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IN THE SUPREME COURT OF THE UNITED STATES

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UNITED STATES, :

Petitioner : No. 12-562

v. :

GARY WOODS, AS TAX MATTERS PARTNER:

OF TESORO DRIVE PARTNERS, ET AL. :

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Washington, D.C.

Wednesday, October 9, 2013

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

APPEARANCES:

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

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

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P R O C E E D I N G S

(10:03 a.m.)

CHIEF JUSTICE ROBERTS: We will hear argument first this morning in Case 12-562, United States v. Woods. Mr. Stewart?

ORAL ARGUMENT OF MALCOLM L. STEWART

ON BEHALF OF THE PETITIONER

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

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

I'd like to begin with the jurisdictional question. And before I focus the Court's attention on the text, I'd like to make two quick preliminary observations about jurisdiction. The first is that the question we say is appropriate for resolution in partnership level proceedings is not whether any individual partner will actually be made to pay the penalty. There's no question in this case that the determination whether the penalty will actually be

1 imposed on individual partners, and if so, in what
2 amount is properly reserved for partner level
3 proceedings.

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

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

18 MR. STEWART: There are two separate
19 questions here. The first is: What can be determined
20 at the partnership level? And once the partnership
21 level proceedings are complete, there are subsidiary
22 partner level proceedings. And some partner level
23 proceedings require a deficiency notice, some partner
24 level proceedings do not.

25 Now, it is part of our position that once

1 the applicability of the penalty has been determined at
2 the partnership level, the penalty can then be imposed
3 on individual partners in partner level proceedings
4 without a deficiency notice. It can still be challenged
5 through a refund proceeding. But because -- there's
6 never the imposition of additional tax or penalties on
7 the partnership itself.

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

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

22 If the Court agreed with the position that
23 we take in Part 2 of our merits brief, namely, that a
24 deduction that is claimed in connection with a
25 transaction that is later determined to be a sham can

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

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

18 And so at the partner level, there might be
19 further determinations about what -- what a relatively
20 small amount of tax the individual partners would --
21 would owe on that. And then if a partner -- if a
22 penalty were assessed on the partner, the partner would
23 have to pay the penalty before challenging it in through
24 a refund action. But -- but we might want to ask on
25 what ground could the partner want to challenge the

1 penalty at that point.

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

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

22 And that language tells us two things: It
23 tells us first that Congress didn't see any necessary
24 unfairness in requiring a partner to pay the penalty
25 first before raising certain sorts of challenges. And

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

9 JUSTICE GINSBURG: Mr. Stewart, can you
10 explain the difference in the two proceedings? First,
11 your position that the proper review is of the final
12 partnership administrative adjustment. How would the
13 penalty be adjudicated in that format, and if your -- if
14 the taxpayer is right, that the adjudication must be
15 made at the partner level proceeding, what would be the
16 difference in the character of the adjudication?

17 MR. STEWART: When we say that the
18 applicability of the penalty should be determined in the
19 partnership level proceeding, all we mean is that the
20 court in the partnership level proceeding should resolve
21 the legal issue that is addressed in Part 2 of the
22 respective briefs for the Petitioner and the Respondent.
23 That is, the court should determine is the substantial
24 valuation misstatement penalty the sort of penalty that
25 can apply to a basis overstatement that is produced

1 through a sham transaction.

2 We wouldn't ask the court in the partnership
3 level proceeding to go beyond that legal determination
4 and to ask whether individual partners had actually
5 underpaid their tax or whether they had actually
6 misstated basis. It's always theoretically possible in
7 a case like this that the partnership could be
8 determined -- that the partner could participate in sham
9 transactions, but by the time it was -- he had to file
10 his own return, he could get cold feet or he could get
11 legal advice that indicated this just isn't going to
12 work. And so it's possible that the partner could
13 prepare his return in a way that was lawful. And the
14 IRS, after the partnership level proceedings were
15 complete, would have to look at the partner return in
16 order to see what that had -- what had happened.

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

18 JUSTICE SCALIA: I was just going to ask:
19 If the question were determined of whether the sham
20 transaction counts as an erroneous statement of the
21 basis, if that were determined at the partner level and
22 not in a partnership proceeding, would it be possible to
23 have different outcomes --

24 MR. STEWART: Yes, absolutely.

25 JUSTICE SCALIA: -- with respect to

1 different partners?

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

7 JUSTICE SCALIA: And -- and you have to
8 relitigate the same issue.

9 MR. STEWART: Exactly. Under Respondent's
10 view, the IRS was not required to say anything at all in
11 the FPAA about the potential imposition of basis
12 overstatement penalties down the road. If the FPAA
13 adjustments -- the shamming determination had been
14 upheld at the partnership level, under Respondent's
15 view, the IRS could then assess penalties against
16 individual partners. And if the individual partners
17 raised an objection, the same arguments that are raised
18 in Part 2 of the Respondent's merits briefs, that would
19 have to be litigated potentially by different judges in
20 different partnership -- in different partner level
21 proceedings with potentially inconsistent outcomes.

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

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

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

20 Now -- now, one advantage of requiring the
21 IRS to make at least this sort of threshold
22 determination of penalties at the outset is that if the
23 IRS makes an adjustment to a partnership item, and the
24 IRS believes that it is the sort of adjustment that down
25 the road could trigger the imposition of penalties,

1 that's the sort of thing an individual partner would
2 want to know in deciding whether to challenge the
3 adjustment.

4 JUSTICE ALITO: Is it correct that your
5 position would allow the IRS to evade the normal statute
6 of limitations?

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

8 JUSTICE ALITO: Or deficiency? No?

9 MR. STEWART: I don't see how. I'm not sure
10 exactly what argument you're referring to. But there
11 are -- I mean, there are provisions that deal with the
12 way the limitations periods runs, depending on when the
13 partnership return is filed and when the partner returns
14 are filed. But I don't see how that would happen.
15 We -- we would still be subject in assessing penalties
16 against any individual partners to whatever limitations
17 period the code provides and either we would or would
18 not have obtained a legal ruling on -- on the legal
19 issue whether the penalties are -- are the sort that
20 could follow from this partnership item adjustment, but
21 I don't think it would have implications for the statute
22 of limitations.

23 JUSTICE GINSBURG: Using the language of the
24 statute that you just quoted, can you explain to us what
25 is the adjustment of the partnership item? That is, the

1 statute says, "Determine the applicability of any
2 penalty which relates to the adjustment of a partnership
3 item." So what is -- what was the partnership item
4 adjustment?

