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1           IN THE SUPREME COURT OF THE UNITED STATES

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3   UNITED STATES,   :

4           Petitioner   :   No. 12-562

5           v.   :

6   GARY WOODS, AS TAX MATTERS PARTNER:

7   OF TESORO DRIVE PARTNERS, ET AL.   :

8   - - - - - x

9                                 Washington, D.C.

10                                Wednesday, October 9, 2013

11

12                 The above-entitled matter came on for oral  
13   argument before the Supreme Court of the United States  
14   at 10:03 a.m.

15   APPEARANCES:

16   MALCOLM L. STEWART, ESQ., Deputy Solicitor General,  
17       Department of Justice, Washington, D.C.; on behalf of  
18       Petitioner.

19   GREGORY G. GARRE, ESQ., Washington, D.C.; on behalf of  
20       Respondents.

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1 P R O C E E D I N G S

2 (10:03 a.m.)

3 CHIEF JUSTICE ROBERTS: We will hear  
4 argument first this morning in Case 12-562, United  
5 States v. Woods.

6 Mr. Stewart.

7 ORAL ARGUMENT OF MALCOLM L. STEWART

8 ON BEHALF OF THE PETITIONER

9 MR. STEWART: Mr. Chief Justice, and may it  
10 please the Court:

11 The merits question in this case is whether  
12 the substantial valuation misstatement penalty applies  
13 when a taxpayer overstates his basis in property in  
14 connection with the transaction that is later determined  
15 to be a sham. The threshold jurisdictional question is  
16 whether the court, in this TEFRA partnership level  
17 proceeding, has authority to decide that merits issue.

18 I'd like to begin with the jurisdictional  
19 question. And before I focus the Court's attention on  
20 the text, I'd like to make two quick preliminary  
21 observations about jurisdiction. The first is that the  
22 question we say is appropriate for resolution in  
23 partnership level proceedings is not whether any  
24 individual partner will actually be made to pay the  
25 penalty.

1           There's no question in this case that the  
2           determination whether the penalty will actually be  
3           imposed on individual partners and, if so, in what  
4           amount is properly reserved for partner level  
5           proceedings.

6           The question is simply whether the Court, in  
7           the partnership level proceeding, can make the threshold  
8           determination whether the sort of error that the IRS  
9           identifies on the partnership return can trigger a  
10          penalty down the road if the individual partner prepares  
11          his or her return in a manner consistent with the  
12          partnership return.

13          JUSTICE SOTOMAYOR:           Excuse me. I thought I  
14          understood that to be your point in your brief, but I --  
15          there is one thing missing from here. I also thought  
16          you were saying that you could impose the penalty before  
17          the amount was determined on the partnership level, that  
18          the tax that you could, without a notice of deficiency,  
19          require a payment upfront.

20          MR. STEWART:           There are two separate  
21          questions here. The first is what can be determined at  
22          the partnership level? And once the partnership level  
23          proceedings are complete, there are subsidiary partner  
24          level proceedings. And some partner level proceedings  
25          require a deficiency notice, some partner level

1 proceedings do not.

2 Now, it is part of our position that, once  
3 the applicability of the penalty has been determined at  
4 the partnership level, the penalty can then be imposed  
5 on individual partners in partner level proceedings  
6 without a deficiency notice. It can still be challenged  
7 through a refund proceeding, but because -- there's  
8 never the imposition of additional tax or penalties on  
9 the partnership itself.

10 JUSTICE SOTOMAYOR: That is the incongruity  
11 of your position in my mind. You claim that the  
12 decision of -- of whether or not or what the true value  
13 is of the basis and how much needs to be paid can't be  
14 determined until the partnership level -- until the  
15 partner level determination, yet you're claiming that  
16 you're entitled to an amount of money beforehand, before  
17 that decision is made. There's a tension in my mind  
18 about that.

19 MR. STEWART: Let me explain, as best I can,  
20 the sequence of events that we think would unfold if  
21 this Court affirmed our view of the -- both held that  
22 the courts below had jurisdiction and agreed with our  
23 view of the way the penalty is supposed to operate.

24 If the Court agreed with the position that  
25 we take in Part 2 of our merits brief, namely, that a

1 deduction that is claimed in connection with a  
2 transaction that is later determined to be a sham can  
3 trigger -- if they agree -- if you agree with us on that  
4 legal issue, then the IRS would examine the returns of  
5 the individual partners, and it would verify that they  
6 did, in fact, claim deductions in connection with this  
7 transaction because they would have this Court's  
8 agreement with the proposition that that's the sort of  
9 thing that can trigger the penalty.

10         They would then determine what the amount of  
11 the overpayment -- of the underpayment was, and they  
12 would, presumably, assess a 40 percent penalty on that.  
13 There would be a subsidiary question because the FPAA,  
14 the Final Partnership Administrative Adjustment, said  
15 that the partnerships were shams. But it also said that the  
16 individual transactions, the purchases and sales of the  
17 options and the currency and the stock, they would be  
18 treated as though they had been engaged in -- by the  
19 individual partners.

20         And so at the partner level, there might be  
21 further determinations about what -- what a relatively  
22 small amount of tax the individual partners would --  
23 would owe on that. And then if a partner -- if a  
24 penalty were assessed on the partner, the partner would  
25 have to pay the penalty before challenging it in through

1 a refund action. But -- but we might want to ask on  
2 what ground could the partner want to challenge the  
3 penalty at that point.

4 The partner couldn't at that stage want to  
5 make the argument that's being made in this Court,  
6 namely, that this is just not the sort of situation to  
7 which the substantial valuation misstatement penalty  
8 applies because that issue would have already been  
9 resolved against the partner in this proceeding by  
10 hypothesis, if the Court agrees with us on the merits.  
11 And so the partner would have had an opportunity to get  
12 that threshold legal issue resolved without prepaying  
13 the penalty first.

14 Now, if an individual partner wanted to  
15 raise the good faith reasonable cause defects that's  
16 provided in 26 USC 6664(c), the partner would have to  
17 pay the penalty first before seeking a refund. But  
18 that's pretty clearly consistent with Congress's intent  
19 because Congress specified in TEFRA itself that, after  
20 the court in the partnership level proceeding has  
21 determined the applicability of the penalty, the partner  
22 can still, through refund proceedings, contend that the  
23 penalty was erroneously imposed.

24 And that language tells us two things. It  
25 tells us, first, that Congress didn't see any necessary

1 unfairness in requiring a partner to pay the penalty  
2 first before raising certain sorts of challenges.

3           And it also indicates that, by  
4 applicability, Congress must have meant something  
5 different from will the penalty ultimately be imposed  
6 because, if the partnership level determination that the  
7 penalty was applicable meant that all the requirements  
8 for imposition were satisfied, there'd be no room for  
9 the partner to argue down the road that the penalty was  
10 erroneously assessed after all. So --

11           JUSTICE GINSBURG:           Mr. Stewart, can you  
12 explain the difference in the two proceedings? First,  
13 your position that the proper review is of the final  
14 partnership administrative adjustment.

15           How would the penalty be adjudicated in that  
16 format, and if your -- if the taxpayer is right, that  
17 the adjudication must be made at the partner level  
18 proceeding, what would be the difference in the  
19 character of the adjudication?

20           MR. STEWART:           When we say that the  
21 applicability of the penalty should be determined in the  
22 partnership level proceeding, all we mean is that the  
23 court in the partnership level proceeding should resolve  
24 the legal issue that is addressed in Part 2 of the  
25 respective briefs for the Petitioner and the Respondent;



1 that is, the court should determine is the substantial  
2 valuation misstatement penalty the sort of penalty that  
3 can apply to a basis overstatement that is produced  
4 through a sham transaction.

5 We wouldn't ask the court in the partnership  
6 level proceeding to go beyond that legal determination  
7 and to ask whether individual partners had actually  
8 underpaid their tax or whether they had actually  
9 misstated basis. It's always theoretically possible in  
10 a case like this that the partnership could be  
11 determined -- that the partner could participate in sham  
12 transactions.

