Oral Argument Is Not Yet Scheduled

IN THE

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

17-1266

JEFF BLAU, TAX MATTERS PARTNER OF RERI HOLDINGS I, LLC,

Petitioner-Appellant,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

PAGE PROOF REPLY BRIEF FOR PETITIONER-APPELLANT

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GLOSSARY

"**AT&T**" refers to AT&T Corp.

"**Code**" refers to the Internal Revenue Code of 1986 (26 U.S.C.), as amended and in effect during the year at issue.[1]

"**Commissioner**" refers to the Commissioner of Internal Revenue.

"**FPAA**" refers to the Notice of Final Partnership Administrative Adjustment issued to RERI Holdings I, LLC, for its 2003 tax year.

"**Hawthorne**" refers to RS Hawthorne, LLC.

"**Holdings**" refers to RS Hawthorne Holdings, LLC.

"LLC" refers to a limited liability company.

"**Property**" refers to the land and web hosting facility owned by RS Hawthorne, LLC.

"**Remainder Interest**" refers to the remainder interest in RS Hawthorne Holdings, LLC, that becomes possessory as of January 1, 2021.

"**RERI**" refers to RERI Holdings I, LLC.

"**Term Interest**" refers to the term of years interest in RS Hawthorne Holdings, LLC, that expires on December 31, 2020.

"University" refers to the University of Michigan.

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[1] Unless otherwise indicated, all "section" references are to Title 26 of the United States Code in effect during the relevant period.

STATUTES AND REGULATIONS

Except for 26 U.S.C. § 6230(l) and Rule 142 of the United States Tax Court Rules of Practice and Procedure, which are set forth in the addendum hereto, the statutes and regulations pertinent to this appeal are contained in appellant's addendum filed with the Court on April 2, 2018, or the addendum to appellee's brief.

SUMMARY OF THE ARGUMENT

The Tax Court incorrectly held that RERI was not entitled to a charitable contribution deduction because of a blank box on RERI's Form 8283, a substantiation issue that the Commissioner never raised below and on which RERI never had an opportunity to introduce evidence or present an argument. The Tax Court also held (again, incorrectly) that the 40 percent penalty applies. The Commissioner failed to satisfy his burden of proving that RERI is allowed to no deduction and that a 40 percent penalty applies.

ARGUMENT

The Commissioner bore the burden of proving that: (1) RERI did not substantiate its deduction; (2) the value of the property was less than $3.9 million; and (3) the gross valuation misstatement penalty applies. He failed to meet those burdens. Thus, the Tax Court's decision should be reversed.

I. THE COMMISSIONER BORE THE BURDEN OF PROOF

Following a partnership audit, the IRS issues a notice of final partnership administrative adjustment (FPAA) notifying the partners of the Commissioner's

determination that adjustments should be made to the partnership's tax return. Michael I. Saltzman & Leslie Book, IRS PRACTICE AND PROCEDURE ¶ 9.11[1], [3]. The Commissioner's determinations in an FPAA are presumed correct and the taxpayer bears the burden of proving otherwise. *Green Gas Del. Stat. Trust v. Comm'r*, 147 T.C. 1, 33 (2016), *aff'd,* No. 17-1025, 2018 WL 3893186 (D.C. Cir. Aug. 14, 2018); Tax Court R. 142(a). However, when a taxpayer seeks judicial review of the Commissioner's determination and the Commissioner raises in his answer an increase in the adjustment to tax or penalty, the Commissioner does not enjoy the presumption of correctness for that increase and bears the burden of proof. *Estate of Braverman v. Comm'r*, 21 T.C.M. (CCH) 98 (1962); Tax Court R. 142(a).

The Commissioner determined in his FPAA that RERI was entitled to a charitable contribution deduction of $3.9 million and asserted a 20 percent substantial valuation misstatement penalty. (Ex. 2-J at RERI-003984-3985, A. __.) That means the Commissioner had determined that RERI had satisfied the substantiation requirements. *See O'Connell v. Comm'r*, T.C.M. (RIA) 2001-158, 2001 WL 739233, at *6 (June 29, 2001) (holding that where the Commissioner allowed deduction in notice but later contended the deduction should be disallowed, substantiation was a new matter on which he had the burden).

It was not until the Commissioner filed his first amendment to answer that he asserted that RERI should receive no deduction. (Doc. 16, A. __.) Then, in his

second amendment to answer, the Commissioner asserted a 40 percent gross valuation misstatement penalty for the first time. (Doc. 99, A. __.) The Commissioner is not entitled to a presumption of correctness for new issues raised in his amendments to answer. It is the Commissioner, not RERI, who bore the burden of proving that RERI is not entitled to a charitable contribution deduction and a gross valuation misstatement penalty applies.