5 MR. STEWART: Yes, Justice Ginsburg. This
6 is on Page 6-A of the appendix to the Government's
7 brief. And the adjustment to the partnership item is
8 the shamming determination. The determination that the
9 partnerships were not engaged in for business purposes,
10 that they were engaged in purely as tax avoidance
11 measures.

12 And Respondent concedes that this is a
13 partnership item, because Respondent concedes that the
14 district court had authority to review the shamming
15 determination, decide whether that determination was
16 appropriate. And that concession necessarily depends
17 upon the proposition that the determination of the
18 partnerships are shams was an adjustment to a
19 partnership item.

20 And it makes sense for two reasons. First,
21 because the determination whether these are valid
22 partnerships necessarily underlies any other
23 determination that the IRS would make about the proper
24 tax treatment of items reported on the partnership
25 return. And second, it is the sort of determination

1 that is going to have one answer for every partner,
2 either the partnership is a sham or it's not. But it
3 can't be the case that a particular partnership is a
4 sham with respect to some partners and not others.

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

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

23 JUSTICE SCALIA: Excuse me. Why would it
24 vary from partner to partner?

25 MR. STEWART: I mean, in the -- in the more

1 typical case the outside basis would depend upon the
2 amount that a particular partner had paid for his own
3 partnership interest. And so in that situation, not
4 every partner would necessarily have -- have paid the
5 same thing. But there are fairly rare situations in
6 which in order to make some determination that is
7 specified in 6226(f), the court and the IRS along the
8 way have to determine outside basis. And one example we
9 gave on page 32 of our brief, we have a footnote that
10 says, it's not implicated here, but outside basis is
11 sometimes a component of a partnership item such as
12 inside basis. And we cite a case that was ultimately
13 decided by this Court, but it's a case in which a
14 partnership took advantage of code proceedings that said
15 you can step up your inside basis to max the outside
16 bases of your partner, partners.

17 JUSTICE KENNEDY: Well, isn't it your
18 position in this case that outside basis in this case is
19 necessarily related to inside basis?

20 MR. STEWART: I think -- I think --

21 JUSTICE KENNEDY: Or am I misstating that.

22 MR. STEWART: I think what we are saying is
23 in order to determine whether the substantial valuation
24 misstatement penalty would be triggered down the road,
25 the IRS and the Court would have to make certain --

1 would have to decide what is the proper outside basis in
2 a sham partnership.

3 If a lawyer were asked for -- if a lawyer
4 saw an adjustment that said we regard these partnerships
5 as shams, and the lawyer were asked, does that mean that
6 I could be subject to the substantial valuation
7 misstatement penalty if I reported deductions on
8 purported losses from that partnership, the only way the
9 lawyer would answer that question is to ask: Well,
10 what's true basis in a sham partnership?

11 JUSTICE KENNEDY: But -- but if we were to
12 write an opinion which says -- an opinion ruling in your
13 favor, that in this case outside basis is necessarily
14 related to inside basis in this transaction, you would
15 say that's wrong?

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

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

19 MR. STEWART: Because I think that's not
20 really the reason we're saying the Court needs to -- I
21 pointed the Court to a different case in which outside
22 basis had to be determined at the partnership level for
23 a different reason; namely, because it was a -- in that
24 case, it was a component of inside basis. And since
25 inside basis is a partnership item, you can only

1 determine that partnership item by reference to outside
2 basis.

3 Here we have a somewhat different argument.
4 We're saying the thing that had to be determined at the
5 partnership level was the applicability of the
6 penalties. And the only way you can decide whether a
7 substantial valuation misstatement penalty is applicable
8 is to determine what would be true basis in a sham
9 partnership.

10 JUSTICE GINSBURG: Mr. Stewart --

11 JUSTICE SOTOMAYOR: Mr. Stewart --

12 JUSTICE GINSBURG: If we -- if we go over to
13 the merits, if this case came up today and today we have
14 a penalty that wasn't there originally and that is for a
15 non -- noneconomic substance penalty, would -- would the
16 government today be going under that noneconomic
17 substance penalty or would it be going under the
18 6626(d)(3), that is the substantial valuation
19 misstatement? Or is it the government's option, it can
20 pick one or the other?

21 MR. STEWART: I think it's the government's
22 option. And if you -- it may be helpful to look at page
23 18a of the appendix to -- to the Respondent's brief,
24 because that actually reproduces the current version of
25 the code that contains the 2010 penalty that -- that

1 you're referring to.

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

4 MR. STEWART: I mean, in some instances, the
5 government will -- the government will pick the one that
6 it thinks is easiest to prove. Some of the penalties
7 are limited to 20 percent whereas some can be bumped up
8 to 40 percent, and we would look for the 40 percent
9 penalty.

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

18 Subsection (6) is a disallowance of claimed
19 tax benefits by reason of a transaction lacking economic
20 substance. That's the -- the 2010 penalty.

21 Now, the two points I would make are:
22 First, it's very clear that many, many cases that would
23 fall under Subsection (6) would also fall under
24 Subsection (1) or (2); that is, they could involve
25 negligence or disregard of rules or regulations. They

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

9 The other point I would make pertains to the
10 introductory language of that provision, and it says:
11 "This section shall apply to the portion of any
12 underpayment which is attributable to one or more of the
13 following." And I think the primary practical
14 significance of the "one or more" language is that it
15 functions as an anti-stacking provision. It tells you
16 it doesn't matter whether your underpayment triggers
17 only one of these penalties or all six of them; you're
18 still limited to 20 percent unless you can get the --
19 the 40 percent through some other provision.

20 So we can't take advantage of the fact that
21 the -- that more than one penalty applies to a
22 particular transaction by getting 20 percent on top of
23 20 percent on top of 20 percent. But the very fact that
24 Congress used that language "which is attributable to
25 one or more of the following" indicates that it

1 anticipated situations in which particular underpayments
2 would be attributable to more than one of those
3 penalties. It didn't see any anomaly in the idea that a
4 penalty that triggers Subsection (3) could trigger
5 Subsection (1) or (2). And, again, there's no reason to
6 think that there's a greater anomaly with respect to
7 Subsection (6).