13 But by the time it was -- he had to file his  
14 own return, he could get cold feet or he could get legal  
15 advice that indicated this just isn't going to work, and  
16 so it's possible that the partner could prepare his  
17 return in a way that was lawful. And the IRS, after the  
18 partnership level proceedings were complete, would have  
19 to look at the partner return in order to see what that  
20 had -- what had happened.

21 I think the main practical -- I'm sorry.

22 JUSTICE SCALIA: I was just going to ask, if  
23 the question were determined of whether the sham  
24 transaction counts as an erroneous statement of the  
25 basis, if that were determined at the partner level and

1 not in a partnership proceeding, would it be possible to  
2 have different outcomes --

3 MR. STEWART: Yes, absolutely.

4 JUSTICE SCALIA: -- with respect to  
5 different partners?

6 MR. STEWART: Absolutely. And I think  
7 that's the main practical difference between the way the  
8 system would operate under our view of TEFRA and the way  
9 it would operate under Respondent's view. That is,  
10 under --

11 JUSTICE SCALIA: And -- and you have to  
12 relitigate the same issue.

13 MR. STEWART: Exactly. Under Respondent's  
14 view, the IRS was not required to say anything at all in  
15 the FPAA about the potential imposition of basis  
16 overstatement penalties down the road. If the FPAA  
17 adjustments -- the shamming determination had been  
18 upheld at the partnership level, under Respondent's  
19 view, the IRS could then assess penalties against  
20 individual partners.

21 And if the individual partners raised an  
22 objection, the same arguments that are raised in Part 2  
23 of the Respondent's merits briefs, that would have to be  
24 litigated potentially by different judges in different  
25 partnership -- in different partner level proceedings

1 with potentially inconsistent outcomes.

2 JUSTICE KAGAN: Would it be a fair way to  
3 look at this to say that what you do at the partnership  
4 level is anything that doesn't require looking at an  
5 individual's tax return?

6 MR. STEWART: I think that's a fair way to  
7 put it. And another way we would put it is any question  
8 that will necessarily have the same answer for all  
9 partners should presumptively be resolved at the  
10 partnership level. That is, the legal issue that's  
11 briefed in Part 2 of the parties' respective merits  
12 briefs, we may be right, Respondent may be right, but the  
13 answer is going to be the same for all partners. Either  
14 this is the sort of basis overstatement that can trigger  
15 the penalty or it isn't.

16 The second practical difference that I  
17 wanted to -- to allude to, at least briefly, between our  
18 position and the Respondent's is that 6226(f) is the  
19 provision that deals with the Court's jurisdiction in a  
20 partnership level proceeding. 6221 is the provision  
21 that tells the IRS what it's supposed to do at the  
22 partnership level, and it also tells the IRS determine  
23 the applicability of any penalty that's related to an  
24 adjustment to a partnership item.

25 Now -- now, one advantage of requiring the

1 IRS to make at least this sort of threshold  
2 determination of penalties at the outset is that, if the  
3 IRS makes an adjustment to a partnership item, and the  
4 IRS believes that it is the sort of adjustment that down  
5 the road could trigger the imposition of penalties,  
6 that's the sort of thing an individual partner would  
7 want to know in deciding whether to challenge the  
8 adjustment.

9 JUSTICE ALITO: Is it correct that your  
10 position would allow the IRS to evade the normal statute  
11 of limitations?

12 MR. STEWART: I don't see --

13 JUSTICE ALITO: Or deficiency? No?

14 MR. STEWART: I don't see how. I'm not sure  
15 exactly what argument you're referring to. But there  
16 are -- I mean, there are provisions that deal with the  
17 way the limitations periods runs, depending on when the  
18 partnership return is filed and when the partner returns  
19 are filed, but I don't see how that would happen.

20 We -- we would still be subject in assessing  
21 penalties against any individual partners to whatever  
22 limitations period the code provides and either we would  
23 or would not have obtained a legal ruling on -- on the  
24 legal issue whether the penalties are -- are the sort  
25 that could follow from this partnership item adjustment,

1 but I don't think it would have implications for the  
2 statute of limitations.

3 JUSTICE GINSBURG: Using the language of the  
4 statute that you just quoted, can you explain to us what  
5 is the adjustment of the partnership item? That is, the  
6 statute says, "Determine the applicability of any  
7 penalty which relates to the adjustment of a partnership  
8 item." So what is -- what was the partnership item  
9 adjustment?

10 MR. STEWART: Yes, Justice Ginsburg. This  
11 is on Page 6-A of the appendix to the government's  
12 brief, and the adjustment to the partnership item is the  
13 shamming determination. The determination that the  
14 partnerships were not engaged in for business purposes,  
15 that they were engaged in purely as tax avoidance  
16 measures.

17 And Respondent concedes that this is a  
18 partnership item because Respondent concedes that the  
19 district court had authority to review the shamming  
20 determination, decide whether that determination was  
21 appropriate. And that concession necessarily depends  
22 upon the proposition that the determination that the  
23 partnerships are shams was an adjustment to a  
24 partnership item.

25 And it makes sense for two reasons. First,

1 because the determination whether these are valid  
2 partnerships necessarily underlies any other  
3 determination that the IRS would make about the proper  
4 tax treatment of items reported on the partnership  
5 return.

6 And second, it is the sort of determination  
7 that is going to have one answer for every partner,  
8 either the partnership is a sham or it's not. But it  
9 can't be the case that a particular partnership is a  
10 sham with respect to some partners and not others.

11 CHIEF JUSTICE ROBERTS: What Judge Sentelle  
12 said in his opinion for the D.C. Circuit is that  
13 based -- agreeing with everything you've said, that  
14 means that the misstatement of basis might be obvious on  
15 the individual partner's returns. What's wrong with it  
16 might be obvious, but it still is made on those returns,  
17 and therefore, that doesn't fall as a partnership item.

18 MR. STEWART: Now, we would agree with Judge  
19 Sentelle that outside basis, in and of itself, is not a  
20 partnership item. An outside basis, in and of itself,  
21 is not designated as one of the things that the court in  
22 a partnership level proceeding can determine. But  
23 there -- and usually, it would be inappropriate to  
24 determine outside basis at that stage because,  
25 typically, outside basis will vary from partner to

1 partner.

2 But there are some instances in which a  
3 court needs to determine outside basis --

4 JUSTICE SCALIA: Excuse me. Why would it  
5 vary from partner to partner?

6 MR. STEWART: I mean, in the -- in the more  
7 typical case, the outside basis would depend upon the  
8 amount that a particular partner had paid for his own  
9 partnership interest. And so, in that situation, not  
10 every partner would necessarily have -- have paid the  
11 same thing. But there are fairly rare situations in  
12 which -- in order to make some determination that is  
13 specified in 6226(f), the court and the IRS along the  
14 way have to determine outside basis.

15 And one example we gave on page 32 of our  
16 brief, we have a footnote that says, it's not implicated  
17 here, but outside basis is sometimes a component of a  
18 partnership item, such as inside basis. And we cite a  
19 case that was ultimately decided by this Court, but it's  
20 a case in which a partnership took advantage of code  
21 proceedings that said you can step up your inside basis  
22 to max the outside basis of your partner -- partners.

23 JUSTICE KENNEDY: Well, isn't it your  
24 position in this case that outside basis in this case is  
25 necessarily related to inside basis?

1 MR. STEWART: I think -- I think --

2 JUSTICE KENNEDY: Or am I misstating that?

3 MR. STEWART: I think what we are saying is,  
4 in order to determine whether the substantial valuation  
5 misstatement penalty would be triggered down the road,  
6 the IRS and the Court would have to make certain --  
7 would have to decide what is the proper outside basis in  
8 a sham partnership.

9 If a lawyer were asked for -- if a lawyer  
10 saw an adjustment that said we regard these partnerships  
11 as shams, and the lawyer were asked, does that mean that  
12 I could be subject to the substantial valuation  
13 misstatement penalty if I reported deductions on  
14 purported losses from that partnership, the only way the  
15 lawyer would answer that question is to ask, well,  
16 what's true basis in a sham partnership?

