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Supreme Court Holds Valuation Misstatement Penalty Applies in Tax Shelter Case

by Andrew Velarde

Summary by taxanalysts

The 40 percent gross valuation misstatement penalty applies to a partner's overstated outside basis when a partnership is disallowed as a sham, the Supreme Court unanimously held on December 3 in *United States v. Woods*, Sup. Ct. Dkt. No. 12-562 (2013).

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The 40 percent gross valuation misstatement penalty applies to a partner's overstated outside basis when a partnership is disallowed as a sham, the Supreme Court unanimously held on December 3 in *United States v. Woods*, Sup. Ct. Dkt. No. 12-562 (2013).

"In short, the partners underpaid their taxes because they overstated their outside basis and they overstated their outside basis because the partnerships were shams. We therefore have no difficulty in concluding that any underpayment resulting from the COBRA tax shelter is attributable to the partners' misrepresentation of outside basis (a valuation misstatement)," said Justice Antonin Scalia, writing for the Court.

Mark D. Allison of Caplin & Drysdale was not surprised by the decision, although he did take issue with the Court's language in its opinion.

The Court's "dismissiveness of the taxpayer's arguments does not readily reflect the difficulty of the issues," Allison told Tax Analysts. "The Court's upholding of jurisdiction of penalties in a partnership-level proceeding sets up potential confusion as to when and how to introduce evidence to defend against those penalties, and to what extent principles of res judicata and collateral estoppel could adversely impact defenses in subsequent partner-level proceedings," he said.

Jasper L. Cummings, Jr., of Alston & Bird LLP also said the decision was "entirely to be expected."

"The taxpayer's arguments were strained and hypertechnical," Cummings said. "The fact that the Court thought so is reflected not only in the words of the Scalia opinion but the unanimity of the opinion, without even a concurrence. In a sense this reflects substantial continuity, with a long history of the Court rejecting plausible arguments made by taxpayers that are out of sync with the overall statutory purpose and legislative intent."

District Court Has Jurisdiction

Gary Woods, tax matters partner for Tesoro Drive Partners and SA Tesoro Investment Partners, had engaged in an abusive partnership tax shelter called current options bring reward alternatives (COBRA), which was marketed to high-income taxpayers in the late 1990s and which generated paper losses to reduce taxable income.

The IRS, which had disallowed the losses in a notice of final partnership administrative adjustment, had asked the Court to reverse a Fifth Circuit decision holding that section 6662 overstatement penalties are not applicable in situations in which the IRS disallows a transaction because of the absence of economic substance. (*Woods v. United States*, No. 11-50487 (5th Cir. 2012), *aff'g* 794 F. Supp.2d 714 (W.D. Tex. 2010).)

Before reaching the merits of the case, the Court addressed the issue of whether the district court has jurisdiction under the 1982 Tax Equity and Fiscal Responsibility Act. The Court found that it does.

Under TEFRA, a district court in a partnership-level proceeding has jurisdiction under section 6226(f) to determine "the applicability of any penalty . . . which relates to an adjustment to a partnership item."

Woods argued that because outside basis is an affected item, not a partnership item, any penalty that arose from a misstatement of outside basis could not be considered at the partnership level.

The Court found the term "relates to" to be "essentially indeterminate" and so it moved its jurisdictional analysis to the structure of TEFRA and its other provisions, whereby it found Woods's narrow jurisdictional characterization as "inconsistent with the nature of the 'applicability' determination that TEFRA requires."

"Barring partnership-level courts from considering the applicability of penalties that cannot be imposed without partner-level inquiries would render TEFRA's authorization to consider some penalties at the partnership level meaningless," Scalia wrote.

Chad D. Nardiello of Latham & Watkins LLP, the firm that represented the taxpayer, said that given the language of the Court and the broad interpretation of the jurisdictional issue, it would be reasonable to expect future litigation on that point.

"That breadth is evidenced by the language the Court uses in its holding when it states, 'courts in partnership-level proceedings [have] jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item.' The key word there is 'could,' which the IRS can rely on in future cases to support broad-based penalty jurisdiction in partnership-level proceedings," Nardiello said.

Nardiello also said that the Court was careful in choosing its language when it described a court's penalty jurisdiction by stating that a court can determine only the applicability of the penalty and that such a determination is provisional and subject to later partner-level challenges that are unique to that partner.

"This clarification by the Court is helpful in maintaining the long-standing dichotomy between partnership- and partner-level proceedings, which is the essence of TEFRA," Nardiello said.