8 The other thing I would say is that in this
9 case, (3) and -- if it arose in connection with a
10 transaction that occurred today, (3) and (6) would be
11 coterminous. Either of them would apply. But there
12 will be plenty of cases in which a substantial valuation
13 misstatement penalty on our view could be triggered by a
14 legal error in computing basis, such as use of the wrong
15 depreciation rate. That would not --

16 CHIEF JUSTICE ROBERTS: Mr. Stewart, if I
17 could focus at a somewhat higher level of abstraction.
18 I understand the general underlying thrust of your
19 friend's position to be that overstatement of basis goes
20 to, you know, miscalculations. It was actually \$20,000,
21 you say it's \$40,000, and that's where the penalty comes
22 from.

23 Well, this case is quite different. We are
24 kind of wiping out the whole transaction and then you're
25 kind of artificially saying, well, if you wipe out the

1 whole thing, when you come to basis it should be this
2 and that. And -- and it's not sort of a fraud or
3 misstatement with respect to the basis itself. It
4 follows from a broad sham determination and that sham
5 determination is made at the partnership level, not the
6 partner level.

7 MR. STEWART: I guess the two things that --
8 or at least two things I would say in response to that
9 are that here the whole point of the avoidance scheme
10 was to create an artificially inflated basis. That is,
11 the high, high basis that's claimed on the individual s'
12 returns was not simply a fortuitous result of an
13 avoidance scheme that operated through some other means.

14 The whole point -- if you want to claim a
15 loss on a transaction where you didn't incur an actual
16 economic loss, you can do it either by under -- by
17 understating the amount that you were paid for the asset
18 or by overstating your basis. And this is one of a
19 number of tax avoidance schemes that operate by
20 overstating basis.

21 So, it's true that the transaction was
22 determined to be a sham, but the sham determination was
23 intimately bound up with the fact that the whole purpose
24 of the scheme was to create an inflated basis.

25 CHIEF JUSTICE ROBERTS: I understand that.

1 But if you were telling people what happened here --
2 maybe you would -- I don't know that your first
3 statement would be: They overstated their basis. I
4 think you would say: They engaged in a completely sham
5 transaction, which had -- which had some obvious, as the
6 D.C. Circuit put it, some obvious consequences. But
7 still, the -- the driving determination was that it was
8 a sham transaction.

9 MR. STEWART: I guess the -- the other
10 couple of points I would make are, there's nothing
11 illegal about engaging in a transaction that lacks
12 economic substance. That is, if the partners had
13 engaged in these offsetting currency transactions but
14 then had decided before filing their return that either
15 we -- we no longer believe that this is right conduct or
16 we believe we're going to get caught, and they had
17 prepared their returns in a lawful way, nothing bad
18 would have happened to them.

19 The -- the thing that subjects them to
20 potential penalties is the fact that they claimed a
21 large loss on their tax returns and they did that by
22 claiming a large false basis in the -- the partnership.

23 The second thing I would say is, you know,
24 when I took math in junior high and high school, the
25 teacher would always tell us to show your work when you

1 handed in an assignment, don't just give the answer at
2 the end; indicate the process by which you arrived at
3 that number. And in essence, when the code says impose
4 penalties on underpayments that are attributable to the
5 following things, it says -- it means we're going to
6 look at your work. When we determine that you have paid
7 too little tax, we're going to look at the calculation
8 process by which you arrived at the amount on your own
9 return and figure out where you went wrong. And if they
10 did that here, they would say the mistake these
11 taxpayers made, the reason they didn't pay as much tax
12 as they owed, was not that they claimed to have sold the
13 assets -- it was not that they claimed to have sold the
14 assets for less than they actually realized; it was that
15 they claimed a basis that had -- had no founding in
16 reality.

17 And the last thing I would say in -- in
18 connection with that is it's no accident that this
19 scheme operated through the creation of sham
20 partnerships. That is, if the taxpayers themselves had
21 bought the offsetting long and short currency options,
22 there would have been no colorable argument that they
23 could have claimed the costs --

24 JUSTICE SOTOMAYOR: Mr. Stewart, what --
25 what is this case a fight about? And -- and -- I'm

1 sorry. Perhaps I'll just ask it on rebuttal, so you can
2 save your time for rebuttal.

3 CHIEF JUSTICE ROBERTS: Thank you, counsel.

4 Mr. Garre.

5 ORAL ARGUMENT OF GREGORY G. GARRE

6 ON BEHALF OF THE RESPONDENTS

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

9 On both jurisdiction and the merits, the
10 Government is asking this Court to adopt an overly
11 expansive interpretation of the code to reach a result
12 that would upset the statutory scheme devised by
13 Congress and lead to further problems down the road.

14 Now, on jurisdiction, I think the most
15 important thing for the Court to recognize is that
16 outside basis, the very thing, as you can tell from my
17 friend's arguments on the merits, that the imposition of
18 this penalty depends on is not a partnership item. In
19 fact --

20 JUSTICE KAGAN: Mr. Garre, it seems as
21 though you and the Government agree on sort of the
22 nature of this problem, right? Which is you have a
23 partnership item, which is the sham determination. That
24 leads to an adjustment in outside basis which, as you
25 just said, is not a partnership item, is instead an

1 affected item; and that leads to a penalty, right?

2 So there's kind of three things, two steps
3 in the process. And you say, well, that's not enough,
4 essentially because the penalty has to directly relate
5 to a partnership item. And they say it is enough
6 because it's okay if it indirectly relates to the
7 partnership item.

8 And I guess the question is: In some sense
9 you're both adding adjectives to the statute. You add
10 directly, they add indirectly. How do we pick between
11 those?

12 MR. GARRE: Well, I think the Government is
13 asking the Court to add a great deal more than that.
14 Just to go to the statutory text, with the provision at
15 6226, and it's on page 2A of the red brief, and what
16 that says is that first it gives the Court jurisdiction
17 to determine all partnership items. Everybody agrees
18 that outside basis is not a partnership item.

19 And then it gives jurisdiction to the Court
20 to determine penalties that relate to partnership items.
21 And what -- and what the Government is asking this Court
22 to do is essentially to read this to say that relates to
23 partnership items or that relates to non-partnership
24 affected items, like outside basis.

25 And the reason why the Court shouldn't do

1 that is, first, in a scheme that divides the worlds into
2 partnership items that can be determined at the
3 partnership level and non-partnership items that must go
4 to the partner level, when Congress says "partnership
5 item," that's significant. It -- it adds defined terms
6 of "non-partnership item" or "affected item." It said
7 "partnership item." So we think that it necessarily
8 excluded non-partnership affected items here and that's
9 the way to read it.

