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IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS
AUSTIN DIVISION

J. WINSTON and SHERI S. KRAUSE

Plaintiffs,

v.

UNITED STATES of AMERICA

Defendant

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CIVIL ACTION NO. A08CA 865SS

PLAINTIFFS' FIRST AMENDED COMPLAINT

Plaintiffs bring this action pursuant to the Internal Revenue Code of 1986 (the "Code"), 26 U.S.C. §1, *et seq.*, claiming a refund of income taxes, penalties and interest paid along with all other amounts to which they are entitled to be refunded, including interest, and for other appropriate relief.

I. PARTIES

1. J. Winston Krause and Sheri S. Krause (the "Krauses") are married adult individuals residing in Austin, Travis County, Texas.
2. Defendant, the United States of America, has appeared herein.

II. JURISDICTION AND VENUE

3. Plaintiffs filed their claim for refund on March 6, 2008. A true and accurate copy of the claim for refund is attached as Exhibit A (Bates No. PL0001 - PL0002) along with the U.S. Postal Service Certified mail Receipt Postmark.
4. More than six months have elapsed since Plaintiffs filed their claim and Defendant has taken no action to allow or deny Plaintiffs' claim for refund.
5. This Court has original jurisdiction over the subject matter of this action pursuant to 26 U.S.C. §7422(a).
6. Venue is proper in this jurisdiction under 28 U.S.C. §1391(e)(2) and (3).

III. OVERVIEW OF FACTS

7. Attached as Exhibit B is a true and correct copy of the IRS' Transcript of Account for Plaintiffs for the 2002 and 2003 tax years (Bates No. PL0003 – PL0006).
8. In October, 2003, the Plaintiffs filed their 2002 tax return with the Internal Revenue Service which it received on November 17, 2003 (See PL0004).
 - (a) The 2002 tax return included a loss in the amount of \$2,791,429.
 - (b) The \$2,791,429 loss is from a partnership named Krause & Associates Advanced Strategies, LP ("KAAS") in which Plaintiffs were partners.
 - (c) Their income tax as originally reported was zero. (See 2002 Transcript of Account PL0004).
9. In October, 2004, the Plaintiffs filed their 2003 tax return with the Internal Revenue Service which received the return on October 19, 2004. (See PL0005)
 - (a) The Plaintiffs' 2003 tax return included a loss carried over from 2002. Their income tax as originally reported was zero. (See PL0006)
 - (b) The Plaintiffs amended their 2003 tax return which the IRS received on November 20, 2004. (See PL0006)
 - (c) The amended 2003 return recalculated their 2003 income tax without the loss carried over from 2002.
 - (d) Plaintiffs paid additional tax of \$50,259 which the IRS received on November 20, 2004. (See PL0006)
10. Attached as Exhibit D is a true and accurate copy of the IRS's Notice of Final Partnership Administrative Adjustment (the "FPAA"). (See PL0034 – PL0045)
 - (a) The FPAA adjusts the KAAS 2002 partnership return.
 - (b) The FPAA adjusts to zero the loss of \$2,791,250 Taxpayers reported in their 2002 return. (See SND at PL0009 and PL0027)

- (c) The FPAA lists as ground number 1 for its adjustments the determination that KAAS was never established as a partnership as a matter of fact and that its purported partners failed to establish the existence of KAAS as a partnership.
- (d) For ground number 2, the FPAA determines that even if KAAS existed as a partnership it was availed of it solely for tax avoidance. (PL0042)
- (e) As ground number 3, the FPAA determines that KAAS "was a sham, lacked substance and, under §1.701-2 . . . was formed and availed of . . . for a principal purpose . . . to reduce . . . its partners aggregate Federal tax liability . . .". (PL0042)
- (f) As ground number 4, the FPAA determined that the obligations under the short positions constituted liabilities in accordance with Treas. Reg. §1.752-6. (PL0043)
- (g) As ground number 5, the FPAA determined that neither KAAS nor its partners entered into the options with a profit motive. (PL0043)
- (h) As ground number 6, the FPAA determined that Plaintiffs' contribution of the short option positions did not increase his tax basis in his partnership interest. (PL0043)
- (i) As ground number 7, the FPAA determined that the loss leg of the offsetting options did not constitute a sale or exchange and therefore no loss is realized. (PL0043)
- (j) As ground number 8, the FPAA determined that the written options contributed to KAAS is in substance a single integrated financial transaction that the FPAA be characterized by setting them off against each other. (PL0043)
- (k) As ground number 9, the FPAA determined that the offsetting option positions did not constitute amount of risk for purposes of §465. (PL0044)
- (l) As ground number 10, the FPAA determined that the loss deductions decreased the amount by the amount of \$2,791,250 and therefore limiting the loss to the partners pursuant to §465. (PL0044)

