Quoted in Tax Notes Today on Valuation Misstatement Case

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"Supreme Court To Hear Valuation Misstatement Case, Requests Briefs On Jurisdiction"; March 25, 2013

The Supreme Court on March 25 granted certiorari in United States v. Gary Woods and has directed both parties to brief and argue whether the District Court had jurisdiction under section 6226 to consider the substantial valuation misstatement penalty.

Practitioners contacted by Tax Analysts said they were surprised the high court sought additional briefing on the question of jurisdiction. The Woods case, which stands to have a large impact on the government's fight against abusive tax shelters and related valuation misstatement penalties, could also affect cases governed by the 1982 Tax Equity and Fiscal Responsibility Act, especially those addressing whether a misstatement of a partner's outside basis is an item subject to the TEFRA rules.

Two such cases -- Tigers Eye Trading LLC v. Commissioner, 138 T.C. 67 (2012) (Doc 2012-2960) and Petaluma FX Partners LLC v. Commissioner, 135 T.C. 581 (2010) (Doc 2010-678) -- are pending for hearing before the D.C. Circuit Court of Appeals. On March 21 the government moved to postpone oral argument in Tigers Eye (now re-captioned as Logan Trust v. Commissioner), originally scheduled for May 10, to be heard on the same day as Petaluma, which has yet to be scheduled.

But the issues in those cases, which involve a determination of whether the Tax Court has jurisdiction in a TEFRA partnership-level proceeding to determine the applicability of section 6662 accuracy-related penalties, may be preempted by the Supreme Court, according to Robert D. Probasco of Thompson & Knight LLP. "The D.C. Circuit might be reluctant to get out ahead of the Supreme Court," he said.

Probasco said the jurisdiction issue was presented to the courts indirectly, with the government mentioning it in a footnote in a reply brief. "I think that it did so just to persuade the Court it didn't need to decline to hear this case, because the jurisdiction issue was still developing in the courts below," he said. Nonetheless, the Supreme Court must have seen the footnote and determined that a jurisdiction issue had to be decided first, he said. The result may be a decision by the Supreme Court that reaches only the Tigers Eye and Petaluma issue, or a decision that also encompasses what was presented originally in Woods, Probasco said.

Footnote 2 of the government's reply brief (Doc 2013-7149) to the Supreme Court in Woods states that the district court exercised its jurisdiction under section 6226(a)(2) to decide the penalty question in a partnership-level proceeding and that the government did not contest jurisdiction. But Petaluma and Jade Trading LLC v. United States, 598 F.3d 1372 (Fed. Cir. 2010) (Doc 2010-6335) "have called into question, without definitively resolving, whether the court in a partnership-level proceeding may determine the threshold applicability of the overstatement penalty for a partnership's participation in sham transactions," the government wrote. The footnote concludes that if the Court grants certiorari, "the jurisdictional issue described above provides no reason to view this case as an unsuitable vehicle for resolving it."

Also pending before the Supreme Court is Alpha 1 LP v. United States, 682 F.3d 1009 (Fed. Cir. 2012) (Doc 2012-12982). The Court has not denied or granted certiorari in that case, and practitioners generally believe that Alpha 1 will be held in abeyance pending the resolution in Woods.

Andrew Roberson of McDermott Will & Emery said the Court's granting certiorari to Woods and not to Alpha 1 has some similarities with its September 2011 decision to grant cert to Home Concrete & Supply LLC v. United States rather than Beard v. Commissioner. That decision surprised practitioners because the petition in Home Concrete was filed after the petition in Beard. (Prior analysis (Doc 2011-17742).)
The petition for Woods was filed on November 6, 2012, five days after the petition for Alpha 1.

Roberson said it was interesting that the Supreme Court asked for a briefing on the jurisdictional issue, which was not a major point of contention in either the district court or the Fifth Circuit opinions in Woods, but which was addressed by both the Court of Federal Claims and the Federal Circuit in Alpha 1. "It could be that the Supreme Court will go through how the TEFRA rules work on jurisdiction in the partnership area," he said. That could be helpful, considering the confusion in that area, he said. (Practice article on the subject by Roberson, Kevin Spencer, and Thomas Connolly (Doc 2013-2639).)