The Commissioner argues that he did not bear the burden on the gross valuation misstatement penalty because RERI is not an individual for purposes of section 7491(c). Under that section, the Commissioner bears the burden of production in any court proceeding concerning the liability of an individual for a penalty. The Tax Court recently concluded that section 7491(c) does not apply in a partnership-level proceeding. *Dynamo Holdings L.P. v. Comm'r*, 150 T.C. No. 10, 2018 WL 2106443, at *5-6 (May 7, 2018). However, this Court more recently recognized the application of section 7491(c) in a partnership proceeding. *Green Gas Del. Stat. Trust v. Comm'r*, No. 17-1025, 2018 WL 3893186, slip. op. at 13 (D.C. Cir. Aug. 14, 2018).

Regardless of section 7491(c), the Commissioner bore the burden because the gross valuation misstatement penalty was a new matter raised in his amendment to answer. *See* Tax Court R. 142(a). While *Dynamo* concludes that the Commissioner does not bear the burden of production under section 7491(c) in a partnership-level

proceeding like this one, it also concludes that the Commissioner bears the burden on penalties raised for the first time in an amendment to answer – precisely the situation here. *Dynamo*, 2018 WL 2106443, at *8.

II. THE COMMISSIONER FAILED TO SHOW THAT RERI WAS ENTITLED TO NO DEDUCTION

RERI substantially complied with the reporting requirements for its charitable contribution deduction. The Commissioner acknowledged RERI's compliance by allowing a deduction of $3,935,470 in the FPAA. The Commissioner bore the burden of proving that RERI's compliance with the reporting requirements was insufficient. He failed to meet his burden, and the holding below disallowing RERI's deduction must be reversed.

A. The Substantial Compliance Doctrine Applies

The list of items to be reported to the IRS for charitable contribution deductions is found in regulations. 26 C.F.R. § 1.170A-13(c). Because the reporting regulations do not relate to the substance of whether a charitable contribution was made, substantial compliance is sufficient, and perfection is not the standard. *Bond v. Comm'r*, 100 T.C. 32, 40-41 (1993); *Scheidelman v. Comm'r*, 682 F.3d 189, 199 (2d Cir. 2012). The Commissioner argues that substantial compliance is insufficient and noncompliance should be excused only if expressly allowed in the regulations, relying on *Rogers v. Commissioner*, 783 F.3d 320, 325 (D.C. Cir. 2015). Appellee

Br. 19. The regulations there were substantive, not procedural. Thus, the Commissioner's reliance on *Rogers* is misplaced.

Unlike in *Rogers*, the regulations in dispute here are procedural. Courts repeatedly have applied the substantial compliance doctrine when addressing procedural requirements. *Bond*, 100 T.C. at 41; *Scheidelman*, 683 F.3d at 199; *see Atlantic Veneer Corp. v. Comm'r*, 812 F.2d 158, 160-61 (4th Cir. 1987); *but see also Volvo Trucks of N.A., Inc. v. United States*, 367 F.3d 204, 209-210 (4th Cir. 2004). Even the Commissioner has relied on substantial compliance to establish that he has sufficiently complied with procedural requirements. *E.g., United States v. Richey*, 632 F.3d 559, 564-65 (9th Cir. 2011). Moreover, this Court has applied a substantial compliance test for procedural requirements in non-tax contexts. *Heller v. Fortis Benefits Ins. Co.*, 142 F.3d 487, 492-93 (D.C. Cir. 1998).

Because the regulations at issue here are procedural and do not relate to the substance of whether RERI made a charitable contribution, the substantial compliance doctrine applies, and the Commissioner's argument to the contrary should be rejected.

B. The Commissioner Failed to Establish that RERI Did Not Substantially Comply With the Regulations

The Commissioner argues that RERI's Form 8283 does not substantially comply with the reporting requirements. Appellee Br. 22. As previously discussed (Appellant Br. 11-14), RERI's Form 8283 together with the attached appraisal,

substantially comply with the reporting requirements because they provided sufficient information to allow the Commissioner to evaluate RERI's reported contribution. *Simmons v. Comm'r*, 98 T.C.M. (CCH) 211, 215, 2009 WL 2950610, at *7 (Sept. 15, 2009), *aff'd*, 646 F.3d 6 (D.C. Cir. 2011); *see also Scheidelman,* 683 F.3d at 198-199.

The Commissioner relies on several cases where courts concluded that the substantial compliance doctrine should apply only if certain conditions are satisfied, *i.e.*, where the taxpayer had a good excuse for the failure to strictly comply and where the requirement was unimportant, unclear, or confusingly worded. Appellee Br. 22-23. None of those cases involves section 170, the statute at issue here.

