IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF TEXAS
AUSTIN DIVISION

J. WINSTON AND SHERI S. KRAUSE Plaintiffs, v. UNITED STATES OF AMERICA, Defendant.	)))))))))	CIVIL NO. 08-CA-865 SS

UNITED STATES OF AMERICA'S
(I) RESPONSE IN OPPOSITION TO PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT AND
(II) MOTION FOR SUMMARY JUDGMENT AGAINST PLAINTIFFS

INTRODUCTION

The United States contends there is no genuine dispute as to a material fact and that it is entitled to summary judgment. An Appendix containing (i) a Statement of Undisputed Facts, and (ii) the Affidavit of Jonathan L. Blacker (the "Blacker Affidavit") with accompanying exhibits is being filed contemporaneously with this Motion.

QUESTIONS PRESENTED

1. Whether Plaintiffs' failure to contest the accuracy-related penalties in a partnership-level proceeding precludes them from contesting the applicability of the penalties on the grounds raised in this matter?

2. Alternatively, whether the Fifth Circuit decisions in *Todd v. Commissioner* and *Heasley v. Commissioner* preclude the imposition of the 40% gross valuation misstatement penalty when Plaintiff J. Winston Krause overstated his basis in foreign currency by more than 400%?

3. Alternatively, if the 40% gross valuation misstatement does not apply, whether the 20% penalty applies for substantial understatement or negligence?

ARGUMENTS AND AUTHORITIES

I. PLAINTIFFS ARE BARRED FROM CHALLENGING THE APPLICABILITY OF THE PENALTY ASSESSMENT IN THIS REFUND ACTION

The IRS determined that accuracy-related penalties applied to the Son of BOSS tax shelter scheme in this case. Plaintiffs failed to contest that determination at the appropriate time, and it is too late to do so now. The penalties were conclusively determined at the partnership level when Plaintiffs did not contest the Notice of Final Partnership Administrative Adjustment ("FPAA") sent to Krause & Associates Advanced Strategies, LP ("KAAS"). This failure to contest the FPAA ultimately resulted in the adjustments being upheld, including the accuracy-related penalties. Plaintiffs' failure to contest the FPAA bars them from now challenging the accuracy-related penalties; rather, they are limited in this proceeding to *partner-level* defenses (*i.e.*, computational errors and/or partner-level reasonable cause). The Plaintiffs are ***not*** asserting there was a computational error or that they had reasonable cause in this refund suit, and therefore, they are not entitled to any relief from the 40% penalty. Therefore, this Court lacks jurisdiction over Plaintiffs' claims. *See* I.R.C. (26 U.S.C.) § 7422(h) (precluding an individual refund action attributable to partnership items).

With the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, Congress formulated comprehensive procedures by which the tax treatment of items of partnership income, loss, deduction, and credit would be determined at the partnership level in a "unified" partnership proceeding, rather than in separate proceedings with the partners. H.R. Conf. Rep. 97-670, at 600, *reprinted in*, 1982-2 C.B. 662. Code Section 6221 provides that the tax treatment of any partnership item "*shall* be determined at the partnership level" (emphasis added). The Fifth Circuit recognized that "TEFRA *requires* the treatment of all partnership items to be determined at the partnership level." *Weiner v.*

Commissioner, 389 F.3d 152, 154 (5th Cir. 2004) (emphasis added); *see also Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 547 (5th Cir. 2009) ("Under TEFRA, the tax treatment of any partnership item (and the ***applicability of any penalty***, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level" (emphasis added) (citing 26 U.S.C. § 6221)); *Abelein v. United States*, 323 F.3d 1210, 1214 (9th Cir. 2003) ("[u]nder TEFRA, the determination of partnership items is made at the partnership level and binds the individual partners thereafter"); *Randell v. United States*, 64 F.3d 101, 104 (2d Cir. 1995) ("under TEFRA, the partnership item [is] resolved at the partnership level and cannot be contested at the individual partner level"); *Kaplan v. United States*, 133 F.3d 469, 473 (7th Cir. 1998) ("TEFRA requires that all challenges to adjustments of partnership items be made in a single, unified agency proceeding; indeed, this is the key component of TEFRA that yields the desired benefits of economy and consistency"); *Stobie Creek Invs., LLC v. United States*, 2008 U.S. Claims LEXIS 75, *12 (Fed. Cl. 2008) ("The applicability of penalties at the partnership level first is determined during the partnership-level proceeding"). In addition to partnership items, Congress also mandated in I.R.C. §§ 6221 and 6226(f) that the accuracy-based penalties are to be determined *at the partnership level*, *i.e.*, in TEFRA partnership proceedings, rather than in individual partner-level proceedings.

