Petaluma and the Limits of Treasury’s Authority

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system. This is just one reason why Congress should encourage the administration to take the steps outlined above.

E. Conclusion

The proposed regulatory changes would materially reduce the incentive for a U.S. corporation to expatriate for tax-motivated reasons by reducing the cash and book tax benefits from expatriating. These approaches would not prevent cross-border combinations that are grounded on real business objectives. They are supported by existing statutory authority and integrate well with future tax reform. Most important, they would stanch the rush to the exit that is motivated by loopholes in our existing tax rules and increase the ability to work toward real international tax reform in the future. Without action, there may be little corporate tax base to reform.

The U.S. Treasury raises more revenue than any other institution in the world. The tax system that accomplishes this task requires constant attention and protection — market forces cannot be relied upon to fix problems. Without tax revenue, the public goods the federal government provides cannot be purchased, vital income transfers cannot be made, and individuals suffer as a result. When corporations do not pay their share, other taxpayers have to make up the difference. Failing to address tax-motivated corporate expatriations risks real damage to the U.S. tax structure. The tools are available; it is time to use them.

Petaluma and the Limits Of Treasury's Authority

By Andy S. Grewal

In United States v. Woods, the Supreme Court seemingly resolved a jurisdictional issue and a penalty issue regarding son-of-BOSS transactions involving partnerships. On the jurisdictional issue, the Court held that section 6226(f) allows a TEFRA court to consider the application of the gross valuation misstatement penalty to the inflation of outside basis in a sham partnership. The Court also seemingly resolved the substantive penalty issue, concluding that the gross valuation misstatement penalty applies to the inflation of outside basis in a sham partnership.

However, as I have previously explained, the Court's opinion does not definitively resolve either issue. On the jurisdictional issue, the parties failed to present a threshold regulatory question that could preclude a TEFRA court from considering any aspect of a case involving a sham partnership. On the penalty issue, the Court itself doubted the validity of reg. section 1.6662-5(g), which extends the gross valuation misstatement penalty to zero basis circumstances. But because the taxpayers in


"TEFRA court" does not refer to any special type of federal court, but rather to a court that is conducting a partnership-level proceeding under the procedures established by the 1982 Tax Equity and Fiscal Responsibility Act, P.L. 97-248, 96 Stat. 324 (1982).

Woods failed to challenge the regulation, the Court said it would assume its validity in deciding the case.\(^6\) In Petaluma v. Commissioner,\(^7\) pending before the D.C. Circuit, the taxpayer has presented the regulatory arguments that the Woods taxpayers missed.\(^8\) Consequently, what was once a mind-numbing, hypertechnical TEFRA case has become a case about fundamental administrative law principles. Depending on how the D.C. Circuit addresses the issues, its eventual opinion may shed light on Treasury’s authority to bypass the Administrative Procedure Act (APA) and its ability to issue a regulation expanding a statute beyond its terms.

This article explores the fundamental administrative law issues raised in Petaluma. It touches on the issues fairly lightly — I have performed extensive doctrinal analysis elsewhere.\(^9\) However, I cannot resist the temptation to critique some of the rather peculiar arguments in the government’s reply brief.

### A. Background

To understand the issues, one needs only a bare description of the facts. Essentially, in Petaluma, as in Woods, the taxpayers engaged in complex son-of-Boss transactions involving partnerships.\(^10\) The transactions were designed to give each partner an egregiously large outside basis in his partnership interest. That outside basis would then be used to generate massive tax losses.

In Petaluma and similar cases, courts have correctly treated the partnerships used in son-of-Boss transactions as shams. Because the partnerships are consequently disregarded for tax purposes, each purported partner’s basis is reduced from an obscenely high amount all the way down to zero.

