Supreme Court holds that Section 6662 valuation misstatement penalties apply when partnerships lacked economic substance

December 10, 2013

In brief

On December 3, 2013, the United States Supreme Court issued a 9-0 opinion in *United States v. Woods*, Sup. Ct. Dkt. No. 12-562 (2013), ruling that:

- the lower District Court had jurisdiction to determine whether the *Tax Equity and Fiscal Responsibility Act of 1982 (*TEFRA) partnerships' lack of economic substance allowed for the imposition of the Section 6662 40% gross valuation misstatement penalty on the partners and
- once the partnerships were declared shams, any tax underpayment from a partner using a non-zero basis in his partnership interests would be 'attributable to' claiming an adjusted basis in the partnerships that exceeded the correct adjusted basis, thereby invoking a valuation misstatement penalty under Section 6662.

In detail

Woods involved a taxpayer who allegedly artificially inflated his outside basis in two TEFRA partnerships by participating in a 'Current Options Bring Reward Alternatives' (COBRA) tax shelter. Upon examination, the Internal Revenue Service (IRS) disallowed the tax treatment of the taxpayer's COBRA transactions on several grounds, including that the partnerships were shams lacking economic substance and therefore should be disregarded. As stated in the Notices of Final Partnership Administrative Adjustment (FPAAs), the IRS found that each "purported partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interests of its purported partners." The IRS also determined that the 40% gross valuation misstatement penalty of Section 6662 was applicable on the portion of any underpayment attributable to the gross overstatement of basis in the partnership interest.

Although both the District Court and Fifth Circuit upheld the IRS's determination that the transactions lacked economic substance, the courts held that the Section 6662 valuation misstatement penalty was inapplicable when a basis-inflating transaction is found to lack economic substance -- when the IRS totally disallows a deduction, it could not penalize a taxpayer for a valuation overstatement included in the deduction because the disallowance was not 'attributable to' an inflated basis claim. The government filed a petition for a writ of certiorari with the Supreme Court challenging the inapplicability of the Section 6662 valuation misstatement penalty. The

Supreme Court granted certiorari on the applicability of the Section 6662 valuation misstatement penalty, and also ordered briefing, *sua sponte*, on whether the District Court lacked jurisdiction to consider the valuation misstatement penalty.

The Court held that while a penalty must be imposed in a partner-level proceeding, TEFRA provided a court the jurisdiction to determine the 'provisional' applicability of any penalty that could result from the adjustment of a partnership item, regardless of whether a later court needed to determine affected or non-partnership items, such as a partner's outside basis. That is, the court could determine that the penalty could apply if the partner claimed an outside basis in the partnership.

With respect to the applicability of the Section 6662 valuation misstatement penalty, the Court stated that the 'plain language' of the statute made the penalty applicable under the facts of *Woods*. Specifically, the Court first held the valuation misstatement penalty encompassed legal as well as factual misrepresentations. It also held that the "basis misstatement and the transaction's lack of economic substance [were] inextricably intertwined" and therefore was 'attributable to' the valuation misstatement even though it could also be attributable to other causes. The Court had 'no difficulty' concluding that the taxpayer's underpayment was attributable to the misrepresentation of outside basis.

The takeaway

In both the jurisdictional and penalty areas, the Supreme Court established principles that may be of substantial application beyond the facts of the *Woods* case.

The issue of defining courts' partnership-level jurisdiction has been very confusing and subject to numerous controversies. The concept of 'provisional' determinations at the partnership-level conceivably expands the number of issues subject to resolution on a partnership-wide basis. One key driver of the Court's opinion was the desire for consistency of resolution affecting all partners and the opinion certainly promotes that desire.

As to the penalty determination, the Court's opinion makes it easier for the IRS to sustain penalties and more difficult for taxpayers to contest them. After the 'provisional' application of the penalty is determined by a court in a partnership proceeding, the IRS could be expected to apply the penalty to all partners automatically. While the Court's opinion allows the partners to individually contest the imposition of penalties, pursuant to Section 6230(c)(1)(C), this can only be done by paying the penalty and suing for refund. Thus, fewer challenges of penalties could be expected.

The Court affirmed the broad interpretation of 'attributable to' when the result may have been caused by multiple findings or actions. The Court confirmed that there is no need to isolate a particular cause or determine a precise factor. If the causes are intertwined, the result is attributable to each of them.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact one of the individuals listed below or a member of your local Tax Controversy and Regulatory Services practice:

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