No. 16-347

In the Supreme Court of the United States

CHEMTECH ROYALTY ASSOCIATES, L.P., BY DOW EUROPE, S.A., AS TAX MATTERS PARTNER, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

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

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the district court clearly erred in finding that the partners in a partnership that petitioners formed as part of a tax-avoidance scheme did not intend to share profits and losses.

2. Whether the Internal Revenue Code's penalty for negligence or substantial understatement of tax is applicable to the tax-avoidance scheme involved in this case.

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OPINIONS BELOW

The opinions of the court of appeals are reported at 766 F.3d 453 (Pet. App. 26a-51a) and 823 F.3d 282 (Pet. App. 1a-18a). The opinions of the district court are not published in the *Federal Supplement* but are available at 2013 WL 704037 (Pet. App. 57a-145a) and 2015 WL 2183807 (Pet. App. 19a-25a). The corrected judgment and order of the district court (Pet. App. 52a-56a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on May 17, 2016. On August 10, 2016, Justice Thomas extended the time within which to file a petition for a writ of certiorari to and including September 14, 2016, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. This case involves a tax-avoidance scheme that manipulated the Internal Revenue Code provisions governing the tax treatment of partnerships. The Code defines "partnership" to include "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of [the Code], a corporation or a trust or estate." 26 U.S.C. 761(a). Under the Code, a partnership is not taxed as a separate entity. Rather, a partnership's income, losses, and other tax items flow through to the individual partners, who report such items on their own income-tax returns. 26 U.S.C. 701, 702.

Congress enacted the partnership tax provisions in order to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring an entity-level tax. The absence of entity-level tax, however, has often given rise to tax-avoidance schemes that attempt to manipulate the unique rules applicable to partnerships to gain tax advantages never envisioned by Congress. A common mid-Twentieth Century scheme, for example, used family partnership arrangements to shift taxable income from a person in a high tax bracket to a family member in a lower tax bracket. See *Commissioner* v. *Tower*, 327 U.S. 280, 285-286 (1946).

In recent decades, tax-avoidance schemes have grown in scope and complexity, with taxpayers seeking to manipulate a wide array of partnership tax provisions through arcane transactions involving multiple partnerships. The Internal Revenue Service (IRS) and the courts have generally rejected those arrange-

ments and have disallowed their purported tax benefits, relying on a number of related judicial doctrines, such as the "economic substance" doctrine, that authorize the IRS to disregard transactions and business structures designed to exploit the tax laws by creating artificial paper losses that do not reflect economic reality. *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 583 (1978); see *Commissioner* v. *Court Holding Co.,* 324 U.S. 331 (1945); *Moline Props. Inc.* v. *Commissioner*, 319 U.S. 436, 439 (1943); *Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935).[1] Those doctrines rest on the bedrock principle that, "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Frank Lyon*, 435 U.S. at 573 (citation omitted); see 26 U.S.C. 7701(*o*) (codifying economic-substance doctrine).

One of the substance-over-form tax doctrines is the sham-partnership doctrine. That doctrine permits the IRS and the courts to disregard the form of a partnership where the partners do not in fact intend to carry on a joint business enterprise. As the Court explained 70 years ago, "[w]hen the existence of an alleged partnership arrangement is challenged by outsiders, the

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[1] See, *e.g.*, *Superior Trading, LLC* v. *Commissioner*, 728 F.3d 676 (7th Cir. 2013) (invalidating a "distressed asset/debt" shelter that manipulated partnership basis rules); *Nevada Partners Fund, LLC* v. *United States,* 720 F.3d 594 (5th Cir. 2013) (invalidating a "FOCus" shelter that created artificial tax losses through tiered partnerships); *Stobie Creek Invs. LLC* v. *United States*, 608 F.3d 1366 (Fed. Cir. 2010) (invalidating a "Son of BOSS" shelter that manipulated partnership basis rules); *TIFD III-E, Inc.* v. *United States*, 459 F.3d 220 (2d Cir. 2006) (invalidating a lease-stripping tax shelter, similar to the one employed in this case, that manipulated partnership income-allocation rules).

question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." *Tower*, 327 U.S. at 286-287. Explaining that the partners' "intention in this respect is a question of fact," the Court held that, if the partners lacked the requisite intent in forming the partnership, the partnership may be disregarded for purposes of determining federal tax liability. *Id.* at 287.

The Court further explicated the sham-partnership doctrine three years later in *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949). As in *Tower*, the Court explained that whether an ostensible partnership will be respected for tax purposes turns on "a question of fact," *i.e.*, whether the putative partners intended to "join together for the purpose of carrying on business and sharing in the profits or losses or both." *Id.* at 741 (quoting *Tower*, 327 U.S. at 287). The Court further clarified that the question must be resolved by examining the totality of the circumstances: "the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent." *Id.* at 742. In the nearly 70 years since *Culbertson* was decided, the IRS and the courts have regularly applied that fact-based intent standard to determine whether to disregard a partnership for federal tax purposes.

