United States Tax Court

Washington, DC 20217

Otay Project LP, Oriole Management LLC, Tax Matters Partner	)	
Petitioner	)	Docket No. 6819-20
v.	)	
Commissioner of Internal Revenue,	)	
Respondent	)	

<u>O R D E R</u>

This case is before the Court on Oriole Management LLC's (petitioner) motion for summary judgment filed on November 20, 2020, pursuant to Rule 121.[1] Petitioner is the "tax matters partner" of Otay Project, LP (the "Partnership"). On January 21, 2021, the Commissioner of Internal Revenue (respondent) filed his response to petitioner's motion for summary judgment. On February 20, 2021, petitioner filed a motion for leave to file a reply to respondent's response, lodging its reply as an attachment. Similarly, on April 16, 2021, respondent filed a motion for leave to file a sur-reply to petitioner's motion for summary judgment, also lodging his sur-reply as an attachment. The Court granted both petitioner's and respondent's motions for leave on June 28, 2021, and petitioner's reply and respondent's sur-reply were filed into the record.

Considering the pleadings and motion papers of the parties and for the reasons detailed below, the Court finds that there remain genuine disputes as to material facts and petitioner is not entitled to summary judgment as a matter of law. Accordingly, we will deny petitioner's motion for summary judgment.

<u>Background</u>

The following facts are drawn from the parties' pleadings and motion papers. The facts stated are not findings of fact by this Court and are stated herein

[1] All section references are to the Internal Revenue Code in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

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solely for the purpose of ruling on petitioner's motion for summary judgment.

On July 10, 2020, petitioner filed a petition for Readjustment of Partnership Items under section 6226 (Petition) seeking a redetermination of the proposed adjustments to partnership items set forth in respondent's Notice of Final Partnership Administrative Adjustments (FPAA) dated March 18, 2020. Petitioner asks this Court to grant summary judgment for each of the following:

a. Whether respondent may apply section 1.701-2, Income Tax Regs. (hereinafter the "Anti-Abuse Rule") to deny the statutorily mandated section 743(b) adjustment.

b. Whether respondent may alternatively deny the section 743(b) adjustment because the Partnership allegedly "incurred additional liabilities" under section 752.

c. If the Court upholds respondent's denial of the section 743(b) adjustment on the grounds that the Partnership incurred additional liabilities, whether such alleged additional liabilities were eliminated during Tax Year 2012, resulting in deemed distributions in Tax Year 2012 of up to $745,886,933.

d. Whether respondent may alternatively deny the section 743(b) adjustment on the ground that the Partnership "is treated as retaining the right to receive payment under certain contracts".

e. If the Court upholds respondent's denial of the section 743(b) adjustment on the grounds that the Partnership "is treated as retaining the right to receive payment under certain contracts," whether such alleged retention resulted in deemed distributions in Tax Year 2012 of "up to $673,334,944".

f. If the Court upholds respondent's denial of the section 743(b) adjustment under any theory, whether respondent's application of the Anti-Abuse Rule to deny a statutorily mandated increase to the basis of the partners in the Partnership (i.e. outside basis) is outside this Court's jurisdiction.

g. Whether respondent may alternatively deny the section 743(b) adjustment under the step transaction doctrine.

h. Whether respondent may alternatively deny the section 743(b) adjustment under the common law lack of economic substance doctrine.

i. Whether respondent may alternatively deny the section 743(b) adjustment under the codified lack of economic substance doctrine under § 7701(o).

j. Whether respondent may alternatively deny the section 743(b) adjustment under the substance-over-form doctrine.

k. If the Court upholds respondent's denial of the section 743(b) adjustment under any theory, whether the gross valuation misstatement penalty asserted in the FPAA under section 6662(b)(3) and (h) applies.

l. If the Court upholds respondent's denial of the section 743(b) adjustment under any theory, whether the penalty due to negligence or disregard of the rules and regulations asserted in the FPAA under section 6662(b)(1) and (c) applies.

m. If the Court upholds respondent's denial of the section 743(b) adjustment on the grounds that the codified lack of economic substance doctrine under section 7701(o) applies, whether the penalty asserted in the Answer under section 6662(b)(6) applies.

n. If the Court upholds respondent's denial of the section 743(b) adjustment under any theory, whether the substantial valuation misstatement penalty asserted in the Amendment to Answer under section 6662(b)(3) and (e)(1)(A) applies.

o. If the Court upholds respondent's denial of the section 743(b) adjustment under any theory, whether the substantial understatement penalty asserted in the Amendment to Answer under section 6662(b)(2) and (d) applies.