The Court expressed concern that inconsistent results and duplicative proceedings would result by deferring consideration of whether a lack of economic substance determination could trigger a valuation misstatement penalty to partner-level proceedings, which TEFRA's enactment had specifically sought to prevent.

Andrew R. Roberson of McDermott Will & Emery speculated that it was that desire to avoid duplicative proceedings that may have influenced the Court to take such a broad reading of the statute for jurisdictional purposes.

Robert D. Probasco of Thompson & Knight LLP welcomed the Court's resolution of the jurisdictional issue, which the Court had raised *sua sponte* when granting certiorari. "The TEFRA procedures have created a lot of quirks and problems, which the courts are still in the process of working out. This decision at least gives us finality with respect to one question, which has proved very confusing to the lower courts," Probasco said.

Statute's Plain Language Key

Although TEFRA jurisdictional issues dominated oral arguments on October 9, a large part of the Court's decision focused on the merits of the penalty, which the Court held was applicable in *Woods*. (Prior coverage.)

Scalia spent much of the opinion examining the meaning of a few key words in the statutory language of section 6662 while rejecting inspection of the legislative history or the Joint Committee on Taxation's blue book commentary.

"This case was one of pure statutory interpretation, Cummings said, adding that choosing Scalia as the author "allowed him to do his thing." Cummings noted that Scalia is the author of a recently published book on statutory interpretation.

"However, the opinion left an exception to this dislike of legislative history big enough to drive a truck through," Cummings said, citing Scalia's comment that the blue book "may be relevant to the extent it is persuasive."

Roberson said that having Scalia author the opinion was a "bad draw" for the taxpayers, given his more textual judicial approach at the expense of legislative history and blue book statements.

Allison likewise noted the Court's dismissal of blue book commentary, expressing disappointment in its decision. "The Court's rejection of the blue book as a means of interpreting the application of the valuation misstatement penalty where multiple legal grounds for a determination exists is ultimately unsatisfying, given how much of the debate in the lower courts had centered around the blue book's language," Allison said.

Valuation Misstatement Penalty Applicable

The Court disagreed with Woods's argument that the language of section 6662, under which a gross valuation misstatement could be applied, connotes a factual rather than a legal concept and that therefore a penalty would not be applicable in a legal determination that a partnership lacked economic substance.

"Even if 'value' were limited to factual matter, the statute refers to 'value' or 'adjusted basis,' and there is no justification for extending that limitation to the latter term, which plainly incorporates legal inquiries. . . . Were we to hold otherwise, we would read the word 'adjusted' out of the statute," Scalia wrote.

The Court also rejected the taxpayers' argument that the economic substance determination to which the underpayment of tax was attributable was independent of the misstatements of outside basis. "This is not a case where a valuation misstatement is a mere side effect of a sham transaction. Rather, the overstatement of outside basis was the linchpin of the COBRA tax shelter and the mechanism by which Woods and McCombs sought to reduce their taxable income," Scalia wrote.

Probasco argued that one part of the Court's penalty analysis was oversimplified and could create problems in the future. "The decision seems to assume that if a partnership is a sham and doesn't exist, the partners have no basis. But that's not always the case," he said. "Sometimes it merely means that the partners must report the transactions as though the partners engaged in the transactions directly. That would mean the partners still had a basis, although much lower. . . . Treating 'partnership was a sham' as 'partners had zero basis' could result in applying the gross valuation misstatement penalty inappropriately in other cases."

Cummings noted that the Court did not express an opinion on the economic substance doctrine itself but rather followed, without endorsing, the IRS and the Fifth Circuit's determination that the economic substance doctrine made the partnership a sham. He did say it was notable that the opinion did not go so far as to call the COBRA transaction an "illegal tax shelter," as some courts of appeals had.

The merits of the tax deduction resulting from the transaction were wholly disregarded in the opinion, Cummings said.

"This tax shelter was based on taxpayers misapplying a government victory in a case that should not have been precedential, *Helmer v. Commissione*r [T.C. Memo. 1975-160], which was superseded by regs proposed in 2003," Cummings said. "It is regrettable that we have this much litigation and create this much procedural law as in the *Woods* case because the Treasury cannot react quickly to an erroneous court decision."

Matthew R. Madara contributed to this article.

Tax Analysts Information

Code Sections:	Section 6662 -- Applicable Penalty Rules Section 6226 -- Partnership Court Review
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