12-1-2013

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BY ANDY S. GREWAL

Over the past 15 years, “Son of BOSS,” “COBRA”1 and similar tax shelters have created significant problems for the tax system. Countless resources have been wasted concocting and litigating these shelters, with no end to the protracted disputes in sight. Society would have been far better off if these aggressive tax shelters had never been undertaken.

The parties in ‘United States v. Woods’ didn’t notice that subject matter jurisdiction ultimately rested on a “permanently temporary” regulation under Section 6233.

However, for those of us who study the intersection between tax and administrative law, there has been a silver lining to the dark tax shelter cloud. The Treasury Department and the Internal Revenue Service have adopted extraordinary regulatory measures to combat tax shelters, and the judicial and scholarly debates over those measures highlight the significant role that administrative law doctrines play in tax practice.

Additionally, the resulting case law and commentary—on matters like fighting regulations, the application of Nat’l Cable & Telecomm. Ass’n v. Brand X Internet Servs., 545 U. S. 967 (2005), to Treasury regulations and restrictions on opinion letter practice—will provide useful guidance when, as seems inevitable, Treasury and the IRS must confront another wave of tax shelters.

Background of ‘Woods’

In Woods, the taxpayers engaged in a so-called COBRA transaction, which, in brief,4 involved the purchase and sale of offsetting foreign currency options and the contribution of those options to a partnership. Under their reading of the Internal Revenue Code and the case law (including the now notorious case, Helmer v. Commissioner, T.C. Memo 1975-160), the taxpayers believed that when they contributed the offsetting options to the partnership, their outside bases would include only the amount paid for the purchased option, with no reduction for the partnership’s assumption of the sold option.

This meant that their outside bases in their partnership interests would be greatly inflated. On an eventual liquidation of the partnership, those inflated outside bases would attach to the properties received in the liquidation, and a sale of those properties would generate huge tax losses.

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1 BOSS stands for bond and option sales strategy; COBRA stands for currency options bring reward alternatives.


4 The taxpayers actually engaged in two COBRA transactions and undertook some steps beyond those summarized here. Those additional steps aren’t necessary to understand the regulatory issues presented and are consequently ignored.
At trial, the IRS successfully argued that the taxpayers’ COBRA transaction lacked economic substance and should be disregarded for tax purposes. This meant that instead of enjoying an inflated basis in their partnership interests, the partners actually had $0 of basis in those interests, because the partnership was deemed not to exist.

However, under the relevant Fifth Circuit precedents, no basis overstatement penalty could apply, because the taxpayers’ understatement of tax related to their transaction’s lack of economic substance, not to their inflation of outside bases. Consequently, the district court rejected the government’s penalty argument and the Fifth Circuit affirmed its decision.

The government then filed a petition for certiorari asking the Supreme Court to address whether the basis overstatement penalty could apply to transactions lacking economic substance. The high court agreed to not only address the question presented in the government’s petition, but also directed the parties to address whether the district court, in a TEFRA proceeding, actually enjoyed jurisdiction to consider whether the basis overstatement applied.

The parties’ jurisdictional arguments in Woods focused closely on the wording of Section 6226(f), which states that a court in a TEFRA proceeding can determine not only partnership items, but also the applicability of any penalty that “relates to” those partnership items.

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In the government’s view, which the Supreme Court upheld, the basis overstatement penalty potentially applied only because the partners’ outside bases were reduced from $45 million to $0, and that reduction naturally followed from the finding that the partnership didn’t exist. Viewed this way, the applicability of the basis overstatement penalty related to a partnership item (the existence of the partnership), and the district court properly considered that penalty in its TEFRA proceeding.6

The Supreme Court rejected the taxpayers’ argument that because outside basis qualifies as an affected item,7 penalties related to the inflation of outside basis fall outside of Section 6226(f).

The Missing Jurisdictional Argument

As originally enacted, TEFRA applied only to real partnerships, not to nonpartnership entities or to sham partnerships. However, this raised potential administrative problems for the IRS, because a nonpartnership entity might erroneously file a partnership return or because a sham partnership might improperly file a partnership tax return.