2. In the 1990s and 2000s, Dow Chemical Company (Dow) executed two tax-avoidance transactions known as Chemtech I (from 1993 to 1998) and Chemtech II

(from 1998 to 2006). In the Chemtech transactions, Dow sought to take advantage of the partnership form to claim more than $1 billion in artificial tax deductions —that is, tax deductions that did not reflect actual losses of $1 billion. Like many corporate tax shelters marketed to Fortune 500 companies during the 1990s, the Chemtech transactions were structured as financing arrangements in which Dow generated a stream of deductible business expenses by leasing its own assets back from a partnership, while shifting the taxable income from those leases to foreign banks not subject to U.S. taxation. See Karen C. Burke & Grayson M.P. McCouch, *Sham Partnerships and Equivocal Transactions*, 69 Tax Law. 625, 626 (2016) (Burke & McCouch) (describing this structure as "typical[]"). That effectively allowed Dow to create the appearance of significant losses for tax purposes, even though it did not actually incur such losses. Although Dow's income and costs from the transactions were largely offsetting, Dow allocated the income to tax-neutral foreign entities while allocating the costs to itself.

The mechanics of the Chemtech transactions are extremely complex and were described in detail by the district court. See Pet. App. 59a-92a; see also Burke & McCouch 627-636. We briefly summarize them.

a. Chemtech I was Dow's implementation of a tax shelter known as "Special Limited Investment Partnerships," or "SLIPs," that Goldman Sachs marketed to Fortune 500 companies during the early 1990s. Burke & McCouch 627-628. Through several subsidiaries, Dow created a partnership named Chemtech Royalty Associates, L.P. (Chemtech) in April 1993. ROA 2211-2219. Dow contributed to the partnership 73 patents, valued at $866,966,000, that Dow was ac-

tively using in its manufacturing business. ROA 2230, 6405-6407. Dow then entered into a license agreement with Chemtech that allowed Dow to continue using the patents in exchange for its agreement to pay substantial royalties to Chemtech. ROA 2219; Joint Ex. (JX) 1Q; DX 6, at 4-5. Dow's contribution of the patents to Chemtech had no effect on Dow's own use of the patents. ROA 5902-5903, 5907, 6405-6407, 6952.

On Dow's behalf, Goldman Sachs then recruited five foreign banks to join Chemtech. ROA 2221-2222. The banks contributed a total of $200 million to Chemtech in exchange for limited-partner interests (with no management rights) totaling 18%. ROA 2221-2225, 4454-4455. The remaining 82% of the partnership interests were held by Dow entities, with petitioner Dow Europe, S.A. (Dow Europe) as Chemtech's only general partner. ROA 2225, 4455.

Critically for the sham-partnership analysis, Dow's arrangement with the foreign banks was designed to provide the banks a fixed rate of return of 6.947% on their $200 million investment. Pet. App. 69a, 97a. The partnership agreement and a number of other agreements effectively guaranteed that the foreign banks would receive back their investment, plus the agreed rate of return, regardless of Chemtech's financial performance. *Id.* at 97a-102a. Although the banks' return could be increased or reduced by a change in the value of Chemtech's patent portfolio, their *collective* interest in any such residual profit or loss was capped at 1% (*i.e.*, 0.2% per bank, on average). *Id.* at 32a n.11, 48a. Moreover, Dow effectively controlled the portfolio's value because Dow Europe could unilaterally cause Chemtech to remove patents from the portfolio and distribute them back to Dow. *Id.* at 48a, 101a.

From April 1993 through June 1998, Dow paid royalties to Chemtech totaling $646 million for the use of the patents it had contributed to Chemtech. ROA 2282, 2289. Dow deducted those payments as business expenses on its tax returns—thus creating a large paper loss for tax purposes. ROA 4376-4377. But after Chemtech paid the foreign banks' fixed returns (totaling approximately $65 million) and a few other minor expenses, it returned the remainder of the royalty payments to Dow in the form of loans. ROA 2282, 2289. At the same time, the vast majority of Chemtech's taxable income from Dow's royalty payments (totaling $546 million, after expenses) was allocated to the foreign banks through a series of highly complex agreements that manipulated then-existing partnership allocation rules. ROA 2282.

In that way, Dow generated $646 million in tax deductions by paying royalties to Chemtech that, for the most part, ultimately flowed back to Dow, while avoiding taxation on most of Chemtech's income from those payments by allocating it for tax purposes to the foreign partners who were exempt from United States taxation. See ROA 4456-4457 (illustrating the circular flow of funds and the non-circular flow of tax consequences under Chemtech I). In June 1998, Dow effectively terminated the Chemtech I transaction by exercising its option under the partnership agreement to repurchase the foreign banks' interests for a total of $210,409,571, consisting of their original contributions plus 1% of the increased value of the patents. ROA 2232-2234.

b. Once Dow had decided to terminate Chemtech I, it began planning the Chemtech II transaction. JX 710. In June 1998, Dow renamed the Chemtech I

partnership Chemtech II and designed a structure that it described as "an off-shoot from the Chemtech I transaction." ROA 2235; JX 710, at 3. This time, instead of patents, Dow contributed a chemical plant to the partnership. As with Chemtech I, however, Chemtech II involved Dow's payment and deduction of rents to lease the plant back, an ostensible foreign-bank partner entitled to a fixed rate of return on its investment, and the loaning back to Dow of its rental payments minus the amount of the bank's return. Pet. App. 81a-92a.