Once the IRS decides to audit a partnership's information return, it sends to each partner (whose name and address has been furnished to it) a notice of the beginning of an administrative proceeding with respect to a partnership item. I.R.C. § 6223(a)(1). Upon conclusion of the audit, if the IRS decides to adjust any partnership items on the partnership's return, it must do so

by a notice of FPAA sent to the same partners. I.R.C. § 6223(a)(2). *See Abelein*, 323 F.3d at 1214.

Within 90 days of the mailing of the notice of FPAA, the tax matters partner (Krause in this case) may file a petition for readjustment of the partnership items with the Tax Court, the appropriate district court, or the United States Court of Federal Claims. I.R.C. § 6226(a). If the tax matters partner does not file a petition within this 90-day period, then any partner entitled to notice under I.R.C. § 6223, or any group of partners who, in the aggregate, own at least a 5% interest in the partnership, may file such a petition within the following 60 days. I.R.C. § 6226(b).

If no partner files a petition in court contesting the FPAA within the combined 150-day period, the adjustments to partnership items as set forth in the FPAA become final and no partner may thereafter seek judicial review of those partnership items in any court. *See Randell v. United States*, 64 F.3d at 108 ("[w]hen no valid petition is filed, the tax treatment of partnership items as set forth in the partnership return and as administratively adjusted by the IRS becomes conclusively established and may not thereafter be contested"); *see also Keener v. United States*, 551F.3d 1358, 1362 (Fed. Cir. 2009) (holding the Court of Federal Claims correctly determined it lacked jurisdiction over taxpayers' claim for a refund in a partner level proceeding attributable to partnership items).

After the completion of a partnership-level proceeding, adjustments to partners' tax items are made based upon the adjustments to partnership items. If a taxpayer believes that the IRS has made a computational error, or has a reasonable cause good faith defense to any penalty, then the partner may bring a refund suit pursuant to Section 6230(c). In such a refund suit,

however, there is no review of the substantive partnership issues. I.R.C. § 6230(c). That is, the adjustments to partnership items are conclusive in the partnership-level proceeding. *Id.* § 6230(c)(4). Further, the determination of the applicability of any penalties is not reviewable. *Id.* In the refund suit, the partner may only raise partner-level (as opposed to partnership-level) defenses to any penalty that has been determined to be applicable. I.R.C. § 6230(c)(4).

In a *partner-level* deficiency proceeding involving this same tax avoidance scheme, the Tax Court has held that it lacked jurisdiction to determine the applicability of penalties, even though they were attributable to a partner's overstated outside basis. The Tax Court concluded in this regard that I.R.C. §§ 6221 and 6226 required the applicability of the penalty to be determined exclusively in a TEFRA partnership-level proceeding. *Domulewicz v. Commissioner*, 129 T.C. 11 (2007), *aff'd in part, rem. in part sub nom. Desmet v. Commissioner*, 581 F.3d 297 (6th Cir 2009); *see also Fears v. Commissioner*, 129 T.C. 8, 10 (2007); *Bedrosian v. Commissioner*, 94 T.C.M. (CCH) 616, 618 (2007), *appeal pending*, Nos. 08-70809, 70508, 70548 (9th Cir. argued October 7, 2009).

It should also be noted that recent cases determining the applicability of the 40% penalty were *partnership-level* cases. Recent partnership-level cases include: *Alpha I, L.P. ex rel. Sands v. United States*, 84 Fed. Cl. 622 (2008); *Klamath Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Maguire Partners-Master Inv., LLC v. United States*, Nos. 06-07371, 2009 WL 2791000, slip op. at 47 (C.D. Cal. February 4, 2009); *Southgate Master Fund, LLC v. United States*, ___ F.Supp.2d ___, 2009 WL 2634854, slip. op. at 72 (N.D. Tex. August 18, 2009).

The FPAA issued to and received by KAAS properly imposed four alternative grounds for the applicability of the accuracy-related penalties under Section 6662 for engaging in this

abusive tax shelter scheme. Depending on the ground, the penalties have different rates: (i) a 40% penalty for a gross valuation misstatement under Section 6662(b)(3), (h); (ii) a 20% penalty for substantial valuation misstatement under Section 6662(b)(3), (e); (iii) a 20% penalty for substantial understatement of income tax under Section 6662(b)(2), (d); and (iv) a 20% penalty for negligence or disregard of rules and regulations under Section 6662(b)(1), (c). The first three grounds are essentially mathematical and will apply if the Court rules for the United States on the merits.