10 And second, if you read the "relates to" as
11 broadly as the Government says, then it makes no sense.
12 The partnership item here might as well say "affected
13 item" because you're right, at some level of
14 abstraction, you can always say that the penalty relates
15 to the partnership item. That's going to be true for
16 lots of these.

17 JUSTICE SCALIA: But it doesn't just say
18 partnership items. Yes, "A court in which jurisdiction
19 a petition is filed shall have jurisdiction to determine
20 all partnership items." But then it goes on: "The
21 proper allocation of such items among the partners and
22 the applicability of any penalty, addition to tax, or
23 additional amount which relates to an adjustment to a
24 partnership item."

25 MR. GARRE: You're right, Justice Scalia,

1 and --

2 JUSTICE SCALIA: What -- what can that
3 possibly mean when you're talking about the
4 applicability of any penalty?

5 MR. GARRE: Well, let me tell you,
6 Justice Scalia.

7 JUSTICE SCALIA: That penalty is going to be
8 applicable at the partner stage.

9 MR. GARRE: Justice Scalia, let me answer it
10 this way: Partnerships can do many things, just like
11 individuals and corporations, and they can engage in
12 things that subject -- that trigger penalties. A
13 partnership can misreport its income. A partnership can
14 make a valuation misstatement. A partnership can engage
15 in negligence, and the court can determine those -- the
16 applicability of those penalties.

17 Now it's true that down the road in -- in a
18 mathematical adjustment, the court is looking to whether
19 or not the partner repeated that error on its return.
20 But what's fundamentally different about this case is
21 the penalty depends not on the partnership, just the
22 partnership item; it depends on this outside basis
23 determination that a court can't make. I mean, to put
24 it another way --

25 JUSTICE KENNEDY: Well, are there cases in

1 which the partnership is liable for a penalty?

2 MR. GARRE: Ultimately, Your Honor, the
3 partner --

4 JUSTICE KENNEDY: I mean, I understand it's
5 all passed through and so forth. But suppose the
6 partnership does something that's a sham, that's a
7 fraud, and then -- and -- and files a partnership
8 information return with that -- with that information.
9 But then the partners find out either because of a
10 ruling of the court that it's void or because they have
11 second thoughts that they're not going to do that, so
12 they change their individual -- they change their --
13 their own tax return. Could there be any penalty
14 against the partnership in that instance?

15 MR. GARRE: Your Honor, the partners don't
16 actually -- the partnership does not pay the penalty,
17 but the partner -- the partnership --

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

20 MR. GARRE: No, I don't believe so. But the
21 partnership --

22 JUSTICE KENNEDY: Would there be criminal
23 liability for filing a false information return?

24 MR. GARRE: I mean, ultimately I think that
25 would trickle down to the partners. But, Your Honor, I

1 think that there are two different schemes here. One is
2 where the partnership is doing things that actually does
3 trigger the penalty. Take the 2010 noneconomic
4 substance transaction.

5 JUSTICE KENNEDY: But then -- then that --
6 that just fortifies the point that Justice Scalia made,
7 that the applicability of the penalty, it's -- it's
8 always going to relate to the partners.

9 MR. GARRE: Yes and no, Your Honor. Yes, in
10 the sense that ultimately what you're looking in the
11 proper proceeding is to determine whether or not the
12 partner repeated the error that's on the partnership
13 return. But you can say at the partnership level that a
14 penalty is -- is applicable because everything is
15 complete. All the elements can be determined. The
16 partnership has misreported its income.

17 In this case, you just can't say that,
18 because outside basis isn't reported anywhere at all on
19 the partnership --

20 JUSTICE BREYER: So what?

21 JUSTICE SCALIA: So what?

22 JUSTICE BREYER: So what? That is, I mean,
23 as I understand it, you agree that on the partnership
24 level, the IRS could say the following in a hypothetical
25 I'll now give you: The partnership says that this asset

1 has a basis of \$10 million. We sold it for 8.
2 Therefore, the partnership has a loss of 2. The IRS
3 says the real value is not \$10 million basis, it was a
4 \$2 million basis, and therefore, in fact, you don't have
5 a loss of 2, you have a gain of 8.

6 Moreover, your understatement was more than
7 400 percent or whatever the percent is, you know, it was
8 a -- it was huge. It was an \$8 million, you know,
9 overstatement, and therefore, penalties of 400 percent
10 attach. Okay? You agree they can say that.

11 MR. GARRE: At the partnership level --

12 JUSTICE BREYER: Yes.

13 MR. GARRE: -- because you're talking
14 about --

15 JUSTICE BREYER: At the -- I'm correct.

16 MR. GARRE: -- inside basis, not outside
17 basis, correct.

18 JUSTICE BREYER: Okay. I understand you're
19 making this. But what they've actually done there,
20 since it doesn't say anything about inside/outside, is
21 they're saying: Partners, to the extent that you use
22 this on your own return, remember, there's a 400 percent
23 penalty attached. Okay. You agree they can do that.

24 Now, what they've done here is they've said:
25 There is no partnership. So, to the extent that you use

1 this as your -- as a basis, as you use this on your
2 individual return, remember there's a 400 percent
3 penalty attached, because 4 times zero or whatever it
4 is. You understand the mathematics.

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

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

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

13 MR. GARRE: And --

14 JUSTICE BREYER: Now, to the extent you
15 don't use it, of course, you don't have to pay anything.
16 But to the extent you use it, you have to pay whatever
17 it is plus the 400 percent.

18 MR. GARRE: What the court is doing -- what
19 the court is doing in both of those situations is
20 fundamentally different. In one case, it's looking at
21 the partnership return, looking at how the partnership
22 reported the basis and determining that the basis
23 overstatement penalty would apply because of the error
24 committed by the partnership. That is everything that
25 we think the court can do under the statutory provision

1 we just referred to, to determine the applicability of
2 that penalty because it relates to a partnership item,
3 the partnership's statement of its income or basis on
4 the partnership return.

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

8 JUSTICE BREYER: So then the question is --
9 the question is, do the words "partnership item" in the
10 section "scope of judicial review" refer only to those
11 items that the partnership in fact is concerned with?
12 Or do they consider the partnership itself?