Furthermore, the Commissioner ignores that, to the extent RERI's reason for not including the basis information is relevant, it was his burden to establish that RERI's omission was not excusable. He failed to do so. He never even raised the issue. Without any support in the record, the Commissioner asserts on brief that "RERI chose . . . not to disclose [its basis] on the Form 8283 because, as the Tax Court found, the 'significant disparity' between the claimed fair market value of the property at the time of contribution . . . and the price RERI paid for it just 17 months earlier . . . 'had it been disclosed, would have alerted [the Commissioner] to a potential overvaluation.'" Appellee Br. 23. The Tax Court did not find, and there is nothing in the record to support a finding, that RERI chose not to disclose the basis

to avoid alerting the Commissioner to any overvaluation. Furthermore, as noted in RERI's opening brief, a blank box is the equivalent of entering zero, which could just as easily alert the Commissioner to any overvaluation. Appellant Br. 12-13.

The Commissioner says that basis information is important based on an *assumption* about Congressional intent. Appellee Br. 25. That assumption is not supported by any citation. RERI's opening brief demonstrates that a taxpayer's basis is of no relevance to the amount of a charitable contribution deduction to which a donor is entitled, except in limited circumstances not applicable here. Appellant Br. 12.

The Tax Court concluded in *Dunlap v. Commissioner*, 103 T.C.M. (CCH) 1689, 2012 WL 1524660 at *29 (May 1, 2012), that basis information on Form 8283 was not necessary to substantially comply with the regulations. The Commissioner claims RERI's reliance on *Dunlap* is misplaced because he says "that case did not even involve the deductibility of a charitable contribution under § 170." Appellee Br. 27. The Commissioner is wrong. The issues before the court in *Dunlap* were whether the taxpayers were entitled to a charitable contribution deduction under section 170 and whether a penalty applied. Furthermore, *Dunlap* involved the same tax year at issue here. We cannot fathom why the Commissioner says *Dunlap* does not apply.

Accordingly, the Commissioner is wrong when he says that RERI did not substantially comply with the reporting requirements.

C. The Commissioner Failed to Establish that RERI Did Not Obtain a Qualified Appraisal

The Commissioner argues that RERI's deduction should be disallowed because RERI did not obtain a qualified appraisal, an issue not decided by the Tax Court, *RERI Holdings I, LLC v. Comm'r*, 143 T.C. 41, 71-83 (2014). To support his argument, the Commissioner says the appraisal values the wrong property and does not disclose restrictions on the University's right to dispose of the contributed property. Appellee Br. 27. He is incorrect.

1. RERI's appraisal sufficiently describes the donated property

The Commissioner contends that RERI's appraisal is insufficient because it appraises a remainder interest in the Property instead of a remainder interest in Holdings. The Commissioner selectively quotes the regulation, mischaracterizes trial testimony, and ignores expert opinion.

The regulations say a qualified appraisal must include a "description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed." 26 C.F.R. § 1.170A-13(c)(3)(ii)(A). The appraisal and Form 8283, which were part of RERI's tax return (Ex. 1-J at RERI-002033-2110,

A.__), together accurately describe the donated property and satisfy the regulations. *See Bond*, 100 T.C. at 41-42.

Furthermore, the Tax Court concluded that "Assuming the evidence in this case demonstrates that the [Remainder Interest] and the remainder interest in the Hawthorne property were of equal value, we would find that the inclusion, in the Form 8283, of the missing information required to be included in the appraisal . . . constituted substantial compliance with that provision." *RERI*, 143 T.C. at 78. The Commissioner failed to introduce any credible evidence comparing the two values.[2]

RERI's expert, Myers, concluded that the values would have been the same (Ex. 271-P at 66, A. __), and Gelbtuch, who performed the appraisal attached to RERI's tax return, testified that he would have reached the same conclusion if he had valued a remainder interest in Holdings (Doc. 276 at 179:12-16, A. __).

The Commissioner focuses on the impact of including the mortgage in an entity-level valuation. However, the mortgage creates a distortion in value. As Myers' expert testimony establishes, a mortgage on property that would be

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[2] Cragg says only "$1.65 million is the maximum (upper bound) of the value of the [Remainder Interest] in Holdings because there is a cost to its lack of marketability and there are additional risks due to its ownership structure." (Ex. 275-R at 24, A. __.) However, he offers no support for this assertion. Abrahams likewise implausibly claims that a single-asset LLC would be subject to a lack of marketability discount not present for a real estate asset held directly. He does not quantify that risk. The Tax Court noted flaws in Abrahams' analysis and did not rely on his report. (Doc. 293 at 49-51, A. __.)

extinguished before the interest in the property becomes possessory does not impact value. (Ex. 271-P at 67-68, A. __.) Even the Commissioner's experts determined a value of the Remainder Interest based on a value of the Property at the end of the term that was free of the debt. (Ex. 276-R at ¶ 17, A. __; Doc. 283 at 719:13-720:5, A. __; Ex. 277-R at 34-38, A. __.)