A 40% gross valuation misstatement penalty applies if the value or adjusted basis of property claimed on the return is 400% more than the amount determined to be the correct amount of such value or adjusted basis. I.R.C. §§ 6662(h)(1), (h)(2)(A)(i). In this case, Krause's true basis in the Canadian Dollars was $20,000 but he claimed a $2.8 million basis. This was an overstatement of *14,000%*.[1] Application of the valuation misstatement penalty is mandatory and applies if the threshold is met. *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636, 704 (2008), *appeal pending*, No. 2008-5190 (Fed. Cir. argued November 2, 2009). Moreover, where, as in this case, Krause's underpayment of tax results from the KAAS transaction lacking economic substance (as conceded by Krause), the valuation misstatement penalty applies. *See Merino v. Commissioner*, 196 F.3d 147, 155 (3d Cir. 1999) (calling application of the penalty "a matter of course"); *Jade Trading v. United States*, 80 Fed. Cl. 11, 53 (2007) (relying on the language of the statute), *appeal pending*, No. 08-5045 (Fed. Cir. argued March 5, 2009); *Long Term Capital Holdings, Ltd. v. United States*, 330 F. Supp.2d 122,

[1] Krause used $20,000 to purchase the Canadian Dollars, yet he claimed his basis in the currency was $2,811,250. Krause ultimately sold the Canadian Dollars for $19,542. Thus, while Krause's economic loss was only $458, he took a loss on his tax return of $2,791,708.

199 (D. Conn. 2004), *aff'd*, 150 Fed.Appx. 40 (2d Cir. 2005); *but see Southgate Master Fund, LLC v. United States*, ___ F.Supp.2d ___, 2009 WL 2634854 (N.D. Tex. August 18, 2009).

The adjustments outlined in the KAAS FPAA, including the applicability of the penalties, are final and conclusive due to the Plaintiffs' failure to contest the FPAA. Therefore, in this refund suit, Krause may only raise partner-level (as opposed to partnership-level) defenses to the penalties already determined to be applicable. That is, Krause may argue that (i) the IRS has made a computational error (which he has ***not*** alleged), or (ii) he has a reasonable cause/good faith defense to the penalties (which he has ***not*** alleged). As the statute and cases make clear, there is no review of the substantive partnership issues – the adjustments to partnership items are conclusive, and the determination of the applicability of any penalties is not reviewable. I.R.C. §§ 6230(c)(4), 7422(h).

III. THE PENALTY ASSESSMENTS RESULTED FROM A VALUATION MISSTATEMENT – *HEASLEY* AND *TODD* ARE DISTINGUISHABLE

The United States' primary contention is that the applicability of the 40% penalty is a partnership-level matter that Plaintiffs were required to contest in a partnership-level proceeding, and not in a partner-level proceeding, as this case is. Even if the Court were to reach the issue, however, Plaintiffs' underpayment of tax is attributable to an abusive Son of BOSS tax shelter designed to artificially inflate basis in foreign currency which was then used to generate an enormous artificial loss to offset income. Plaintiffs allege that the IRS cannot impose penalties when a deduction or credit is disallowed, citing *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988) and *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990).

Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988) is distinguishable. In *Todd*, the Fifth Circuit held that tax benefits generated from purchasing refrigerated shipping containers were

not allowable because the containers were not placed in service during the years in issue. The Court then held that the taxpayer there was not liable for the overvaluation penalty because his underpayment was "attributable to" a reason other than overvaluation.

Here, on the other hand, there are no grounds for disallowing the tax benefits that are wholly divorced from Krause's inflated basis in his partnership interest and ultimately the foreign currency. Krause's overstatement of his partnership basis and the foreign currency was the *sole reason* the IRS disallowed the deduction. Unlike in *Todd* (which disallowed the deduction because the containers were not placed in service in the tax year), there is no reason Krause's deduction was disallowed other than his grossly overstated basis.

Heasley is also factually distinguishable in that *Heasley* focused on the lack of experience in investing and the Heasley's employment in determining that the Heasleys showed reasonable cause for substantial understatement of tax so as to make imposition of the substantial understatement penalty improper (the Heasleys were unsophisticated, blue-collar taxpayers who had not graduated from high school and who were duped into investing in a tax shelter by their financial advisor). In distinguishing *Heasley*, the Third Circuit aptly notes