- (m) As ground number 11, the FPAA determined that the adjusted bases of the debt instruments and short positions have not been established under §723 and therefore the adjusted basis cannot be greater than zero. (PL0044)
 - (n) As ground number 12, the FPAA determined that KAAS nor its partners established that the partners' basis in the partnership interest is greater than zero. (PL0044)
 - (o) And lastly, for ground number 13, the FPAA determined that KAAS §754 election was of no effect because there was no difference between outside and inside basis. (PL0044)
11. Neither Plaintiffs nor KAAS contested the FPAA.
12. On January 4, 2007, the IRS issued the Statutory Notice of Deficiency ("SND") to the Krauses for tax years 2002 and 2003 and a true and correct copy of which is attached as Exhibit C (PL0007 – PL0033).
- (a) The SND "Explanation of Items" disallows Plaintiffs' deduction of \$2,791,250 providing in paragraph 1 the following four grounds.
 - (1) Plaintiffs failed to establish the purported loss as sustained. (PL0027)
 - (2) Plaintiffs failed to establish that the transaction generating the loss in question was entered into for profit. (PL0027)
 - (3) Plaintiffs fails to establish that any portion of the loss was allowable under any other provision of the Internal Revenue Code. (PL0027)
 - (4) Additionally, the FPAA determined that Plaintiffs failed to establish that even if a loss is sustained that a deduction would not be specifically limited or disallowed by §§165, 183, 212, 704(d) or 465. (PL0027)
 - (b) In paragraph 2 (PL0027), the SND sets forth an additional ground determining that the loss is disallowed as the offsetting options were entered into for tax avoidance purposes. (PL0027)

- (c) In paragraph 3 (PL0027), the SND determined that the loss of \$2,791,250 is disallowed for failing to establish that the basis in options and foreign currency was greater than zero. (PL0027)
 - (d) In paragraphs 4 through 11, the SND determines eight (more or less), additional, alternate grounds for disallowing the loss. (PL0028 – PL0029)
 - (e) The only penalty the SND provides for on the "Explanation of Items" related Accuracy-Related Penalties (PL0033) is the 40 percent Misvaluation penalty of §6662(h).
13. Plaintiffs do not contest the SND.

2002 Tax Year

14. The Notice of Deficiency determined the Plaintiffs' 2002 income tax without the \$2,791,250 loss to be \$155,439. (See PL0007 and PL0009 – Line 16).
- (a) The following described adjustments occur automatically due to the IRS disallowing the loss deduction: itemized deductions, personal exemptions and the SE AGI Adjustment. (See PL0009 – Lines 1d, e and f).
 - (b) The Notice of Deficiency determined an increase in tax of \$155,439 for 2002. (See PL0009 – Line 16).
 - (c) The Notice of Deficiency determined a 40 percent Gross Valuation Misstatement penalty of \$62,175.60 pursuant to Code §6662(h) for 2002. (See PL0007 and PL0010).
 - (d) The Notice of Deficiency sets forth the IRS' determination of the Valuation Misstatement penalty for 2002. (See PL0007, PL0010 – Line 10b and PL0033).
 - (e) The 2002 penalty amount of \$62,175.20 is exactly 40 percent of the increase in income tax of \$155,439.
 - (f) The IRS assessed \$41,771.42 of interest on the 2002 interest and tax and penalty. (See PL0015).
 - (g) The amount of interest assessed on the penalty is \$13,783.26 (See PL0004).

15. Plaintiffs' 2002 Transcript of Account reflects no outstanding amount due the IRS. (See PL0004).

2003 Tax Year

16. The October 6, 2006 SND recalculated Plaintiffs' 2003 income tax both without the loss as originally filed but also without itemized (charitable contribution) deductions carried over from 2002 disallowed due to the recalculation of 2002 taxes. (See PL0009)

(a) The 2003 tax increase resulted from the IRS disallowing the loss deduction originally claimed and from the IRS disallowing the 2002 loss deduction (which caused charitable itemized deductions to no longer carry over from 2002 to 2003).