17 JUSTICE KENNEDY: But -- but if we were to  
18 write an opinion which says -- an opinion ruling in your  
19 favor, that, in this case, outside basis is necessarily  
20 related to inside basis in this transaction, you would  
21 say that's wrong?

22 MR. STEWART: I wouldn't -- I wouldn't put  
23 it that way. I mean, I think in this --

24 JUSTICE KENNEDY: Why -- and why is that?

25 MR. STEWART: Because I think that's not



1 really the reason we're saying the Court needs to -- I  
2 pointed the Court to a different case in which outside  
3 basis had to be determined at the partnership level for  
4 a different reason; namely, because it was a -- in that  
5 case, it was a component of inside basis. And since  
6 inside basis is a partnership item, you can only  
7 determine that partnership item by reference to outside  
8 basis.

9 Here, we have a somewhat different argument.  
10 We're saying the thing that had to be determined at the  
11 partnership level was the applicability of the  
12 penalties. And the only way you can decide whether the  
13 substantial valuation misstatement penalty is applicable  
14 is to determine what would be true basis in a sham  
15 partnership.

16 JUSTICE GINSBURG: Mr. Stewart --

17 JUSTICE SOTOMAYOR: Mr. Stewart --

18 JUSTICE GINSBURG: If we -- if we go over to  
19 the merits, if this case came up today, and today, we  
20 have a penalty that wasn't there originally and that is  
21 for a non -- noneconomic substance penalty, would --  
22 would the government today be going under that  
23 noneconomic substance penalty or would it be going under  
24 the 662(d)(3), that is the substantial valuation  
25 misstatement?

1           Or is it the government's option, it can  
2 pick one or the other?

3           MR. STEWART:           I think it's the government's  
4 option. And if you -- it may be helpful to look at page  
5 18a of the appendix to -- to the Respondent's brief  
6 because that actually reproduces the current version of  
7 the code that contains the 2010 penalty that -- that  
8 you're referring to.

9           JUSTICE GINSBURG:       If the government could  
10 choose either one, what would determine its choice?

11          MR. STEWART:           I mean, in some instances, the  
12 government will -- the government will pick the one that  
13 it thinks is easiest to prove. Some of the penalties  
14 are limited to 20 percent, whereas some can be bumped up  
15 to 40 percent, and we would look for the 40 percent  
16 penalty.

17          But if I could, on page 18a, we're talking  
18 about Section 6662(b), and it says, "Portion of  
19 underpayment to which section applies." And then it  
20 says, "This section shall apply to the portion of any  
21 underpayment which is attributable to one or more of the  
22 following," and then it lists six items. Subsection (3)  
23 is the substantial valuation misstatement penalty that  
24 we're relying on here.

25          Subsection (6) is a disallowance of claimed

1 tax benefits by reason of a transaction lacking economic  
2 substance. That's the -- the 2010 penalty.

3 Now, the two points I would make are, first,  
4 it's very clear that many, many cases that would fall  
5 under Subsection (6) would also fall under Subsection  
6 (1) or (2); that is, they could involve negligence or  
7 disregard of rules or regulations.

8 They could also involve a substantial  
9 understatement of income tax, which basically means any  
10 understatement of income tax that's 10 percent or more  
11 of the true tax owed. And so if there's no incongruity  
12 in saying Subsection (6) should apply to some cases  
13 where (1) and (2) would also apply, there shouldn't be  
14 any greater incongruity in saying it can apply to some  
15 cases where Subsection (3) would apply.

16 The other point I would make pertains to the  
17 introductory language of that provision, and it says,  
18 "This section shall apply to the portion of any  
19 underpayment, which is attributable to one or more of  
20 the following." And I think the primary practical  
21 significance of the "one or more" language is that it  
22 functions as an anti-stacking provision. It tells you  
23 it doesn't matter whether your underpayment triggers  
24 only one of these penalties or all six of them; you're  
25 still limited to 20 percent, unless you can get the --

1 the 40 percent through some other provision.

2 So we can't take advantage of the fact that  
3 the -- that more than one penalty applies to a  
4 particular transaction by getting 20 percent on top of  
5 20 percent on top of 20 percent. But the very fact that  
6 Congress used that language "which is attributable to  
7 one or more of the following" indicates that it  
8 anticipated situations in which particular underpayments  
9 would be attributable to more than one of those  
10 penalties.

11 It didn't see any anomaly in the idea that a  
12 penalty that triggers Subsection (3) could trigger  
13 Subsection (1) or (2). And, again, there's no reason to  
14 think that there's a greater anomaly with respect to  
15 Subsection (6).

16 The other thing I would say is that, in this  
17 case, (3) and -- if it arose in connection with a  
18 transaction that occurred today, (3) and (6) would be  
19 coterminous. Either of them would apply. But there  
20 will be plenty of cases in which a substantial valuation  
21 misstatement penalty on our view could be triggered by a  
22 legal error in computing basis, such as use of the wrong  
23 depreciation rate. That would not --

24 CHIEF JUSTICE ROBERTS: Mr. Stewart, if I  
25 could focus at a somewhat higher level of abstraction.

1 I understand the general underlying thrust of your  
2 friend's position to be that overstatement of basis goes  
3 to -- you know, miscalculations. It was actually  
4 \$20,000, you say it's \$40,000, and that's where the  
5 penalty comes from.

6 Well, this case is quite different. We are  
7 kind of wiping out the whole transaction, and then  
8 you're kind of artificially saying, well, if you wipe  
9 out the whole thing, when you come to basis it should be  
10 this and that. And -- and it's not sort of a fraud or  
11 misstatement with respect to the basis itself. It  
12 follows from a broad sham determination, and that sham  
13 determination is made at the partnership level, not the  
14 partner level.

15 MR. STEWART: I guess the two things that --  
16 or at least two things I would say in response to that  
17 are that here the whole point of the avoidance scheme  
18 was to create an artificially inflated basis; that is,  
19 the high, high basis that's claimed on the individual's  
20 returns was not simply a fortuitous result of an  
21 avoidance scheme that operated through some other means.

22 The whole point -- if you want to claim a  
23 loss on a transaction where you didn't incur an actual  
24 economic loss, you can do it either by under -- by  
25 understating the amount that you were paid for the asset

1 or by overstating your basis. And this is one of a  
2 number of tax avoidance schemes that operate by  
3 overstating basis.

4 So it's true that the transaction was  
5 determined to be a sham, but the sham determination was  
6 intimately bound up with the fact that the whole purpose  
7 of the scheme was to create an inflated basis.

8 CHIEF JUSTICE ROBERTS: I understand that,  
9 but if you were telling people what happened here --  
10 maybe you would -- I don't know that your first  
11 statement would be, they overstated their basis. I  
12 think you would say, they engaged in a completely sham  
13 transaction, which had -- which had some obvious, as the  
14 D.C. Circuit put it, some obvious consequences. But  
15 still, the -- the driving determination was that it was  
16 a sham transaction.

17 MR. STEWART: I guess the -- the other  
18 couple of points I would make are, there's nothing  
19 illegal about engaging in a transaction that lacks  
20 economic substance; that is, if the partners had engaged  
21 in these offsetting currency transactions, but then had  
22 decided before filing their return that either we -- we  
23 no longer believe that this is right conduct or we  
24 believe we're going to get caught, and they had prepared  
25 their returns in a lawful way, nothing bad would have

1 happened to them.

2           The -- the thing that subjects them to  
3 potential penalties is the fact that they claimed a  
4 large loss on their tax returns, and they did that by  
5 claiming a large false basis in the -- the partnership.

6           The second thing I would say is -- you know,  
7 when I took math in junior high and high school, the  
8 teacher would always tell us to show your work when you  
9 handed in an assignment, don't just give the answer at  
10 the end; indicate the process by which you arrived at  
11 that number.