Gelbtuch correctly determined fair market value for tax purposes by valuing the underlying Property. A property's fair market value "is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." 26 C.F.R. § 1.170A-1(c)(2). A limited liability company ("LLC") with a single owner is disregarded for federal tax purposes. 26 C.F.R. § 301.7701-3. Because it is disregarded for tax purposes, the sale of an interest in such an entity is treated as a sale of a proportionate interest in the entity's assets. Rev. Rul. 99-5, 1999-1 C.B. 434. For example, if a partnership is the sole member of an LLC that holds assets, the LLC is ignored for federal tax purposes. When the partnership sells its LLC interest, the partnership's partners are taxed as if they sold the assets of the LLC, not the LLC itself. There is no question that had RERI sold the Remainder Interest its members would have been taxed as if it had sold a remainder interest directly in the Property.

"A gift is the functional equivalent of a below-market sale . . . ." *Murphy v. IRS*, 493 F.3d 170, 185 (D.C. Cir. 2007). The Commissioner offers no sound explanation as to why the transfer of an LLC interest should be treated inconsistently when computing the income tax, especially where the regulations unambiguously instruct that the LLC is to be disregarded.

In *Pierre v. Commissioner*, 133 T.C. 24 (2009), a gift tax case, a divided Tax Court valued an interest in an LLC based on the entity's value, rather than the value of its assets. The Tax Court's holding was based on state corporate law that says an LLC is an entity distinct from its owner. But the regulations state: "Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." 26 C.F.R. § 301.7701-1(a)(1). *Pierre* misapplied the language of 26 C.F.R. § 301.7701-1(a)(1). In any event, *Pierre* should not be extended beyond the gift tax context. The gift tax, which is an excise tax, operates in a fundamentally different way than the income tax. This is an income tax case and income tax principles governing transfers of LLC interests must control.

Even if the Court were to ignore well-established federal tax principles concerning sales of LLC interests, the actual interest being donated still must be considered. Here, the property that was donated was a remainder interest in an entity that indirectly owned real estate that, as noted above, would have been free of any

debt by the time the interest in the entity became possessory. (Ex. 271-P at 67-68, A. ___.)

2. RERI did not restrict the University's rights in the property

The Commissioner argues that RERI's appraisal is not a qualified appraisal because it does not disclose restrictions on the right to use or dispose of the contributed property. Appellee Br. 31. The Commissioner's argument rests on an unenforceable gift agreement to which RERI was not a party. (Ex. 125-J, A. __.)

The gift agreement, which was between Stephen Ross and the University, provides that the University shall sell the Remainder Interest in a manner and to a buyer of its choosing at any time after two years. (Ex. 125-J, A. __.) Ross' pledge under the agreement was to be paid by the later of December 31, 2007, or 30 days after the sale of the Remainder Interest. The agreement does not provide a date on which the University must sell the Remainder Interest; Ross could not have forced the University to sell the interest; and the University believed it was not required to sell the interest (Ex. 151-J at RERI-016412, A. __).

The hold provision is relevant to whether RERI's appraisal is a qualified appraisal only if the Commissioner proves that it affected value. *RERI*, 143 T.C. at 79-80. Gelbtuch testified that the hold provision would not have impacted his conclusions. (Doc. 276 at 181:12 – 185:5, A. __.) Myers opined that the agreement had no impact on the value of the Remainder Interest because the interest has a

significant marketing time; the mere passage of time would tend to increase the value of the interest as the interest moves closer to becoming possessory; and buyers typically do not buy real estate as a short-term investment. (Ex. 271-P at 68, A. __.)

Finally, Gelbtuch was not required to consider the gift agreement because it was unenforceable. Ross lacked standing to bring suit to compel the University not to sell. Under Michigan law, a pledge agreement creates a charitable trust. *Prentis Family Found. v. Barbara Ann Karmanos Cancer Inst.*, 698 N.W.2d 900, 913-914 (Mich. Ct. App. 2005). The settlor of a charitable trust has no standing to sue to enforce its terms. *Id.* Furthermore, if Ross unilaterally elected not to fulfill his pledge, and the University sued him, he could not defend on the grounds that the University failed to honor the hold provision. *See Eberspaecher N. Am., Inc. v. Nelson Global Products, Inc.*, No. 12-11045, 2012 WL 4356781, at *8 (E.D. Mich. Sept. 23, 2012).

The Commissioner failed to meet his burden to show RERI's deduction was not substantiated. Accordingly, the decision below should be reversed.

III. The Gross Valuation Misstatement Penalty Cannot Be Sustained

The Commissioner failed to show that he complied with section 6751(b)(1), that any underpayment is "attributable to" a gross valuation misstatement, that the value was less than $3,935,470, and that RERI lacked reasonable cause. A finding

in RERI's favor on any one of these issues results in a reversal of the lower court's decision.