The Partnership is a limited partnership formed under the laws of the State of California. At relevant times, petitioner was a general partner of the Partnership, and Otay Project LLC (OPLLC) and Otay Ranch Development LLC (ORD) were limited partners of the Partnership. OPLLC's partners were Oriole and ORD, and ORD was owned by 34 separate limited liability companies which were ultimately owned by Al Baldwin and Jim Baldwin (brothers and business partners) and their family members. In 1999, the Partnership acquired Otay Ranch, a real estate project consisting of 22,000 acres of land in San Diego County, California, and developed Otay Ranch from 2000 through 2005. The property was held in the Partnership.

While developing Otay Ranch, the Partnership sold tracts of land to third parties and other entities owned by Al and Jim Baldwin. The sales involved a contract for land sale by the Partnership and an unsecured promissory note to complete the construction of improvements on the land.[2] The sales ultimately generated over $1 billion in gross revenue and the total face value of the promissory notes received by the Partnership was about $921 million.

Based on these obligations to complete construction on the land, the Partnership accounted for the majority of the land sales under the completed contract method (CCM) of accounting under section 1.460-4(d), Income Tax Regs. Under the CCM method, the Partnership recognized income on a sale only after the construction obligations in the contract were completed.[3] The Partnership accounted for the construction obligations as partnership liabilities under section 752 in the total amount of $175 million, and these liabilities were allocated to petitioner, the Partnership's general partner.

Around 2002, Al and Jim Baldwin decided to divide Otay Ranch pursuant to a handwritten memorandum of understanding. In 2005, the Partnership formed two additional lower-tier partnership entities, AB Finco, LLC and JB Finco, LLC (collectively the "Fincos"). Shortly after the formation of the Fincos, the Partnership contributed the promissory notes it held from land sales to the Fincos. According to petitioner, the legal rights to collect on the promissory notes were transferred to the Fincos; however, the obligations to perform the construction improvements to the land remained with the Partnership.

In 2007, Al and Jim Baldwin started forming additional partnerships, whereby Al and Jim Baldwin, along with their respective spouses, transferred (or donated) interests in several upper-tier partnerships (namely some 34 LLCs, collectively holding interests in the Partnership) to newly formed family partnerships which were indirectly owned by their children and grandchildren. Together with the Finco transactions, these transactions resulted in a basis step-up of some $867 million under section 743(b) to the Partnership property, solely with respect to OPLLC.[4]

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[2] At least some of the contracts prevented buyers from rescinding the contracts even if OPLP failed to complete its obligations. Instead, remedy under the contracts was limited to damages.

[3] Respondent has not challenged OPLP's use of the CCM in the 2012 Taxable Year or in 2005, 2006, 2007, or any other taxable year.

[4] More specifically, the Partnership 2007 tax return reported a positive $866,981,686 step-up for partner OPLLC, and a negative adjustment of $283,395 for partner ORD.

In 2012, the Partnership was terminated under section 708 for Federal income tax purposes. At this time, the Partnership had not yet completed its construction obligations. The termination triggered all remaining income deferred under the CCM method to be recognized under the "constructive completion rules" of section 1.460-4(k), Income Tax Regs. and the Partnership recognized all of its deferred income of $717,916,957. The vast majority of this income was allocated to OPLLC, which held a 99.9 percent interest in the Partnership. However, OPLLC's previously stepped-up basis under section 743(b) offset this deferred income.

On or about July 8, 2014, respondent notified the Partnership that its 2012 tax return was selected for examination. After issuing several Information Document Requests and holding conferences over a span of four years, respondent issued the FPAA on March 18, 2020. In the FPAA, respondent disallowed the reported stepped-up basis and adjusted the Partnership's 2012 ordinary income by $713,759,615.

On October 21, 2020, respondent filed his Answer asserting additional legal theories in further support of the FPAA, including the common law lack of economic substance doctrine, the codified lack of economic substance doctrine under section 7701(o), and the substance over form doctrine (collectively the "Answer Theories"). In addition, respondent set forth facts supporting the Answer Theories as well as additional penalties. On December 29, 2020, respondent filed a motion for leave to file Second Amendment to Answer. In response, the Court struck the First Amendment to Answer from the record and ordered respondent to file an Amended and Restated Answer, reflecting the contentions made in the first and second proposed amendments to the answer. Respondent filed an amended answer on June 10, 2021.

