No. 13-99

In the Supreme Court of the United States

NEAL CRISPIN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Section 6662 of the Internal Revenue Code imposes a penalty for an underpayment of federal income tax that is "attributable to" an overstatement of adjusted basis in property. See 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1). The question presented is as follows:

Whether the overstatement penalty applies to an underpayment of tax resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the adjusted basis of property.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-28a) is reported at 708 F.3d 507.[1] The opinion of the Tax Court (Pet. App. 31a-59a) is unreported but is available at 2012 WL 858406.

JURISDICTION

The judgment of the court of appeals was entered on February 25, 2013. A petition for rehearing was denied on April 25, 2013 (Pet. App. 1a-2a). The petition for a writ of certiorari was filed on July 23, 2013. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] The court of appeals amended its opinion on March 19, 2013. The version of the court's opinion attached to the petition does not include the amendment. The amendment is reprinted in the appendix to this brief.

STATEMENT

Section 6662 of the Internal Revenue Code imposes a penalty for an underpayment of income tax that is "attributable to" an overstatement of the value or adjusted basis of property. 26 U.S.C. 6662(a), (b)(3), (e)(1)(A) and (h)(1).[2] The question presented is whether that penalty can apply when a court concludes that a transaction designed to make it appear that a taxpayer has a very large basis in a piece of property lacks economic substance and therefore must be disregarded for tax purposes. This Court granted certiorari to decide that question in *United States* v. *Woods*, No. 12-562 (to be argued Oct. 9, 2013). Accordingly, this case should be held for *Woods*.

Because the Court added a jurisdictional question in *Woods*, however, it is possible that *Woods* will not resolve the question presented in this case. That jurisdictional question concerns the scope of a district court's authority in so-called "partnership-level" proceedings. The jurisdictional issue presented in *Woods* does not arise here because this case does not involve a partnership. If the Court in *Woods* holds that the district court lacked jurisdiction to consider penalty-related issues in that partnership-level proceeding, this case would be an appropriate vehicle for resolution of the merits issue on which this Court previously granted review in *Woods*.

1. Our federal tax system prescribes various penalties for taxpayers who fail to report and pay all of the tax that they owe. As relevant here, the Internal Revenue Code imposes penalties if a taxpayer overstates the value of property, or the taxpayer's adjusted basis in

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[2] Unless otherwise indicated, all citations to 26 U.S.C. 6662 are to that statute as it appears in the 2000 edition of the United States Code.

property, on a tax return in a way that reduces the total taxes reported and paid. For example, a taxpayer might overstate the value of a painting donated to charity to obtain a larger charitable deduction. Likewise, a taxpayer might overstate her basis in shares of stock that she sold to make it appear that she realized a loss (or a lesser gain) on the transaction. See 26 U.S.C. 1012(a) (defining "basis" generally as "the cost of * * * property" to the taxpayer).

To deter such overstatements, Section 6662 of the Code provides that "there shall be added to the [income] tax [owed] an amount equal to 20 percent of the portion of the underpayment * * * which is attributable to * * * [a]ny substantial valuation misstatement." 26 U.S.C. 6662(a) and (b)(3). A taxpayer commits a "substantial valuation misstatement" if, *inter alia*, "the value of any property (or the adjusted basis of any property) claimed on any [tax return] is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." 26 U.S.C. 6662(e)(1)(A). No penalty may be imposed, however, unless the underpayment exceeds $5000. 26 U.S.C. 6662(e)(2).

Section 6662 also establishes a greater penalty for a "gross valuation misstatement[]," defined to be an overstatement of the value or basis of property that is 400 percent or more of the correct amount. 26 U.S.C. 6662(h)(2)(A)(i).[3] "To the extent that a portion of the underpayment [of income tax] is attributable to one or

[3] Section 6662 was amended in 2006 to provide that the threshold for a "substantial valuation misstatement" is 150 percent (26 U.S.C. 6662(e)(1)(A)) and the threshold for a "gross valuation misstatement[]" is 200 percent (26 U.S.C. 6662(h)(1)). See Pension Protection Act of 2006, Pub. L. No. 109-280, § 1219(a)(1) and (2), 120 Stat. 1083.

more gross valuation misstatements," a penalty equal to 40 percent of that portion of the underpayment is imposed on the taxpayer. 26 U.S.C. 6662(h)(1).

2. This case arises from an abusive tax shelter called Custom Adjustable Rate Debt Structure, or CARDS. Pet. App. 4a-7a. The purpose of CARDS is to generate a large paper loss that can offset actual gains that the taxpayer realizes in a given tax year. *Id.* at 5a-7a. Like a number of other tax shelters that proliferated during the late 1990s and early 2000s, CARDS generates that paper loss by artificially inflating the taxpayer's basis in particular assets. When the assets are sold for far less than the asserted basis, the taxpayer claims a large loss on that sale that can be used to offset real gains from other transactions.

