

Supreme Court Upholds IRS's Application Of Valuation Misstatement Penalty To Sham Transaction

◆ *Woods, S.Ct., December 3, 2013*

Resolving a split among the Circuit Courts of Appeal, the U.S. Supreme Court has unanimously held that the IRS may impose a Code Sec. 6662(e) valuation misstatement penalty where two partnerships had engaged in a tax shelter transaction and lacked economic substance. Once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim a basis in his or her partnership interest greater than zero and where an asset's adjusted basis is zero, a valuation misstatement is automatically deemed gross, the Court found.

■ **CCH Take Away.** “The Supreme Court has finally disposed of two important issues which have caused a backlog of cases in the Tax Court and other trial level courts, namely the jurisdiction of the trial court to determine penalties in a partnership level proceeding and the applicability of gross valuation misstatement penalties in cases where the IRS or the court determines that the transaction in dispute lacks economic substance,” Mark Allison, Caplin & Drysdale, Chartered, New York, told CCH. “While questions remain following the *Woods* decision, including whether and to what extent partner level defenses can be asserted or waived

in a partnership level proceeding, it is likely that pending cases that were awaiting *Woods* should now be disposed and resolved.”

■ **Comment.** The *Health Care and Education Reconciliation Act of 2010* enacted Code Sec. 6662(i), which provides a 40 percent penalty for an underpayment attributable to a nondisclosed economic substance transaction entered into on or after March 30, 2010.

Background

Two partnerships engaged in Current Options Bring Reward Alternatives (COBRA) transactions. The IRS issued each partnership a Notice of Final Partnership Administrative Adjustment (FPAA), determining that the partnerships lacked economic substance and were shams. The IRS also determined that the partners had not established adjusted bases in their respective partnership interests in an amount greater than zero so that any resulting tax underpayments would be subject to the 40 percent penalty for gross valuation misstatements. The tax matters partner (TMP) for both partnerships sought judicial review of the FPAs.

■ **Comment.** The accuracy-related penalty is increased to 40 percent in the case of a gross valuation misstatement. A gross valuation misstatement exists if the value (or adjusted basis) of any property on any income tax return is 200 percent or more of the corrected amount (generally 400 percent or more for returns filed before August 18, 2006). Under regs, the value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero

is considered to be 400 percent or more of the correct amount.

A federal district court agreed with the IRS that the transactions lacked economic substance. However, the district court found that the misstatement penalty did not apply. The Fifth Circuit affirmed the lower court's decision.

Court's ruling

Justice Antonin Scalia delivered the opinion of the Court. “The COBRA transactions were designed to generate losses by enabling the partners to claim a high outside basis in the partnerships. But once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim an outside basis greater than zero. Accordingly, if a partner used an outside basis figure greater than zero to claim losses on his tax return, and if deducting those losses caused the partner to underpay his taxes, then the resulting underpayment would be ‘attributable to’ the partner’s having claimed an ‘adjusted basis’ in the partnerships that exceeded ‘the correct amount of such ... adjusted basis.’”

The Court also rejected the TMP's argument that the misstatement penalty applies only to factual misrepresentations about an asset's worth or cost, not to misrepresentations that rest on legal errors (like the use of a sham partnership). “The valuation-misstatement penalty encompasses legal as well as factual misstatements of adjusted basis.”

Likewise, the Court rejected the TMP's argument that any underpayments of tax in the case would be attributable not to the misstatements of outside basis, but rather to the determination that the partnerships were shams. “The economic-substance determination and the basis misstatement are not ‘independent’ of one another,” Additionally, the Court found that the district court had jurisdiction to determine the applicability of the misstatement penalty.

References: 2013-2 USTC ¶50,604; TRC PENALTY: 3,110.25.

Mileage Rates

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or qualified charitable miles driven, on or after January 1, 2014.

References: FED ¶¶46,591, 46,592; TRC BUSEXP: 24,506.05

Reference Key

FED references are to *Standard Federal Tax Reporter*
USTC references are to *U.S. Tax Cases*
CCH Dec references are to *Tax Court Reports*
TRC references are to *Tax Research Consultant*

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