. 59-60) that Beal is entitled to utilize $28.5 million in losses if Southgate is respected and the GNMA/basis-build transaction is disregarded. Moreover, the correct amount of Beal's basis in Southgate is an issue that is outside the scope of this § 6226 partnership proceeding. *See Jade Trading LLC v. United States*, 598 F.3d 1372, 1379 (Fed. Cir. 2010).

II

The District Court erroneously held that penalties did not apply to Beal's attempt to shelter $1 billion through a sham partnership

Standard of Review

The District Court's interpretation of statutory terms such as "valuation misstatement" is subject to *de novo* review. "Whether the elements that constitute 'reasonable cause' are present in a given situation is a question of fact, but 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).

A. Introduction

Section 6662 imposes a penalty equal to 20 percent of the portion of any underpayment of tax that is attributable to one or more of the following: (i) negligence; (ii) any substantial understatement of income tax; and (iii) any substantial valuation misstatement under chapter 1 (income tax). The valuation-misstatement penalty is increased to 40 percent in the case of a gross valuation misstatement.[30] § 6662(h)(1).

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[30] The penalties are imposed in the alternative, and are not cumulative. Treas. Reg. § 1.6662-2(c).

Although accuracy-related penalties are inapplicable if the taxpayer proves that there was reasonable cause for his underpayment and that he acted in good faith, § 6664(c), penalties play a critical role in our system of "self-assessed" taxes. Thus, Congress envisioned that relief from penalties would be the "exception" to the rule of mandatory accuracy-related penalties, § 6664(c), and taxpayers bear a "'heavy burden'" of proving that they fit within the exception, *Richardson v. Commissioner*, 125 F.3d 551, 558 (7th Cir. 1997) (citation omitted).

As demonstrated below, the District Court erred in determining that none of the accuracy-related penalties were applicable to Beal's basis-inflating DAD shelter. The court further erred in determining that there was reasonable cause for claiming the shelter's astronomical, and wholly artificial, tax benefits.

B. The penalty for basis misstatements applies to Southgate's basis-inflating DAD shelter

Section 6662 imposes a graduated penalty for valuation misstatements, which exist if the "value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 [or, for gross misstatements, 400] percent or more of

the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." § 6662(b)(3), (e)(1)(A), (h)(1) & (2)(A)(i).[31]

Here, the parties disagreed over Southgate's basis in the NPLs. Southgate claimed that it acquired a carryover basis of $1.1 billion, and the Government argued (under alternative theories) that it was $19.4 million or zero. The court agreed with the Government that Southgate had misstated its basis by over $1 billion.[32] Nevertheless, the court concluded that the valuation-misstatement penalty — which by its terms applies to "basis" misstatements — did not apply. The court felt constrained by *Heasley v. Commissioner*, 902 F.2d 380, 383 (5th Cir.

[31] Much of the case law cited in this Section addresses former § 6659, § 6662(b)(3)'s predecessor. The pertinent language in both statutes is identical.

[32] The court found that "Southgate's basis is $19.4 million rather than the $1.1 billion claimed" pursuant to the court's judicial-doctrine rulings. (R15399.) As a technical matter, Southgate's basis is zero under the court's sham-partnership and substance-over-form rulings. In addition, the court sometimes incorrectly stated that the carryover basis in the NPLs was "$1,379,780,386." (R15282.) The parties stipulated that the claimed basis in the NPLs ("including accrued interest") was "$1,145,479,064." (R14410.) Neither error, however, has any impact on the case, because the FPAA adjusted Southgate's basis in the NPLs to zero, and the court held that the FPAA adjustments were correct. (R15415.)

1990), to hold that the valuation-misstatement penalty does not apply here, even though it noted that the penalty would apply in other circuits.[33] (R15407.) Quoting *Heasley*, the court stated that "'[w]henever the IRS totally disallows a deduction or credit, the IRS may not penalize the taxpayer for a valuation overstatement included in that deduction or credit.'" (R15406-15407.) As demonstrated below, that statement is no longer good law. Moreover, *Heasley* is distinguishable from the instant case.