"If the Supreme Court is really going to get into jurisdiction in the TEFRA context -- what is a partnership item, or what is the right forum to be addressing these issues -- that could provide some helpful guidance that impacts potentially more cases than just the ones that have the substantial valuation misstatement issue," Roberson said. "The jurisdictional question could be very interesting."

Woods

In 1999 taxpayer Gary Woods participated in the COBRA tax shelter developed and marketed by Jenkens & Gilchrist and Ernst & Young LLP. In a final partnership administrative adjustment, the IRS disallowed ordinary and capital losses on the basis that the transaction lacked economic substance, and it imposed substantial valuation misstatement penalties under section 6662. In Woods's refund suit, the Western District of Texas held that under Fifth Circuit precedent, when the IRS "totally disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in the deduction." The court also claimed jurisdiction under section 6226(a)(2) because the principal place of business of the shelter partnerships was in San Antonio. (Gary Woods v. United States, No. 11-50487 (5th Cir. 2012), aff'g 794 F. Supp.2d 714 (W.D. Tex. 2011) (Doc 2013-3034).)

The Fifth Circuit, in an unpublished opinion, affirmed the district court. The government petitioned the Supreme Court to decide "whether the overstatement penalty applies to an underpayment resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating a taxpayer's basis in property." (Petition (Doc 2013-960).)

Circuits have been split over application of the section 6662(h) penalty, which imposes a 40 percent penalty if there is a gross valuation misstatement. Section 6662 imposes a penalty for an underpayment of income tax that is attributable to overstatement of the value or basis of property. The Fifth and Ninth Circuits have adopted a minority view that the penalty does not apply to sham transactions lacking economic substance.

Eight other circuits have concluded that when underpayment stems from disallowed deductions from a transaction lacking economic substance, the deficiency is attributable to an overstatement and is subject to the section 6662 penalty. Recently, the Tax Court in AHG Investments LLC v. Commissioner, 140 T.C. No. 7 (2013) (Doc 2013-6120), departed from precedent and adopted the majority view that the taxpayer could not avoid the section 6662(h) penalty by conceding a deduction or credit on grounds unrelated to value or basis of property. (Prior coverage (Doc 2013-6124).)

Outlook

"We may get a decision on an issue, but it may not be the issue we thought we were getting a decision on," Probasco said, referring to the jurisdictional question raised by the Supreme Court. The Petaluma and Tigers Eye issues will get resolved unless the Court decides the question should not have been raised, he said.

Depending on that decision, the Supreme Court may also address the 20 percent versus 40 percent valuation misstatement penalties of sections 6662(a) and (h), respectively, Probasco said.

Mark D. Allison of Caplin & Drysdale said, "There are a number of cases in Tax Court in which the penalty jurisdiction issue is front and center, and as a result, a number have been placed on the back-burner, pending the disposition of Petaluma and Tigers Eye." Resolution of those cases in the D.C. Circuit or the Supreme Court "might be beneficial to all parties," he said.

"Otherwise, they're just lingering with no particular direction at this point," Allison said. Because Woods is a Fifth Circuit case, the Court has an opportunity to resolve the cases on the jurisdictional and penalty issues.
and avoid the continuing circuit split, he said. "This would resolve all of that, potentially, in one package decision. And that might be a very efficient resolution by the Supreme Court," Allison said.

**MyMail Petition Denied**

The same day it granted certiorari in Woods, the Court denied certiorari to a petition filed by the partnership MyMail Ltd. MyMail petitioned the Court for review of a Fifth Circuit decision that affirmed a district court's grant of summary judgment to the government in its challenge to a notice of final partnership administrative adjustment.

The court held that the partnership wasn't entitled to currency fee deductions based on the difference between the face value and market value of coins distributed to partners. MyMail claimed that the lower court abused its discretion by refusing to allow MyMail to supplement the record with gold clause contracts in support of its claimed currency fee deductions. MyMail Ltd. v. Commissioner, S. Ct. Dkt. No. 12-983 (2013) No. 11-41311 (5th Cir. 2012) (Doc 2012-23651).

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