(b) The Notice of Deficiency determined the Plaintiffs' 2003 income tax without the disallowed deductions to be \$77,702. (See PL0009)

(c) The Notice of Deficiency determined a 40 percent Gross Valuation Misstatement penalty of \$31,082 pursuant to Code §6662(h) for 2003. (See PL0010 and PL0033)

(d) The Notice of Deficiency sets forth the IRS' computation of the Valuation Misstatement penalty for 2003.

(e) The 2003 penalty of \$31,082 is forty percent of the increase in income tax of \$77,702.

(f) The IRS assessed interest on November 19, 2008 in the amount of \$10,215.50. The portion allocable to the 2003 penalty is $\$10,215.50 \times [\$31,082 / (\$31,082 + \$27,443)] = \$5,425.34$. (See PL0006)

17. Plaintiffs paid the increase in tax, penalty and interest at the dates reflected on the 2003 Transcript of Account. (See PL0006)

18. The 2003 Transcript of Account reflects no amounts currently due to the IRS. (See PL0006)

IV. CAUSE OF ACTION

19. The preceding facts and allegations are incorporated herein by reference.
20. Defendant assessed an accuracy-related penalty described in Code §6662(e) as a "Substantial Valuation Misstatement Under Chapter 1" augmented pursuant to Code §6662(h)(1) and 20 percent to 40 percent.
21. Thus, based on disallowing Plaintiffs' loss deduction for 2002, Defendant assessed a Valuation Misstatement penalty of 40 percent in an amount equal to \$62,175.60.
22. And based on disallowing Plaintiffs' loss deduction and a charitable deduction for 2003, Defendant assessed not only additionally income tax but also assessed a 2003 Valuation Misstatement penalty of 40 percent in an amount equal to \$31,082.
23. The Defendant may not assess a Valuation Misstatement accuracy-related penalty on Plaintiffs pursuant to Code §6662(e) and (h) when it merely disallows a deduction.
24. In this case, Defendant merely disallowed a loss deduction for 2002 yet still assessed a Valuation Misstatement accuracy-related penalty of \$62,175.60 and interest thereon of \$11,934 for a total of \$74,109.60 for which Plaintiffs make claim.
25. And for 2003, Defendant merely disallowed a loss deduction and a charitable deduction yet still assessed a Valuation Misstatement accuracy-related penalty of \$31,082 and interest thereon of \$5,425.34 for a total of \$36,507.34 for which Plaintiffs make claim.
26. Plaintiffs' claims for both years cumulatively equal \$112,466.20.
27. In *Heasley v. Commissioner*,¹ the United States Court of Appeals for the Fifth Circuit affirmed its ruling in *Todd v. Commissioner*² that, "whenever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit." *Heasley* at 383. The reasoning of the *Heasley* and *Todd* Courts controls in this matter: viz., the IRS may

¹ *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990).

² *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988).

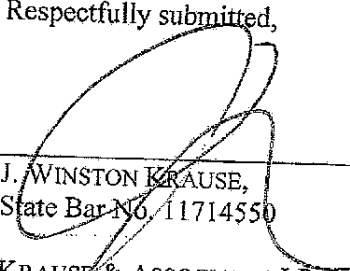
not penalize taxpayers with a valuation overstatement that does not exist when it disallows losses on deductions.

28. To the extent allowed by Code §7430, Plaintiffs make claim for administrative fees and attorney and other fees and costs.

V. RELIEF SOUGHT

29. Plaintiffs request that the Court (a) determine Plaintiffs' claims herein; (b) enter a monetary judgment in favor of Plaintiffs for \$112,466.20 plus interest and attorney fees; and (c) grant Plaintiffs such further legal and equitable relief as the Court may deem just and proper.

