Supreme Court Upholds Partner’s Tax-Shelter Penalty

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The U.S. Supreme Court on Dec. 3 held that the 40 percent gross valuation misstatement penalty applies to partnerships that understate their capital-gains tax liability by inflating the cost of acquiring property that is later sold.

The case stems from financial penalties resulting from a basis-inflating tax shelter that generated losses ultimately disregarded by the Internal Revenue Service.

The unanimous ruling authored by Associate Justice Antonin Scalia held the IRS valuation-misstatement penalty is applicable to tax underpayments resulting from entities or transactions determined to be tax-avoidance shams and deemed invalid for lacking economic substance.

The High Court further affirmed the penalty under Title IV of the Tax Equity and Fiscal Responsibility Act (TEFRA; Pub.L. 97–248).

“We hold that TEFRA gives courts in partnership-level proceedings 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 nonpartnership items such as outside basis,” Scalia wrote.

The ruling stems from IRS penalties assessed against Texas businessmen Gary Woods and Billy Joe “Red” McCombs, co-founder of Clear Channel Communications Inc. and a former owner of the San Antonio Spurs, Denver Nuggets and Minnesota Vikings professional sports franchises.

To reduce their taxable income, the men established three sets of business entities–two limited liability companies, two general partnerships and two subchapter S corporations–that would implement a tax-avoidance strategy known as COBRA, short for Current Options Bring Reward Alternatives.

Using paper losses on 30-day options on foreign currencies to offset taxable gains, they were able to claim $45 million in losses that actually only cost them $1.37 million, court papers indicate.

“The reason the corporations were able to claim such vast losses—the alchemy at the heart of an offsetting-options tax shelter—lay in how Woods and McCombs calculated the tax basis of their interests in the partnerships,” Scalia wrote.

COBRA, an offsetting-option tax shelter marketed by the accounting firm Ernst & Young mostly in the 1990s, sought to give parties an artificially high basis in a partnership interest, enabling the taxpayer to claim a significant tax loss upon disposition of the interest.

"This is not a case where a valuation misstatement is a mere side effect of a sham transaction," Scalia wrote. "Rather, the overstatement of outside basis was the linchpin of the COBRA tax shelter and the mechanism by which Woods and McCombs sought to reduce their taxable income."

Noneconomic tax losses by artificially overstating basis in partnership interests are not allowable as deductions for federal income tax purposes (IRS Notice 2000–44).

Following an IRS partnership-level audit of their federal returns, the COBRA-generated losses their S-corporations reported were disallowed and penalties were assessed for gross-valuation misstatements related to transactions determined to solely exist to generate losses to offset tax liability.

In a Notice of Final Partnership Administrative Adjustment (FPAA), the IRS disregarded–for tax purposes–the partnerships engineered to generate losses by artificially inflating the taxpayers' basis in property.

Once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim a basis in his partnership interest greater than zero, the ruling noted.

"Any underpayment resulting from use of a non-zero basis would therefore be 'attributable to' the partner's having claimed an 'adjusted basis' in the partnerships that exceeded 'the correct amount of such . . . adjusted basis.'" Scalia wrote.

As the tax-matter partner in the COBRA-related entities, Woods in July 2005 asked a federal court to thwart the IRS determinations and block resulting penalties.

Plaintiffs challenged the FPAA under the TEFRA judicial review provision.

In U.S. District Court for the Western District of Texas, they argued the IRS erred in assessing error penalties for transactions that were accurately reported.

In the 20-page ruling, Scalia called the argument unpersuasive.

"The valuation misstatement penalty encompasses misstatements that rest on legal as well as factual errors, so it is applicable to misstatements that rest on the use of a sham partnership," Scalia wrote. "And the partnerships' lack of economic substance is not an independent ground separate from them is statement of basis in this case."

IRS regulation provides that when an asset's true value or adjusted basis is zero, "[t]he value or adjusted basis claimed . . . is considered to be 400 percent or more of the correct amount," so that the resulting valuation misstatement is automatically deemed gross and subject to the 40-percent penalty (Treas. Reg. §1.6662–5(g))

The Internal Revenue Code establishes an accuracy-related penalty of 20 percent of an underpayment "attributable to" any substantial understatement of income tax or any substantial valuation misstatement. The penalty increases to 40 percent if there is a gross valuation misstatement.

The Supreme Court ruling reverses lower court decisions in the matter.

Following a consolidated bench trial, U.S. District Court Senior Judge Harry Hudspeth sided with plaintiffs, ruling that the valuation-misstatement penalties were not applicable.

"These were collateral transactions, which not only did not produce the tax benefit at issue in this case, but did the opposite–they resulted in taxable income to the partnerships," Hudspeth wrote. "The 'transaction that is relevant in this case is the plaintiff's use of two partnerships with a six-week life span to conduct that trading for the sole purpose of generating a paper loss."

The IRS appealed the trial court ruling. In June 2012, the U.S. Court of Appeals for the Fifth Circuit affirmed the lower court ruling in a *per curiam* opinion.

The appeals court held that the issue was "well settled" in the circuit under its April 2012 decision in *Bemont Investments, L.L.C. v. United States*, a case involving a tax shelter similar to COBRA.

To resolve a Circuit split over interpretation of Section 6662, the Supreme Court in March granted the government's petition for a writ of certiorari.

The Fifth and Ninth Circuits have held that whenever the IRS disallows a deduction, the government may not penalize the taxpayer for valuation overstatement. Meanwhile, the First, Second, Third, Fourth, Sixth and Eighth Circuits have held the opposite view.

The justices heard the case Oct. 9.

The case is *United States v. Woods*, No. 12-562. The Supreme Court ruling.

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