12           And in essence, when the code says impose  
13 penalties on underpayments that are attributable to the  
14 following things, it says -- it means we're going to  
15 look at your work. When we determine that you have paid  
16 too little tax, we're going to look at the calculation  
17 process by which you arrived at the amount on your own  
18 return and figure out where you went wrong.

19           And if they did that here, they would say  
20 the mistake these taxpayers made, the reason that they didn't  
21 pay as much tax as they owed, was not that they claimed  
22 to have sold the assets -- it was not that they claimed  
23 to have sold the assets for less than they actually  
24 realized; it was that they claimed a basis that had --  
25 had no founding in reality.

1           And the last thing I would say in -- in  
2 connection with that is it's no accident that this  
3 scheme operated through the creation of sham  
4 partnerships; that is, if the taxpayers themselves had  
5 bought the offsetting long and short currency options,  
6 there would have been no colorable argument that they  
7 could have claimed the costs --

8           JUSTICE SOTOMAYOR:           Mr. Stewart, what --  
9 what is this case a fight about? And -- and -- I'm  
10 sorry. Perhaps I'll just ask it on rebuttal, so you can  
11 save your time for rebuttal.

12           CHIEF JUSTICE ROBERTS:           Thank you, counsel.  
13 Mr. Garre.

14           ORAL ARGUMENT OF GREGORY G. GARRE

15           ON BEHALF OF THE RESPONDENTS

16           MR. GARRE:           Thank you, Mr. Chief Justice,  
17 and may it please the Court:

18           On both jurisdiction and the merits, the  
19 government is asking this Court to adopt an overly  
20 expansive interpretation of the code to reach a result  
21 that would upset the statutory scheme devised by  
22 Congress and lead to further problems down the road.

23           Now, on jurisdiction, I think the most  
24 important thing for the Court to recognize is that  
25 outside basis, the very thing, as you can tell from my



1 friend's arguments on the merits, that the imposition of  
2 this penalty depends on is not a partnership item. In  
3 fact --

4 JUSTICE KAGAN: Mr. Garre, it seems as  
5 though you and the government agree on sort of the  
6 nature of this problem, right, which is you have a  
7 partnership item, which is the sham determination. That  
8 leads to an adjustment in outside basis which, as you  
9 just said, is not a partnership item, is instead an  
10 affected item; and that leads to a penalty, right?

11 So there's kind of three things, two steps  
12 in the process. And you say, well, that's not enough,  
13 essentially, because the penalty has to directly relate  
14 to a partnership item. And they say it is enough  
15 because it's okay if it indirectly relates to the  
16 partnership item.

17 And I guess the question is, in some sense,  
18 you're both adding adjectives to the statute. You add  
19 directly, they add indirectly. How do we pick between  
20 those?

21 MR. GARRE: Well, I think the government is  
22 asking the Court to add a great deal more than that.  
23 Just to go to the statutory text, with the provision at  
24 6226, and it's on page 2A of the red brief, and what  
25 that says is that first it gives the court jurisdiction

1 to determine all partnership items. Everybody agrees  
2 that outside basis is not a partnership item.

3 And then it gives jurisdiction to the court  
4 to determine penalties that relate to partnership items.  
5 And what -- and what the government is asking this Court  
6 to do is, essentially, to read this to say that relates  
7 to partnership items or that relates to non-partnership  
8 affected items, like outside basis.

9 And the reason why the Court shouldn't do  
10 that is, first, in a scheme that divides the world into  
11 partnership items that can be determined at the  
12 partnership level and non-partnership items that must go  
13 to the partner level, when Congress says "partnership  
14 item," that's significant.

15 It -- it adds defined terms of  
16 "non-partnership item" or "affected item." It said  
17 "partnership item." So we think that it necessarily  
18 excluded non-partnership affected items here, and that's  
19 the way to read it.

20 And second, if you read the "relates to" as  
21 broadly as the government says, then it makes no sense.  
22 The partnership item here might as well say "affected  
23 item" because you're right, at some level of  
24 abstraction, you can always say that the penalty relates  
25 to the partnership item. That's going to be true for

1 lots of these.

2 JUSTICE SCALIA: But it doesn't just say  
3 partnership items. Yes, "A court in which jurisdiction  
4 a petition is filed shall have jurisdiction to determine  
5 all partnership items." But then it goes on, "The  
6 proper allocation of such items among the partners and  
7 the applicability of any penalty, addition to tax, or  
8 additional amount which relates to an adjustment to a  
9 partnership item."

10 MR. GARRE: You're right, Justice Scalia,  
11 and --

12 JUSTICE SCALIA: What -- what can that  
13 possibly mean when you're talking about the  
14 applicability of any penalty?

15 MR. GARRE: Well, let me tell you,  
16 Justice Scalia --

17 JUSTICE SCALIA: That penalty is going to be  
18 applicable at the partner stage.

19 MR. GARRE: Justice Scalia, let me answer it  
20 this way: Partnerships can do many things, just like  
21 individuals and corporations, and they can engage in  
22 things that subject -- that trigger penalties. A  
23 partnership can misreport its income. A partnership can  
24 make a valuation misstatement. A partnership can engage  
25 in negligence, and the court can determine those -- the

1 applicability of those penalties.

2 Now, it's true that, down the road, in -- in  
3 a mathematical adjustment, the court is looking to  
4 whether or not the partner repeated that error on its  
5 return. But what's fundamentally different about this  
6 case is the penalty depends not on the partnership, just  
7 the partnership item; it depends on this outside basis  
8 determination that a court can't make. I mean, to put  
9 it another way --

10 JUSTICE KENNEDY: Well, are there cases in  
11 which the partnership is liable for a penalty?

12 MR. GARRE: Ultimately, Your Honor, the  
13 partner --

14 JUSTICE KENNEDY: I mean, I understand it's  
15 all passed through and so forth, But suppose the  
16 partnership does something that's a sham, that's a  
17 fraud, and then -- and -- and files a partnership  
18 information return with that -- with that information,  
19 but then the partners find out, either because of a  
20 ruling of the court that it's void or because they have  
21 second thoughts that they're not going to do that, so  
22 they change their individual -- they change their --  
23 their own tax return.

24 Could there be any penalty against the  
25 partnership in that instance?

1 MR. GARRE: Your Honor, the partners don't  
2 actually -- the partnership does not pay the penalty,  
3 but the partner -- the partnership --

4 JUSTICE KENNEDY: Would there be any penalty  
5 against the partners in that instance that I put?

6 MR. GARRE: No, I don't believe so, but the  
7 partnership --

8 JUSTICE KENNEDY: Would there be criminal  
9 liability for filing a false information return?

10 MR. GARRE: I mean, ultimately, I think that  
11 would trickle down to the partners. But, Your Honor, I  
12 think there are two different schemes here. One is  
13 where the partnership is doing things that actually does  
14 trigger the penalty. Take the 2010 noneconomic  
15 substance transaction.

16 JUSTICE KENNEDY: But then -- then that --  
17 that just fortifies the point that Justice Scalia made,  
18 that applicability of the penalty, it's -- it's  
19 always going to relate to the partners.

20 MR. GARRE: Yes and no, Your Honor. Yes, in  
21 the sense that, ultimately, what you're looking in the  
22 proper proceeding is to determine whether or not the  
23 partner repeated the error that's on the partnership  
24 return, but you can say, at the partnership level, that  
25 a penalty is -- is applicable because everything is

1 complete. All the elements can be determined. The  
2 partnership has misreported its income.

3 In this case, you just can't say that  
4 because outside basis isn't reported anywhere at all on  
5 the partnership --

6 JUSTICE BREYER: So what?

7 JUSTICE SCALIA: So what?

8 JUSTICE BREYER: So what? That is, I mean,  
9 as I understand it, you agree that, on the partnership  
10 level, the IRS could say the following in a  
11 hypothetical, I'll now give you. The partnership says  
12 that this asset has a basis of \$10 million. We sold it  
13 for 8. Therefore, the partnership has a loss of 2. The  
14 IRS says the real value is not \$10 million basis, it was  
15 a \$2 million basis, and therefore, in fact, you don't  
16 have a loss of 2, you have a gain of 8.

