The Eleventh Circuit Looks at Valuation Misstatement Penalties.

Section 6662 of the Internal Revenue Code imposes a 20% penalty in various situations when a taxpayer is negligent; these include penalties for a "substantial valuation misstatement." I.R.C. § 6662(b)(3). A substantial valuation misstatement occurs where the taxpayer claims a basis in property that is 150% or more of the correct value. I.R.C. § 6662(e)(1)(A). Moreover, the penalty is increased from 20% to 40% if the taxpayer overstates basis by 200% or more. I.R.C. § 6662(h)(1). Section 6662 also imposes a 20% penalty regime where a taxpayer enters into a transaction that lacks economic substance. I.R.C. § 6662(b)(6). Although there are alternative penalties, only one may be applied to a particular underpayment of tax. Treas. Reg. § 1.6662-2(c).

So if a taxpayer negligently enters into a transaction that lacks economic substance, and the result of that transaction is to overstate basis by 200% or more, which penalty applies: the 20% economic substance penalty or the 40% enhanced substantial valuation misstatement penalty? Courts have split on the issue.

In *Gustashaw v. Commissioner*, 2012 U.S. App. LEXIS 20379 (11th Cir. September 28, 2012), the Eleventh Circuit ruled that the 40% substantial valuation penalty should apply, rejecting the approach taken by the Ninth Circuit in *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), and the Fifth Circuit in *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988). Concluding that the heart of the disallowed transaction was the manufacture of losses through inflated basis, the Eleventh Circuit concluded that the enhanced substantial valuation misstatement penalty should be applied, noting that the statute spoke in mandatory terms. 2012 U.S. App. LEXIS 20379, slip op. at *30. The Court saw little reason to apply the twenty percent penalty: "We can discern no exception for when the valuation or basis misstatements are so egregious that the entire tax benefit is disallowed, and no suggestion that the penalty should not apply when the correct basis or value is determined to be zero because the transaction is completely lacking in economic substance." *Id.*

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