To create the artificially high basis, the CARDS shelter involves a series of prearranged steps. See Pet. App. 5a-6a; see generally *Gustashaw* v. *Commissioner*, 696 F.3d 1124, 1127-1131 (11th Cir. 2012) (describing CARDS). First, a party not subject to U.S. taxation, such as a foreign entity, borrows foreign currency from a foreign bank. Pet. App. 5a. A U.S. taxpayer then purchases a small amount of the borrowed currency by assuming liability for an equal amount of the loan. *Ibid.* The taxpayer also agrees, however, to be jointly and severally liable for the entire loan. *Ibid.* Finally, the taxpayer exchanges his portion of the currency for an equivalent amount of U.S. dollars. *Id.* at 6a.

In determining the gain or loss from that exchange, the taxpayer claims that his basis in the exchanged currency is the *full* amount of the loan to the foreign entity—because he assumed joint and several liability for the entire amount of the loan—not simply the small amount of the currency that the taxpayer has actually purchased from the foreign party. Pet. App. 6a. Accordingly, the taxpayer claims that the exchange generated a large loss (the full amount of the loan minus the dollars obtained in the exchange). The taxpayer can use that phony loss to offset real income for income-tax purposes.

The CARDS shelter is predicated on an invalid application of the assumption-of-liability rules applicable to the calculation of basis under the Internal Revenue Code. See Gov't C.A. App. 54-56. Under tax-law principles, a taxpayer's "cost" of property (and therefore his basis in the property) generally includes the amount of the seller's liabilities that the buyer assumes. See *Commissioner* v. *Tufts*, 461 U.S. 300, 308-310 (1983). That principle, however, depends on the expectation that the liabilities will be paid in full by the buyer. *Id.* at 308-309. In executing CARDS, the taxpayer and the foreign accommodating party agree, between themselves, that the taxpayer will repay only a small portion of the total liabilities and that the foreign party will repay the remainder. See Gov't C.A. App. 148-149, 254-255, 292. Critically, the proceeds of the "loan" to the foreign party at all times remain at the lending bank as collateral, where they are used for no purpose other than ultimate repayment of the "loan." *Id.* at 148-149, 255, 281.

By way of illustration, assume that a foreign accommodating party borrows $5 million worth of euros from a foreign bank. The taxpayer purchases $800,000 worth of the euros from the foreign party, but agrees to be jointly and severally liable for the entire loan. The taxpayer then exchanges his euros for $800,000. For economic purposes, the currency exchange by the taxpayer is a wash—$800,000 worth of euros is exchanged for

$800,000. The loss on the transaction should therefore be zero. For tax purposes, however, the taxpayer claims a $4.2 million loss, on the theory that his basis in the exchanged euros was $5 million, the entire amount of the loan. Although the CARDS promotional materials stated that this transaction provides "financing" to the participants, no actual financing is provided because the foreign bank requires the "loan proceeds" to remain at the bank as collateral for the loan unless the purported "borrowers" deliver to the bank cash or cash equivalents to secure the use of any of the loan proceeds. Pet. App. 6a-7a.

3. Petitioner employed CARDS to generate an artificial loss of more than $7 million, which he used to offset an equal amount of income earned by his wholly owned S corporation, Murus Equities, Inc. (Murus), from mortgage-backed securities. Pet. App. 4a, 7a.[4] Petitioner participated in the mortgage-securities business with a business partner, John Campbell. *Id.* at 9a, 34a n.3. In 2001, petitioner (through Murus) earned $7.6 million from that business. *Ibid.* Petitioner and Campbell used the artificial losses generated by the CARDS shelter to entirely offset their mortgage-securities income earned in 2001. *Ibid.* They engaged in one CARDS transaction and split the shelter's losses at the same ratio as their income, with Campbell assuming approximately two-thirds of the available CARDS loan and petitioner the remaining third. *Ibid.*

At the direction of the promoter of CARDS, petitioner and Campbell engaged Croxley Financial Trading LLC (Croxley) to serve as the foreign borrower and

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[4] As an S corporation, Murus is not subject to federal income taxation, 26 U.S.C. 1363(a), and its income flowed through to petitioner for tax purposes. Pet. App. 12a n.12, 33a.