Unlike Chemtech I, Chemtech II allocated most of the income from Dow's rental payments to the Dow-subsidiary partners, largely offsetting the tax benefit of Dow's deduction for those payments. ROA 2284, 4377. Instead, the tax benefit of Chemtech II arose primarily from Dow's inflation of the chemical plant's tax basis from $18.5 million to $381 million, which enabled Dow to claim artificially large depreciation deductions. ROA 2236, 2239, 2284, 4377. From 1998 through 2003, Dow was allocated $337 million of Chemtech's rental income, and it claimed tax deductions totaling $342 million for depreciation and $415 million for its rental payments, resulting in a net tax benefit to Dow of $420 million. ROA 2284, 4377. Dow continued to claim tax benefits from the Chemtech II transaction through at least 2007. ROA 48.

c. The IRS issued notices of final partnership administrative adjustment (FPAAs) to Chemtech for its 1993 through 2006 tax years. The FPAAs disallowed the claimed tax benefits of the Chemtech I and Chemtech II transactions and reallocated nearly all of the partnership's income to the Dow subsidiary partners. ROA 26, 125, 816. For the 1997 through 2006

tax years, the IRS also determined that Dow's resulting underpayments of tax were subject to a 20% penalty, pursuant to 26 U.S.C. 6662, based either on Dow's substantial understatement of its tax liability or on negligence.[2] ROA 42-43, 139, 955-957. The IRS further determined that the portion of Dow's underpayments attributable to Chemtech II were, alternatively, subject to a 40% penalty for gross valuation misstatement. ROA 43, 140.

3. Petitioners are subsidiaries of Dow and were the tax-matters partners of the Chemtech partnership under Chemtech I and Chemtech II, respectively. Between 2005 and 2010, petitioners brought four actions in the district court contesting both the IRS's adjustments to Chemtech's tax reporting and the penalties. The district court consolidated those actions, and the consolidated cases proceeded to trial in June 2011.

a. After a five-day bench trial, the district court ruled in favor of the government. Pet. App. 52a-145a. The court sustained the IRS's disallowance of the transactions' tax benefits on three alternative grounds: (1) the partnership was a sham and should be disregarded for tax purposes under *Tower* and *Culbertson*; (2) the banks were, in substance, lenders to Dow rather than true partners; and (3) the transactions in which Dow contributed its assets to Chemtech and then leased them back lacked economic substance.

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[2] Penalties were not asserted in the IRS's notice covering the 1993 through 1996 tax years only because the law at that time did not allow penalties to be determined at the partnership level. See 26 U.S.C. 6221, 6226 (1996); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, Tit. XII, § 1238(a) and (b)(1), 111 Stat. 1026. Penalties for those years may be imposed at the partner level.

On the sham-partnership issue, the district court held that "[t]he facts and circumstances of this case make it plain" that the partnership was a sham under *Tower* and *Culbertson* because "Dow and the foreign banks did not 'in good faith and acting with a business purpose,' join together in the present conduct of an enterprise." Pet. App. 124a-125a. The court explained that "[t]he evidence in this case le[d] [it] to find that Dow had no business purpose for entering into the Chemtech transactions other than to obtain tax benefits." *Id.* at 107a-108a. After observing that "Dow does not contend that it entered into the transaction[s] to make a profit," the court rejected Dow's claim that their purpose was "rather to obtain ['off balance sheet' financing] that would sustain its credit rating." *Id.* at 119a. The court described that "professed business purpose" as "contrived" and as "a false wall in the maze of the Chemtech transactions." *Id.* at 107a, 135a.

The district court found instead that "Dow's purpose in entering into the Chemtech transactions was to obtain tax benefits." Pet. App. 120a. "Everything other than tax motivation," the court explained, "fades under the glare of analysis." *Ibid.* (citation omitted). *Inter alia*, the court found that "[t]ax law was the basis for the SLIPs transaction from the beginning," that "[n]o evidence was presented in this case showing that Dow identified any specific project prior to the Chemtech transaction that reflected a purpose other than the generation of large tax benefits," and that "Dow had no apparent need for the $200 million investment [from the foreign banks]" and "did not prove" that the off-balance-sheet aspect of the financing "had any appreciable affect or value to Dow." *Id.* at 105a-

106a, 108a, 117a. The court expressly declined to credit the testimony of Dow executives that the transactions' purpose was to obtain off-balance-sheet financing, finding that those executives had little involvement and were unfamiliar with the details of the transactions. *Id.* at 120a-121a.

The district court also found that "[t]he SLIPs transaction did not change Dow's financial position." Pet. App. 116a. The evidence showed, for example, that Dow's transfers of the patents and the chemical plant to the partnership "did not result in any economic advantage[s] to Dow" and had no effect on Dow's continued use of those assets. *Ibid.*; see *id.* at 63a-64a, 79a. To the contrary, the court found it "obvious * * * that Dow never had an intention to derive any additional revenue by transferring the patents to Chemtech" because there was no realistic possibility that the patents could be licensed to third parties. *Id.* at 125a. The court further explained that, "at trial, Dow abandoned the idea that the Chemtech partnership was designed to manage patents or maximize the revenues of the patents by licensing them to third parties." *Ibid.* The court determined that the royalties and rents Dow had paid to continue using its patents and chemical plant were merely part of "[a] circular flow of money" that "beg[an] with Dow, circulate[d] through Chemtech entities, and return[ed] back to Dow." *Id.* at 71a, 116a.

