U.S. Supreme Court Holds Valuation Misstatement Penalty May Apply When Underlying Deduction or Credit is Disallowed for Reasons Not Specifically Attributable to a Valuation Overstatement

The Supreme Court in *United States v. Woods*, 134 S. Ct. 557 (2013) reversed the 5th Circuit decision in *Woods v. United States*, 471 Fed. Appx. 320 (5th Cir. Tex. 2012), and held that the valuation misstatement penalty under Internal Revenue Code (“IRC”) § 6662(h) can be applied when the underlying deduction, or credit, giving rise to the understatement has been disallowed for reasons not specifically attributable to a valuation overstatement. This ruling resolves the prior circuit split regarding the applicability of the valuation misstatement penalty when the deduction or credit giving rise to the tax understatement was disallowed on grounds unrelated to valuation.

**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.

As discussed in the March edition of IRS Insights, a split had existed in the U.S. Court of Appeals 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 previously held that a valuation misstatement penalty was 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.

In *Woods*, the taxpayers participated in certain transaction the court found were to designed to generate losses. According to the opinion, the partners contributed approximately $3.2 million in option spreads and cash to acquire their interests in the two partnerships. For purposes of computing outside basis, the partners considered only the long component of the spreads and disregarded the nearly offsetting short component on the theory that it was “too contingent” to count. Accordingly, when the partnerships assets were sold, the partners claimed losses. The IRS issued a Notice of Final Administrative Adjustment (“FPAA”) proposing to disallow the losses the grounds that the partnerships lacked economic substance and asserting the 40% gross valuation misstatement penalty. The IRS asserted that this penalty was applicable as there were no valid partnerships for tax purposes, therefore, the partners had no basis in their partnership interests and the resulting tax underpayments were subject to a 40-percent penalty for gross valuation misstatements.

The district court in *Woods v. United States*, 794 F. Supp. 2d 714 (W.D. Tex. 2011) held that IRC § 6662(h) was not applicable when the entire deduction was denied due to a lack of economic substance of the transaction. The Fifth Circuit court of appeals affirmed this decision in *Woods v. United States*, 471 Fed. Appx. 320 (5th Cir. Tex. 2012) and the United States Government filed a writ of certiorari with the U.S. Supreme Court.

**Holding**

The Court first addressed whether district courts had jurisdiction to consider the valuation misstatement penalty. Under section 6226(f), a court in a partnership-level proceeding has jurisdiction to determine partnership items and “the applicability of any penalty…which relates to an adjustment to a partnership item.” The jurisdictional question therefore was whether the valuation-misstatement penalty “relates to” the determination that the partnerships Woods and McCombs created were shams.

The taxpayer argued that the district court did not have jurisdiction to decide the penalty issue because outside basis is not a partnership item, but rather affected item, and a penalty that would rest on a misstatement of outside basis cannot be considered at the partnership level because it requires a partner-level determination.
The Court held that in partnership-level proceedings there is jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item, even if imposing the penalty would also require determining affected or non-partnership items, such as outside basis. The Court stressed that in the partnership-level proceeding, the court may decide only whether adjustments properly made at the partnership level have the potential to trigger the penalty. Each partner remains free to raise, in subsequent partner-level proceedings, partner-level defenses to the penalty.

For the valuation misstatement penalty, the Court looked to the statutory language of I.R.C. § 6662, which provides for a 20 percent penalty on “any portion of an underpayment” which is attributable to a “substantial valuation misstatement.” Under I.R.C. § 6662(e)(1)(A), a substantial valuation misstatement exists when “the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).” Subsection (h) provides that the penalty is increased to 40 percent if the value of any property (or the adjusted basis of any property) is 400 percent or more of the correct amount. This is known as “gross valuation misstatements.”

The Court stated that the plain language of the statutory provision made it applicable to a situation, whereby, the taxpayer’s basis was disallowed based upon grounds such as a lack of economic substance. The Court explained that once the taxpayers’ partnerships were deemed not to exist for tax purposes, no partner could legitimately claim a basis in their partnership interest greater than zero.

According to the Court, the partners underpaid their taxes because they overstated their outside basis, as the partnerships were shams; therefore any underpayment resulting from the transactions is attributable to the partners’ misrepresentation of outside basis (a valuation misstatement). The Court then explained that under Treas. Reg. §1.6662-5(g) when an asset’s true value or adjusted basis is zero, a valuation misstatement is automatically deemed gross.

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1 I.R.C. § 6662(a) and (b)(3)