In Woods, the Supreme Court addressed a jurisdictional issue and a penalty issue regarding these son-of-Boss cases. In its first holding, the Court concluded that a TEFRA court could determine whether the gross valuation misstatement penalty applied to the partners, even though outside basis is generally an affected item, and not a partnership item. That ruling stemmed from section 6626(f), which allowed a TEFRA court to address any penalty that relates to a partnership item and not merely penalties that involve only partnership items. In its second holding, the Court applied regulation section 1.6662-5(g) and held that the gross valuation misstatement penalty applies when a partnership is disregarded and a partner’s outside basis is reduced to zero. However, in reaching these narrow holdings, the Court did not address a threshold jurisdictional issue, and it expressly reserved ruling on the validity of regulation section 1.6662-5(g).

Regarding the jurisdictional issue, neither party addressed whether TEFRA applied at all to sham partnerships for the tax years at issue. That is, section 6233 extends TEFRA to sham partnerships only “to the extent provided in regulations.” But the promulgation of regulation section 301.6233-1T violated the APA, and if general administrative law doctrines apply, the regulation would be invalid.\(^11\) Without the regulation, nothing would extend TEFRA to sham partnerships for pre-2001 tax years, like those at issue in Woods and Petaluma.

Regarding the second issue, the Court noted my argument that regulation section 1.6662-5(g) stands in tension with the statutory language.\(^12\) It is mathematically impossible to apply a percentage-based penalty, like the gross valuation misstatement penalty, in zero basis circumstances. However, the taxpayers in Woods did not challenge the regulation, so the Court assumed its validity in deciding the case.

In the pending controversy, Petaluma FX Partners LLC, unlike the taxpayers in Woods, argues that regulation section 301.6233-1T violates the APA and is thus invalid. It also argues that regulation section 1.6662-5(g) reflects an improper interpretation of the statute. These arguments implicate fundamental administrative law issues that have caused confusion among the lower courts.

### B. Will the Court Hear Petaluma’s Arguments?

Before getting too excited about how the D.C. Circuit will address Petaluma’s arguments, one must consider whether the court will even entertain them. Petaluma’s controversy has gone on for some time and has ping-ponged between the Tax Court and the D.C. Circuit.\(^13\) Thus, the taxpayer has had

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\(^6\)See Woods, 134 S. Ct. at 566, n.4 (“Woods has not challenged the regulation before this Court, so we assume its validity for purposes of deciding this case”).

\(^7\)No. 12-1364 (D.C. Cir. filed Aug. 22, 2012).


\(^10\)The transaction in Woods was a variant of son-of-Boss, marketed under the name COBRA. See 134 S. Ct. at 560.

\(^11\)See reg. section 301.6233-1T(c)(1) (TEFRA “shall apply where a partnership return is filed for a taxable year but it is determined that there is no entity for such taxable year”).

\(^12\)See Woods, 134 S. Ct. at 566, n.4 (citing Brief of Amicus Curiae Prof. Amandeep S. Grewal in Support of Neither Party at 20, n.7).

\(^13\)See Petaluma FX Partners LLC v. Commissioner, 131 T.C. 84 (2008); Petaluma FX Partners LLC v. Commissioner, 591 F.3d 649 (Footnote continued on next page.)
ample opportunity to present the arguments that it now raises for the first time.

In this context, the “law of the case” and “waiver” doctrines may preclude consideration of Petaluma’s jurisdictional and substantive arguments, respectively. Regarding the jurisdictional argument, in a previous opinion, the D.C. Circuit explained that reg. section 301.6233-1T allows a TEFRA court to determine whether a partnership is a sham. And under the law of the case doctrine, an issue decided in an earlier appeal of a given case generally will not be revisited, so Petaluma’s challenge to reg. section 301.6233-1T might be foreclosed by the prior determination.15

However, the D.C. Circuit did not actually address the procedural defects of reg. section 301.6233-1T. Rather, it addressed only how the regulation applied. And how a regulation applies reflects an issue legally distinct from whether it is valid.16 Thus, the law of the case doctrine may not apply. That doctrine is relevant “when a court decides upon a rule of law,”17 but in Petaluma, there was no decision about the regulation’s validity.