Respectfully submitted,



J. WINSTON KRAUSE,
State Bar No. 11714550

KRAUSE & ASSOCIATES LP
P.O. Box 5399
Austin, Texas 78763-5399
512.477.6707
512.477.6708 fax

ATTORNEY FOR PLAINTIFFS

CERTIFICATE OF CONFERENCE

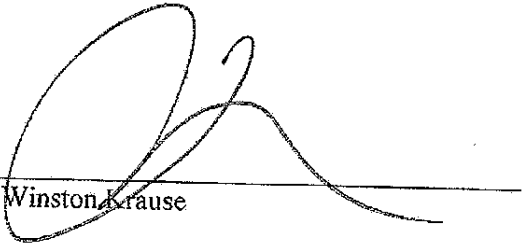
Plaintiffs' counsel has conferred with counsel for Defendant who is unopposed to this Amended Complaint.

CERTIFICATE OF SERVICE

The undersigned certifies that on this 17th day of February, 2009, the following counsel of record who are deemed to have consented to electronic service are being served with a copy of this document through the Court's CM/ECF system under Local Rule CB-5(a)(3):

Jonathan Blacker
Attorney, Tax Division
Department of Justice
717 N. Harwood, Suite 400
Dallas, TX 75201
(214) 880-9741 (fax)

Moha P. Yepuri
Attorney, Tax Division
Department of Justice
717 N. Harwood, Suite 400
Dallas, TX 75201
(214) 880-9741 (fax)



J. Winston Krause



J. WINSTON AND SHERI S. KRAUSE
PO Box 5399
Austin, Texas 78763
(512) 477-6707 Telephone
(512) 477-6708 Fax

March 6, 2008

Internal Revenue Service
Austin Service Center
Austin, TX 73301

Via Certified Mail No. 7006 0810 0003 9469 6461

Re: **CLAIM FOR REFUND**

Taxpayers: J. Winston Krause and Sheri S. Krause
SSN: [REDACTED]

Dear Sir or Madam:

This claim is for the amount of penalties and interest paid for the 2002 and 2003 tax years as well as interest that may be due under law in connection with this refundable amount. The amount being claimed for refund for 2002 is the forty percent valuation misstatement penalty assessed and paid in amount of \$62,175.60 plus interest thereon of \$13,783.26 or more for a total for 2002 of \$75,958.86. The amount being claimed for refund for 2003 is the forty percent valuation misstatement penalty assessed and paid in amount of \$31,082 plus interest thereon of \$5,425.34 or more for a total for 2003 of \$36,507.34. The total refund being claimed for both years is \$112,466.20.

Grounds for Refund

The Internal Revenue Service may not assess an accuracy-related penalty on us pursuant to § 6662(e) of the Internal Revenue Code ("the Code") for a valuation misstatement under the circumstances of our case. An accuracy-related penalty for such a valuation misstatement may only be assessed for understatement of tax attributable to a valuation misstatement – and not for merely disallowing a deduction, as the IRS did in our case.

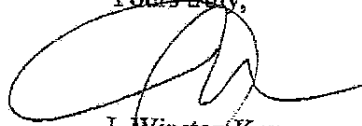
The portion of a tax underpayment that is attributable to a valuation overstatement is to be determined by first taking into account any other proper adjustments to the tax liability, such as disallowing all improper deductions. Only thereafter is a taxpayer's tax liability both with and without the purported valuation misstatement included compared to each other. The IRS used no such formula, as is the law, but instead wrongfully applied the valuation misstatement penalty to an understatement of tax attributable to a disallowed deduction – and not attributable to any purported valuation misstatement. Even if the valuation misstatement is included in the disallowed deduction the mere disallowance of a deduction may not cause an understatement of tax to which a valuation misstatement penalty may be attributed.

PL0001

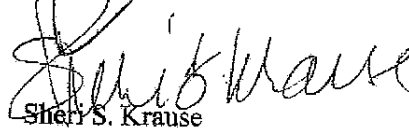
Internal Revenue Service
March 5, 2008
Page 2

We respectfully request that we be refunded the \$112,466.20 we paid in penalties and interest for 2002 and 2003, together with all interest accrued to those amounts had we not paid them as additions to tax.