As particularly relevant here, in support of its holding that the Chemtech partnership was a sham, the district court further found that Dow and the foreign banks had not genuinely intended to share the profits and losses of an enterprise. See *Culbertson*, 337 U.S. at 741. The court explained that "[a] partner whose

risks are all insured at the expense of another partner hardly fits within the traditional notion of a partnership," and that "[a] valid partnership is not formed where, among other things, one partner receives a guaranteed, specific return." Pet. App. 126a (citation omitted). In this case, the court determined that both problems were present: The banks were essentially "guaranteed a return just under 7% each year," and the arrangements were carefully designed "to ensure the banks' risk of loss would be de minimis." *Id.* at 129a. The court noted, in particular, that Chemtech's revenues (*i.e.*, Dow's royalty and rental payments) were virtually guaranteed, thereby assuring that the banks would receive back their original investments plus the priority return, and that there was virtually no risk of loss because Dow had provided many indemnities and because Chemtech was over-collateralized. *Id.* at 100a-102a, 128a-129a. The court concluded for those reasons that the banks had not borne "the risks of a true partner or entrepreneur." *Id.* at 126a.

Although petitioners emphasized the banks' collective 1% interest in any increase or decrease in the value of the partnership assets, the district court found that this interest "was nothing but window dressing." Pet. App. 136a. For example, at the conclusion of Chemtech I, Dow had deemed the foreign banks to be "greedy" for claiming that Dow was under-valuing the patents' gains by as much as $100 million. *Id.* at 77a; see *id.* at 76a-78a, 127a. The court explained that, "if Chemtech were a true joint venture, all parties would be pleased with high gains in market-to-market valuation of the patents." *Id.* at 77a. Given that Dow held the remaining 99% interest

in such gains, the court found that Dow's "unwavering" insistence on a valuation that, according to the banks, was far below the patents' fair-market value was understandable only "if Chemtech were, in fact, something other than a true partnership where each party had a real ownership stake." *Id.* at 77a-78a.

Based on those extensive findings, the district court held that the Chemtech partnership was a sham and should be disregarded for tax purposes under the rule of *Tower* and *Culbertson*. The court also held in the alternative that many of those same findings, in addition to other findings, established that the banks were not "true partners" for tax purposes because their "interests were in the nature of debt, not equity," and that the transactions in which Dow had contributed its assets to Chemtech and leased them back lacked economic substance. Pet. App. 127a; see *id.* at 122a.

b. Regarding penalties, the district court upheld the 20% penalty for tax years 1997-2006 on both negligence and substantial-understatement-of-tax grounds. Pet. App. 144a. The court rejected the alternative 40% penalty for the underpayments of tax attributable to Chemtech II, holding that then-controlling Fifth Circuit precedent precluded valuation misstatement penalties when a transaction is disregarded for lack of economic substance. *Id.* at 141a-144a.

4. Petitioners appealed the district court's rulings upholding the disallowance of the tax benefits and the 20% penalty for negligence or substantial understatement of tax, and the government appealed the rejection of the 40% penalty for gross valuation misstatement. Pet. App. 26a-51a. Agreeing with the government, the court of appeals affirmed as to the tax

benefits and reversed as to the 40% penalty, but it remanded all penalties to the district court for further consideration. *Ibid.*

a. With respect to the disallowance of the tax benefits, the court of appeals affirmed the district court's sham-partnership holding and expressly declined to reach its alternative holdings that the foreign banks' interests were debt rather than equity and that the contribution-leaseback transactions lacked economic substance. Pet. App. 36a n.18, 48a-49a. The court of appeals explained that, under *Tower* and *Culbertson*, "[t]he *sine qua non* of a partnership is an intent to join together for the purpose of sharing in the profits and losses of a genuine business." *Id.* at 45a (quoting *Southgate Master Fund, LLC* v. *United States*, 659 F.3d 466, 488 (5th Cir. 2011)). Focusing its inquiry "on whether Dow had the intent to share the profits and losses with the foreign banks," the court "consider[ed] all relevant 'facts throwing light on their true intent,' and review[ed] only for clear error." *Ibid.* (quoting *Culbertson*, 337 U.S. at 742).