> we do not find the *Heasley* rationale persuasive here because the court's decision appears to have been driven by understandable sympathy for the Heasleys rather than by a technical analysis of the statute. . . . Mr. and Mrs. Heasley were blue-collar workers who had not graduated from high school. The Heasleys had four children, were concerned about their children's futures, and were aware that they were not knowledgeable enough to invest on their own. Consequently, they relied completely on the advice of an investment advisor who led them into the challenged tax avoidance scheme. . . . The Court of Appeals concluded that the Heasleys should not be subjected to the additional interest penalty for a tax-motivated transaction because they had a good faith expectation of profit, even though the court accepted the Tax Court's findings that the entity in which the Heasleys invested lacked economic substance and generated only tax deductions and credits and not income. . . . Thus, as the Court of Appeals for the Fourth Circuit subsequently observed, 'the Heasleys were indeed scammed out of

a considerable sum of money.' However, the Merinos are not the Heasleys. *Merino v. Commissioner*, 196 F.3d 147, 158 (3d Cir. 1999) (footnote and citations omitted) (citing *Zfass v. Commissioner*, 118 F.3d 184, 190 n.8 (4th Cir. 1997)). Similarly, the Plaintiffs are not the Heasleys. Krause is an extremely sophisticated business person, *a tax lawyer who invested in two tax shelters and advised other taxpayers regarding their tax shelters*. There is no indication of a lack of experience in investing or that the Plaintiffs were "duped" into investing in this tax shelter.

In *Kornman & Assoc., Inc. v. United States*, 527 F.3d 443 (5th Cir. 2008), the Fifth Circuit rejected a version of Son of BOSS that used a Treasury short sale to inflate basis. The Court referred to the tax shelter scheme as a "conspicuous raid on the Treasury". *Id*. at 456. The Court went on to liken the scheme to alchemy, stating.

> Before we begin our excursion into Subchapter K, we would be remiss if we did not comment on the elephant in the room. The Trust acknowledges that it only suffered a $200,000 economic loss in connection with these transactions, yet it claimed a $102.6 Million tax loss on its return. The Trust used this fake loss in 1999 to offset over $2 Million in legitimate income and capital gains in 2000 and 2001. The Appellants' premeditated attempt to transform this wash transaction (for economic purposes) into a windfall (for tax purposes) is reminiscent of an alchemist's attempt to transmute lead into gold.

Id. at 456.

Given the Fifth Circuit's distaste for the Son of BOSS tax shelter scheme, it is unlikely that the Court would intend that a sophisticated taxpayer, like Krause, enter into such a scheme with impunity. In other words, it is unlikely that the Court would find that the *Heasley* decision has application to the basis inflation situation here. Furthermore, to the extent the *Todd* and *Heasley* cases are interpreted as imposing a different penalty regime for taxpayers in the Fifth Circuit, the United States disagrees with these cases. Federal tax law should be uniformly

applied to all taxpayers throughout the United States.

IV. THE 20% PENALTY UNDER SECTION 6662 APPLIES IN THE ALTERNATIVE

The Plaintiffs assert that the IRS assessed only the 40% valuation misstatement penalty and thus the 20% accuracy related penalty is inapplicable. The Plaintiffs misunderstand the imposition of the accuracy-related penalties. Even assuming that the 40% penalty is inapplicable, the Plaintiffs will be liable for the 20% penalty for substantial understatement or negligence. The Treasury Regulations clearly indicate there is no stacking of penalties; thus, the maximum penalty is either 40% or 20% of the underpayment of tax, even if an underpayment is attributable to more than one type of misconduct. Treas. Reg. § 1.6662-2(c). So while more than one basis for applying the penalty may exist, the maximum allowable penalty will be 40% in the case of a gross valuation misstatement, or 20% for substantial understatement or negligence. *See Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009) (remanding to the Tax Court with instructions to impose a 20% accuracy-related penalty after determining the 40% penalty was inapplicable); *LFX Inv., LLC v. Commissioner*, T.C. Memo 2009-129, 2009 WL 2601920 (2009) ("The Commissioner may not stack or compound parts of the accuracy-related penalty to impose a penalty in excess of 20 percent on any given portion of an underpayment, or 40 percent, if such portion is attributable to a gross valuation misstatement").

CONCLUSION

The United States respectfully requests that this Court deny the Plaintiffs' Motion for Summary Judgment and enter summary judgment in favor of the United States.

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CERTIFICATE OF SERVICE

I certify that a true and correct copy of the foregoing was served upon the following via electronic means as listed on the Court's ECF Noticing System or by regular mail on the 2nd day of November 2009:

J. Winston Krause
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/s/ Jonathan L. Blacker
JONATHAN L. BLACKER

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ORDER GRANTING UNITED STATES OF AMERICA'S MOTION FOR SUMMARY JUDGMENT

Before the Court are Plaintiffs' Motion for Summary Judgment, the Defendant United States of America's Motion for Summary Judgment, the Parties' responses and replies, and the supporting documents filed by both Parties. The Court, having considered both Motions for Summary Judgment, finds the United States' Motion for Summary Judgment to have merit.

According, it is hereby ORDERED that the United States' Motion for Summary Judgment is GRANTED and this case is dismissed.

DATED _____

_____
UNITED STATES DISTRICT JUDGE