Discussion

I. Summary Judgment

A. Background

In petitioner's motion for summary judgment, petitioner disputes the FPAA on a number of grounds. First, petitioner argues that the Partnership was required to make a section 743(b) adjustment under express statutory and regulatory provisions.[5] Second, petitioner argues that the Anti-Abuse Rule, which respondent primarily relies on as the basis for disallowing the section 743(b) adjustment, is invalid because it exceeds the authority of the Treasury Department. Specifically, petitioner contends that the Anti-Abuse Rule is invalid because it constitutes an impermissible effort to reserve to respondent the extraordinary authority to adjudicate deductions on a case-by-case basis. In addition, petitioner argues that the rule is too vague to satisfy the requirements of the Due Process Clause of the Constitution.

Petitioner also challenges respondent's alternative arguments from the FPAA and maintains that the Partnership properly accounted for its liabilities under section 752. With respect to respondent's second alternative argument, petitioner asserts that the Notes were distributed up through the ownership chain and the Partnership did not retain the right to receive payments under the contracts In addition, petitioner claims that respondent cannot meet his burden of proof with respect to his Answer Theories and the assertion of penalties against the Partnership is improper.[6] Finally, petitioner challenges this Court's jurisdiction to uphold respondent's determination as to the partners' outside tax basis in the Partnership. Based on these arguments, petitioner seeks summary judgment in this case.

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[5] Petitioner states that a section 743(b) election was required in this case because (1) an interest in the Partnership was transferred by sale or exchange and (2) the Partnership had a section 754 election in effect.

[6] Respondent's Answer Theories accept that a positive section 743(b) adjustment must be made with respect to OPLLC and only disputes the computation of such adjustment.

In his written response to petitioner's motion for summary judgment, respondent first argues that the Anti-Abuse Rule is valid under the Chevron doctrine and that the Anti-Abuse Rule it not impermissibly vague. Respondent asserts that the Anti-Abuse Rule is not based on the statutory language of section 701, but rather the entirety of subchapter K and the general authority granted in section 7805(a).

In addition to his reliance on the Anti-Abuse Rule, respondent provides two alternative arguments to support the FPAA. Respondent contends that the Partnership's basis adjustments made under section 743(b) are incorrect since it failed to properly account for its section 752 liabilities. Respondent also argues that the Partnership's 2012 liquidation resulted in a deemed distribution of all of its liabilities for Federal income tax purposes. Respondent further contends countless material facts remain in dispute, none of the Partnership's partners are treated as having assumed any of the Partnership's obligations for Federal tax purposes, and the partner assuming the Partnership's contracts would be the petitioner, not OPLLC. Respondent also asserts that the $867 million 743(b) basis step-up is inappropriate under the doctrines of step transaction, economic substance (common law and/or codified), and substance over form. Respondent disputes petitioner's challenge to this Court's jurisdiction and asserts that the FPAA only adjusts partnership items of the Partnership. Finally, respondent outlines in his sur-reply how the asserted penalties were properly asserted in compliance with section 6751(b).

B. Standard of Review for Summary Judgment

A party may move for summary judgment regarding all or any part of the legal issues in controversy. See Rule 121(a); Wachter v. Commissioner, 142 T.C. 140, 145 (2014). We may grant summary judgment if the pleadings, stipulations and exhibits, and any other acceptable materials show that there is no genuine dispute as to any material fact and that a decision may be rendered as a matter of law. See Rule 121(a) and (b); see also CGG Americas, Inc. v. Commissioner, 147 T.C. 78, 82 (2016); Elec. Arts, Inc. & Subs. v. Commissioner, 118 T.C. 226, 238 (2002). We construe the facts and draw all inferences in the light most favorable to the nonmoving party to decide whether summary judgment is appropriate. Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992), aff'd, 17 F.3d 965 (7th Cir. 1994). The moving party has the burden of proving that there is no genuine issue of material fact. Naftel v. Commissioner, 85 T.C. 527, 529 (1985). However, the nonmoving party may not rest upon the mere allegations or denials in its pleadings but instead must "set forth specific facts showing that there is a genuine dispute for trial." Rule 121(d); see also Sundstrand Corp. v. Commissioner, 98 T.C. at 520.

