Practice Update

Supreme Court Upholds a 40 Percent Valuation Misstatement Penalty Based on a Misrepresentation of Basis

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In *United States v. Woods*, No. 12-562, 2013 U.S. LEXIS 8776 (December 3, 2013), the U.S. Supreme Court upheld the imposition of the 40 percent gross valuation misstatement penalty set forth in 26 U.S.C. § 6662 where the underpayment of tax resulted from a misstatement of basis. The Supreme Court's holding in *Woods* emphasizes the significant tax consequences that can flow from a misstatement of basis.

Valuation misstatement penalties are ordinarily levied at 20 percent of any misstatement if the property's value or adjusted basis claimed on the tax return is 150 percent or more of that determined to be the correct amount. 26 U.S.C. § 6662(a), (b)(3). The penalty is doubled to 40 percent in cases of "gross valuation misstatements" where claimed value or adjusted basis exceeds the correct amount by 200 percent or more. 26 U.S.C. § 6662(h). If the taxpayer's basis in the disallowed losses is reduced to zero, the 40 percent gross valuation misstatement penalty applies. 26 C.F.R. § 1.6662-5(g).

Woods was a so-called "COBRA" tax shelter – a transaction that was designed to artificially inflate a taxpayer's basis in a partnership interest, thereby creating significant losses on the subsequent disposition of that interest. The IRS instituted a partnership-level proceeding pursuant to the Tax Equity and Fiscal Responsibility Act (TEFRA) in which it determined that the transaction was a sham and lacked economic substance. Based on this determination, the IRS reduced the taxpayer's outside basis in the partnership to zero and determined that any underpayments resulting from this reduction of basis would be subject to the 40 penalty for gross valuation misstatements found in 26 U.S.C. § 6662.

The Supreme Court initially resolved the question of whether the determination that a penalty arising from the misstatement of basis applies can even be made at the partnership level. The circuit courts had been split on this issue. TEFRA provides that courts reviewing partnership-level proceedings have jurisdiction to determine not only partnership items, but also the applicability of any penalty that "relates to" adjustments of partnership items. 26 U.S.C. § 6226(f). Several courts had found that valuation misstatement penalties could not be determined at the partnership level because a determination of the applicability of the penalties to any particular partner could not be conclusively made at the partnership level. Some further determination at the partner level was also required.

The Supreme Court concluded that prohibiting courts from considering the applicability of penalties at the partnership level, even if they require some further determination at the partner level, is inconsistent with the purpose behind TEFRA. The two-stage structure of TEFRA is designed to promote judicial economy by allowing some determinations to be made in a single partnership level proceeding and to prevent inconsistent results by applying these determinations uniformly to all the partners. The Supreme Court explained that the imposition of a penalty will always require some further determination that can only be made at the partner level, but that does not preclude the threshold applicability of the penalty being determined at the partnership level. The applicability determination at the partnership level will therefore always be provisional, and each individual partner retains the right to show why the penalty should not be applied against that partner. For example, the partner might not have carried the error over to the partner's return, or the error may not have resulted in a large enough underpayment to trigger the penalty.

The taxpayers then argued that the gross valuation misstatement penalty cannot be imposed following the IRS's determination that the tax shelter was a sham and lacked economic substance because the penalty applies only to factual misrepresentations about an asset's value and excludes legal determinations regarding the broader transaction. The Supreme Court rejected this distinction, observing that value depends on both factual and legal considerations. Even if "value" could be construed as a purely factual consideration, 26 U.S.C. § 6662 provides for a penalty to misstatements of either value or adjusted basis, the latter of which is a creature solely of the tax laws and requires the application of numerous legal rules.

The taxpayers alternatively argued that the penalty could not be imposed on them because any tax underpayment was due to the sham tax shelter determination rather than the misstatement of basis —an argument that had also divided the circuit courts of appeals. Many circuits had held that valuation misstatement penalties are properly assessable where the transaction underlying the tax deficiency lacks economic substance and results in an inflated basis. In contrast, the Fifth and Ninth Circuits have held that such penalties are inapplicable under such circumstances because it is ultimately the IRS's disallowance of a deduction, not the valuation misstatement, that generated the underpayment of income tax. The Supreme Court held that the economic substance determination and the basis misstatement are not independent of one another – they are inextricably intertwined. Indeed, the valuation misstatements were the "linchpin" of the operation of the COBRA tax shelter. As the Court stated: “We therefore have no difficulty concluding that any underpayment resulting from the COBRA tax shelter is attributable to the partners’ misrepresentation of outside basis (a valuation misstatement).”

The *Woods* ruling is the second decision in as many years that considered the impact of a basis misstatement. In *United States v. Home Concrete & Supply, LLC,* 132 S. Ct. 1836 (2012), the Supreme Court held that an overstatement of basis was not an omission of gross income that extended the statute of limitations for making assessments from the ordinary three years to the longer six year period. Although the taxpayer ultimately prevailed in the *Home Concrete* case, the IRS aggressively pursued a significant tax obligation stemming from the misstatement of basis. Regardless of particular outcome of *Woods* and *Home Concrete,* both cases demonstrate that serious consequences can result from the mere misstatement of basis.