Nonetheless, the law of the case doctrine is notoriously murky, and the D.C. Circuit might conclude that its prior determination regarding reg. section 301.6233-1T implicitly addresses issues regarding its procedural defects. If that is so, the taxpayer might argue that the doctrine does not apply for other reasons.18 For example, courts generally do not apply it when the resolution of an issue was uncontested.19 Petaluma, in the earlier proceedings, did not contest that the section 6233 regulations extended TEFRA to sham partnerships. Rather, it argued that that jurisdiction was improper because the sham determination was not a partnership item,20 and it assumed that the section 6233 regulations were valid.

Regarding the gross valuation misstatement penalty, Petaluma had not previously challenged the Treasury regulation extending the penalty to zero basis circumstances. In ordinary circumstances, Petaluma would have waived the argument. Circuit courts generally do not consider arguments raised for the first time on appeal.

However, doctrines on the law of the case and waivers do not limit a court’s authority — they reflect discretionary tools used to further judicial economy.21 Also, the somewhat strange procedural history of Petaluma suggests that the court stands ready to hear new arguments. After the Court issued Woods, the government in Petaluma moved for summary reversal, and the taxpayer threw in the towel and supported the government’s motion.22 But the D.C. Circuit rejected the parties’ joint request. Instead, on its own motion, it ordered a new round of briefing and put the case on the calendar for oral argument, concluding that the “merits of the parties’ positions are not so clear as to warrant summary action.”23

It’s hard to tell why the court would ask for more analysis after the taxpayer already laid down its sword. It might want arguments on TEFRA issues entirely unrelated to those discussed here, or it might want an expansion of the arguments presented in connection with the motion for summary arguments under the law of the case doctrine (Petaluma’s arguments are unequivocally late), but the law of the circuit doctrine has no relevance here.

19Aside from making arguments based on the law of the case doctrine, the government argues that the law of the circuit doctrine forecloses the D.C. Circuit’s consideration of Petaluma’s jurisdictional arguments. See Replacement Reply Brief for the Appellant, at 10-11, Petaluma FX v. Commissioner, No. 12-1364 (D.C. Cir. filed July 10, 2014), 2014 WL 3378308. The D.C. Circuit’s earlier decision made no mention of the APA, and it’s hard to believe that the current and future panels of the D.C. Circuit cannot consider issues that weren’t even addressed in the earlier case and that future taxpayers cannot even present them except to an en banc court. Perhaps the court should exercise its discretion to deny consideration of Petaluma’s (Footnote continued in next column.)
reversal. But the call for a new round of briefing contemplates the examination of some new arguments, and it would be surprising if a court prevented a taxpayer from fighting after pushing its sword back into its hands. Also, regarding penalty matters, it’s quite difficult to ignore the Supreme Court’s flagging of an issue, and an intervening decision of the nation’s highest court reflects the exact type of circumstance under which a lower court will consider an argument that was otherwise waived. At the very least, one can expect the D.C. Circuit to consider Petaluma’s regulatory challenges during oral arguments, and the related discussion may provide some helpful insights about the court’s view on fundamental administrative law issues.

C. The Jurisdictional Challenge

Petaluma argues that the procedural irregularities associated with reg. section 301.6233-1T invalidate it. The government promulgated the regulation by first issuing a notice of proposed rulemaking, as required by the APA. That notice prompted comments, but the government declined to address them. Instead, it promulgated a temporary regulation that was identical to the proposed regulation. Treasury offered no “good cause” explanation for bypassing comment procedures, but it promised to incorporate, in due course, the comments it received. However, Treasury did not make good on its promise, and reg. section 301.6233-1T sat on the shelf until it was finalized in 2001, with an effective date after the tax year at issue in Petaluma. Petaluma argues that those procedures did not comply with the APA, and, of course, the government disagrees. The dispute raises several fundamental issues.

1. The distinction between substantive and interpretive rules. The government argues that reg. section 301.6233-1T qualifies as an interpretive rule exempt from the APA’s notice and comment procedures. The precise distinction between substantive and interpretive rules remains elusive, but rules that alter or modify existing rights generally qualify as substantive.