The court of appeals identified three key features of the Chemtech partnership that established that the district court had not committed clear error in finding that the parties to the partnership lacked the intent to share profits and losses. "First, the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment regardless of the success of the [Chemtech] venture." Pet. App. 46a (internal quotation marks omitted; brackets in original). "Second, Dow agreed to bear all of the non-insignificant risks arising out of the Chemtech transactions" and gave "four significant 'ironclad' assurances to ensure that Dow would not misappropriate or

otherwise lose the banks' initial investment." *Id.* at 46a-47a. "Third, * * * the foreign banks did not meaningfully share in any potential upside" because, *inter alia*, "no one expected or designed [Chemtech] to be profitable." *Id.* at 48a. Concluding that "these considerations demonstrate that the district court did not clearly err in determining that Dow lacked the intent to share the profits and losses of the Chemtech transactions with the foreign banks," the court of appeals affirmed the district court's holding that the partnership was a sham and that the IRS therefore had acted permissibly in disregarding the artificial losses generated by the transactions. *Ibid.*

b. With respect to the penalties, the court of appeals noted that this Court's intervening decision in *United States* v. *Woods*, 134 S. Ct. 557 (2013), had overruled the Fifth Circuit authority that had compelled the district court's rejection of the 40% penalty. Pet. App. 50a. Accordingly, the court of appeals remanded for the district court to determine whether to impose that penalty. *Id.* at 51a. Although the court of appeals "express[ed] no opinion on whether the [district] court erred in imposing the negligence and substantial-understatement penalties," it also stated without further elaboration that, "[o]n remand, the court should consider the extent to which imposing those penalties remains consistent with this opinion." *Ibid.*

5. On remand, petitioners conceded that, in light of *Woods*, the underpayments of tax attributable to Chemtech II were subject to the 40% penalty for gross valuation misstatement, and the district court so ordered. Pet. App. at 23a-25a. With respect to the 20% penalty for negligence or substantial under-

statement of tax, the district court noted that the court of appeals had "not indicated that the [district court] misapplied the law to these penalties," and that "[t]he relevant underlying facts * * * remain unchanged." *Id.* at 22a & n.5. Based on its prior findings and conclusions, the court of appeals therefore reinstated its decision that a 20% penalty was applicable to all underpayments for the 1997-2006 tax years. *Id.* at 22a.[3]

6. Petitioners appealed the district court's holding that the 20% penalty was applicable to the 1997 and 1998 tax years of Chemtech I. The court of appeals affirmed. Pet. App. 1a-18a. The court upheld the applicability of the 20% penalty because no substantial authority or reasonable legal basis supported petitioners' position that Chemtech was a valid partnership. *Id.* at 11a. Rejecting petitioners' argument that their position was supported by a pair of Tax Court decisions, *Morris* v. *Commissioner*, 13 T.C. 1020 (1949) and *Hunt* v. *Commissioner*, 59 T.C.M. (CCH) 635 (1990) (unpublished), the court concluded that petitioners' interpretation of those decisions was incorrect. Pet. App. 15a-16a. The court also concluded that *Morris* and *Hunt* were "materially distinguishable on

[3] As the district court noted, accuracy-related penalties are imposed alternatively, rather than cumulatively. Pet. App. 24a. Thus, a 40% penalty and a 20% penalty cannot both be imposed on the same underpayment of tax. But as this Court explained in *Woods*, the penalty decision in a partnership-level proceeding such as this is only a provisional determination of the penalties that are *applicable*; penalties are actually *imposed* only at the partner level, which may require further, partner-specific determinations. 134 S. Ct. at 564. Thus, a court may properly hold, at the partnership level, that multiple penalties are "applicab[le]," even though no more than one may ultimately be imposed. *Ibid.*

their facts," and that their value as authority for respecting the Chemtech partnership was insubstantial compared to contrary circuit authority. *Id.* at 17a; see *id.* at 17a-18a (citing *Merryman* v. *Commissioner*, 873 F.2d 879 (5th Cir. 1989)).

ARGUMENT

Petitioners principally challenge (Pet. 15-34) the court of appeals' holding that the Chemtech partnership was a sham. Applying clear-error review, the court of appeals correctly upheld the district court's finding that the putative partners lacked the requisite intent to form a legitimate partnership, and the Fifth Circuit's resolution of that factbound question does not conflict with any decision of this Court or another court of appeals.[4] Petitioners also briefly challenge (Pet. 34-35) the lower courts' conclusion that petitioners are subject to the 20% penalty for negligence and substantial understatement of tax because they lacked substantial authority for their position. The court of appeals correctly held that the penalty applied given the well-established sham-partnership doctrine, and in any event that case-specific question similarly does not warrant this Court's review.

1. The court of appeals correctly affirmed, as not clearly erroneous, the district court's finding that the Chemtech partnership was a sham because "Dow lacked the intent to share the profits and losses of the Chemtech transactions with the foreign banks" that served as putative partners in the Chemtech partnership. Pet. App. 48a.

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[4] Last Term, this Court denied certiorari in a Second Circuit case involving a virtually identical transaction. See *TIFD III-E, LLC* v. *United States*, 136 S. Ct. 796 (2016) (No. 15-331).

a. In *Commissioner* v. *Tower*, 327 U.S. 280 (1946), and *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), this Court recognized that the IRS need not accept a taxpayer's characterization of a business relationship as a "partnership" for federal tax purposes unless "the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits or losses or both." *Culbertson*, 337 U.S. at 741 (quoting *Tower*, 327 U.S. at 287); see *id.* at 740 (quoting *Tower*, 327 U.S. at 286, for the proposition that a partnership requires "community of interest in the profits and losses"). The Court explained that, when analyzing the relationship between the putative partners, the IRS and courts should consider the totality of the relevant circumstances, including the legal agreements between the parties, their statements and conduct, the "actual control" of the business's income, and "any other facts throwing light on their true intent." *Id.* at 742.