II. Partnership Basis Adjustments

Section 742 provides that the basis of an interest in a partnership acquired other than by contribution of property shall be determined under sections 1011 through 1015. Section 1012 provides that the basis of property shall be the cost of such property. Section 743(a) provides the general rule that basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or a partner's death, unless a section 754 election is in effect with respect to the partnership.

Section 754 provides that if a partnership files an election, the basis of partnership property shall be adjusted, in the case of a transfer of a partnership interest, in the manner provided in section 743(b). Section 743(b) provides that, in the case of a transfer of a partnership interest by sale or exchange or upon the death of a partner, a partnership in which an election provided for in section 754 is in effect shall: (1) increase the adjusted basis of partnership property by the excess of the basis to the transferee partner of such partner's interest in the partnership over the partner's proportionate share of the adjusted basis of partnership property, or (2) decrease the adjusted basis of partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of partnership property over the basis of such partner's interest in the partnership. Section 743(b) further provides that the increase or decrease shall be an adjustment to the basis of partnership property with respect to the transferee partner only. Section 1.743-1(d)(1), Income Tax Regs. provides that in general, a partner's share of the adjusted basis of partnership property is equal to the sum of that partner's interest as a partner in partnership capital and surplus, plus that partner's share of partnership liabilities.[7]

III. Determining Partnership Liabilities

Section 752 provides for the treatment of certain partnership liabilities. Treasury Regulation section 752 defines the term "liability" as an "obligation". Sec. 1.752-1(a)(4), Income Tax Regs. An obligation is further defined to include "any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code." Sec. 1.752-1(a)(4)(ii), Income Tax Regs.

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[7] Essentially, if a section 754 election is in effect, the partnership is treated as an aggregate of its partners, and the transferee partner's overall basis in the assets of the partnership is generally the same as if the transferee partners held a direct ownership in the underlying partnership assets.

Consequently, an "obligation" is a "liability" for purposes of sections 752 and 1.752-1, Income Tax Regs. to the extent that incurring the obligation either adjusts the basis of the obligor partnership's assets, gives rise to an immediate deduction to the obligor partnership, or gives rise to an expense that is not deductible in computing the obligor partnership's income, nor is it properly chargeable to capital. Sec.1.752-1(a)(4)(i), Income Tax Regs.[8]

IV. <u>Validity of the Anti-Abuse Rule and Respondent's Answer Theories</u>

In the FPAA, motion papers, and Amended and Restated Answer, respondent sets forth several arguments in support of his adjustments to the Partnership's gross income. The primary basis for the FPAA adjustments is grounded in respondent's application of the Anti-Abuse Rule, which reads, in part, as follows:

> (a) Intent of subchapter K. Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements -
>
>> (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
>>
>> (2) The form of each partnership transaction must be respected under substance over form principles.
>>
>> (3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income).
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> * * * * * * *

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[8] The IRS has also issued rulings on the meaning of a "liability" for section 752 in Revenue Rulings 88-77, 73-301 and 95-26.

Petitioner challenges respondent's reliance on this regulation to support the FPAA and seeks to have the regulation declared invalid by this Court based on several legal theories. In the alternative, petitioner seeks to have the Anti-Abuse Rule declared invalid as applied here in this case. When considering a taxpayer's challenge to the substantive validity of a regulation, we employ the two-part test under Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984). First, we determine "whether Congress has directly spoken to the precise question at issue." Id. at 842. When a statute is silent, the Court will move on to the second part of the test and examine "whether the agency's answer is based on a permissible construction of the statute. Id. at 843.

However, courts have refused to rule on the validity of a regulation when there existed other doctrines or theories that independently supported a party's claim. See, e.g., AD Glob. FX Fund, LLC v. United States, 114 A.F.T.R.2D 2014-1582, n.9 (S.D.N.Y. Mar. 31, 2014) ("Were defendant to prevail on any of these theories [based on doctrines], there would be no need to address the validity of the regulation."); Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104, n.84 ("Because we decide these cases utilizing existing judicial doctrines, we need not and do not decide whether the partnership anti abuse regulation is valid or whether it applies to any of the transactions in these cases."); Jade Trading, LLC v. United States, 60 Fed. Cl. 558, 562 (2004) ("Because further development of the record may eliminate the need to address the claimed invalidity of a regulation, the Court denies Plaintiffs' first motion for partial summary judgment without prejudice.").