17 Moreover, your understatement was more than  
18 400 percent or whatever the percent is -- you know, it  
19 was a -- it was huge. It was an \$8 million -- you know,  
20 overstatement and, therefore, penalties of 400 percent  
21 attach. Okay? You agree they can say that.

22 MR. GARRE: At the partnership level --

23 JUSTICE BREYER: Yes.

24 MR. GARRE: -- because you're talking  
25 about --

1 JUSTICE BREYER: At the -- right correct.

2 MR. GARRE: -- inside basis, not outside  
3 basis, correct.

4 JUSTICE BREYER: Okay. I understand you're  
5 making this, but what they've actually done there, since  
6 it doesn't say anything about inside/outside, is they're  
7 saying, partners, to the extent that you use this on  
8 your own return, remember, there's a 400 percent penalty  
9 attached. Okay. You agree they can do that.

10 Now, what they've done here is they've said,  
11 there is no partnership. So to the extent that you use  
12 this as your -- as a basis, as you use this on your  
13 individual return, remember there's a 400 percent  
14 penalty attached because 4 times zero or whatever it is,  
15 you understand the mathematics.

16 So we haven't got any reference to  
17 inside/outside basis here. In both cases, it seems to  
18 me they're doing roughly the same thing. And so where  
19 in the statute does it say they can't do it? They're  
20 saying, indeed, a penalty attaches to --

21 MR. GARRE: Your Honor, I think --

22 JUSTICE BREYER: -- the use of this  
23 partnership by you, the partner, to reduce your taxes.

24 MR. GARRE: And --

25 JUSTICE BREYER: Now, to the extent you

1 don't use it, of course, you don't have to pay anything,  
2 but to the extent you use it, you have to pay whatever  
3 it is, plus the 400 percent.

4 MR. GARRE: What the court in doing -- what  
5 the court is doing in both of those situations is  
6 fundamentally different. In one case, it's looking at  
7 the partnership return, looking at how the partnership  
8 reported the basis and determining that the basis  
9 overstatement penalty would apply because of the error  
10 committed by the partnership.

11 That is everything that we think the court  
12 can do under the statutory provision we just referred  
13 to, to determine the applicability of that penalty  
14 because it relates to a partnership item, the  
15 partnership's statement of its income or basis on the  
16 partnership return.

17 Now, what's happening here is the partner --  
18 the penalty is applying to the partner's statement of  
19 basis. That outside basis doesn't appear anywhere.

20 JUSTICE BREYER: So then the question is --  
21 the question is do the words "partnership item" in the  
22 section "scope of judicial review" refer only to those  
23 items that the partnership in fact is concerned with?  
24 Or do they consider the partnership itself?

25 MR. GARRE: Right. And the three --



1 JUSTICE BREYER: That's the issue. Okay.

2 MR. GARRE: And the three circuit courts  
3 that have addressed that have agreed with us. And as  
4 Justice --

5 JUSTICE BREYER: We're interpreting the word  
6 "partnership items" in that statute, and you are saying  
7 the partnership itself is not a partnership item.

8 MR. GARRE: No, not at all, Your Honor.

9 JUSTICE BREYER: What? No?

10 MR. GARRE: What we're saying is outside  
11 basis is not a partnership item.

12 JUSTICE BREYER: Oh, no, no, But I'm --  
13 that's just a question of how they use it on the return.  
14 There are many ways in which a person could use a  
15 partnership item on the return. If this is a  
16 partnership item -- I mean, a person might, for example,  
17 have no tax, in which case --

18 MR. GARRE: Your Honor, I think that the  
19 confusion maybe is between the statement at issue here.  
20 The statement at issue in this case is the basis that  
21 the partners reported on their individual returns as a  
22 result of these transactions.

23 If you go to the partnership return and go  
24 to page 169 of the Joint Appendix, and it may be  
25 difficult to find now because of these fold-outs, but

1 you'll find what the partnership reported, and it  
2 reported all of the transactions at issue, and it  
3 reported accurately --

4 JUSTICE BREYER: I understand how someone  
5 could be confused, and I am genuinely confused. I have  
6 read this several times.

7 MR. GARRE: Right, and --

8 JUSTICE BREYER: And the reason I'm confused  
9 is this: That I -- I understand your difference between  
10 the outside basis and the inside basis. Now, what I'm  
11 trying to do is to figure out, via the statute, I think  
12 like what Justice Scalia was trying to do, I think,  
13 where does that matter?

14 MR. GARRE: Well, it matters in the scope of  
15 jurisdiction, Your Honor. And again --

16 JUSTICE BREYER: No, I understand that, too.  
17 I'm just trying to get the precise words of the statute  
18 that it would make a difference because, in common  
19 sense, it doesn't seem to me to make much difference,  
20 but -- but maybe in this statutory language it does, so  
21 I want to know what words.

22 MR. GARRE: The words that matter is  
23 "partnership item." This is a statutory scheme that --  
24 that talks about non-partnership items and partnership  
25 items.

1 JUSTICE BREYER: Okay. Now, you just told  
2 me. I said that, I thought, and you said, no, it  
3 didn't, those weren't the right words. But if you say  
4 those are the right words, then explain to me why a  
5 partnership item cannot include a partnership itself.

6 MR. GARRE: The partnership item, Your  
7 Honor, can include the partnership. We're not -- we're  
8 not disputing that part of the sham determination. My  
9 point is that the imposition of the penalty depends on  
10 an additional determination, which is a non-partnership  
11 item. And the Court --

12 JUSTICE KAGAN: And in that sense,  
13 Mr. Garre, it strikes me as wrong to say the words in  
14 dispute are "partnership item." Actually, everybody  
15 agrees what "partnership item" means, what it includes,  
16 and what it doesn't include. It doesn't include outside  
17 basis. The government is perfectly happy to concede  
18 that.

19 It seems as though the words in dispute are  
20 what does "relate to" mean and does "relate to" have to  
21 be "relate to" in this very direct way that excludes  
22 this intermediate step of adjusting outside basis.

23 MR. GARRE: Right. And the reason why --  
24 and I think that gets back to partnership item because,  
25 if you read "relates to" in the broad sense that the

1 government is asking you to read it, then, in essence,  
2 you are adding -- you're taking away the limitation of  
3 "partnership item," and you are adding words that says  
4 "or affected item," because what they're saying is,  
5 look, anytime you have a partnership item that is in any  
6 way related to the imposition of a penalty down the  
7 road, then you can do it.

8 But another way of saying that, and the way  
9 that Congress would have said if it meant it was,  
10 courts, you can determine the applicability of any  
11 penalty that relates to a partnership item or an  
12 affected item. But Congress didn't say that.

13 JUSTICE SCALIA: But it is in addition to  
14 partnership item. You say, oh, you can't do that  
15 because it would add to partnership items. But the  
16 statute does not say "just partnership item." It says  
17 "partnership items, the proper allocation of such items,  
18 and the applicability of any penalty, addition to tax,  
19 or additional amount."

20 MR. GARRE: Right.

21 JUSTICE SCALIA: It's in addition to  
22 partnership items.

23 MR. GARRE: Now --

24 JUSTICE SCALIA: And -- and it's -- it seems  
25 to me, not enough to say, well, if you interpret that

1 third part to go beyond partnership items, you're  
2 destroying the statute. I don't think so.

3 MR. GARRE: Our point is the one that the  
4 D.C. Circuit and the other circuits have adopted, which  
5 is that to make this determination you have to go beyond  
6 the partnership item; you have to determine a  
7 non-partnership item, and this grant of jurisdiction --

8 JUSTICE SCALIA: When would you not have to  
9 do that, if you are applying the third item, "the  
10 applicability of any penalty, addition to tax, or  
11 additional amount which relates to adjustment to a  
12 partnership"?