To the extent that *Heasley* concluded that the valuation-misstatement penalty can never apply when a deduction or credit is totally disallowed, that rule can no longer be relied upon in light of subsequently issued regulations that directly contradict that notion. *See* Treas. Reg. § 1.6662-5(g) (providing that any misstatement of value or basis with respect to property with a correct value or basis of "zero" is a gross valuation misstatement); Treas. Reg. § 1.6662-5(d), ex. 3

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[33] *See Merino v. Commissioner*, 196 F.3d 147, 155, 157-159 (3d Cir. 1999); *Zfass v. Commissioner*, 118 F.3d 184, 190-191 (4th Cir. 1997); *Illes v. Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992); *Gilman v. Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991); *Massengill v. Commissioner*, 876 F.2d 616, 619-620 (8th Cir. 1989). *But see Keller v. Commissioner*, 556 F.3d 1056, 1061 (9th Cir. 2009).

(gross-valuation-misstatement penalty applies to understatement of tax resulting from total disallowance of depreciation deduction claimed with respect to property having a correct basis of zero). The regulations recognize that it makes no sense to conclude that the penalty is inapplicable when the basis misstatement is so extreme that the accurate basis is actually zero. Those reasonable regulations are entitled to deference. "Before a judicial construction of a statute, whether contained in a precedent or not, may trump an agency's, the court must hold that the statute unambiguously requires the court's construction." *Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 985 (2005). This Court has held that the valuation-misstatement statute is "ambiguous," *Todd v. Commissioner*, 862 F.2d 540, 542 (5th Cir. 1988), leaving room for the IRS to issue regulations. The District Court's reliance on *Heasley*'s "total disallowance" statement conflicts with those regulations (issued after *Heasley* was decided) and, accordingly, was erroneous as a matter of law.

Limiting *Heasley*'s scope not only is required by *Brand X*, but it would also further the valuation-misstatement penalty's underlying

purpose. The penalty was designed to deter taxpayers from claiming large tax benefits from transactions that inflate value or basis. The entire purpose of the DAD shelter is to generate enormous tax benefits by inflating basis in an asset. The penalty should apply to Southgate's $1 billion basis misstatement, just as it applied to similar schemes in *Long-Term Capital,* 330 F. Supp. 2d at 199 and *Santa Monica*, 89 T.C.M. (CCH) at 1225-1227.[34]

In any event, *Heasley*'s "total disallowance" rule is inapplicable to the facts here. The District Court did not totally disallow all tax benefits arising from the NPL acquisition, just the inflated basis created by the sham partnership. Because the court held that the NPL acquisition had economic substance, Beal and Montgomery will have an opportunity in partner-level proceedings to demonstrate that they realized actual economic losses in the NPL acquisition, as noted, above, at n.13.

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[34] In our view, *Heasley* was incorrectly decided, as a majority of the courts have held. *See*, above, n.33.

C. The substantial-understatement penalty applies

In the case of noncorporate taxpayers, an understatement of income tax is substantial if it exceeds the greater of (i) 10 percent of the tax required to be shown on the return, or (ii) $5,000. § 6662(d)(1)(A). For these purposes, the amount of an understatement is reduced by the portion thereof that is attributable to (i) the tax treatment of any item if there is substantial authority for such treatment; or (ii) any item that is adequately disclosed, if taxpayer has a reasonable basis for the item's tax treatment. § 6662(d)(2)(B). There is substantial authority for an item's tax treatment only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(i).

In the case of any item of a noncorporate taxpayer that is attributable to a tax shelter, the "adequate disclosure" alternative to substantial-authority relief is not available, and substantial-authority relief is not available unless the taxpayer reasonably believed that its tax treatment of such item was more likely than not the proper

treatment. § 6662(d)(2)(C)(i).[35] For these purposes, the term "tax shelter" includes any partnership, plan, or arrangement, a "significant purpose" of which is the avoidance of Federal income tax. § 6662(d)(2)(C)(iii). Since the court determined that Southgate was a sham partnership designed to generate $1 billion in artificial tax benefits for Beal, the tax-shelter rule applies.

For purposes of the tax-shelter rule, a taxpayer's "more likely than not" belief will be considered reasonable if the taxpayer reasonably relies on a legal opinion that (i) concludes that there is a greater than 50-percent likelihood that the item's tax treatment will be upheld if challenged by the IRS, and (ii) satisfies the minimum requirements of Treasury Regulation § 1.6664-4(c)(1) (relating to the reasonable-cause exception applicable to all § 6662 penalties). Treas. Reg. § 1.6662-4(g)(4).