A. The Failure to Obtain Supervisory Approval Cannot Be Excused

The Commissioner does not dispute that section 6751 requires that the initial determination of a penalty be personally approved in writing by the immediate supervisor of the individual making the penalty determination. *See* 26 U.S.C. § 6751(b)(1); *Chai v. Comm'r*, 851 F.3d 190, 217-18 (2d Cir. 2017). He also does not dispute that there is nothing in the record establishing that the required approval was obtained. Instead, he argues (incorrectly) that the matter was not raised in the Tax Court and (again, incorrectly) that he did not bear the burden of production.

1. The issue is properly before this Court

The Commissioner relies on *Mellow Partners v. Commissioner*, 890 F.3d 1070 (D.C. Cir. 2018), for the proposition that the court of appeals will not hear a challenge grounded in section 6751 if not raised in the lower court. Appellee Br. 32-33. The Commissioner's discussion of *Mellow Partners* omits controlling factors in that case that do not exist here. The taxpayer in *Mellow Partners* consented to judgment on penalties in the Tax Court. RERI has not consented to judgment. Also, *the Commissioner* raised the issue in this case, adopting a reading of section 6751 that was later rejected by the U.S. Court of Appeals for the Second Circuit. In his pretrial memorandum, the Commissioner stated, "Section 6751(b)(1) imposes a

requirement relating to supervisory approval prior to assessment of penalties. However, in a Tax Court case, assessment does not occur until the decision of the Tax Court has become final … so section 6751(b)(1) has no application here." (Doc. 252 at 44; A. __.) The Commissioner adopted that position at his peril because the burden concerning compliance with section 6751 was squarely on him. In any event, where the parties identified the governing statute, "the Tax Court was obliged to apply [the statute] correctly, whether or not [the parties] developed the issue in detail …." *Transport Labor Contract/Leasing, Inc. v. Comm'r*, 461 F.3d 1030, 1034 (8th Cir. 2006).

Even if the issue had not been identified below, this Court has discretion to review the issue. "Courts of appeals are not rigidly limited to issues raised in the tribunal of first instance; they have a fair measure of discretion to determine what questions to consider and resolve for the first time on appeal." *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 419 n.5 (D.C. Cir. 1992).

Circumstances in which the courts of appeals will consider issues not raised below include where there has been an intervening change in law. *Id.* It was only after this case was fully submitted to the Tax Court that the Second Circuit issued its decision in *Chai*. That decision was the first time any court had interpreted the relevant portion of section 6751. As this Court noted in *Mellow Partners*, 890 F.3d at 1081-82, section 6751 has been in the Code since 1998, with no development in

the case law. That was not because the correct interpretation of that provision was clear. As reflected in the Commissioner's pretrial memorandum and in a now-reversed Tax Court decision, *Graev v. Comm'r*, 147 T.C. 460 (2016), the prevailing view of the IRS was that it was not required to obtain supervisory approval of a penalty until the point of assessment (which occurs only after a Tax Court decision becomes final, see 26 U.S.C. § 6215(a)). Therefore, the Second Circuit's decision in *Chai* represents an intervening change in law, meriting this Court's review.

2. The Commissioner failed to prove supervisory approval was obtained

As shown above, the Commissioner bore the burden concerning the increase in penalty raised in the answer. *See Dynamo*, 2018 WL 2106443, at *8. Even if the burden of production had been on RERI concerning supervisory approval for the gross valuation misstatement (which it was not), that burden was satisfied by evidence in the record. The Commissioner asserted the gross valuation misstatement penalty for the first time in his second amendment to answer, which obviously is part of the record. That answer contained the "initial determination" of the penalty, as that phrase is used in section 6751(b). *Chai*, 851 F.3d at 221. The second amendment to answer is signed by the Commissioner's trial counsel. (Doc. 99, A.__.) It does not include any written approval from counsel's immediate supervisor as required by section 6751. In Chief Counsel Notice 2018-006, 2018 WL 2971640 (June 6, 2018), the IRS Office of Chief Counsel described its procedures for

complying with section 6751 when a penalty is first asserted in an answer, as is the case here. It states: "If an attorney raises a penalty in an answer or amended answer, the attorney's immediate supervisor must sign the answer or amended answer, and the answer or amended answer must identify the supervisor's signature as the written supervisory approval of the attorney's initial determination pursuant to section 6751(b)(1)." IRS CCN CC-2018-006. It is apparent from the face of the second amendment to answer that the Commissioner did not satisfy section 6751(b)(1). Therefore, the Tax Court's decision imposing the penalty should be reversed.