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

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

15 MR. GARRE: And the three circuit courts
16 that have addressed that have agreed with us. And as
17 Justice --

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

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

22 JUSTICE BREYER: What? No?

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

25 JUSTICE BREYER: Oh, no, no. But I'm --

1 that's just a question of how they use it on the return.
2 There are many ways in which a person could use a
3 partnership item on the return. If this is a
4 partnership item -- I mean, a person might, for example,
5 have no tax, in which case --

6 MR. GARRE: Your Honor, I think that the
7 confusion maybe is between the statement at issue here.
8 The statement at issue in this case is the basis that
9 the partners reported on their individual returns as a
10 result of these transactions. If you go to the
11 partnership return and go to page 169 of the Joint
12 Appendix, and it may be difficult to find now because of
13 these fold-outs, but you'll find what the partnership
14 reported. And it reported all of the transactions at
15 issue and it reported accurately --

16 JUSTICE BREYER: I understand how someone
17 could be confused, and I am genuinely confused. I have
18 read this several times.

19 MR. GARRE: Right, and --

20 JUSTICE BREYER: And the reason I'm confused
21 is this: That I -- I understand your difference between
22 the outside basis and the inside basis. Now what I'm
23 trying to do is to figure out, via the statute, I think
24 like what Justice Scalia was trying to do, I think,
25 where does that matter?

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

3 JUSTICE BREYER: No, I understand that, too.
4 I'm just trying to get the precise words of the statute
5 that it would make a difference, because in common sense
6 it doesn't seem to me to make much difference, but --
7 but maybe in this statutory language it does. So I want
8 to know what words.

9 MR. GARRE: The words that matter is
10 "partnership item." This is a statutory scheme that --
11 that talks about non-partnership items and partnership
12 items.

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

18 MR. GARRE: The partnership item, Your
19 Honor, can include the partnership. We're not -- we're
20 not disputing that part of the sham determination. My
21 point is that the imposition of the penalty depends on
22 an additional determination, which is a non-partnership
23 item. And the Court --

24 JUSTICE KAGAN: And in that sense, Mr.
25 Garre, it strikes me as wrong to say the words in

1 dispute are "partnership item." Actually, everybody
2 agrees what "partnership item: Means, what it includes,
3 and what it doesn't include. It doesn't include outside
4 basis. The government is perfectly happy to concede
5 that.

6 It seems as though the words in dispute are
7 what does "relate to" mean and does "relate to" have to
8 be "relate to" in this very direct way that excludes
9 this intermediate step of adjusting outside basis.

10 MR. GARRE: Right. And the reason why --
11 and I think that gets back to partnership item, because
12 if you read "relates to" in the broad sense that the
13 government is asking you to read it, then in essence you
14 are adding -- you're taking away the limitation of
15 "partnership item" and you are adding words that says
16 "or affected item." Because what they're saying is,
17 look, anytime you have a partnership item that is in any
18 way related to the imposition of a penalty down the
19 road, then you can do it.

20 But another way of saying that, and the way
21 that Congress would have said if it meant it was:
22 Courts, you can determine the applicability of any
23 penalty that relates to a partnership item or an
24 affected item. But Congress didn't say that.

25 JUSTICE SCALIA: But it is in addition to

1 partnership item. You say: Oh, you can't do that
2 because it would add to partnership item.

3 But the statute does not say "just
4 partnership item." It says "partnership items, the
5 proper allocation of such items, and the applicability
6 of any penalty, addition to tax, or additional amount."

7 MR. GARRE: Right.

8 JUSTICE SCALIA: It's in addition to
9 partnership items.

10 MR. GARRE: Now --

11 JUSTICE SCALIA: And -- and it's, it seems
12 to me, not enough to say, well, if you interpret that
13 third part to go beyond partnership items, you're
14 destroying the statute. I don't think so.

15 MR. GARRE: Our point is the one that the
16 D.C. Circuit and the other circuits have adopted, which
17 is that to make this determination you have to go beyond
18 the partnership item; you have to determine a
19 non-partnership item, and this grant of jurisdiction --

20 JUSTICE SCALIA: When would you not have to
21 do that if you are applying the third item, "the
22 applicability of any penalty, addition to tax, or
23 additional amount which relates to adjustment to a
24 partnership"?

25 MR. GARRE: Again --

1 JUSTICE SCALIA: That will always require
2 you to go down to the partner level.

3 MR. GARRE: No. When the penalty is -- is
4 complete based on what the partnership has done, you can
5 determine the applicability of the penalty. You can say
6 all of the elements are met because of what the
7 partnership did. And then later, you're only looking to
8 whether or not the partners repeated that error. Here,
9 that's not -- that's not what's happening.

10 JUSTICE GINSBURG: Mr. Garre, suppose the
11 government had asserted this penalty under sub (6), or
12 the transaction lacking economic substance. Would you
13 be -- would you say it doesn't make any difference, it's
14 the same? Or would you say that under (6) your argument
15 is not applicable to that and the determination could be
16 made at the partnership level?

17 MR. GARRE: We would, Your Honor. The
18 noneconomic substance penalty that Congress passed to
19 cover this situation here solves all the problems. As
20 to jurisdiction, courts could determine it at the
21 partnership level because looking to whether or not the
22 partnership is a sham is a partnership item. And so
23 courts have jurisdiction to do that. And of course that
24 solves the merits question, too, because Congress
25 actually addressed the situation here on the merits.

1 Instead we have the government trying to fit a square
2 peg into a round hole.

3 I mean, on jurisdiction, before I go to the
4 merits, I just want to talk about the practical
5 consequences of this ruling. It's very significant from
6 the standpoint of the taxpayers. What the government
7 wants to do is funnel all these penalty determinations
8 into a computational adjustment as opposed to the
9 deficiency proceeding, which is a default rule under the
10 statute, Section 6230.

11 And from the taxpayers' perspective, that
12 has huge consequence. It means that the taxpayers have
13 to pay the refund up front, as Justice Sotomayor
14 recognized. That means that, even in disputed
15 penalties, they've got to pay all that up front. And
16 then that limits their ability to challenge it. It
17 means they can't go to the Tax Court to challenge it.
18 They have to do it in a more expedited fashion.

19 The default rule is deficiency proceedings.
20 That is where Congress intended these penalty issues of
21 the type that we have here that pertain to
22 non-partnership items --

23 JUSTICE SOTOMAYOR: But let me ask you
24 something. There's no reason to go into a sham
25 transaction except to misstate the outside basis in the

1 individual partnership level. So I -- it's low-hanging
2 fruit, according to the D.C. court. But why shouldn't
3 you be able to pick it?