In *Tower*, the Tax Court had found that a taxpayer had converted his business into a partnership with his wife solely to obtain favorable tax consequences and "did not intend to carry on business as a partnership." 327 U.S. at 287. This Court explained that the putative partners' "intention in this respect is a question of fact," and that since the Tax Court's "finding of fact" was "supported by evidence," it should be upheld. *Id.* at 287 (citations omitted). Likewise in *Culbertson*, which concerned a putative partnership between a taxpayer and his four sons, the Court explained that "[t]he question is * * * whether, considering all the facts[,] * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." 337 U.S. at

742. The Court noted that "[t]riers of fact are constantly called upon to determine the intent with which a person acted." *Id.* at 743. The Court remanded for a determination of that factual question in the first instance by the Tax Court, which had applied the wrong standard. *Id.* at 748.

b. The court of appeals correctly applied the intent standard set out in *Tower* and *Culbertson* in concluding that the district court did not commit "clear error" when it found that the parties to the Chemtech partnerships did not have either "the intent to share profits" or "the intent to share losses." Pet. App. 45a-46a.

i. At the outset of its analysis, the court of appeals correctly stated that "whether a partnership will be respected for tax purposes depends on whether the parties in good faith and acting with a business purpose genuinely intended to join together for the purpose of carrying on the business and sharing in the profits and losses." Pet. App. 40a (quoting *Southgate Master Fund, LLC* v. *United States*, 659 F.3d 466, 483 (5th Cir. 2011)). That description of the applicable legal standard precisely tracks the test articulated in *Tower* and *Culbertson*.

The court of appeals then identified three characteristics of the Chemtech tax-avoidance scheme that supported the district court's finding that the parties to the Chemtech partnership lacked the requisite intent. "First, the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment 'regardless of the success of the [Chemtech] venture.'" Pet. App. 46a (brackets in original). "Second, Dow agreed to bear all non-insignificant costs arising out of the Chemtech transactions" and gave "four significant 'ironclad' assur-

ances to ensure that Dow would not misappropriate or otherwise lose the banks' initial investment." *Id.* at 46a-47a. "Third, * * * the foreign banks did not meaningfully share in any potential upside" from the transactions. *Id.* at 48a. Petitioners do not contest those subsidiary factual findings, and any such case-specific objection would not warrant this Court's review.

Based on those three subsidiary findings, the court of appeals concluded that "the district court did not clearly err in determining that Dow lacked the intent to share the profits and losses of the Chemtech transactions with the foreign banks." Pet. App. 48a. That conclusion was correct. The district court's fact-finding demonstrates that the Chemtech transactions were designed to generate a large paper loss for Dow without exposing the foreign banks to any significant risk of loss, and without any significant possibility that the foreign banks would profit from the partnership's successes. The district court's intent finding thus represents a straightforward application of the standard articulated in *Tower* and *Culbertson* to the complex facts of this case. And in any event, the court's case-specific conclusion that the district court did not commit clear error in determining Dow's intent does not present any question of general applicability warranting this Court's review.

ii. Petitioners' principal contention (Pet. 15-24) is that the court of appeals impermissibly applied "heightened scrutiny" in reviewing the Chemtech tax-avoidance scheme. That contention reflects a misapprehension of the court of appeals' analysis, which relied on the intent standard set out in *Tower* and *Culbertson* and

the clear-error standard of appellate review for a district court's factual findings.

Petitioners rely on the court of appeals' passing statement, quoting its prior decision in *Southgate*, that "[b]ecause so many abusive tax-avoidance schemes are designed to exploit the Code's partnership provisions, our scrutiny of a taxpayer's choice to use the partnership form is especially stringent." Pet. App. 38a (quoting *Southgate*, 659 F.3d at 483-484). But beginning with the next sentence, the court dedicated three paragraphs to scrupulously articulating both the governing sham-partnership standard of *Tower* and *Culbertson* and the clear-error standard of appellate review that applies to a district court's factual findings. *Id.* at 38a-40a. Petitioners do not contend that the court of appeals erred in that exhaustive explication of the governing legal standards. The court then correctly applied those standards, reviewing for clear error the factual determination that Dow and the banks lacked the intent to share profits and losses. *Id.* at 45a-49a.

Read in proper context, the court of appeals' passing reference to "especially stringent" scrutiny most likely referred to the difference between the sham-partnership doctrine of *Tower* and *Culbertson* and the economic-substance or sham-transaction doctrine, which has stricter requirements. That is what the Fifth Circuit meant when it first used that phrase in *Southgate*. See 659 F.3d at 483-484. Tax-shelter participants often argue that the existence of a non-tax business purpose for the underlying transaction satisfies not only the economic-substance test, but also the sham-partnership test. But in *Southgate*, the court of appeals rejected that argument, holding that the par-

tnership at issue was a sham under *Tower* and *Culbertson* even though the underlying transactions had some economic substance. *Id.* at 483-485. The court explained that "[t]he fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny." *Id.* at 484.[5]