B. The Commissioner Failed to Show that the Underpayment Is Attributable to a Gross Valuation Misstatement

The Commissioner accepts, as he must, that a penalty can apply in this case only if the underpayment of tax (if any) is "attributable to" a valuation misstatement. Appellee Br. 35; 26 U.S.C. § 6662(b)(3). However, he fails to offer any explanation as to how the underpayment here, which is based on an irrelevant box being left blank in an attachment to RERI's tax return, bears any relationship to valuation.

Several courts have concluded that "an underpayment of tax *may be* attributable to a valuation misstatement for purposes of [section 6662] even when the IRS asserts both a valuation misstatement ground and a non-valuation-misstatement ground for the same adjustment." *Alpha I, L.P. v. United States*, 682 F.3d 1009, 1030 (Fed. Cir. 2012) (emphasis added). But the Supreme Court has held that the valuation and non-valuation grounds must be "inextricably intertwined" with

one another for the valuation penalty to be "attributable to" a nonvaluation ground. *United States v. Woods*, 571 U.S. 31, 47-48 (2013); *see* Appellant Br. 15-18. The Commissioner does not explain how leaving a box that had no relevance to the computation of RERI's deduction blank could be "inextricably intertwined" with a valuation misstatement. The simple answer is that no explanation is offered because there isn't one.

C. The Tax Court Determined a Gross Valuation Misstatement by Disregarding Mandatory Valuation Tables and Relying on Unreliable Expert Conclusions

The Tax Court erred when it concluded that the value of RERI's gift was only $3,462,886 and applied the gross valuation misstatement penalty. These errors rest primarily on the lower court's disregard of mandatory valuation tables to arrive at its own "rough justice" valuation conclusions and its willingness to rely on patently incorrect expert conclusions to justify that result. Most of the Commissioner's arguments in support of the Tax Court's faulty reasoning have been addressed in RERI's opening brief.

1. No exception to the mandatory valuation tables applies

Congress has chosen simplicity over scientific accuracy when valuing remainder interests to prevent precisely the type of valuation dispute that the Commissioner seeks to have this Court referee. Appellant Br. 22-24. Congress recognized, of course, that there might be limited circumstances in which exceptions

should be made. Those exceptions are provided in Treasury regulations. *See* 26 C.F.R. § 1.7520-3(b). The Commissioner points to two possible exceptions in the regulations: (1) where the property will not be adequately preserved and protected "consistent with the preservation and protection that the law of trusts would provide" (the exception on which the Tax Court's decision rests) and (2) where the remainder interest is a "restricted beneficial interest" (an exception the Tax Court did not consider). He also relies on a judicially-created exception that has not been adopted by this circuit.

a. The remainder interest is adequately preserved and protected

Appellant already has addressed the points raised by the Commissioner and does not repeat them. *See* Appellant Br. 26-29. The Commissioner's argument in essence is that the protections provided must be *identical* to the law of trusts. The regulations, however, do not require this. If that were the case, no remainder interest would ever be valued using the mandatory tables. For example, the law of trusts provides that a trustee has a fiduciary duty to the trust's beneficiaries. *See In re Garrasi*, 943 N.Y.S.2d 791 (Sur. Ct. 2011). A term holder, however, does not have a fiduciary duty to a remainderman. Thus, all remainder interests would always fail the test proposed by the Commissioner. An exception cannot be interpreted so that the general rule never applies. *Dunaway v. New York*, 442 U.S. 200, 213 (1979). The Commissioner's argument should be rejected.

b. The remainder interest is not a "restricted beneficial interest"

The regulations include an exception for a "restricted beneficial interest," which is a "remainder . . . interest that is subject to contingency, power, or other restriction." 26 C.F.R. § 1.7520-3(b)(1)(ii). This language, on first blush, appears broad, and the Commissioner urges this Court to interpret it so that the exception swallows the rule. The U.S. Court of Appeals for the Fifth Circuit already has rejected this near limitless interpretation. *Anthony v. United States*, 520 F.3d 374 (5th Cir. 2008).

The Commissioner argues that the mortgage represents a "contingency" meriting disregarding the tables. *Anthony* counsels a far more limited reading. The type of contingency contemplated by the regulation is one that "undermine[s] the fundamental assumptions" under the tables and in which the remainderman is virtually guaranteed to never come into possession. One example of the kind of "restricted beneficial interest" contemplated by the regulations is "the right to receive annuity payments . . . contingent on the survival of a person who is terminally ill." *Id.* at 380. In other words, the type of defeasing contingency is one that is almost certain to happen.[3]

[3] The Commissioner also relies on the gift agreement as a "restriction." We have disposed of the Commissioner's misinterpretation of that agreement above. In addition, restrictions on the right to transfer are not "restrictions" within the meaning of the regulations. *Anthony*, 520 F.3d at 383.

c. The judicially-created exception to the tables does not apply and this court should not adopt the exception

Even though the statute expressly says that the tables under section 7520 "shall" be used to value remainder interests except in situations identified by regulation, some circuits have adopted an additional exception not in the regulations. These courts use fair market value when the tables produce a result that is "substantially unrealistic and unreasonable." *See Shackleford v. United States*, 262 F.3d 1028 (9th Cir. 2001); *Gribauskas v. Comm'r*, 342 F.3d 85 (2d Cir. 2003); *Cook v. Comm'r,* 349 F.3d 850 (5th Cir. 2003). Even these courts have held that "[t]he party challenging applicability of the tables has the substantial burden of demonstrating that the tables produce an unreasonable result." *Cook*, 349 F.3d at 854-55. The Commissioner has not met that substantial burden.