The District Court erred in determining that Southgate had substantial authority for its $1 billion basis misstatement. That one of the Government's technical arguments (*i.e.*, the "Section 482

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[35] In 2004, § 6662(d) was amended to make § 6662(d)(2)(B)'s reduction provisions wholly inapplicable to tax-shelter items. Pub. L. No. 108-357, § 812(d).

argument") was a "matter of first impression," as the court noted (R15409), is legally irrelevant to the penalties issue. The court did not disallow Southgate's losses because of § 482; the court disallowed the losses because the "partnership" was a sham and Cinda's "contribution" of the NPLs was in substance a sale. Far from being a matter of first impression, it is well settled that taxpayers may not claim tax benefits from transactions that are shams or lack substance. There is no authority — let alone substantial authority — to the contrary. The court further erred in concluding that Southgate "reasonably relied" on the De Castro and Coscia opinions because those opinions failed to comply with Treasury Regulation § 1.6664-4(c)(1)'s minimum requirements, as demonstrated below in Section II.E.

D. The negligence penalty applies

An understatement of tax is due to "negligence" if the taxpayer fails to make a reasonable attempt to comply with the tax laws. § 6662(c). Negligence is strongly indicated where the taxpayer claims a deduction that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. Treas. Reg.

§ 1.6662-3(b)(1). Return positions that have a reasonable basis, however, are not attributable to negligence. *Id.*

Here, a reasonable person would understand that the tax results Beal sought were plainly "too good to be true." 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*. While legitimate transactions sometimes produce tax losses in excess of economic losses, as the District Court noted (R15412), no court or legislature has — or should — condone a transaction where the tax loss dwarfs the economic loss to the extent claimed here. Further, there was no reasonable basis for Southgate's return position, as demonstrated below.

E. Southgate did not have reasonable cause

The determination whether a taxpayer acted with reasonable cause and good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1). Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause. *Id.* For purposes of determining whether such reliance was reasonable, the taxpayer's

education, sophistication, and business experience must be taken into account. Treas. Reg. § 1.6664-4(c)(1). In this regard, Southgate was managed by Beal and Montgomery, both highly sophisticated businessmen.[36] (R15258-15259,15412.)

Here, Beal purchased a tax scheme that promised to provide over $1 billion in artificial tax deductions. 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). Having lost the bet, Southgate and Beal cannot use Coscia's and De Castro's advice as a hedge against penalties, and now must do more than merely repay the $400 million underpayment of tax. As demonstrated below, the tax advice could not reasonably and in good

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[36] In partnership proceedings, courts have jurisdiction to review both the claimed tax treatment of a partnership item, and the applicability of any penalty which relates to an adjustment to a partnership item. § 6226(f). When (as here) the partnership itself is asserting reasonable cause for its return position, courts may adjudicate such defense in a partnership-level proceeding and look to the conduct of the partnership's managing partners in evaluating the reasonableness of the partnership's reporting position. *Klamath*, 568 F.3d at 548.

faith be relied on because (i) the tax opinions violated a binding regulation, and (ii) Beal failed to follow the advice.

1. The De Castro and Coscia opinions fail to satisfy Treasury Regulation § 1.6664-4(c)(1)'s minimum regulatory requirements

In order for tax advice to support a reasonable-cause defense, the taxpayer must (among other things) demonstrate that the advice was not "based on unreasonable factual or legal assumptions," including assumptions or representations that the taxpayer knows or should have known are "unlikely to be true." Treas. Reg. § 1.6664-4(c)(1)(ii). As relevant here, the regulation emphasizes that the advice must not be based on an "inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring the transaction in a particular manner" so as to generate the tax benefits at issue. *Id.* This requirement is particularly key in the tax-shelter context, where attorneys often provide their clients favorable tax opinions by simply assuming they had a legitimate business purpose for entering a particular transaction or structuring it in a particular manner. *See* Joint Committee on Taxation, *Enron Report* (JCS-3-03) at 22-25, 172-180, C326-370 (criticizing King &

Spalding's facilitation of Enron's tax shelters by issuing tax opinions that assumed shelter's structure had a "business purpose").