In these circumstances, confusion could follow, because the IRS would likely observe TEFRA procedures until it actually determined that a partnership tax return shouldn’t have been filed, in which case it would then realize that TEFRA procedures didn’t apply.

To solve this problem, Congress could have enacted a blanket extension of TEFRA procedures to all entities or non-entities filing a partnership tax return. But a broad rule could also sow confusion. The various TEFRA rules operate under the assumption that a bona fide partnership is in play,8 and TEFRA concepts don’t always translate easily to nonpartnership entities or to sham partnerships. For example, when the IRS must determine the partnership items or the affected items of a sham partnership, “an element of make-believe”9 pervades the audit process.

Rather than squarely address the confusion that results from applying TEFRA procedures to nonpartnership entities or to sham partnerships, Congress granted Treasury the discretionary authority to issue regulations extending TEFRA to them.10 Under Section 6233(a), if a nonpartnership entity files a partnership return, then, “to the extent provided in regulations,” the TEFRA procedures will apply to the nonpartnership entity. Under Section 6233(b) (most relevant to Woods), a similar rule applies when a sham partnership files a partnership return, again “to the extent provided in regulations.”

Regulations issued under Section 6233(b) purportedly established the district court’s jurisdiction in Woods. Those regulations were issued in temporary form in 1987,11 about a year after Treasury had first issued proposed regulations under Section 6233(b).12 Although the proposed regulations received comments from the public,13 the 1987 temporary regulations didn’t respond to those comments. Rather, the Treasury promised that the temporary regulations would “be fi-

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6 Under Section 6231(a)(3), partnership items are those that the treasury secretary determines, by regulation, are more appropriately determined at the partnership level.
7 Under Section 6231(a)(5), an affected item is an item to the extent that it is affected by a partnership item.
8 See Section 6231(a)(1)(A) (adopting Section 761(a) definition of partnership, via double cross reference, for purposes of TEFRA provisions).
10 See Section 6233(b)(1). Section 6233 was added to the tax code by Pub. L. No. 98-369, Section 714(p)(I), 98 Stat. 494, 964 (1984), a little short of two years after TEFRA’s enactment.
13 See supra note 11 at 6780 (“Several comments on the proposed regulations were received.”).
nalized in due course with any changes that may be made as a result of comments received." 14

Also, Treasury didn’t make any statement of good cause for skipping the notice and comment process, as the Administrative Procedure Act requires. Instead, Treasury merely stated that the temporary regulations were issued to provide “immediate guidance” to partners and partnerships. 15

In 2001, the Treasury issued final regulations under Section 6233(b), but those regulations didn’t apply in Woods. 16 The final regulations apply only for partnership taxable years (not audits) commencing after Oct. 3, 2001, and the transaction in Woods occurred in 1999. Thus, the extension of TEFRA to the Woods taxpayers rests on temporary regulations issued in 1987, which had sat on the shelf for 12 years at the time of the taxpayers’ transaction.

Courts have come dangerously close to invalidating permanently temporary regulations of this sort. In Tedori v. United States, for example, the Ninth Circuit stated that the government could offer “[n]o explanation . . . as to why such a ‘temporary regulation,’ issued in 1987 shortly after enactment of the Tax Reform Act of 1986, should remain ‘temporary’ well over a decade later.” 17 However, the court ultimately held against the government on different grounds and thus didn’t set aside the regulation.