Here, respondent has set forth alternative theories that also address the legitimacy of the Partnership's $867 million 743(b) basis step-up. If respondent prevails on any one of these alternative arguments, there would not be a need for this Court to address the validity of the Anti-Abuse Rule. As such, we conclude that ruling on the validity of the Anti-Abuse Rule is premature at this stage and will deny petitioner's motion for summary judgment, without prejudice, as to this issue.

Petitioner also seeks summary judgment on the Answer Theories and argues that respondent cannot meet his burden on these arguments. As respondent argues, the Answer Theories provide independent support for the adjustment in the FPAA. The key issue here is the tax treatment of the Finco Transactions and 2007 Transactions, which involve complicated questions of fact and law. The Court recognizes that there remain genuine disputes as to material facts regarding the Answer Theories, which have been properly raised before the Court in respondent's Answer, filed on September 30, 2020.[9] Therefore, we will deny petitioner's motion for summary judgment with respect to the Answer Theories.

Similarly, we find that respondent's alternative theories as to the Partnership's additional liabilities and how these additional liabilities resulted in a deemed distribution in 2012 involve mixed questions of fact and law that cannot be resolved by summary judgment at this time. We agree with respondent that considerable factual development is needed to understand these partnership liabilities stemming from the land sale transactions and the validity of respondent's position. Only after developing these facts will the Court be able to determine whether the regulations under section 752 have been properly applied. In addition, further factual development is necessary to establish whether the Partnership resulted in a deemed distribution in the amount of its liabilities as originally claimed, and whether these liabilities were assumed by petitioner or OPLLC. As such, ruling on petitioner's motion for summary judgment is premature as to these two alternative theories as well.

V. Our Jurisdiction[10]

In the motion for summary judgment, petitioner contends that if the Court upholds respondent's denial of the section 743(b) adjustment under any theory, then the Court should find that respondent's purported determination in the FPAA regarding a partner's outside basis in the Partnership is outside this Court's

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[9] In its motion for summary judgment, petitioner argues that since the four alternative arguments (step transaction doctrine, common law lack of economic substance doctrine, codified lack of economic substance doctrine under section 7701(o), and substance-over-form doctrine) were not included in the FPAA but were first raised in respondent's answer, respondent bears the burden of proof under Rule 142(a)(1). According to petitioner, these alternative arguments should be dismissed because respondent cannot satisfy his burden. Rule 142(a)(1) provides that the burden of proof shall be upon the petitioner, except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon the respondent. Here, the alternative arguments are not new matters but additional theories that support the deficiency that respondent already set forth in the FPAA.

[10] Although petitioner seeks a ruling on this issue only upon a determination upholding respondent's FPAA, which has not yet been made, the Court is compelled to now address the arguments being made by petitioner since they call into question the extent of this Court's jurisdiction and therefore require a resolution.

jurisdiction. In response, respondent contends that the FPAA adjustments are properly classified as partnership items of the Partnership to which this Court's jurisdiction extends, since they include adjustments under section 743(b). We agree with respondent on this point.

If the IRS decides to modify any partnership items on a partnership's informational income tax return, the IRS must issue a FPAA to notify the individual partners of the adjustment. Sec. 6231. Generally, the IRS's determinations in a FPAA are presumed correct, and the party challenging the FPAA bears the burden of proving that those determinations are erroneous. See Rule 142(a)(1); Crescent Holdings, LLC v. Commissioner, 141 T.C. 477, 485 (2013); Republic Plaza Props. P'ship v. Commissioner, 107 T.C. 94, 104 (1996). However, the party alleging our jurisdiction to determine partnership items bears the burden of proving the facts establishing our jurisdiction. Jimastowlo Oil, LLC v. Commissioner, T.C. Memo. 2013-195, at *6; see also McNutt v. Gen. Motors Acceptance Corp. of Ind., 298 U.S. 178, 189 (1936); Pietanza v. Commissioner, 92 T.C. 729, 736-737 (1989), aff'd without published opinion, 935 F.2d 1282 (3d Cir. 1991).

The Tax Court has jurisdiction to determine any partnership items of the partnership for the taxable year to which the FPAA relates. Secs. 6226, 6231(a)(3). Any adjustment to items of income, gain, loss, deductions or credit of a partnership, and any partner's distributive share thereof, shall be determined at the partnership level. Sec. 6221(a).