If the tax 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. For example, in *Long-Term Capital*, the district court held — and the Second Circuit affirmed — that a partnership lacked reasonable cause for its partnership-basis-inflating shelter where the tax opinion contained factual assertions regarding the transaction's structure that the taxpayer should have known were false. 330 F. Supp. 2d at 206, 209*; see Santa Monica*, 89 T.C.M. (CCH) at 1233 (same).

The De Castro and Coscia opinion letters provided to Southgate suffer from this same flaw. Both opinions assumed that Beal and Montgomery had a valid business purpose for using the partnership structure to invest in NPLs. (Ex8 at 85, Ex61 at 40, 62.) That assumption was incorrect, and Beal and Montgomery should have known it was incorrect. *See*, above, at pp. 33-58, 60-67.

Further, both 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." (Ex8 at 22, 82, Ex61 at 6, 18, 31.) Those assumptions were incorrect, and Beal and Montgomery should have known they were incorrect. *See*, above, at pp. 39-50.

Finally, both opinions assumed that Southgate's profit potential was substantial compared to the expected tax benefits. The Coscia opinion relied on Beal's representation "that the main purpose of the investment in Southgate was for profit." (Ex8 at 65.) Similarly, the De Castro opinion assumed that the transaction's "profit potential" was "substantial in comparison to the present value of the expected tax benefits." (Ex61 at 63-64.) Those statements were incorrect, and Beal and Montgomery should have known they were incorrect. *See*, above, at pp. 67-72.

That Coscia and De Castro were "qualified accountants and tax attorneys" does not — as the District Court supposed (R15414) — immunize their opinions from scrutiny. The same was true in *Long-Term Capital* and *Santa Monica*. Because the Coscia and De Castro opinions contained assumptions and representations that Beal and

Montgomery knew or should have known were not true,[37] the opinions could not satisfy the reasonable-cause defense. As the regulation mandates, "[i]n no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied." Treas. Reg. § 1.6664-4(c)(1). The regulation leaves no room for discretion on that point — if the advice is based on statements that are demonstrably untrue, then the advice cannot, under any circumstances, support a reasonable-cause defense.

2. Southgate and Beal sought penalty protection, not independent legal advice, as evidenced by the fact that Beal failed to follow his attorneys' advice regarding the GNMAs

A taxpayer's honest effort to assess his proper tax liability is the most important factor in determining reasonable cause and good faith. Treas. Reg. § 1.6664-4(b)(1). Transactions driven by "tax avoidance" — like the transaction here — weigh against a finding of reasonable cause, *Stanford v. Commissioner*, 152 F.3d 450, 461 (5th Cir. 1998), as does a taxpayer's failure to follow his attorney's tax advice, *InterTAN,*

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[37] To the extent the court found to the contrary (R15340,15342), those findings are clearly erroneous.

Inc. v. Commissioner, 87 T.C.M. (CCH) 767, 776-777, *aff'd*, 117 Fed. Appx. 348 (5th Cir. 2004).

Here, Southgate sought penalty protection from its advisors, not objective tax advice. Montgomery obtained De Castro's assurance that it would bless the shelter *before* the partnership was formed or the relevant facts had even occurred. (R15340, Ex67.) Moreover, Beal disregarded the objective advice that he received regarding the GNMA "contribution." *See*, above, at pp. 13, 43-44. By ruling that a taxpayer is immunized from penalties so long as it pays reputable advisors for tax advice regarding a blatant tax shelter — even if the tax advice is ignored or based on false posited facts — the District Court's decision creates perverse incentives that will undermine the full and fair enforcement of the tax laws.

The 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.) That ruling creates dangerous precedent. Almost every tax shelter is designed to comply with a literal reading of the Code and regulations, and any tax professional can issue an opinion providing that the shelter complies

with the black-letter law. The court apparently approved of Beal's "gambl[ing]" with the tax laws (R15414), and its ruling will only encourage other shelter-seeking taxpayers to do the same. Because Congress enacted the accuracy-related penalties precisely to deter such gambling, the court's penalty determination should be reversed.

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,

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CERTIFICATE OF SERVICE

It is hereby certified that on this 28th day of May, 2010, the foregoing 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 brief was made on counsel for the appellant/cross-appellee by sending an electronic copy to twelty@sonnenschein.com, and by mailing two copies thereof by First Class Mail to counsel at the address set forth below:

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