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Along similar lines, the Seventh Circuit in Kikalos v. Commissioner stated that without any evidence that a temporary regulation has “undergone the scrutiny that typifies a pre-adoption notice and comment period,” 18 the regulation should be treated as a mere proposed regulation. And the Sixth Circuit, in Hosp. Corp. of Am. v. Commissioner, acknowledged that temporary regulations may be invalid for the failure to comply with notice and comment requirements, but the court ultimately declined to address that issue, given the taxpayer’s failure to raise it. 19

More recently, in Intermountain Ins. Serv. of Vail LLC v. Commissioner, a case involving temporary regulations addressing tax shelters and the Section 6501 statute of limitations rules, two concurring Tax Court judges concluded that those regulations were invalid for failure to comply with notice and comment requirements. (The majority in that case held against the government on different grounds.) 20

If the Section 6233(b) temporary regulations were invalid, the Woods district court wouldn’t have enjoyed jurisdiction to address the applicability of the basis overstatement penalty. Section 6233(b), by its terms, applies “to the extent of regulations,” 21 and if the temporary regulations were set aside, no regulation would extend TEFRA to sham partnerships, at least for the taxable year involved in Woods. 22

Because the taxpayers in Woods challenged the district court’s penalty jurisdiction, they might have been expected to argue, but didn’t argue, that the regulations extending TEFRA to their sham partnership were invalid. Under general administrative law doctrines, it would seem unimaginable that an agency could bypass notice-and-comment procedures, offer no required “good cause” explanation, promise to take comments into account but ignore them and then, more than a decade later, adversely invoke its temporary regulation against a citizen. 23

Although some previously questioned whether general administrative law doctrines apply to the tax law, the Supreme Court flatly rejected any claims of tax exceptionalism in Mayo. 24

Nonetheless, like the government, the taxpayers based their jurisdictional arguments solely on Section 6226(f). Also, like the government, the taxpayers didn’t actually cite the temporary regulations in their brief but, in passing, referred the court to the final regulations. It is thus no surprise that the court focused only on Section 6226(f) when it decided Woods, and its opinion makes no mention of either Section 6233 or the defectively issued regulations.

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14 Supra note 11 at 6780.
15 Supra note 11 at 6780.
17 Tedori v. United States, 211 F.3d 488, 491 n. 9 (9th Cir. 2000) (discussing Temp. Reg. Section 1.163-9T(b)(2)(i)).
18 Kikalos v. Commissioner, 190 F.3d 791, 796 (7th Cir. 1999).
19 Hosp. Corp. of Am. v. Commissioner, 348 F.3d 136, 144-45 & n. 3 (6th Cir. 2003).
20 Intermountain Ins. Serv. of Vail LLC v. Commissioner, 134 T.C. 211, 230 (2010). In United States v. Home Concrete & Supply LLC, 132 S.Ct. 1836 (2012), the court addressed the same statute of limitations issue presented in Intermountain and held against the government without addressing the procedural irregularities associated with temporary regulations.
21 A minority of courts believe that when a tax statute refers to regulations, the statute can operate even without regulations. However, even under the criteria used by courts in this minority, it is doubtful that Section 6233(b) would operate without regulations. For an analysis of the phantom regulations problem, see Amandeep S. Grewal, “Substance Over Form—Phantom Regulations and the Internal Revenue Code,” 7 Hous. Bus. & Tax. L. J. 42 (2006); Amandeep S. Grewal, “Mixing Management Fee Waivers with Mayo,” 15 Fla. Tax. Rev. __ (2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2333213.
22 This argument would be moot for partnership taxable years on or after Oct. 4, 2001, assuming that the final regulations under Section 6233 complied with the Administrative Procedure Act.
23 See, e.g., Chrysler Corp. v. Brown, 441 U.S. 281, 315 (1979) (“In enacting the APA, Congress made a judgment that notions of fairness and informed administrative decisionmaking require that agency decisions be made only after affording interested persons notice and an opportunity to comment.”).
24 One might argue that Section 7805(e), which provides a three-year expiration period for temporary regulations issued after Nov. 20, 1988, effectively provides an unlimited shelf life for any temporary regulation issued on or before that date. But that position is impossible to reconcile with the Administrative Procedure Act’s express statement rule. See Amandeep S. Grewal, “Legislative Entrenchment Rules in the Tax Law,” 62 Admin. L. Rev. 1011, 1051-1058 (2010).
Other taxpayers, however, might raise Section 6233 regulatory arguments in their proceedings—many disputes regarding COBRA and related shelters continue. And while lower courts typically don’t revisit issues seemingly resolved by the Supreme Court (unless they like to be reversed), litigants have wide latitude to raise jurisdictional arguments at any stage of the proceedings. In fact, in Woods itself, the parties didn’t brief jurisdictional issues until the Supreme Court asked them to do so.