A "partnership item" is defined as "any item required to be taken into account for the partnership's taxable year under any provisions of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." Sec. 301.6231(a)(3)-1, Proced. & Admin. Regs. The regulation includes "optional adjustments to the basis of partnership property pursuant to an election under section 754 (including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest)" and distributions from the partnership. Sec. 301.6231(a)(3)-1(a)(3) and (a)(4)(ii), Proced. & Admin. Regs.[11]

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[11] Two Courts of Appeal have previously held that a partner's outside basis is not a partnership item to which this Court has jurisdiction to redetermine. See Jade Trading, LLC v. United States, 598 F.3d 1372 (Fed. Cir. 2010), aff'g in part, rev'g in part, vacating in part and remanding in part 80 Fed. Cl. 11
(continued)

Under section 6226, this Court has jurisdiction to redetermine all partnership items of the Partnership, including the proper allocation of such items among the partners and any adjustments to partnership items. While partnerships generally do not keep track of a partner's basis in the partnership, in some instances partnerships are required to take into account a partner's basis. One such instance occurs when a partnership makes optional adjustments to the basis of partnership property pursuant to a section 754 election. If a 754 election is made, the partner's initial basis in the partnership is a partnership item that is required to be taken into account for the taxable year of a partnership. Sec. 301.6231(a)(3)-1(a)(3), Proced. & Admin. Regs.; see Greenwald v. Commissioner, 142 T.C. 308, 313 (2014).

Here, adjustments were made pursuant to a section 754 election and therefore all calculations relating to such adjustments are considered partnership items under section 301.6231(a)(3)-1(a)(3) to which this Court's jurisdiction extends. Since respondent is seeking to redetermine partnership items of the Partnership, this Court's jurisdiction extends over those adjustments. Accordingly, we have jurisdiction to consider the correctness of the adjustments contained in the FPAA, including a necessary determination of a transferee partner's basis in a partnership interest.[12]

VI. Penalties

Petitioner seeks summary judgment on the following penalties:

a) Gross valuation misstatement penalty under section 6662(a), (b), and (h) set forth in the FPAA;
b) Negligence or disregard penalty under section 6662(a), (b) and (c)_set forth in the FPAA;
c) Lack of economic substance penalty under section 6662(b)(6) set forth in respondent's Answer;
d) Substantial valuation misstatement penalty under section 6662(b)(3) and (e)(1)(A) set forth in respondent's First Amendment to Answer;
e) Substantial understatement penalty under section 6662(b)(2) and (d) set forth in respondent's First Amendment to Answer.

(2007); Petaluma FX Partners, LLC v. Commissioner, 591 F.3d 649 (D.C. Cir. 2010), aff'g in part, rev'g in part, vacating in part and remanding in part 131 T.C. 84, (2008).

[12] We do not decide here whether respondent's adjustment at issue is proper but only that the adjustment to 2012 gross income made in the FPAA is properly classified as a partnership item of the Partnership.

In the Amended and Restated Answer filed on June 10, 2021, respondent did not include the substantial understatement penalty which was first plead in his First Amendment to Answer. Nor did he discuss the penalty in his sur-reply to motion for summary judgment. Therefore, we conclude that respondent has effectively conceded the substantial understatement penalty under section 6662(b)(2) and (d).[13]

Petitioner contends that these penalties are improper because the claimed adjustments are erroneous and respondent has failed to show compliance with section 6751(b)(1).

Under section 7491(c), the Commissioner carries "the burden of production in any court proceeding with respect to the liability of any individual for any penalty." This burden requires the Commissioner to come forward with sufficient evidence indicating that imposition of the penalty is appropriate. See Higbee v. Commissioner, 116 T.C. 438, 446 (2001). The Commissioner's burden of production under section 7491(c) includes establishing compliance with section 6751(b)(1). See Chai v. Commissioner, 851 F.3d 190, 217, 221-222 (2nd Cir. 2017), aff'g in part, rev'g in part T.C. Memo. 2015-42; Graev v. Commissioner, 149 T.C. 485 (2017), supplementing and overruling in part 147 T.C. 460 (2016). Section 6751(b)(1) provides that "[n]o penalty * * * shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination". We recently held that the "initial determination" of a penalty, for purposes of section 6751(b)(1), must be a "formal act" that resembles a determination. Belair Woods, LLC v. Commissioner, 154 T.C. 1, 15 (2020). We also concluded that in a deficiency context "the document by which the Examination Division formally notifies the taxpayer, in writing, that it has completed its work and made an unequivocal decision to assert penalties" would embody the initial determination of those penalties. Id. at 24-25; see Clay v. Commissioner, 152 T.C. 223, 249 (2019).

