Tax Controversy Updates:  
Government and Taxpayers Petition the U.S. Supreme Court to Resolve the Circuit Split on the Application of the Valuation Misstatement Penalty

The United States Government (“Government”) and independently, a group of taxpayers have filed writs of certiorari with the U.S. Supreme Court to appeal two separate rulings from the U.S. Courts of Appeals regarding the application of the valuation misstatement penalties under Internal Revenue Code (“IRC”) § 6662. The circuit split is over the applicability of the valuation misstatement penalty when the Internal Revenue Service (“IRS”) has disallowed the underlying deduction or credit on grounds unrelated to valuation. A ruling from the U.S. Supreme Court on the issue would resolve the current split among the various U.S. Courts of Appeals on the application of the penalty.

Background

Under IRC § 6662(b)(3), a 20% accuracy-related penalty is imposed on any underpayment of tax attributable to a “substantial valuation misstatement”, which occurs when the value or the adjusted basis of any property claimed on a return is 150% or more of the amount ultimately determined to be the correct value or adjusted basis. Under IRC § 6662(h), this penalty is increased to 40% if the underpayment is attributable to a “gross valuation misstatement,” which occurs when the value or adjusted basis of any property claimed on a return is 200% or more of the amount determined to be the correct value or adjusted basis.

The split in the U.S. Court of Appeals is over the applicability of the valuation misstatement penalty when the underlying deduction, or credit, giving rise to the understatement has been disallowed for reasons not specifically attributable to a valuation overstatement. The U.S. Courts of Appeals for the Fifth and the Ninth Circuits have held that a valuation misstatement penalty is not applicable when the transaction giving rise to the understatement was disallowed because it lacked economic substance. Conversely, the majority of the Circuits have held that the valuation misstatement penalty may be applied in such instances, because the overvaluation is intertwined with the transaction being disallowed.

Petitions

The Government has filed a petition for a writ of certiorari asking the U.S. Supreme Court to review the U.S. Court of Appeals for the Fifth Circuit’s decision in Woods v. United States, 471 Fed. Appx. 320 (5th Cir. Tex. 2012). In Woods, the 5th Circuit upheld a district court decision that held the gross valuation misstatement penalty under IRC § 6662(h) is not applicable when the entire deduction was denied on grounds unrelated to valuation. In its petition, the Government claims that the U.S. Court of Appeals for the Fifth Circuit’s interpretation of IRC § 6662 is inconsistent with the statute’s text and is at odds with the holdings of eight other Circuit Courts on this issue. The Government also points out that there are numerous cases currently pending in the Fifth Circuit and as a result the government may be denied hundreds of millions of dollars in penalties “from the worst tax scofflaws.”

Shortly before the Government filed its petition, a group of taxpayers (“Taxpayers”) filed a petition for a writ of certiorari requesting that the U.S. Supreme Court review the U.S. Court of Appeals for the Federal Circuit’s decision in Alpha I, L.P. v. United States, 682 F.3d 1009 (Fed. Cir. 2012). In Alpha, the Federal Circuit overturned a Federal Court of Claims decision and held that the valuation misstatement penalty may be applied when the IRS asserts both a valuation-misstatement ground and a non-valuation-misstatement ground for the same adjustment. In its petition, the Taxpayers state that the Alpha decision deepens the split among the circuits, and absent review by the U.S. Supreme Court, decisions with identically situated taxpayers will receive disparate treatment based solely on geographic happenstance.

In Alpha, the Federal Circuit also addressed the issue of whether the identity of a partner could be determined in a partnership level TEFRA proceeding when the IRS is trying to determine if the transfer of a partnership interest to another partner is a sham. The Federal Circuit also reversed the lower court on this issue, and ruled that the identity of a partner could impact the allocation of partnership items and therefore may be determined in a partnership level proceeding. With regards to this determination, the Taxpayers argue that the U.S. Supreme Court should review the decision because the Federal Circuit’s decision expands the courts’ jurisdiction in partnership proceedings beyond what is permitted by the statute.