Even if courts conclude that Woods forecloses all jurisdictional arguments related to the basis overstatement penalty, a regulatory argument based on Section 6233 could be used to challenge jurisdiction on other matters. That is, if the permanently temporary Section 6233 regulations are invalid, no aspect of TEFRA would apply to sham partnerships. Consequently, recalcitrant taxpayers who have lost on general economic substance issues in a TEFRA proceeding might try to set aside any prior opinion on jurisdictional grounds and take another swing at the bat in a non-TEFRA proceeding.

It is of course hard to see what social good would arise from this. A taxpayer must be incorrigibly optimistic or deliberately nettlesome to pursue arguments that the COBRA transaction or similar transactions actually work—the courts have made their rejection of those strategies perfectly clear. Nonetheless, Woods, Peta-luma FX Partners LLC v. Commissioner (T.C. Memo. 2012-142, 2012 BL 127641, 5/17/12) and similar cases show that some taxpayers want to secure the potential procedural benefits associated with non-TEFRA proceedings.

If taxpayers pursued regulatory arguments related to Section 6233, there could be a silver lining to the protraction of their disputes. Although Mayo casts doubt on permanently temporary regulations (they are impossible to reconcile with either the APA or general administrative law doctrines), the Treasury and IRS continue to treat them as if they were properly promulgated. Thus, while jurisdictional arguments based on Section 6233 may protract an already overdrawn battle on tax shelters, case law on the status of permanently temporary regulations would provide helpful guidance to the many taxpayers affected by them.

25 The Supreme Court in Woods left open a possible non-jurisdictional challenge to the basis overstatement penalty, noting that Treas. Reg. Section 1.6662-5(g) “is in tension with the mathematical rule forbidding division by zero.” Woods, No. 12-562, slip op. at n. 4 (2013). That point followed from and is further detailed in an amicus brief submitted by this writer. See Brief for Prof. Amandeep S. Grewal In Support of Neither Party in United States v. Woods, pp. 20-21 n. 7, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2274857. The court expressed no opinion on this argument but assumed the validity of the regulation for purposes of deciding Woods. See Woods, No. 12-562, slip op. at n. 4 (2013). Consequently, although the court generally held that the basis overstatement penalty applies to the inflation of basis via a transaction lacking economic substance, taxpayers can challenge the regulation’s extension of the penalty in zero basis circumstances. Additionally, the court reserved on expressing an opinion on economic substance matters. See Woods, No. 12-562, slip op. at n. 1 (2013).

26 Under Section 6231(g)(1), if the IRS reviews a partnership return and reasonably determines that TEFRA applies to the partnership, then TEFRA will apply, even if that determination proves erroneous. This statute contemplates that the misclassified entity is a bona fide partnership and it thus doesn’t extend TEFRA jurisdiction to a sham partnerships. Instead, Section 6231(g)(1) applies when, for example, a bona fide partnership qualifies for the Section 6231(a)(1)(B) small partnership exception from TEFRA but the IRS reasonably (yet erroneously) concludes, based on the partnership’s tax return, that the partnership comes within TEFRA. In these circumstances, TEFRA procedures would apply notwithstanding the small partnership exception.

27 For a discussion of potential procedural advantages that non-TEFRA proceedings enjoy over partnership-level proceedings, see Chad Nardiello, “Is It a Partnership Item,” 140 Tax Notes, Sept. 30, 2013, p. 1557-58. In the context of penalties, a partner-level proceeding would allow a court to determine both whether the penalty applies and any individual partner defenses. In a partnership level proceeding, a court can make only the preliminary determination that a penalty applies, and individual partners must present defenses in subsequent administrative or judicial proceedings.