13 MR. GARRE: Again --

14 JUSTICE SCALIA: That will always require  
15 you to go down to the partner level.

16 MR. GARRE: No. When the penalty is -- is  
17 complete based on what the partnership has done, you can  
18 determine the applicability of the penalty. You can say  
19 all of the elements are met because of what the  
20 partnership did. And then, later, you're only looking  
21 to whether or not the partners repeated that error.  
22 Here, that's not -- that's not what's happening.

23 JUSTICE GINSBURG: Mr. Garre, suppose the  
24 government had asserted this penalty under sub (6), or  
25 the transaction lacking economic substance. Would you

1 be -- would you say it doesn't make any difference, it's  
2 the same? Or would you say that, under (6), your  
3 argument is not applicable to that and the determination  
4 could be made at the partnership level?

5 MR. GARRE: We would, Your Honor. The  
6 noneconomic substance penalty that Congress passed to  
7 cover this situation here solves all the problems. As  
8 to jurisdiction, courts could determine it at the  
9 partnership level because looking to whether or not the  
10 partnership is a sham is a partnership item.

11 And so courts have jurisdiction to do that.  
12 And of course, that solves the merits question, too,  
13 because Congress actually addressed the situation here  
14 on the merits. Instead, we have the government trying  
15 to fit a square peg into a round hole.

16 I mean, on jurisdiction, before I go to the  
17 merits, I just want to talk about the practical  
18 consequences of this ruling. It's very significant from  
19 the standpoint of the taxpayers. What the government  
20 wants to do is funnel all of these penalty determinations  
21 into a computational adjustment, as opposed to the  
22 deficiency proceeding, which is the default rule under the  
23 statute, Section 6230.

24 And from the taxpayers' perspective, that  
25 has huge consequence. It means that the taxpayers have

1 to pay the refund up front, as Justice Sotomayor  
2 recognized. That means that, even in disputed  
3 penalties, they've got to pay all that up front, and  
4 then that limits their ability to challenge it. It  
5 means they can't go to the Tax Court to challenge it.  
6 They have to do it in a more expedited fashion.

7 The default rule is deficiency proceedings.  
8 That is where Congress intended these penalty issues of  
9 the type that we have here that pertain to  
10 non-partnership items --

11 JUSTICE SOTOMAYOR: Let me ask you  
12 something. There's no reason to go into a sham  
13 transaction, except to misstate the outside basis in the  
14 individual partnership level, so I -- it's low-hanging  
15 fruit, according to the D.C. court. But why shouldn't  
16 you be able to pick it?

17 MR. GARRE: Well --

18 JUSTICE SOTOMAYOR: I mean, it's sort of  
19 obvious, just as it's obvious that, if a partnership  
20 item has a miscalculation that the partner is going to  
21 include it in their tax return later. That's why we  
22 permit the penalty to be imposed up front and to pay the  
23 tax up front because you're making an assumption that  
24 it's been included erroneously on the partner level.

25 MR. GARRE: And I think what you would

1 be doing is assuming a fact necessary to the penalty,  
2 that outside basis was reported as zero, for purposes of  
3 finding jurisdiction, and we don't think the court could  
4 do that.

5 The government acknowledges that it -- that  
6 it's at least possible that the taxpayer, in a fit of  
7 conscience or having fully -- more fully understood the  
8 transactions, would not inflate its basis, it would  
9 report a zero basis, and yet nobody would know that, in  
10 a partnership-level proceeding, because the partners'  
11 outside basis isn't even before the court -- before the  
12 IRS or the court in that proceeding.

13 JUSTICE BREYER: Try with me again. Again,  
14 just try once more. Suppose that a person owes a gift  
15 tax and what he gave to his children or whatever was in  
16 part an interest in a partnership. Now, go back to my  
17 example, all right, because I want to get -- my example  
18 is everybody agrees that the 8, 10 million versus 8  
19 million, there's a penalty attached. Well, he -- he  
20 doesn't take that into account when he gives the gift.

21 Now, if he did give the gift, it would --  
22 he'd have to pay a tax on the gift, on his gift tax  
23 return. Okay? He -- they assess that on the -- they  
24 would assess that, wouldn't they, even though it's a  
25 gift tax return, not an -- not an income tax return.



1 MR. GARRE. Right. I mean, ultimately --

2 JUSTICE BREYER: Okay. So no matter what  
3 kind of return you use, no matter what the tax  
4 situation, if the partnership real -- real value makes a  
5 difference, you have to put it in, don't you?

6 MR. GARRE: In the individual return.

7 JUSTICE BREYER: Yes, yes, in individual  
8 gift tax return. Maybe it's in a State tax return.  
9 Maybe it's an income tax return.

10 MR. GARRE: You do, but the partner --

11 JUSTICE BREYER: So it affects the taxpayer  
12 differently, and I'm just saying, why does it matter?

13 MR. GARRE: Every --

14 JUSTICE BREYER: -- that the way this  
15 affects the taxpayer is through what you call his  
16 outside basis. Why does that matter?

17 MR. GARRE: Well, Your Honor, every  
18 partner's outside basis is going to vary in the typical  
19 situation.

20 JUSTICE BREYER: Yes, yes. But of  
21 course, any -- in my example, too, it will vary. Of  
22 course, it will vary. Some people will use -- have no  
23 tax to pay, no extra tax, because their -- their income  
24 tax that they paid was zero. In fact, the government  
25 owed them a refund, so it didn't matter. It varies in

1 many ways.

2 So since it varies in many ways and varies  
3 by many returns, it might vary depending upon whether it  
4 affected your outside basis or something else.

5 MR. GARRE: And the fact that it can vary,  
6 Your Honor, is one of the reasons why Congress wanted  
7 these determinations made at the partner level.

8 And another thing on the jurisdictional  
9 question. I don't think the Court could resolve this  
10 question looking only to the sham partnership situation  
11 here. Sometimes, transactions are shams; sometimes,  
12 partnerships are shammed. And the jurisdictional question  
13 or answer to the question should apply across the board.

14 And yet, if you have a situation where you  
15 have only a transaction shammed, then even the government  
16 would have to acknowledge that basis could be affected  
17 in many different ways in that situation. And, again,  
18 getting back --

19 JUSTICE SCALIA: Couldn't the government  
20 have pursued this, instead of saying -- you know, it's a  
21 sham partnership, just -- just -- couldn't the  
22 government simply have said that the partnership  
23 overstated its basis?

24 MR. GARRE: It couldn't because -- and it  
25 didn't because, again, if you go back to page 186 -- 169

1 of the Joint Appendix, everything about these  
2 transactions is accurately reported on that form which  
3 is in the partnership return. The partnership actually  
4 reported a gain on these transactions.

5 The error comes in at the partner level and  
6 is only on the partner return in this situation. And  
7 that's why you can't determine outside basis at the  
8 partnership level, and that's why you can't determine  
9 the applicability of this penalty at the partnership  
10 level.

11 JUSTICE SCALIA: Now, I have a second  
12 question, which I asked your friend as well. Is he  
13 correct that, if we rule for you, each partner may have  
14 a different result because different courts will find  
15 this to be a sham or not to be a sham?

16 MR. GARRE: No, no, Your Honor, in this  
17 sense, if this Court resolves the merits question, then  
18 that -- that ruling whether the penalty applies or not  
19 in this context is going to apply to all partners. So  
20 that -- that issue is not going to vary by partner.

21 What can happen by partner is different  
22 partners may have different outside basis. Even in this  
23 situation, my friend acknowledged you could have a  
24 partner that, nevertheless, reports zero as his basis in  
25 this situation and not the inflated basis

1 JUSTICE SCALIA: Well, but why -- why  
2 wouldn't -- couldn't one court say I don't think it's a  
3 sham partnership?

4 MR. GARRE: Well, that determination, Your  
5 Honor, is being made at the partnership level, and we  
6 agree that it can be made at that level, and that  
7 determination applies to all the partners. There is no  
8 inconsistency about that.