Zurich Bank to serve as the foreign lender. See Pet. App. 9a-10a, 34a-35a. Zurich Bank loaned Croxley 74 million Swiss francs ($43 million) for a stated 30-year term, but payable at any time after one year. *Id.* at 10a. Croxley promptly pledged the Swiss francs back to Zurich Bank as collateral for the "loan," so no money actually changed hands. *Ibid.* Croxley then sold petitioner 4.8 million Swiss francs (worth $2.7 million) in exchange for petitioner's agreement to be jointly and severally liable for a share of Croxley's loan obligations to Zurich Bank ($14.75 million). *Ibid.* Petitioner transferred those proceeds to Murus, which guaranteed petitioner's obligations on the loan. *Ibid.* Murus immediately swapped 3.1 million of the Swiss francs for their equivalent value in U.S. dollars ($1.8 million)—the taxable event generating the phony loss. *Ibid.*

The Croxley CARDS loan lasted only one year. Pet. App. 11a. During that year, neither Murus nor petitioner had access to the CARDS loan proceeds. At all times, the full amount of the loan was pledged as collateral for the loan by Croxley, petitioner, Campbell, and Murus, and it was therefore in Zurich Bank's complete possession and control. *Id.* at 17a. When the loan terminated, the collateral was used to repay the loan. *Id.* at 11a, 40a.

Pursuant to the CARDS strategy, petitioner claimed that for tax purposes Murus's basis in the Swiss francs exchanged for U.S. dollars was $9.4 million (based on the entire amount of the loan assumed by petitioner), rather than his actual cost of $1.8 million. He therefore claimed that Murus had realized a $7.6 million tax loss on the foreign-currency exchange when in reality Murus had merely exchanged $1.8 million worth of Swiss francs for $1.8 million. Pet. App. 12a, 41a. Murus used the $7.6 million loss to offset the $7.6 million in mortgage-securities income that it had earned in 2001. *Id.* at 12a, 42a.

4. The IRS disallowed the tax treatment of the CARDS transaction on various grounds, including, as particularly relevant here, that the CARDS transaction lacked economic substance. See Pet. App. 13a; Gov't C.A. App. 125-126, 132. Under the economic-substance doctrine, a longstanding common-law principle codified by Congress in 2010, "tax benefits * * * with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." 26 U.S.C. 7701(*o*)(5)(A) (Supp. V 2011). In this case, the IRS determined that petitioner's CARDS transaction lacked economic substance because petitioner had entered into it solely to "claim an inflated basis in assets" and thereby to create "an artificial loss that is used to offset other unrelated taxable income." Gov't C.A. App. 121, 134-135. The IRS therefore required petitioner to pay the amount of taxes ($3.1 million) that he had underpaid as a result of CARDS. Pet. App. 13a. The IRS further determined that petitioner's tax underpayment was subject to (among other non-cumulative penalties) a basis-overstatement penalty of 40% of the tax underpayment generated by CARDS, which equaled $1.2 million. See *ibid.*

5. Petitioner filed a petition in Tax Court, challenging both the IRS's determination that the loss should be disallowed and its determination that penalties, including the valuation misstatement penalty, should be imposed. See Pet. App. 13a. The Tax Court rejected that challenge. See *id.* at 31a-59a.

The Tax Court first upheld the Commissioner's determination that CARDS lacked economic substance and that petitioner therefore was liable for the resulting tax deficiency. Pet. App. 44a-53a. The court explained that CARDS was designed solely to "artificially inflate basis and generate petitioner's desired loss," not to generate any "economic profit." *Id.* at 50a-51a. The Tax Court did not address the IRS's alternative grounds for disallowing petitioner's claimed loss. See *id.* at 44a & n.12.

The Tax Court also upheld the IRS's determination that petitioner's underpayment of tax was subject to the 40-percent penalty for overstating the basis of property by 400% or more. Pet. App. 54a-55a. The court explained that "the gross valuation penalty applies when an underpayment stems from deductions or credits that are disallowed because of lack of economic substance." *Id.* at 55a.

6. The court of appeals affirmed. Pet. App. 3a-28a. The court found no error in the Tax Court's economic-substance determination and therefore concluded that the IRS had properly disallowed petitioner's claimed $7.6 million "paper loss." *Id.* at 15a-18a. Like the Tax Court, the court of appeals did not address the IRS's alternative grounds for disallowing petitioner's claimed loss. *Id.* at 15a n.15.

The court of appeals also upheld the Tax Court's determination that petitioner was liable for the basis-overstatement penalty. Pet. App. 19a-24a. The court of appeals observed that the "circuits are divided as to whether [that] penalty applies to tax deductions that have been totally disallowed under the economic substance doctrine." *Id.* at 20a-21a n.18. The court explained, however, that it had previously adopted the "majority rule" that the penalty applies when a basis-inflating transaction is found to lack economic substance. *Ibid.* (citing *Merino* v. *Commissioner*, 196 F.3d 147, 157-159 (3d Cir. 1999)). Such transactions, the court explained, are treated as nullities for tax purposes and therefore cannot support a taxpayer's claimed basis in the property. *Id.* at 23a.