Reg. section 301.6233-1T seems to qualify as a substantive rule. It completely changes the audit and litigation procedures for sham partnerships. Without that regulation, which extends the TEFRA regime, issues concerning sham partnerships would be litigated on a partner-by-partner basis. Petaluma, Woods, and numerous other cases are all about the significant consequences associated with being under one regime or another. Reg. section 301.6233-1T thus falls within the classic definition of a substantive rule.

The government nonetheless argues that the regulation is interpretive, under the erroneous assumption that the regulation changes nothing. That is, the government argues that section 6233 itself applies TEFRA to sham partnerships and that the regulation reflects an unnecessary parroting of that statute. That argument leads us to another fundamental issue raised in the Petaluma appeal.

2. The validity of phantom regulations. The Supreme Court and numerous circuit courts have held that a statute that calls for regulations lacks effect until regulations are issued. Under the Supreme Court’s approach, section 6233 does not, by itself, extend TEFRA to sham partnerships, because the statute’s rule applies only “to the extent provided in regulations.”

Some courts, including the Tax Court, frequently apply “phantom regulations” when a tax statute
calls for regulations but none have been issued.\textsuperscript{30} Under that approach, whether reg. section 301.6233-1T was validly promulgated would be irrelevant. An agency can always invoke phantom regulations to apply a statute whenever it has failed to implement a statute’s rulemaking command.

The government in \textit{Petaluma} seems to adopt the phantom approach and argues that section 6233 itself extends TEFRA to sham partnerships. However, the government relies, in part, on a case that explicitly rejects that approach.\textsuperscript{31} Its brief cites \textit{Phillips v. Amoco Oil Co.},\textsuperscript{32} in which the Eleventh Circuit held that a statute that referred to regulations could not operate without them. Worse still, the statute in that case contained delegating language essentially identical to that found in section 6233.\textsuperscript{33}

It’s not unusual for a litigant to spin an adverse case in its favor, but the government does not present \textit{Phillips} as supporting its position. Rather, it quotes \textit{Phillips} for its holding that a statute’s rule cannot operate “absent the promulgation of regulations.” The government’s position is hard to understand and may need elaboration at oral arguments.

\subsection*{3. Whether notice alone satisfies notice and comment requirements}

The government argues that because it issued a notice of proposed rulemaking and temporary regulations, without addressing comments, it satisfied notice and comment requirements.\textsuperscript{34} The government also emphasizes that because the temporary regulation was identical to the proposed regulation, it complied with notice and comment requirements.\textsuperscript{35}

It’s a bit difficult to make sense of that argument. Usually, an agency establishes that it complied with notice and comment requirements by showing that it gave notice and responded to comments. Here, the government argues that because it did not respond to comments (the temporary regulation was identical to the proposed regulation), it satisfied notice and comment requirements. Also, the government criticizes the taxpayer for failing to specifically identify the comments about which Treasury provided no detailed information in the regulation’s preamble.\textsuperscript{36} Those arguments seem quite novel, and the D.C. Circuit’s opinion may provide guidance on whether the APA’s notice and comment requirements obligate agencies to both give notice and provide opportunities for comment, or whether notice alone satisfies those requirements.

\subsection*{4. Whether ‘permanently’ temporary regulations remain effective}

In the 1980s, Treasury issued many regulations, like reg. section 301.6233-1T, without observing notice and comment requirements. The problem became sufficiently severe that Congress, in 1988, amended section 7805 and mandated a three-year expiration period for temporary regulations.\textsuperscript{37} However, the amendment applied only prospectively, and there are many decades-old temporary regulations that remain on the books.

