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CLIENT ALERT

Supreme Court Holds Valuation Misstatement Penalty Applicable; Rejects Blue Book Analysis

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The Supreme Court ruled in a unanimous decision last week that the 40 percent gross valuation misstatement penalty under I.R.C. § 6662 applied to a taxpayer who claimed an outside basis of more than zero in a partnership that was deemed to lack economic substance. The Court reversed the Fifth Circuit's holding that the valuation misstatement penalty does not apply when the relevant transaction is disregarded for lacking economic substance, resolving a circuit split on the issue. The Court also held as a threshold matter that a district court in a partnership-level TEFRA proceeding has jurisdiction to make a provisional determination that the valuation misstatement penalty applies to individual partners. The decision is a significant victory for the IRS in its campaign to penalize taxpayers who invested in tax shelter transactions that used the partnership basis rules to create paper losses. It also brings some clarity to TEFRA's jurisdictional rules on penalty determinations. Notably, in reaching its decision, the Court specifically declined to rely on the Joint Committee on Taxation's "Blue Book," which the Court described as a post-legislation explanation of the statute analogous to a law review article.

A. The Transaction

The valuation misstatement at issue resulted from a tax shelter under which the taxpayer purchased currency option spreads consisting of long options, entitling him to receive money from the seller under certain conditions, and short options, entitling the seller to receive money from the taxpayer under certain conditions. The premium the taxpayer paid for the long options was largely offset by the premium received for sale of the short options. But when the taxpayer contributed the option spreads to partnerships created specifically to generate tax losses, he considered only the long option component in computing his outside basis. The taxpayer thus reported a much higher basis in the partnerships than he would have had he taken into account the offsetting effect of the short options. When the partnerships were liquidated and their assets distributed to partner corporations, the high outside basis was carried over to the corporations' basis in the distributed assets. Upon sale of the assets, the corporations reported losses.

The IRS found that the partnerships were shams lacking economic substance. It therefore found that the taxpayer had a basis of zero in the partnerships, and that the resulting tax underpayments were subject to the 40 percent penalty for gross valuation misstatements under I.R.C. § 6662(b)(3). The District Court agreed that the partnerships were shams, but held that the valuation misstatement penalty did not apply under the Fifth Circuit's *Todd*/*Heasley* line of cases. (The Ninth Circuit had a similar rule in the *Gainer*/*Keller* line of cases.) The Fifth Circuit signaled an interest in overruling the *Todd/Heasley* rule last year, when all three judges on the panel in *Bemont Investments, LLC v. United States*, No. 10-41132 (Apr. 26, 2012), wrote a concurring opinion that criticized the rule, but that case settled. Nevertheless, in *Woods*, the Fifth Circuit affirmed the district court.

B. Jurisdiction Under TEFRA

An important threshold question in *Woods* was whether the district court has jurisdiction in a TEFRA partnership proceeding to consider an individual partner's liability for the valuation misstatement penalty. Under TEFRA, the court in a partnership-level proceeding may determine any partnership item, as well as "the applicability of any penalty . . . which relates to an adjustment to a partnership item." I.R.C. § 6226(f). The taxpayer in *Woods* argued that the gross valuation penalty was based on a misstatement of outside basis, which was not a partnership item because it requires a partner-level determination. He further argued that the valuation penalty did not "relate to" a partnership item. The government argued in opposition that it was appropriate to determine the valuation penalty in the partnership-level proceeding because a determination that a partnership is a sham is an adjustment to a partnership item. Applicability of the valuation misstatement penalty therefore "relates to" a partnership item.

Justice Scalia, writing for a unanimous Court, agreed with the government, finding that where a partnership is a sham, any partner who declares an outside basis greater than zero commits a valuation misstatement. "In other words," the Court reasoned, "the penalty flows logically and inevitably from the economic-substance determination." The Court explained that the district court, having appropriately determined at the partnership level that the partnership was a sham, was entitled to take into account the clear partner-level consequence of that determination: that it would be a "legal impossibility" for any partner to have an outside basis greater than zero. However, the decision leaves open the issue of whether a district court would have jurisdiction to determine the partner-level applicability of a penalty where the partnership was not found to be a sham. The Court explained that the district court could not have made a formal adjustment of any partner's outside basis in the partnership-level proceeding.

The Court also noted that the "partnership-level [penalty] applicability determination . . . is provisional," and "[e]ach partner remains free to raise, in subsequent, partner-level proceedings, any reasons why the penalty may not be imposed on him specifically." The court mentioned possible partner level defenses, including that the partner has no substantial understatement, or that the partner meets the exception for reasonable cause and good faith.

C. Gross Valuation Penalty Applies

Finding the district court's jurisdiction proper, the Court went on to hold that the valuation misstatement penalty applies where a tax underpayment results from participation in a sham partnership. Under the version of I.R.C. § 6662 in effect at the time the case arose, a taxpayer who made a substantial valuation misstatement, overstating the adjusted basis in property by 200 percent or more, was subject to a penalty of 20 percent of the underpayment "attributable to" the misstatement (the threshold has since been lowered to 150 percent). A taxpayer making a gross valuation misstatement, overstating the adjusted basis by 400 percent or more (currently 200 percent), was subject to a 40 percent penalty. The Court found that under the plain language of the statute, the taxpayer's underpayment resulting from participation in the sham partnership was "attributable to" the misstatement of the value of the outside basis in the partnership. The Court explained that "once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim an outside basis figure 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 adjusted basis.

The Court rejected two alternative arguments from the taxpayer. First, the taxpayer argued that the penalty should not apply because the use of a sham partnership was a legal determination, not a factual misrepresentation about an asset's cost. The Court rejected the premise that the valuation misstatement penalty only applies to factual, and not legal, determinations, finding that calculating adjusted basis inherently involves legal conclusions. Second, the taxpayer argued that the underpayment of tax was "attributable to" the determination that the partnerships were shams, not to the misstatement of outside basis. The Court rejected this argument because it concluded that "the economic-substance determination and the basis misstatement are not 'independent' of one another." The Court explained, "In short, the partners underpaid their taxes because they overstated their outside basis, and they overstated their outside basis because the partnerships were shams."

D. Blue Book Not Authoritative Source of Legislative Interpretation

Justice Scalia's analysis in the *Woods* opinion emphasized the plain meaning of I.R.C. § 6662 and specifically declined to consider the Joint Committee Blue Book explanation. He wrote that because Blue Books are written after the passage of the laws they describe, they cannot be used to inform statutory interpretation. He analogized Blue Books to law review articles, noting that both types of sources are only relevant "to the extent [they are] persuasive." Justice Scalia explained that although the Court has relied on Blue Books in the past, it has more recently turned away from this practice.

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