This Court should not adopt the judicially-created exception to the regulations because it is contrary to the statute and because the rule rests on an unsupportable foundation. The courts adopting this exception rely on *O'Reilly v. Commissioner,* 973 F.2d 1403 (8th Cir. 1992). That reliance is misplaced.

O'Reilly was decided under pre-7520 law and addressed the conflict between actual value and value under the tables in the context of a statute that *mandated fair market value*. Section 7520 constituted a change in the approach toward the fair market value standard. Thus, *Shackleford, Gribauskas,* and *Cook*, which are post-7520 cases, address the conflict between actual value and value under the tables in

the context of a statute that *mandates use of the tables*. In fact, *O'Reilly* turns on statutory text requiring fair market value. *O'Reilly*, 973 F.2d at 1407.

The concerns that convinced the *O'Reilly* court to depart from the tables not only no longer apply, but now drive forcefully in the opposite direction – deference to the statute weighs in favor of adherence to, not departure from, the tables. Congress mandated that any exceptions would be made using the formal regulatory process which ensures more predictable, coordinated, circumspect, transparent and evenhanded rules.

Because no exception in the regulations under section 7520 applies, the Remainder Interest must be valued under the actuarial tables. It was error for the Tax Court to set aside the tables.

2. Cragg's Approach Contravenes Basic Valuation Principles

Because the Tax Court set aside the tables under section 7520, it determined the fair market value of the Remainder Interest. The Tax Court relied on Cragg, the Commissioner's expert, for its discount rate. As discussed in RERI's opening brief, the discount factor accounts for almost the entire difference between the parties' fair market value conclusions. Appellant Br. 31. Because Cragg's method was unreliable, it was clear error for the Tax Court to rely on his discount rate. Even if it was not clear error to accept his method, it was clear error not to include a liquidity premium in determining the discount rate to apply.

a. Cragg's method was suspect

Cragg's approach relied entirely on his ability to infer the discount rates the parties to the February 2002 transaction applied to subsets of cashflows. The treatise on which the Commissioner relies states that a "basic principle" of valuation is that when relying on "specific comparative market transactions for guidance . . . investors' specific expectations regarding future returns and risk . . . are not known." *See* Shannon P. Pratt & Alina V. Niculita, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 70 (5th ed. 2008). Cragg's approach contravened this "basic principle." Accordingly, it was clear error for the Tax Court to accept his method as the more reliable method.

b. It was clear error not to apply a liquidity premium

If this Court does not agree that relying on Cragg's method was clear error, the Tax Court committed clear error in accepting Cragg's conclusions about the discount rate. The most glaring error was not requiring the addition of a liquidity premium to Cragg's 7.92 percent discount rate for the initial term cash flows.

The Commissioner cites Cragg's claim that AT&T's credit risk was the only relevant risk (Appellee Br. 57), but ignores Cragg's admissions to the contrary. Appellant Br. 36-37. Moreover, Cragg's approach contravenes yet another "basic principle" of valuation from the treatise relied on by the Commissioner: "The market

. . . demands a discount for lack of liquidity as compared with a liquid asset." *See* Pratt & Niculita, *supra* at 71.

The Commissioner relies on the happenstance that RERI's expert cited a 7.5 percent rate (including a 1.5 percent liquidity premium) for the correct valuation date, 18 months later than the wrong valuation date used by Cragg. Appellee Br. 56. The only conclusion to be drawn from that reference is that a 1.5 percent liquidity rate should have been added to the 7.92 percent AT&T corporate bond rate used by Cragg. Appellant Br. 38.

Accordingly, the case should be remanded with instructions to apply at least a 9.42 percent discount rate.

D. The Commissioner Failed to Show Lack of Reasonable Cause

The Tax Court erred in concluding that the Commissioner met his burden to show that RERI did not satisfy the reasonable cause exception to the imposition of a gross valuation misstatement penalty. The Commissioner's primary complaint is that he says he did not have the burden of proof. He relies on *Barnes v. Commissioner*, 712 F.3d 581, 584 (D.C. Cir. 2013), but that case does not support his position. Appellee Br. 60-61.