\textit{Petaluma} presents the first opportunity for an appellate court to squarely consider whether “permanently” temporary regulations remain effective. Taxpayers have generally hesitated to bring APA-based challenges to Treasury regulations, including permanently temporary ones. However, the rejection of tax exceptionalism in \textit{Mayo} seems to be changing things.\textsuperscript{38}

In \textit{Cohen v. United States}, the D.C. Circuit stated that “the IRS is not special” and that “no exception

\footnotesize{\bibliography{references}}
exists shielding it — unlike the rest of the Federal Government — from suit under the APA.” If the D.C. Circuit remains committed to its rejection of tax exceptionalism, it should invalidate reg. section 301.6233-1T. Only a tax-exceptional approach can save the regulation: The APA simply does not allow an agency to propose regulations, promise to incorporate comments but ignore them, issue immediately effective regulations without good cause, and then, decades later, apply that regulation adversely against a citizen.40

Nonetheless, even if the D.C. Circuit invalidates reg. section 301.6233-1T, its holding might not reach other permanently temporary regulations. The procedural history of reg. section 301.6233-1T reveals numerous defects, and the court could invalidate it for regulation-specific reasons, such as the failure to incorporate received comments. Consequently, a decision for the taxpayer in Petaluma might not cast doubt on all permanently temporary regulations. Also, Treasury finalized a set of TEFRA regulations in 2001,41 and the invalidation of reg. section 301.6233-1T would directly affect only a presumably small number of old cases involving sham partnerships.

Even if the D.C. Circuit issues a broad opinion, its ruling will have limited effect when a permanently temporary regulation reflects an entirely sensible interpretation of a self-executing statute. For example, if a statute imposes a tax on prizes, and a temporary regulation provides that the statute reaches lottery winnings, the invalidation of the regulation does little to change the result. With or without the regulation, lottery winnings would surely come within the statute. However, for temporary regulations issued under statutes like section 6233, whose effect is conditioned on these regulations, the consequences of the court’s holding would be more significant.

D. The Penalty Challenge

If the Court finds that the Tax Court enjoyed jurisdiction, or if it finds that Petaluma’s jurisdictional arguments are barred under the law of the case doctrine, it will address the validity of reg. section 1.6662-5(g), which extends the gross valuation misstatement penalty to zero basis circumstances. In Woods, the Supreme Court applied this regulation in holding against the taxpayers. However, the Court observed that there was some tension between the regulation and the statutory language, and it assumed the validity of the regulation in deciding the case.

On appeal, Petaluma argues that the regulation is invalid and reflects an improper interpretation of the statute.42 The gross valuation misstatement penalty applies only when a taxpayer’s claimed basis is “400 percent or more” of the true basis,43 and the percent by which the Petaluma partner’s claimed outside basis (about $25 million) exceeds his true basis ($0) is undefined.44 Consequently, the statutory condition is not satisfied (“400 percent or more” does not include undefined amounts), and the Treasury regulation that simply treats zero basis circumstances as satisfying that standard is invalid.

The viability of this argument will turn on whether the D.C. Circuit believes that section 6662’s language defines the scope of Treasury’s rulemaking authority. That language does not yield the ambiguity of the sort needed to validate the regulation — Congress has spoken precisely on when the gross valuation misstatement penalty applies. The claimed basis must be 400 percent or more of the true basis — not 250 percent, 350 percent, or as here, an undefined percentage. Therefore, if the statutory language controls, the regulation fails.

The application of section 6662 to zero basis circumstances is confusing because it is impossible to even explain the percentage by which each partners’ claimed basis exceeded his true basis. It might seem like Treasury has the authority to address this confusing question, since agencies routinely issue clarifying guidance. But agencies have the authority to address the confusion found in statutes themselves, not to address the confusion