Yours truly,



J. Winston Krause



Sheri S. Krause

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7006 0810 0003 9469 6461

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CERTIFIED MAIL RECEIPT
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OFFICIAL USE

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Return Receipt Fee (Endorsement Required)	
Restricted Delivery Fee (Endorsement Required)	
Total Postage & Fees	\$ 3.06

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USPS

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City, State, ZIP+4: Austin, TX 73301

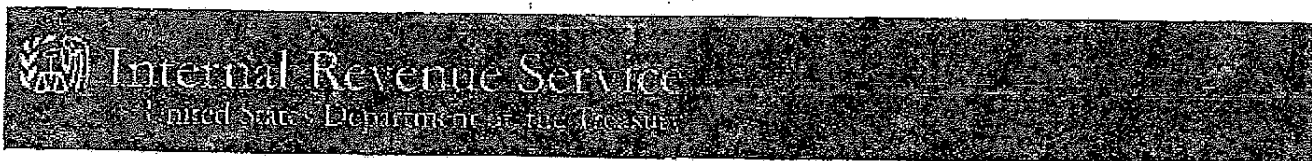
PS Form 3800, June 2007 See Reverse for Instructions

PL0002

3 Account Transcript [REDACTED] 1040 Dec. 31, 2002 KRAU

Page 1 of 2

Exhibit B



This Product Contains Sensitive Taxpayer Data

Account Transcript

Request Date: 02-14-2008
Response Date: 02-14-2008
IRS Employee Number: N8YDE
Tracking Number: 100023622592

FORM NUMBER: 1040

TAX PERIOD: Dec. 31, 2002

TAXPAYER IDENTIFICATION NUMBER: [REDACTED]

SPOUSE TAXPAYER IDENTIFICATION NUMBER: [REDACTED]

J WINSTON & SHERI S KRAUSE
PO BOX 5399
AUSTIN, TX 78763-5399-995

--- ANY MINUS SIGN SHOWN BELOW SIGNIFIES A CREDIT AMOUNT ---

ACCOUNT BALANCE: 0.00
ACCRUED INTEREST: 0.00 AS OF: Feb. 25, 2008
ACCRUED PENALTY: 0.00 AS OF: Feb. 25, 2008

ACCOUNT BALANCE
PLUS ACCRUALS: 0.00

** INFORMATION FROM THE RETURN OR AS ADJUSTED **

EXEMPTIONS: 05 FILING STATUS: Married Filing Joint

ADJUSTED

GROSS INCOME: 498,456.00

TAXABLE INCOME: 406,585.00

TAX PER RETURN: 0.00

SE TAXABLE

INCOME TAXPAYER: 0.00

SE TAXABLE

INCOME SPOUSE: 0.00

TOTAL SELF

EMPLOYMENT TAX: 25,955.00

RETURN DUE DATE OR RETURN RECEIVED DATE (WHICHEVER IS LATER) Oct. 18, 2003

PROCESSING DATE Nov. 17, 2003

PL0003

02/14/2008

Account Transcript [REDACTED] 040 Dec. 31, 2002 KRAU

TRANSACTIONS

CODE	EXPLANATION OF TRANSACTION	CYCLE DATE	AMOUNT
150	RETURN FILED AND TAX ASSESSED 18221-295-46404-3	20034508 11-17-2003	\$0.00
806	WITHHOLDING CREDIT	04-15-2003	-\$4,524.00
460	EXTENSION OF TIME TO FILE EXT. DATE 08-15-2003	04-15-2003	\$0.00
460	EXTENSION OF TIME TO FILE EXT. DATE 10-15-2003	08-14-2003	\$0.00
766	REFUNDABLE CREDIT	04-15-2003	-\$1,800.00
846	REFUND	11-17-2003	\$6,324.00
766	REFUNDABLE CREDIT	11-24-2003	-\$800.00
290	ADDITIONAL TAX ASSESSED 18254-999-05099-3	20034608 11-24-2003	\$0.00
846	REFUND	11-24-2003	\$800.00
640	ADVANCE PAYMENT OF DEFICIENCY	10-27-2004	-
680	DESIGNATED INTEREST PAYMENT	10-27-2004	\$201,103.00
300	ADDITIONAL TAX ASSESSED BY EXAMINATION 29247-479-10000-7	20071608 04-30-2007	-\$34,694.00
240	MISCELLANEOUS PENALTY 17251-073-13200-7	20072008 03-14-2007	\$0.00
300	QUICK ASSESSMENT 17251-073-13200-7	20072008 03-14-2007	\$62,175.60
767	REFUNDABLE CREDIT REVERSED	04-15-2003	\$153,639.00
190	INTEREST ASSESSED	20072008 03-14-2007	\$1,800.00
196	INTEREST ASSESSED	20072008 05-28-2007	\$13,783.26
826	OVERPAYMENT CREDIT TRANSFERRED 1040 200312	20072008 05-28-2007	\$0.02
560	ASSESSMENT STATUTE EXPIRATION DATE EXTEND TO 03-03-2008	10-27-2004	\$4,399.12
		02-08-2008	\$0.00