4 MR. GARRE: Well --

5 JUSTICE SOTOMAYOR: I mean, it's sort of
6 obvious, just as it's obvious that if a partnership item
7 has a miscalculation that the partner is going to
8 include it in their tax return later. That's why we
9 permit the penalty to be imposed up front and to pay the
10 tax up front, because you're making an assumption that
11 it's been included erroneously on the partner level.

12 MR. GARRE: And then I think what you would
13 be doing is assuming a fact necessary to the penalty,
14 that outside basis was reported as zero, for purposes of
15 finding jurisdiction, and we don't think the court could
16 do that. The government acknowledges that it -- that
17 it's at least possible that the taxpayer, in a fit of
18 conscience or having fully -- more fully understood the
19 transactions, would not inflate its basis, it would
20 report a zero basis, and yet nobody would know that in a
21 partnership-level proceeding because the partners'
22 outside basis isn't even before the court -- before the
23 IRS or the court in that proceeding.

24 JUSTICE BREYER: Try with me again. Again,
25 just try once more. Suppose that a person owes a gift

1 tax and what he gave to his children or whatever was in
2 part an interest in a partnership. Now go back to my
3 example, all right, because I want to get -- my example
4 is everybody agrees that the 8, 10 million versus 8
5 million, there's a penalty attached. Well, he -- he
6 doesn't take that into account when he gives the gift.

7 Now, if he did give the gift, it would --
8 he'd have to pay a tax on the gift, on his gift tax
9 return. Okay? He -- they assess that on the -- they
10 would assess that, wouldn't they, even though it's a
11 gift tax return, not an -- not an income tax return.

12 MR. GARRE. Right. I mean ultimately --

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

17 MR. GARRE: In the individual return?

18 JUSTICE BREYER: Yes, yes, in individual
19 gift tax return. Maybe it's in a State tax return.
20 Maybe it's an income tax return.

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

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

24 MR. GARRE: Every --

25 JUSTICE BREYER: -- that the way this

1 affects the taxpayer is through what you call his
2 outside basis. Why does that matter?

3 MR. GARRE: Well, Your Honor, every
4 partner's outside basis is going to vary in the typical
5 situation.

6 JUSTICE BREYER: Well, yes, yes. But of
7 course any -- in my example, too, it will vary. Of
8 course it will vary. Some people will use -- have no
9 tax to pay, no extra tax, because their -- their income
10 tax that they paid was zero. In fact, the government
11 owed them a refund, so it didn't matter. It varies in
12 many ways.

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

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

19 And another thing on the jurisdictional
20 question. I don't think the Court could resolve this
21 question looking only to the sham partnership situation
22 here. Sometimes transactions are shams, sometimes
23 partnerships are shams, and the jurisdictional question
24 or answer to the question should apply across the board.

25 And yet if you have a situation where you

1 have only a transaction sham, then even the Government
2 would have to acknowledge that basis could be affected
3 in many different ways in that situation. And, again,
4 getting back --

5 JUSTICE SCALIA: Couldn't the Government
6 have pursued this instead of saying, you know, it's a
7 sham partnership, just -- just -- couldn't the
8 Government simply have said that the partnership
9 overstated its basis?

10 MR. GARRE: It couldn't, because -- and it
11 didn't, because again, if you go back to page 186 -- 169
12 of the Joint Appendix, everything about these
13 transactions is accurately reported on that form which
14 is in the partnership return. The partnership actually
15 reported a gain on these transactions.

16 The error comes in at the partner level and
17 is only on the partner return in this situation. And
18 that's why you can't determine outside basis at the
19 partnership level and that's why you can't determine the
20 applicability of this penalty at the partnership level.

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

1 MR. GARRE: No. No, Your Honor, in this
2 sense: If this Court resolves the merits question, then
3 that -- that ruling whether the penalty applies or not
4 in this context is going to apply to all partners. So
5 that -- that issue is not going to vary by partner.

6 What can happen by partner is different
7 partners may have different outside basis. Even in this
8 situation, my friend acknowledged you could have a
9 partner that nevertheless reports zero as his basis in
10 this situation and not the --

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

14 MR. GARRE: Well, that determination, Your
15 Honor, is being made at the partnership level, and we
16 agree that it can be made at that level, and that
17 determination applies to all the partners. There is no
18 inconsistency about that. The only question here
19 is whether the -- the partnership level court can
20 determine the applicability of the -- the basis
21 misstatement penalty as the Government calls it. And --
22 and it doesn't have jurisdiction to do that because it
23 depends on that outside basis to do it.

24 JUSTICE KAGAN: But I think that --

25 CHIEF JUSTICE ROBERTS: You say that -- you

1 say that that's not true because individual partners may
2 respond differently to the partnership determination
3 with respect to basis.

4 MR. GARRE: Yes.

5 CHIEF JUSTICE ROBERTS: Some of them are
6 going to put in something else, but somebody may put in
7 zero for a number of the reasons that the IRS's counsel
8 suggested.

9 MR. GARRE: Yes.

10 CHIEF JUSTICE ROBERTS: And now, I suspect
11 that those will be only in rare circumstances. And I
12 guess that's why the D.C. Circuit said, even though the
13 result here may be obvious, it nonetheless depends on
14 the outside basis determination.

15 MR. GARRE: Exactly.

16 CHIEF JUSTICE ROBERTS: And I think what I
17 understand your friend to be saying is it's not just
18 that it's obvious, but it's ineluctable, and therefore,
19 it doesn't depend on the outside partnership
20 determinations.

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

25 MR. GARRE: I -- I think largely, yes, but

1 if I can explain that. First, it presents the
2 low-hanging fruit situation the D.C. Circuit resolved.
3 And we think they were right to say even if you think
4 it's low hanging, you're forbidden to pick it.

5 Second, here the whole partnership is
6 shammed, but there's certainly cases where individual
7 transactions are shammed. And if individual
8 transactions are shammed, then the -- the outside basis
9 can vary widely based on the individual circumstances of
10 the partners. And so there, in that situation, it's not
11 at all obvious or -- or necessarily true that the basis
12 is going to be overstated. You have to look.