39650 F.3d 717, 723 (D.C. Cir. 2011) (en banc).
40The government does not argue that it had good cause for skipping notice and comment procedures regarding reg. section 301.6233-1T. However, even if it had, that would not justify the application of the regulation to Petaluma’s 2000 tax year. When an agency properly invokes good cause and bypasses notice and comment procedures, a failure to offer the public a post-promulgation comment opportunity may be arbitrary and capricious. See, e.g., Nat’l Fed’n of Fed. Emps. v. Devine, 671 F.2d 607, 613 (D.C. Cir. 1982) (“The validity of a temporary regulation ... is conditioned on expeditious conduct of notice and comment procedures in good faith”); and Am. Fed’n of Gov’t Emps., AFL-CIO v. Block, 655 F.2d 1153, 1157 (D.C. Cir. 1981) (“Common sense suggests that any administrative action taken in a rare ‘emergency’ situation ... while perhaps necessarily ‘immediately effective,’ need only be temporary, pending public notice-and-comment procedures”).
41It’s unclear whether the 2001 regulations addressed the comments received in the 1980s or whether the failure to address those comments casts doubt on the final regulations.
43See section 6662(e)(1)(A) and (h). Section 6662(e) establishes the standard valuation misstatement penalty, and subsection (h) enhances it for gross valuation misstatements.
44The $25 million figure reflects the two partners’ aggregate outside bases, not each individual partner’s basis. References to a single partner with a $25 million basis are made for ease of exposition.
created by extending statutes beyond their terms.\textsuperscript{45} The application of the gross valuation misstatement penalty to a zero basis circumstance, although confusing, is not connected to any statutory ambiguity.

To appreciate that point, consider a hypothetical statute that taxes the sale of fruit, and then think about this question: What type of fruit is a polar bear?

This question is surely confusing. A polar bear is an animal, and it makes no sense to classify it as any type of fruit. But the confusion does not stem from any statutory ambiguity. There are no interpretive choices involved in classifying a polar bear as a banana, mango, or any other type of fruit, and if a Treasury regulation treated a polar bear as one, the regulation would be invalid. Treasury lacks the authority to extend the fruit statute to polar bears and then address the confusion raised by that extension.

\textit{Petaluma}, of course, does not involve questions about arctic beasts. Rather, the penalty question asks: Is the claimed $25 million basis 400 percent or more of the true $0 basis?

This question is as nonsensical as the earlier one regarding polar bears. To determine what percentage one number is of another number, one must divide the first number by the second number. For example, 10 is 500 percent of two, because $10/2 = 5$. But in \textit{Petaluma}, one must divide by zero ($25 million/0$) to apply the statutory formula, and that makes no sense. You can explain to someone what it means to divide a pizza into 10 pieces, but you cannot even try to explain what it means to divide a pizza into zero pieces.

But again, this confusion does not stem from statutory ambiguity, and Treasury therefore lacks the authority to address it. A percentage-based penalty simply does not apply to zero basis circumstances (the phrase “400 percent or more” does not reach things that are undefined), just as a fruit statute does not reach polar bears. We can confuse ourselves by expanding the statutes and asking nonsensical questions, but that’s not the right path to determining the scope of regulatory authority.

Now, we might say that the partner’s inflation of outside basis from $0 to $25 million looks a lot like the 400 percent overstatement situation that section 6662 reaches. For example, if the partner’s true basis were $1, the $25 million misstatement would easily satisfy the 400 percent threshold. And given that the true basis is $0, it might seem close enough to apply the statute.

In terms of general policy, the two situations are quite similar. But section 6662 is written in terms of mathematical percentages, not general policies, and in mathematical terms, the situations are worlds apart. Dividing by one is simple; “dividing by zero destroys the entire framework of mathematics.”\textsuperscript{46} We might casually say that the zero basis circumstance looks like the $1 basis circumstance, just as we might casually say that some type of white, furry fruit vaguely resembles a polar bear. But a regulation extending either statute that way would be invalid.

This analysis assumes that statutory text defines the scope of an agency’s regulatory authority, but not all courts accept that view. In Gilman v. Commissioner, for example, the Second Circuit applied the gross valuation misstatement penalty in a zero basis circumstance.\textsuperscript{47} The court acknowledged that its ultimate holding “strain[ed] the natural reading of the statute” and that it was “somewhat odd” to apply the percentage-based penalty, but it concluded that the application of the penalty would “surely reinforce the Congressional objective of lessening tax shelter abuse.”\textsuperscript{48}

Even putting aside the Second Circuit’s improper disregard of statutory language, it’s easy to find fault with its approach.\textsuperscript{49} Although courts should