The court of appeals concluded that, in the CARDS context, the economic-substance doctrine might lead to one of two conclusions about the correct basis in the foreign currency, either of which would support the overstatement penalty in this case. Pet. App. 22a. First, a court could determine that petitioner's basis in the foreign currency was $1.8 million, the amount that petitioner had, as a matter of economic reality, agreed to pay to acquire that currency. *Ibid.* Alternatively, a court could determine that petitioner's basis was zero, because each of the transactions that make up the CARDS shelter (including the final currency exchange) lack economic substance and so must be disregarded for tax purposes. *Id.* at 23a. Under either approach, the court explained, the basis-overstatement penalty would apply to petitioner's understatement of tax, because his claimed basis of $9.4 million exceeds 400% of both $1.8 million and zero. *Id.* at 24a; see 26 C.F.R. 1.6662-5(g) (providing that any overstatement of the basis of property with a correct basis of zero "is considered to be 400 percent or more of the correct amount").

DISCUSSION

Petitioner contends that the basis-overstatement penalty set forth in 26 U.S.C. 6662 cannot apply to an underpayment of income tax when the underlying tax deduction is disallowed solely on the ground that the transactions on which the deduction is premised lacked economic substance. In *United States* v. *Woods*, No. 12-562 (to be argued Oct. 9, 2013), the Court granted certiorari on that question. The Court should accordingly hold this petition pending its decision in *Woods* and then dispose of the petition as appropriate in light of that decision.

1. If the Court in *Woods* holds that the basis-overstatement penalty applies to an underpayment resulting from a determination that a transaction lacks economic substance, the petition for a writ of certiorari should be denied, because that is the same conclusion reached by the court below. If the Court holds that the penalty cannot apply to an underpayment resulting from a determination that a transaction lacks economic substance, it should grant the petition, vacate the court of appeals' judgment, and remand this case for further consideration in light of this Court's holding. On remand, the courts below will have the opportunity to consider in the first instance whether any of the IRS's alternative reasons for disallowing petitioner's $7.6 million loss supports application of the overstatement penalty. In their decisions below, the court of appeals and the Tax Court acknowledged but did not address the IRS's alternative arguments. See Pet. App. 15a n.15, 44a & n.12.

2. In *Woods*, this Court also granted certiorari on the following threshold question: "Whether the district court had jurisdiction in this case under 26 U.S.C. § 6226 to consider the substantial valuation misstatement penalty." Section 6226 defines the authority of district courts in partnership-level proceedings to resolve issues that may ultimately bear on the tax and penalty liability of individual partners.

If the Court in *Woods* holds that the district court lacked jurisdiction to consider the applicability of the valuation misstatement penalty in that case, the Court should grant review in this case. Unlike *Woods* and *Alpha I, L.P.* v. *United States*, petition for cert. pending, No. 12-550 (filed Nov. 1, 2012), this case does not arise in the partnership context and therefore does not raise any jurisdictional question under Section 6226. In addition, as the United States noted in its brief opposing certiorari in *Alpha I*, the court of appeals' decision in that case does not squarely implicate the question presented and arises in an interlocutory posture. See U.S. Br. in Opp. at 16, 21-22, No. 12-550 (Jan. 2, 2013).

CONCLUSION

The petition for a writ of certiorari should be held pending this Court's decision in *United States* v. *Woods*, No. 12-562, and then disposed of as appropriate in light of the Court's decision in that case.

Respectfully submitted.

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SEPTEMBER 2013

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12-2275

NEAL CRISPIN, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE

Argued: Jan. 8, 2013
Filed: Mar. 19, 2013

On Appeal from the United States Tax Court
(No. 28980-07)
Judge: Hon. Diane L. Kroupa

Before RENDELL, FISHER, and JORDAN, *Circuit Judges*.

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ORDER AMENDING OPINION

JORDAN, *Circuit Judge*.

IT IS NOW ORDERED that the above-captioned opinion be amended as follows:

Footnote 3 shall now read:

> The Commissioner contends that that step in the CARDS transaction "is predicated on an invalid application of the . . . basis provisions of the Internal Revenue Code." (Appellee's Br. at 4.)
>
> Specifically, I.R.C. § 1012 provides that a taxpayer's basis in property is generally equal to the purchase price paid by the taxpayer. That purchase price includes the amount of the seller's liabilities assumed by the taxpayer as part of the purchase, on the assumption that the taxpayer will eventually repay those liabilities. *See Comm'r v. Tufts*, 461 U.S. 300, 308-09 (1983). But in a CARDS transac-

tion, the Commissioner argues, the taxpayer and the foreign borrower agree that the taxpayer will repay only the portion of the loan equal to the amount of currency the taxpayer actually purchases.

/s/ KENT A. JORDAN
KENT A. JORDAN
Circuit Judge

DATED: Mar. 19, 2013