Unlike here, the penalties in *Barnes* were all determined by the Commissioner in his notice of deficiency (the equivalent of the FPAA in this case), and therefore were entitled to a presumption of correctness. Here, the penalty at issue – the gross

valuation misstatement penalty – was not proposed until the Commissioner adopted a new litigating position in his second amendment to answer. Therefore, as discussed above (*supra* Point I), under section 6230(l) and Tax Court Rule 142(a)(1), the burden was on the Commissioner to prove that the taxpayer did not have reasonable cause. He did not meet his burden.

The Commissioner argues that RERI did not obtain a qualified appraisal, and therefore there can be no reasonable cause. RERI obtained a qualified appraisal, as discussed above. *See supra* Point II.C.

The Commissioner alleges that there were numerous defects in the appraisal that should have alerted Harold Levine, the managing member of RERI, that he should not rely on the appraisal. For example, the Commissioner focuses on the fact that the appraisal values the real estate, not the entity holding the real estate. He ignores, however, that it was well-settled that a wholly-owned LLC is disregarded for federal tax purposes, that *Pierre* had not been decided by the time RERI's appraisal was performed, and that it was *the Commissioner* in *Pierre* who took the position that a wholly-owned LLC should be disregarded in determining value for federal tax purposes. *See supra* Point II.C.1. It was reasonable for Levine, a tax lawyer (Doc. 271 ¶¶4, 5, A.__), to view the Remainder Interest as an interest in the Property for purposes of determining RERI's charitable contribution deduction.

The Commissioner focuses on Levine's knowledge of the existence of the mortgage. We have explained above why, when valuing a disregarded entity, the mortgage would not be considered. *See supra* Point II.C.1. The Commissioner's last objection is that Levine was aware "of the restrictions RERI placed on the University's right to use or dispose of the [Remainder Interest], including the two-year hold restriction and the mandatory-sell requirement." That misstates the facts. RERI was not a party to the agreement (Ex. 125-J) and the description distorts the terms. *See supra* Point II.C.2.

In an apparent effort to sidestep the parties' stipulation concerning value, the Commissioner claims "the $2.95 million price RERI paid to acquire the [Remainder Interest] in March 2002 . . . was much more probative information in RERI's hands of the [Remainder Interest's] correct value at the time of the donation." Appellee Br. 66. The Commissioner relegates to a footnote the admission that the parties stipulated that the $2.95 million price "did not represent the fair market value" of the remainder interest. Appellee Br. 67 n.9. He attempts to backpedal from this stipulation with an excuse (not in the record) as to why he agreed to the stipulation.[4] This excuse should be ignored.

[4] The Commissioner misstates the record when he discusses Levine's intent. Appellee Br. 67. He cites to several stipulations that describe the course of events after the University sold the Remainder Interest. The parties did not stipulate to Levine's intent and it is pure speculation on the Commissioner's part.

Finally, the Commissioner urges that RERI should have known that the deduction was "too good to be true" because "RERI could not have reasonably believed under any circumstances that an asset it had only recently acquired the year before could have magically increased in value more than ten-fold . . . ." Appellee Br. 66. The Commissioner's rhetoric aside, it was eminently reasonable to conclude that based on the congressionally-mandated table the amount of the donation would be different than the amount paid. Indeed, when the tax matters partner was asked whether he thought the result was "too good to be true," he testified that "there was really no uncertainty in the valuation process because the IRS mandates that you use the same tables that are used for estate tax purposes, and you kind of plug it into the formula, and the outcome would be the outcome, whatever that number is." (Doc. 277 at 276:15-24, 278:1-7, A. __.)

RERI acted reasonably and the Commissioner has not shown otherwise.

CONCLUSION

For the foregoing reasons and the reasons set forth in RERI's opening brief, appellant respectfully requests that the Court reverse the decision of the Tax Court.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that, on August 16, 2018, the foregoing Reply Brief for Petitioner-Appellant was filed with the Clerk of the United States Court of Appeals for the District of Columbia Circuit, and served on Jacob Earl Christensen, counsel for Appellee, at jacob.e.christensen@usdoj.gov using the Court's electronic filing system (CM/ECF).

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ADDENDUM

26 U.S.C. § 6230(l)

(l) Court Rules. – Any action brought under any provision of this subchapter shall be conducted in accordance with such rules of practice and procedure as may be prescribed by the Court in which the action is brought.

Tax Court Rules of Practice and Procedure, Rule 142(a)

(a) General: (1) The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon the respondent. As to affirmative defenses, see Rule 39.

(2) See Code section 7491 where credible evidence is introduced by the taxpayer, or any item of income is reconstructed by the Commissioner solely through the use of statistical information on unrelated taxpayers, or any penalty, addition to tax, or additional amount is determined by the Commissioner.