This Product Contains Sensitive Taxpayer Data

PL0004



This Product Contains Sensitive Taxpayer Data

Account Transcript

Request Date: 02-06-2008
Response Date: 02-06-2008
IRS Employee Number: N8YDE
Tracking Number: 100023342612

FORM NUMBER: 1040 TAX PERIOD: Dec. 31, 2003

TAXPAYER IDENTIFICATION NUMBER: [REDACTED]
SPOUSE TAXPAYER IDENTIFICATION NUMBER: [REDACTED]

J WINSTON & SHERI S KRAUSE
PO BOX 5399
AUSTIN, TX 78763-5399-995

--- ANY MINUS SIGN SHOWN BELOW SIGNIFIES A CREDIT AMOUNT ---

ACCOUNT BALANCE: 0.00
ACCRUED INTEREST: 0.00 AS OF: Feb. 11, 2008
ACCRUED PENALTY: 0.00 AS OF: Feb. 11, 2008

ACCOUNT BALANCE
PLUS ACCRUALS: 0.00

** INFORMATION FROM THE RETURN OR AS ADJUSTED **

EXEMPTIONS: 05 FILING STATUS: Married Filing Joint

ADJUSTED
GROSS INCOME: 401,669.00
TAXABLE INCOME: 291,974.00
TAX PER RETURN: 0.00
SE TAXABLE
INCOME TAXPAYER: 0.00
SE TAXABLE
INCOME SPOUSE: 0.00
TOTAL SELF
EMPLOYMENT TAX: 0.00

RETURN DUE DATE OR RETURN RECEIVED DATE (WHICHEVER IS LATER) Oct. 19, 2004
PROCESSING DATE Nov. 15, 2004

PL0005

TRANSACTIONS

CODE	EXPLANATION OF TRANSACTION	CYCLE DATE	AMOUNT
150	RETURN FILED AND TAX ASSESSED 18221-295-13912-4	20044408 11-15-2004	\$0.00
806	WITHHOLDING CREDIT	04-15-2004	-\$821.00
460	EXTENSION OF TIME TO FILE EXT. DATE 08-15-2004	04-15-2004	\$0.00
460	EXTENSION OF TIME TO FILE EXT. DATE 10-15-2004	08-25-2004	\$0.00
846	REFUND	11-15-2004	\$821.00
670	SUBSEQUENT PAYMENT	11-20-2004	-\$50,259.00
977	AMENDED RETURN FILED 18277-737-00695-4	11-20-2004	\$0.00
290	ADDITIONAL TAX ASSESSED 18254-750-05710-4	20045108 01-03-2005	\$50,259.00
196	INTEREST ASSESSED	20045108 01-03-2005	\$1,382.31
670	SUBSEQUENT PAYMENT	02-10-2005	-\$1,388.95
196	INTEREST ASSESSED	20050708 02-28-2005	\$6.64
560	ASSESSMENT STATUTE EXPIRATION DATE EXTEND TO 03-13-2008	02-28-2007	\$0.00
240	MISCELLANEOUS PENALTY 29247-479-10001-7	20071308 04-09-2007	\$31,082.00
300	ADDITIONAL TAX ASSESSED BY EXAMINATION 29247-479-10001-7	20071308 04-09-2007	\$27,443.00
706	OVERPAID CREDIT APPLIED 1040 200212	10-27-2004	-\$4,399.12
706	OVERPAID CREDIT APPLIED 1040 200512	04-15-2006	-\$5,832.22
706	OVERPAID CREDIT APPLIED 1040 200612	04-15-2007	-\$58,509.16
196	INTEREST ASSESSED	20074508 11-19-2007	\$10,215.50

This Product Contains Sensitive Taxpayer Data

PL0006