\textsuperscript{45}For specific delegations of rulemaking authority, the validity of an agency’s action does not turn on the presence or absence of ambiguity. For example, if Congress granted Treasury the authority “to issue regulations applying penalties to valuation misstatements,” Treasury could surely issue a regulation applying penalties in zero basis circumstances. For specific delegations, the question is generally whether the statute provides some “intelligible principle” and whether the agency acted within the scope of the delegated authority. See Whitman v. American Trucking Ass’ns, 531 U.S. 457, 472 (2001). However, reg. section 1.6662-5(g) involves the construction of a statute in which Congress itself prescribed the criteria for the application of its desired rule. In those circumstances, an agency has the authority to fill gaps, not to expand or modify the statutory rule.

\textsuperscript{46}\textsuperscript{Charles Seife,} \textit{Zero: The Biography of a Dangerous Idea} 23 (2000).
\textsuperscript{47}933 F.2d 143 (2d Cir. 1991).
\textsuperscript{48}933 F.2d 143, 151 (2d Cir. 1991).
\textsuperscript{49}The Supreme Court apparently wasn’t swayed by Gilman. The Court in Woods was informed of that case, and it was also informed that no taxpayer had challenged reg. section 1.6662-5(g) on the grounds suggested here, yet it still reserved on the validity of the regulation. See Brief of Amicus Curiae Prof. Amandeep S. Grewal in Support of Neither Party at 20 n.7, Woods, 134 S. Ct. 557 (2013) (No. 12-1364). Although it’s a stretch to assume that the Court is aware of the contents of amicus briefs, and almost fanciful to assume that it is aware of footnotes in amicus briefs, it cited that particular footnote. Also, the Court performed independent research on the “zero” issue, citing Lee’s \textit{Summit v. Surface Transp. Bd.}, 231 F.3d 39, 41-42 (D.C. Cir. 2000) (explaining problems associated with applying percentage-based rules to a baseline of zero). That case was not cited in any brief or proceeding mentioned below. Thus, the Court’s reservation on the validity of reg. section 1.6662-5(g) seems to have been done deliberately, after it performed research beyond that.
hesitate to read penalty provisions as excusing outrageous behavior (such as the improper inflation of outside basis from $0 to $25 million), a court does not need to stretch section 6662(e) to discourage tax abuse. Even if participants in sham partnership transactions escape the gross valuation misstatement penalty, they face a menu of other penalties, including some especially severe ones. Participants in fraudulent transactions face a 75 percent penalty under section 6663, and especially bad behavior results in jail time — a court recently sentenced a promoter of son-of-BOSS and related transactions to 15 years in prison.50

Also, it might seem odd that Petaluma’s partners would escape the valuation misstatement penalty, but those quirks are inherent in any percentage-based regime. A taxpayer who claims a $70,000 basis in $15,000 basis property gets hit with the gross valuation misstatement penalty, but a taxpayer who claims a $140 million basis in $100 million basis property does not, even when trying to dodge millions in taxes. This illustrates why the code needs and has numerous types of penalties, including ones that turn on absolute dollar amounts and bad motives.51 But mere quirks should not establish a new standard for regulatory deference. An agency regulation should be valid whenever it fills a gap or resolves an ambiguity in a statute, but not when it expands a statute to address a nonsensical question unconnected to any textual ambiguity.

E. Conclusion

At first glance, Petaluma seems to be about two things that are almost equally impossible to understand: TEFRA jurisdiction and division by zero. However, the case presents fundamental administrative law issues that touch on matters well beyond son-of-BOSS transactions. All taxpayers should pay attention to the D.C. Circuit’s resolution of these issues.

presented in the briefs. Lee’s Summit upheld a federal agency’s decision to apply an absolute number standard rather than a percentage-based standard in a zero baseline situation. The D.C. Circuit did not specifically address whether it would be appropriate to apply a percentage-based standard, which is the issue raised in Petaluma.50 See Larson, “Record $8 Billion Tax Fraud Gets Ex-Lawyer 15 Years,” Bloomberg Businessweek (June 25, 2014).

51 See, e.g., section 6662(b)(2); section 6663.