13 And, again, that's why it's a completely
14 separate determination made --

15 JUSTICE SOTOMAYOR: Could you give me a
16 concrete example, because I'm not quite sure about what
17 you're talking about.

18 MR. GARRE: Well, you could have a
19 partnership, Your Honor, that engages in many
20 transactions. And the IRS would determine that one of
21 the many transactions that it entered into was a sham.
22 That particular transaction was only designed for tax
23 purposes. But other transactions that it engaged in
24 were legitimate.

25 Now, in this case, the IRS is saying that

1 the whole -- everything the partnership did is a sham.
2 But in my case, some transactions are okay, some are
3 different. In that case, the individual partners'
4 outside basis, they may have -- they may have tried to
5 take advantage of the sham transaction, but yet, all the
6 other transactions affect their basis as well in the
7 partnership.

8 JUSTICE SOTOMAYOR: I'm -- I'm a little
9 confused on this example. Presumably, it's only if they
10 carried forward, which we're assuming they would have
11 done, carried forward the outside basis, the penalty
12 would have been determined just on that one transaction.

13 MR. GARRE: No, because, Your Honor, again,
14 the penalty is based on what the individual partner
15 claims as his basis, and that partner is going to be
16 looking to everything that goes into his partnership
17 interest, the costs or investment in the partnership,
18 pertaining not only to the one transaction that we have
19 hypothesized has been shammed, but many other
20 transactions as well.

21 So you -- you can't conclude either that
22 there's been any misstatement or that any misstatement
23 triggers the valuation misstatement penalty here.

24 If I could talk a little bit about the
25 merits. On the merits, our fundamental question is that

1 the valuation misstatement penalty that Congress devised
2 in 1981 was not intended at all to apply to the
3 fundamentally different situation here where the
4 Government is claiming not that you misstated the
5 correct amount of the value or that you didn't have an
6 accurate amount of the value or the number that you put
7 for basis or value, but that the thing that's the
8 subject of the valuation or the basis doesn't exist at
9 all.

10 I mean, we know if you look at the -- the
11 pre-enactment history, the post-enactment history, we
12 know that this is not what Congress had in mind. If you
13 look at the pre-enactment history, it's all about
14 resolving a problem of a backlog of cases where
15 taxpayers were misvaluing property and the tax would --

16 JUSTICE KAGAN: Well, that was the
17 prototypical case, Mr. Garre. There's no question that
18 that's the central case that -- that Congress had in
19 mind. But it doesn't have to be the only case. And
20 they wrote words that seem to be applicable to this case
21 as well as to the kind of case that you're talking
22 about.

23 MR. GARRE: Your Honor, they have basis and
24 we have context, punctuation, pre-enactment history,
25 post-enactment history and structure.

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

3 (Laughter.)

4 MR. GARRE: No. Not at all, Your Honor,
5 because this is a valuation misstatement penalty. The
6 reference to "or adjusted basis" comes in a
7 parenthetical, subordinate way.

8 And let me give you a hypothetical. One of
9 my associates came up with a good example, I think. If
10 you had a contract for a wedding that provided for
11 flowers or plants in parentheses, you would -- you would
12 understand that to mean flowers or plants like -- like
13 lilies or ferns that would accompany flowers in the
14 wedding. You wouldn't read that to include an oak tree
15 in the middle of the reception area.

16 Well, the Government's basis overstatement
17 penalty is the oak tree in the middle of the reception
18 area here. The most common situation in which basis
19 misstatements are made, the Government acknowledges
20 throughout its brief, is where you misstate the price or
21 cost of a good. And yet, they're moving -- which is --
22 which is why the reference to adjusted basis makes sense
23 in the statutory scheme here. It covers that situation.

24 But -- but they're saying, you don't need
25 to -- it goes far beyond that, not only to the prosaic

1 situation as they call it, but to a situation where
2 you're not complaining about whether the thing -- what
3 the correct number is or what the correct amount is.
4 You're saying the thing doesn't exist at all.

5 I mean, if I donate a painting that I say is
6 worth \$1 million to a church and I put that on my
7 return, but, in fact, it turns out that I didn't donate
8 the painting, I may have committed a fraud. I may have
9 lied about contributing the painting, but I haven't made
10 a valuation misstatement, nor have I misstated my basis.

11 And I think our -- our position is here that
12 if you look at everything, as I mentioned, the words of
13 the statute, the context in which a basis is -- appears,
14 the structure, there's a graduated scheme that makes no
15 sense with a zero basis situation, which is essentially
16 a nullity.

17 If you look at the fact that Congress
18 addressed this in 2010, not by amending the valuation
19 misstatement penalty, but by enacting a penalty designed
20 to apply to this situation, the noneconomic transaction
21 situation.

22 JUSTICE GINSBURG: So just to be clear, if
23 this is -- 6 had been on the books, then you would have
24 no quarrel with the Government 's position, they could
25 do this at the partnership level and --

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

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

5 MR. GARRE: If the noneconomic substance
6 transaction penalty that was enacted in 2010 was on the
7 books, what would happen is a court could determine the
8 applicability of that penalty, which is based on what
9 the partnership did at the partnership proceeding, and
10 we would agree that penalty applies. All the problems
11 are solved by what Congress did to address this
12 particular situation. The Government is trying to put
13 that square peg in a round hole.

14 And if you add everything up, I think
15 what's -- what's interesting about the Government's
16 reply brief is it doesn't contest that -- that if
17 there's any ambiguity here, the statute has to be read
18 in favor of the taxpayer. And that's because of the
19 canon that this Court has recognized that tax penalties
20 are strictly construed in favor of the taxpayer.

21 Here, at a bare minimum, there is ambiguity
22 as to whether the Congress that passed the valuation
23 misstatement penalty ever intended it to apply to this
24 fundamentally different situation where no one disagrees
25 about the numbers reported on the return. Again, if you

1 go to the partnership return, the transactions are
2 accurately reported. If you go to the outside bases,
3 it's true that they reported a loss, but that's because
4 they were following the IRS' rules about how you treat
5 contingent liabilities. So that number is actually
6 accurate under the IRS' rules. That's why the IRS has
7 to come up with a sham to get rid of the property
8 altogether and say that we are going to pretend that it
9 doesn't exist at all.