It was in that context of distinguishing the *Tower/Culbertson* sham-partnership standard from the economic-substance doctrine that the Fifth Circuit in *Southgate* described its scrutiny of the partnership form as "especially stringent." 659 F.3d at 483-484. The Second Circuit has similarly described the *Culbertson* test as "less favorable to the taxpayer" than the test under the economic-substance doctrine. *TIFD III-E* v. *United States*, 459 F.3d 220, 231 (2006). Both standards require a genuine business purpose, but the *Tower/Culbertson* standard further requires the intent to join together for that purpose *and* the intent to share profits and losses. See *Culbertson*, 337 U.S. at 741. (A loan, for example, is an arrangement with economic substance, but one who loans money for a fixed rate of return does not thereby manifest an

[5] See, *e.g.*, *TIFD III-E* v. *United States*, 459 F.3d 220, 232 n.13 (2d Cir. 2006) ("While a classification that fails the sham[-transaction (*i.e.*, economic substance)] test may be certain also to fail the *Culbertson* analysis, a classification that passes the sham[-transaction] test would not necessarily survive *Culbertson*."); *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511-513 (D.C. Cir.) (recognizing distinction between sham-partnership and economic-substance doctrines), cert. denied, 531 U.S. 871 (2000); see also *Historic Boardwalk Hall, LLC* v. *Commissioner*, 694 F.3d 425, 448 n.50 (3d Cir. 2012) (disregarding partnership under *Culbertson* while assuming, without deciding, that the transactions had economic substance), cert. denied, 133 S. Ct. 2734 (2013).

intent to share in the borrower's profits or losses.) The latter requirement was not satisfied in this case.

Neither the court of appeals' analysis of the district court's intent finding, nor its ultimate conclusion that the finding was not clearly erroneous, suggests that the court of appeals departed from this Court's decisions in *Tower* and *Culbertson*. Accordingly, the central premise of petitioners' argument (Pet. 15)—that an improperly heightened standard "infuses and infects [the court's] entire approach to the sham-partnership issue"—is incorrect. For the same reason, petitioners are wrong in arguing that the court's analysis conflicts with the approach of other courts of appeals to sham-partnership questions.

iii. Petitioners further contend that "*Tower* and *Culbertson* establish that anyone that contributes capital in exchange for an equity interest is a partner for tax purposes," and that the Chemtech partnership therefore must be respected for tax purposes. Pet. 26 (capitalization altered); see Pet. 26-34. That argument is also incorrect, and petitioners identify no court of appeals that has adopted that interpretation of those decisions.

Petitioners' contention rests on a misunderstanding of *Tower* and *Culbertson*. According to petitioners (Pet. 26), this Court in *Tower* identified "two objective factors that would establish the requisite intent to form a partnership: whether all partners either invested capital that originated with them or performed valuable services." They further argue that "*Culbertson* establishes the same proposition: an investor that exchanges its own capital for an equity stake in an otherwise valid partnership must be respected as a partner for tax purposes." Pet. 26-27.

That is precisely the sort of bright-line rule that the *Culbertson* Court rejected in favor of a totality-of-the-circumstances analysis of the purported partners' intent. The Court in *Culbertson* explained that "[t]he question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard." 337 U.S. at 742 (emphasis added). Indeed, as petitioners acknowledge (Pet. 26), this Court expressly rejected an interpretation of *Tower* that deemed their "two objective factors" dispositive of the sham-partnership inquiry. See *Culbertson*, 337 U.S. at 744 (explaining that, contrary to Tax Court's interpretation of *Tower*, a determination that a partner did not contribute valuable services or original capital "is not conclusive"). Instead, the question under both *Tower* and *Culbertson* is "whether, considering all the facts * * * throwing light on their true intent," the purported partners "intended to join together in the present conduct of the enterprise," including by "sharing in the profits or losses or both." *Id.* at 741-742 (quoting *Tower*, 327 U.S. at 287).

Petitioners point (Pet. 27) to a passage at the end of the *Culbertson* opinion in which the Court explained that the question on remand would be whether the taxpayer and his sons had "a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners." 337 U.S. at 748. That passage, however, does not suggest that a contribution of capital alone establishes the requisite intent. Where a party's contribution of capital does not meaningfully subject the party to the risk of loss or the possibility of gain from the partnership, as in

the Chemtech transactions, it does not establish the requisite intent to "shar[e] in the profits or losses or both." *Id.* at 741 (quoting *Tower*, 327 U.S. at 287). Under *Culbertson*, it is necessary that the contribution of capital actually subject the partner to a risk of gain or loss.

Here, the district court found, based on all the evidence, that Dow and the foreign banks did not intend to share in profits and losses. The court of appeals correctly held that the district court's finding was not clearly erroneous. Pet. App. 45a-48a. Neither *Tower* nor *Culbertson* supports petitioners' effort to convert the long-established intent standard into a single-factor, bright-line rule that would immunize any tax-avoidance scheme from the sham-partnership doctrine so long as a partner contributed some amount of equity to the putative partnership, regardless of whether the partner had the intent to share in the partnership's gains and losses.

c. Petitioners argue that the decision below is "inconsistent" with decisions of the Second and Third Circuits that resolved the sham-partnership question on the ground that the partners had contributed debt rather than equity to the partnership. Pet. 30 (capitalization omitted); see Pet. 31-33 (discussing *TIFD III-E*, *supra*, and *Historic Boardwalk Hall, LLC* v. *Commissioner*, 694 F.3d 425 (3d Cir. 2012) (*Historic Boardwalk*), cert. denied, 133 S. Ct. 2734 (2013)). But the two cited decisions did not hold that a partnership is immune from scrutiny under the sham-partnership doctrine so long as the partners contributed interests that are best characterized as equity interests, even if the intent standard of *Tower* and *Culbertson* is not met because the partners were not exposed to any

genuine risk of loss or possibility of gain. Those decisions therefore do not conflict with the decision below.