9 The only question here is whether the -- the  
10 partnership level court can determine the applicability  
11 of the -- the basis misstatement penalty as the  
12 government calls it. And -- and it doesn't have  
13 jurisdiction to do that because it depends on that  
14 outside basis to do it.

15 JUSTICE KAGAN: But I think that --

16 CHIEF JUSTICE ROBERTS: You say that -- you  
17 say that that's not true because individual partners may  
18 respond differently to the partnership determination  
19 with respect to basis.

20 MR. GARRE: Yes.

21 CHIEF JUSTICE ROBERTS: Some of them are  
22 going to put in something else, but somebody may put in  
23 zero for a number of the reasons that the IRS's counsel  
24 suggested.

25 MR. GARRE: Yes.

1 CHIEF JUSTICE ROBERTS: And now, I suspect  
2 that those will be only in rare circumstances, and I  
3 guess that's why the D.C. Circuit said, even though the  
4 result here may be obvious, it nonetheless depends on  
5 the outside basis determination.

6 MR. GARRE: Exactly.

7 CHIEF JUSTICE ROBERTS: And I think what I  
8 understand your friend to be saying is it's not just  
9 that it's obvious, but it's ineluctable, and therefore,  
10 it doesn't depend on the outside partnership  
11 determinations.

12 So does your case hinge on the perhaps  
13 unusual situations where you have one of these partners  
14 having a fit of conscience and decides to put down the  
15 real number or has some other adjustment to it?

16 MR. GARRE: I -- I think largely, yes, but  
17 if I can explain that. First, that presents the  
18 low-hanging fruit situation the D.C. Circuit resolved.  
19 And we think they were right to say, even if you think  
20 it's low hanging, you're forbidden to pick it.

21 Second, here, the whole partnership is  
22 shammed, but there's certainly cases where individual  
23 transactions are shammed. And if individual  
24 transactions are shammed, then the -- the outside basis  
25 can vary widely based on the individual circumstances of

1 the partners.

2 And so there, in that situation, it's not at  
3 all obvious or -- or necessarily true that the basis is  
4 going to be overstated. You have to look. And, again,  
5 that's why it's a completely separate  
6 determination made -- partner level.

7 JUSTICE SOTOMAYOR: Could you give me a  
8 concrete example? Because I'm not quite sure about what  
9 you're talking about.

10 MR. GARRE: Well, you could have a  
11 partnership, Your Honor, that engages in many  
12 transactions. And the IRS would determine that one of  
13 the many transactions that it entered into was a sham.  
14 That particular transaction was only designed for tax  
15 purposes, but other transactions that it engaged in were  
16 legitimate.

17 Now, in this case, the IRS is saying that  
18 the whole -- everything the partnership did is a sham.  
19 But in my case, some transactions are okay, some are  
20 different. In that case, the individual partners'  
21 outside basis, they may have -- they may have tried to  
22 take advantage of the sham transaction, but yet, all the  
23 other transactions affect their basis as well in the  
24 partnership.

25 JUSTICE SOTOMAYOR: I'm -- I'm a little

1 confused on this example. Presumably, it's only if they  
2 carried forward, which we're assuming they would have  
3 done, carried forward the outside basis, the penalty  
4 would have been determined just on that one transaction.

5 MR. GARRE: No, because, Your Honor, again,  
6 the penalty is based on what the individual partner  
7 claims as his basis, and that partner is going to be  
8 looking to everything that goes into his partnership  
9 interest, the costs or investment in the partnership,  
10 pertaining not only to the one transaction that we have  
11 hypothesized has been shammed, but many other  
12 transactions as well.

13 So you -- you can't conclude either that  
14 there's been any misstatement or that any misstatement  
15 triggers the valuation misstatement penalty here.

16 If I could talk a little bit about the  
17 merits, on the merits, our fundamental question is that  
18 the valuation misstatement penalty that Congress devised  
19 in 1981 was not intended at all to apply to the  
20 fundamentally different situation here where the  
21 government is claiming not that you misstated the  
22 correct amount of the value or that you didn't have an  
23 accurate amount of the value or the number that you put  
24 for basis or value, but that the thing that's the  
25 subject of the valuation or the basis doesn't exist at

1 all.

2 I mean, we know if you look at the -- the  
3 pre-enactment history, the post-enactment history, we  
4 know that this is not what Congress had in mind. If you  
5 look at the pre-enactment history, it's all about  
6 resolving a problem of a backlog of cases where  
7 taxpayers were misvaluing property and the tax would --

8 JUSTICE KAGAN: Well, that was the  
9 prototypical case, Mr. Garre. There's no question that  
10 that's the central case that -- that Congress had in  
11 mind, but it doesn't have to be the only case.

12 And they wrote words that seem to be  
13 applicable to this case, as well as to the kind of case  
14 that you're talking about.

15 MR. GARRE: Your Honor, they have basis, and  
16 we have context, punctuation, pre-enactment history,  
17 post-enactment history, and structure.

18 JUSTICE KAGAN: I'm sorry. You're saying  
19 they have text, and you have a bunch of other things.

20 (Laughter.)

21 MR. GARRE: No, not at all, Your Honor,  
22 because this is a valuation misstatement penalty. The  
23 reference to "or adjusted basis" comes in a  
24 parenthetical, subordinate way.

25 And let me give you a hypothetical. One of



1 my associates came up with a good example, I think. If  
2 you had a contract for a wedding that provided for  
3 flowers or plants in parentheses, you would -- you would  
4 understand that to mean flowers or plants like -- like  
5 lilies or ferns that would accompany flowers in the  
6 wedding. You wouldn't read that to include an oak tree  
7 in the middle of the reception area.

8 Well, the government's basis overstatement  
9 penalty is the oak tree in the middle of the reception  
10 area here. The most common situation in which basis  
11 misstatements are made, the government acknowledges  
12 throughout its brief, is where you misstate the price or  
13 cost of a good. And yet, they're moving -- which is --  
14 which is why the reference to adjusted basis makes sense  
15 in the statutory scheme here. It covers that situation.

16 But -- but they're saying, you don't need  
17 to -- it goes far beyond that, not only to the prosaic  
18 situation as they call it, but to a situation where  
19 you're not complaining about whether the thing -- what  
20 the correct number is or what the correct amount is.  
21 You're saying the thing doesn't exist at all.

22 I mean, if I donate a painting that I say is  
23 worth \$1 million to a church, and I put that on my  
24 return, but, in fact, it turns out that I didn't donate  
25 the painting, I may have committed a fraud. I may have

1    lied about contributing the painting, but I haven't made  
2    a valuation misstatement, nor have I misstated my basis.

3           And I think our -- our position is here  
4    that, if you look at everything, as I mentioned, the  
5    words of the statute, the context in which a basis is --  
6    appears, the structure, there's a graduated scheme that  
7    makes no sense with a zero basis situation, which is  
8    essentially a nullity.

9           If you look at the fact that Congress  
10   addressed this in 2010, not by amending the valuation  
11   misstatement penalty, but by enacting a penalty designed  
12   to apply to this situation, the noneconomic transaction  
13   situation.

14           JUSTICE GINSBURG:            So just to be clear, if  
15   this is -- 6 had been on the books, then you would have  
16   no quarrel with the government's position, they could do  
17   this at the partnership level and --

18           MR. GARRE:                    Yes, absolutely. That's the way  
19   Congress designed it. And unless --

20           JUSTICE SCALIA:             I didn't get the question.  
21   If -- if what was --

22           MR. GARRE:                    If the noneconomic substance  
23   transaction penalty that was enacted in 2010 was on the  
24   books, what would happen is a court could determine the  
25   applicability of that penalty, which is based on what

1 the partnership did at the partnership proceeding, and  
2 we would agree that penalty applies.

3 All the problems are solved by what Congress  
4 did to address this particular situation. The  
5 government is trying to put that square peg in a round  
6 hole.