10 But, again, that's not a valuation
11 misstatement. When the penalty talks about correct
12 amounts, about accuracy, about value, it's trying to get
13 at the number that the thing is worth. It is not
14 concerned with a situation in which the IRS is claiming
15 that the property doesn't exist at all. That -- that is
16 a different problem. Congress addressed it in a direct
17 way, in a noneconomic substance penalty. So this Court
18 doesn't have to worry about this problem being
19 unaddressed. But what it should do is correctly
20 interpret the penalty that Congress enacted, which was
21 on the books when these events occurred, which is the
22 valuation misstatement penalty and not the
23 all-encompassing basis overstatement penalty.

24 I think if you're going to read one of the
25 amicus briefs, read the Shakow amicus brief. It talks

1 about all the additional situations which IRS or
2 Congress never applied this penalty to which would be
3 swept in by the government's position here today.

4 Thank you very much.

5 CHIEF JUSTICE ROBERTS: Thank you, counsel.

6 Mr. Stewart, you have five minutes left.

7 REBUTTAL ARGUMENT OF MALCOLM L. STEWART

8 ON BEHALF OF THE PETITIONER

9 MR. STEWART: Mr. Chief Justice.

10 Justice Kagan, I agree with your point that
11 on the jurisdictional issue the crucial contested
12 language is "relates to" and the issue is whether the
13 basis overstatement penalty here relates to the sham --

14 JUSTICE BREYER: How does it not?

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

18 Okay. Whether there is a partnership at all
19 does underlie the determination of whether the
20 partnership return, which had all kinds of numbers on
21 it, if it shows anything.

22 MR. STEWART: That's correct.

23 JUSTICE BREYER: All right. So therefore
24 it's a partnership item. Does this penalty relate to a
25 partnership item? I don't want to say that you are

1 right for the wrong reasons, so you better be sure I'm
2 right.

3 That is, the -- the -- does it relate to a
4 partnership item? I just told you what a partnership
5 item was. It certainly seems to because zero is what it
6 relates to.

7 MR. STEWART: I mean --

8 JUSTICE BREYER: End of case?

9 CHIEF JUSTICE ROBERTS: Perhaps --

10 JUSTICE BREYER: It can't be that simple.
11 We have three courts here --

12 CHIEF JUSTICE ROBERTS: Let me -- let me
13 pose perhaps a less friendly question.

14 (Laughter.)

15 CHIEF JUSTICE ROBERTS: What do you do with
16 your friend's hypothetical? On the tax returns you say:
17 I gave a painting to a charity worth a million dollars,
18 in fact he did not.

19 And he says: What you are doing is you are
20 going to go in and say: That wasn't worth a million
21 dollars; it was worth nothing. When in fact what you
22 should be saying is: You didn't give the painting at
23 all.

24 MR. STEWART: I think this is a different
25 situation because the IRS did not determine that the

1 underlying transactions, the purchases and sale of
2 currency options and so forth, didn't occur. It
3 determined that the partnerships were shams. And I
4 think that this is an important point.

5 CHIEF JUSTICE ROBERTS: Well, but if you
6 determine that the partnerships were shams, that's like
7 saying that there were no partnerships.

8 MR. STEWART: There were no partnerships --

9 CHIEF JUSTICE ROBERTS: And if you say, you
10 know, I didn't really give the painting, that means that
11 there wasn't any painting. It seems to me they're
12 pretty closely parallel.

13 MR. STEWART: But what the FPAA also said
14 was, because there were no partnerships, the
15 transactions should be treated as though they had --
16 were engaged in by the individual partners.

17 JUSTICE KENNEDY: Maybe it was a frame with
18 a blank canvas.

19 MR. STEWART: Well -- and I -- and I think,
20 as -- as I was starting to say at the close of my
21 opening argument, it's no accident that the partnerships
22 were used to effectuate this scheme, because if the
23 individuals had bought and sold the offsetting foreign
24 currency options, they would have had no colorable
25 rationale for contending that they were entitled to a

1 deduction for the cost of the long option but they were
2 not required to treat as income the amount they received
3 from the short option. It would have been absolutely
4 clear that the transaction, taken as a whole, was a
5 wash.

6 The only way that they could try to create
7 the appearance of a paper loss was by manipulating the
8 rules that govern the computation of basis in
9 partnerships. And so the shamming determination, in
10 effect, was a determination that, for tax purposes, you
11 can't try to take advantage of the Helmer rule that says
12 that, for computing basis in a partnership, we will
13 ignore the -- the contingent liability created by the
14 short option.

15 The -- the one thing -- other thing I would
16 say on the merits as to why we care about this case is
17 that Respondent's argument doesn't just go to -- on --
18 on Subsection 3, doesn't just go to basis overstatements
19 that are produced through sham transactions. It goes to
20 all basis overstatements that are produced through legal
21 errors. And I think that --

22 CHIEF JUSTICE ROBERTS: Do you -- do you
23 agree that the new legislation completely resolves this
24 problem?

25 MR. STEWART: It completely resolves the

1 specific problem posed by this -- almost completely
2 resolves the specific problem.

3 Subsection 6 undoubtedly would cover this
4 case. Now Subsection 6, the trigger for having a
5 40 percent penalty rather than a 20 percent penalty is
6 slightly different. Under Subsection 6 you are -- if
7 you disclose the relevant information on your tax
8 return, then even if it's later determined that the
9 transaction lacked economic substance, you would be
10 subject only to the 20 percent penalty. Under
11 Subsection 3 you can get the 40 percent if the
12 overstatement is 400 percent or more regardless of
13 disclosure. But it almost completely covers it.

14 But other -- other --

15 JUSTICE SOTOMAYOR: Could you -- could you
16 go back just one moment to the practical point that your
17 brother made? Is this issue only about whether you
18 collect the tax beforehand or after? Because he says
19 that they are bound in a partner-level proceeding to the
20 finding that the outside basis was -- benefit was
21 claimed in the partnership level it was zero.

22 MR. STEWART: With respect to jurisdiction,
23 the question simply goes to the allocation of
24 responsibilities between the partnership-level court and
25 the partner-level court.

1 Now, when he says we are trying to avoid
2 deficiency proceedings, I -- I think it ignores the fact
3 that, under our reading, the important legal objections
4 that Respondent has made to the penalty, and then he
5 made the arguments that are set forth in Part 2 of their
6 brief, can resolve -- under our theory, can be resolved
7 at the partnership level without prepayment of
8 penalties.

9 CHIEF JUSTICE ROBERTS: Thank you, counsel.

10 The case is submitted.

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

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