A. Penalties Asserted in the FPAA

Petitioner argues that respondent's revenue agent failed to obtain prior written approval for the penalties set forth in the FPAA, as required under section 6751(b)(1). According to petitioner the Summary Report is the relevant communication to which prior approval was required because by this time,

[13] In his proposed Second Amendment to Answer, respondent sought to strike the penalty.

respondent's revenue agent had concluded his work regarding the FPAA penalties. In response, respondent argues that the 60-day letter is the relevant document in this case because petitioner was invited to submit more information for consideration after the Summary Report was issued. Respondent contends that since respondent's revenue agent obtained the requisite approval before the 60-day letter was issued, the penalties in the FPAA were timely approved by the revenue agent's supervisor.

Respondent first communicated penalties (gross valuation misstatement penalty under section 6662(b)(3) and (h) and negligence or disregard penalty under section 6662(b)(1) and (c)) to the Partnership in its Notice of Proposed Adjustment (NOPA) dated February 18, 2018. On April 17, 2018, respondent issued the Summary Report which also discussed the same penalties. Petitioner waived the closing conference and respondent issued a 60-day letter on August 13, 2018. The revenue agent's supervisor approved the FPAA penalties in writing via a penalty approval form on or about July 27, 2018.

The issue here is whether the Summary Report constituted a formal act which triggered the written approval requirement under section 6751(b)(1). Based on the Court's review of the motion papers, we find that there exists a genuine dispute as to material facts as to which document constituted a formal act that resembles a determination; therefore, the Court will deny petitioner's motion for summary judgment as to the penalties set forth in the FPAA.[14]

B. Penalties Asserted in Respondent's Answer

In his Answer, respondent adds a lack of economic substance penalty under section 6662(b)(6). The lack of economic substance penalty is also asserted by respondent in his Amended and Restated Answer.

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[14] In its reply to respondent's response to motion for summary judgment, petitioner argues that the substantial valuation misstatement penalty under section 6662(b)(3) and (e)(1)(A) is the same penalty as the gross valuation misstatement penalty under section 6662(b)(3) and (h). Even if the substantial valuation misstatement penalty asserted in respondent's First Amendment to Answer and the gross valuation misstatement penalty asserted in the FPAA are the same, we conclude that whether timely approval was obtained as required by section 6751(b)(1) is a question of fact and will deny petitioner's motion for summary judgment as to the substantial valuation misstatement penalty under section 6662(b)(3) and (e)(1)(A).

In addition to arguing that respondent has not demonstrated the required written approval under section 6751(b)(1) for this penalty, petitioner argues in its reply to respondent's response to motion for summary judgment that the section 6662(b)(6) penalty cannot be imposed here because the relevant transactions occurred before March 30, 2010. Respondent also contends that the penalties asserted in his Answer were approved by respondent's counsel's supervisor before respondent filed his Answer.

Section 6662(b)(6) contains a reference to the codified economic substance doctrine under section 7701(o) and therefore only applies to the transactions entered into after March 30, 2010. IRS Notice 2014-58 defines "transaction" in this context as "generally include[ing] all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan." Here, the key issues arise from the land sales and 2007 Finco transactions, which no doubt occurred before 2010. However, in describing his theory under the economic substance doctrine, respondent argues, "the transactions in the case potentially spanning the March 31, 2010, effective date of I.R.C. § 7701-the Finco Transactions occurred in 2006, the 2007 Transactions in 2007, and the tax triggering event in 2012. No judicial guidance on which date controls for the purpose of I.R.C. § 7701 exists." According to respondent, the termination of the Partnership should be viewed as a part of the same transactions that started March 10, 2010, and therefore sections 7701(o) and 6662(b)(6) are applicable. Because petitioner has not met its burden in demonstrating that all of the transactions at issue occurred after March 30, 2010, and because there remains a genuine dispute of material facts with respect to whether respondent obtained the requisite approval for this penalty, the Court will deny petitioner's motion for summary judgment as to the assertion of the lack of economic substance penalty under section 6662(b)(6).

Based on the foregoing reasons, it is

ORDERED that petitioner's motion for summary judgment filed on November 20, 2020, is denied. It is further

ORDERED that on or before November 30, 2021, the parties shall file a joint status report (or if a joint report is not expedient, then separate reports) setting forth the issues for trial and recommending a schedule for further proceedings in this case.

(Signed) Christian N. Weiler
Judge