The Second Circuit in *TIFD III-E* applied the standard of *Tower* and *Culbertson* to a partnership that was materially identical to petitioners', and it held that the partnership should be treated as a sham. 459 F.3d at 231, 241; see *TIFD III-E, Inc.* v. *United States*, 666 F.3d 836, 837-838 (2d Cir. 2012). "[D]espite some differences of emphasis and terminology," the analysis of the court of appeals in this case "seems virtually identical to the approach elaborated by the Second Circuit in [*TIFD III-E*] in determining whether the members of a purported partnership will be treated as partners for tax purposes." Burke & McCouch 654. Indeed, the court below extensively relied on the Second Circuit's decision. See Pet. App. 41a-43a, 46a-48a; see also *Historic Boardwalk*, 694 F.3d at 449, 455-463 (articulating and applying same intent-based, totality-of-the-circumstances test as decision below).

In particular, the court below observed that the relevant "transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment regardless of the success of the Chemtech venture, just as in the transaction in [*TIFD III-E*]," Pet. App. 46a (brackets and internal quotation marks omitted), and that "just as in [*TIFD III-E*], the foreign banks did not meaningfully share in any potential upside," *id.* at 48a. Like the Second Circuit, the court below viewed the substance of the transactions as supporting the conclusion that "Dow lacked the intent to share the profits and losses of the Chemtech transactions with the foreign banks." *Ibid.* The principal difference between the two courts' anal-

yses concerned the distinct (and essentially abstract) question whether the insubstantial nature of the foreign banks' stake in the success or failure of the enterprises meant that the foreign banks' interests were properly characterized as "debt" rather than "equity" interests. Whereas the Fifth Circuit "express[ed] no opinion as to whether the [foreign banks'] interests should be classified as debt," *id.* at 45a, the Second Circuit in *TIFD III-E* concluded that the IRS "was on sound ground in rejecting the partnership's purported characterization of the [foreign] banks' interest as bona fide equity participation" because "the [foreign] banks' interest was overwhelmingly in the nature of a secured lender's interest." 459 F.3d at 231; see 666 F.3d at 837. This Court's review is not necessary to resolve terminological differences between circuits that applied the same functional standard and reached the same result.[6]

2. Petitioners briefly challenge (Pet. 34-35) the court of appeals' holding that the 20% penalty for negligence or substantial understatement of tax under 26 U.S.C. 6662 applies in this case. Further review of that holding is not warranted.

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[6] Petitioners also cite (Pet. 31) three decisions of the Tax Court. A conflict between a decision of a court of appeals and decisions of the Tax Court would not warrant this Court's review. And in any event, as the court of appeals explained, petitioners misunderstand the Tax Court precedents, which "explicitly recognize and purport to apply *Culbertson's* holding and thus cannot be read * * * as authority that the owner of an equity instrument automatically satisfies *Culbertson.*" Pet. App. 15a. "To the contrary, [Tax Court precedents] show that an interest with minimal sharing in profits and losses can qualify as a partnership interest only *if* the owner of that interest intends to share profits and losses." *Id.* at 15a-16a.

Section 6662 provides for the imposition of a penalty equal to 20% of the portion of a taxpayer's underpayment of tax that is attributable to negligence or to a substantial understatement of tax. 26 U.S.C. 6662(a) and (b). In the court of appeals, petitioners relied on two related defenses to that penalty. With respect to negligence, 26 C.F.R. 1.6662-3(b)(1) provides that "[a] return position that has a reasonable basis * * * is not attributable to negligence." Section 6662(d)(2)(B)(i) of the Code similarly provides that, for purposes of the substantial-understatement penalty, the amount of the taxpayer's understatement is generally reduced to the extent the taxpayer can show "substantial authority" for the claimed tax treatment.

Petitioners do not dispute that the court of appeals correctly summarized the legal standards for those defenses. The court also correctly explained that the Tax Court decisions cited by petitioners provided neither substantial authority nor a reasonable basis for their tax position that Chemtech was a valid partnership. Pet. App. 14a-18a; see note 6, *supra*. The court's straightforward application of settled legal standards was correct and raises no legal issue of general applicability warranting this Court's review.

Petitioners' argument (Pet. 35) on the penalty issue relies primarily on their misunderstanding of the decision below as applying a form of heightened scrutiny beyond what is required by *Tower* and *Culbertson*. See pp. 20-23, *supra*. As explained above, however, the court of appeals carefully and correctly articulated the sham-partnership standard set out in those decisions, as well as the applicable standard of appellate review for a district court's factual finding.

The penalty question therefore does not warrant this Court's review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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