7 And if you add everything up, I think  
8 what's -- what's interesting about the government's  
9 reply brief is it doesn't contest that -- that if  
10 there's any ambiguity here, the statute has to be read  
11 in favor of the taxpayer. And that's because of the  
12 canon that this Court has recognized that tax penalties  
13 are strictly construed in favor of the taxpayer.

14 Here, at a bare minimum, there is ambiguity  
15 as to whether the Congress that passed the valuation  
16 misstatement penalty ever intended it to apply to this  
17 fundamentally different situation where no one disagrees  
18 about the numbers reported on the return.

19 Again, if you go to the partnership return,  
20 the transactions are accurately reported. If you go to  
21 the outside basis, it's true that they reported a loss,  
22 but that's because they were following the IRS' rules  
23 about how you treat contingent liabilities. So that  
24 number is actually accurate under the IRS' rules.

25 That's why the IRS has to come up with a

1 sham to get rid of the property altogether and say that  
2 we are going to pretend that it doesn't exist at all.

3 But, again, that's not a valuation  
4 misstatement. When the penalty talks about correct  
5 amounts, about accuracy, about value, it's trying to get  
6 at the number that the thing is worth. It is not  
7 concerned with a situation in which the IRS is claiming  
8 that the property doesn't exist at all.

9 That -- that is a different problem.  
10 Congress addressed it in a direct way, in a noneconomic  
11 substance penalty. So this Court doesn't have to worry  
12 about this problem being unaddressed.

13 But what it should do is correctly interpret  
14 the penalty that Congress enacted, which was on the  
15 books when these events occurred, which is the valuation  
16 misstatement penalty it is not the all-encompassing basis  
17 overstatement penalty.

18 I think, if you're going to read one of the  
19 amicus briefs, read the Shakow amicus brief. It talks  
20 about all the additional situations, which IRS or  
21 Congress never applied this penalty to which would be  
22 swept in by the government's position here today.

23 Thank you very much.

24 CHIEF JUSTICE ROBERTS: Thank you, counsel.

25 Mr. Stewart, you have five minutes left.

1 REBUTTAL ARGUMENT OF MALCOLM L. STEWART

2 ON BEHALF OF THE PETITIONER

3 MR. STEWART: Mr. Chief Justice.

4 Justice Kagan, I agree with your point that,  
5 on the jurisdictional issue, the crucial contested  
6 language is "relates to," and the issue is whether the  
7 basis overstatement penalty here relates to the sham --

8 JUSTICE BREYER: How does it not?

9 "Partnership items" is defined to include legal and  
10 factual determinations that underlie the determination,  
11 among other things, of income, credit, gain/loss.

12 Okay. Whether there is a partnership at all  
13 does underlie the determination of whether the  
14 partnership return, which had all kinds of numbers on  
15 it, if it shows anything.

16 MR. STEWART: That's correct.

17 JUSTICE BREYER: All right. So therefore,  
18 it's a partnership item. Does this penalty relate to a  
19 partnership item? I don't want to say that you are  
20 right for the wrong reasons, so you better be sure I'm  
21 right.

22 That is, the -- the -- does it relate to a  
23 partnership item? I just told you what a partnership  
24 item was. It certainly seems to because zero is what it  
25 relates to.

1 MR. STEWART: I mean --

2 JUSTICE BREYER: End of case?

3 CHIEF JUSTICE ROBERTS: Perhaps --

4 JUSTICE BREYER: It can't be that simple.

5 We have three courts here --

6 CHIEF JUSTICE ROBERTS: Let me -- let me  
7 pose perhaps a less friendly question.

8 (Laughter.)

9 CHIEF JUSTICE ROBERTS: What do you do with  
10 your friend's hypothetical? On the tax returns, you  
11 say, I gave a painting to a charity worth a million  
12 dollars. And in fact, he did not.

13 And he says, what you are doing is you are  
14 going to go in and say, That wasn't worth a million  
15 dollars; it was worth nothing, when, in fact, what you  
16 should be saying is, You didn't give the painting at  
17 all.

18 MR. STEWART: I think this is a different  
19 situation because the IRS did not determine that the  
20 underlying transactions, the purchases and sale of  
21 currency options and so forth, didn't occur. It  
22 determined that the partnerships were shams. And I  
23 think that this is an important point.

24 CHIEF JUSTICE ROBERTS: Well -- but if you  
25 determine that the partnerships were shams, that's like

1 saying that there were no partnerships.

2 MR. STEWART: There were no partnerships --

3 CHIEF JUSTICE ROBERTS: And if you  
4 say -- you know, I didn't really give the painting, that  
5 means that there wasn't any painting. It seems to me  
6 they're pretty closely parallel.

7 MR. STEWART: But what the FPAA also said  
8 was, because there were no partnerships, the  
9 transactions should be treated as though they had --  
10 were engaged in by the individual partners.

11 JUSTICE KENNEDY: Maybe it was a frame with  
12 a blank canvas.

13 MR. STEWART: Well -- and I -- and I think,  
14 as -- as I was starting to say at the close of my  
15 opening argument, it's no accident that partnerships  
16 were used to effectuate this scheme because, if the  
17 individuals had bought and sold the offsetting foreign  
18 currency options, they would have had no colorable  
19 rationale for contending that they were entitled to a  
20 deduction for the cost of the long option, but they were  
21 not required to treat as income the amount they received  
22 from the short option.

23 It would have been absolutely clear that the  
24 transaction, taken as a whole, was a wash. The only way  
25 that they could try to create the appearance of a paper

1 loss was by manipulating the rules that govern the  
2 computation of basis in partnerships. And so the  
3 shamming determination, in effect, was a determination  
4 that, for tax purposes, you can't try to take advantage  
5 of the Helmer rule that says that, for computing basis  
6 in a partnership, we will ignore the -- the contingent  
7 liability created by the short option.

8 The -- the one thing -- other thing I would  
9 say on the merits as to why we care about this case is  
10 that Respondent's argument doesn't just go to -- on --  
11 on Subsection 3, doesn't just go to basis overstatements  
12 that are produced through sham transactions. It goes to  
13 all basis overstatements that are produced through legal  
14 errors. And I think that --

15 CHIEF JUSTICE ROBERTS: Do you -- do you  
16 agree that the new legislation completely resolves this  
17 problem?

18 MR. STEWART: It completely resolves the  
19 specific problem posed by this -- almost completely  
20 resolves the specific problem.

21 Subsection 6 undoubtedly would cover this  
22 case. Now, Subsection 6, the trigger for having a  
23 40 percent penalty, rather than a 20 percent penalty is  
24 slightly different. Under Subsection 6, you are -- if  
25 you disclose the relevant information on your tax



1 return, then even if it's later determined that the  
2 transaction lacked economic substance, you would be  
3 subject only to the 20 percent penalty.

4 Under Subsection 3, you can get the  
5 40 percent if the overstatement is 400 percent or more  
6 regardless of disclosure. But it almost completely  
7 covers it. But other -- other --

8 JUSTICE SOTOMAYOR: Could you -- could you  
9 go back just one moment to the practical point that your  
10 brother made? Is this issue only about whether you  
11 collect the tax beforehand or after? Because he says  
12 that they are bound in a partner-level proceeding to the  
13 finding that the outside basis was -- benefit was  
14 claimed in the partnership level it was zero.

15 MR. STEWART: With respect to jurisdiction,  
16 the question simply goes to the allocation of  
17 responsibilities between the partnership-level court and  
18 the partner-level court.

19 Now, when he says we are trying to avoid  
20 deficiency proceedings, I -- I think it ignores the fact  
21 that, under our reading, the important legal objections  
22 that Respondent has made to the penalty, namely the arguments  
23 that are set forth in Part 2 of their brief, can resolve -  
24 under our theory, can be resolved at the partnership level  
25 without prepayment of penalties.

1 CHIEF JUSTICE ROBERTS: Thank you, counsel.

2 The case is submitted.

3 (Whereupon, at 11:03 a.m., the case in the  
4 above-entitled matter was submitted.)

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