Tax Controversy Services

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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."[1] 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.

[1] I.R.C. § 6662(a) and (b)(3)

Second Circuit Vacates Tax Court Decision, Endorsing Two-Pronged Analysis of Transferee Liability under § 6901 and Finding Liability under State Law, and Remands to Tax Court for Determination of Procedural Issues Governed by Federal Law

In *Diebold Foundation, Inc. v. Comm'r*, 2013 U.S. App. LEXIS 22964, the U.S. Court of Appeals for the Second Circuit vacated the Tax Court's decision in *Diebold v. Comm'r*, T.C. Memo 2010-238, wherein the Tax Court held that there was no transferee liability for seller's shareholders in a Midco transaction.[2] Applying New York substantive law and concluding that the Midco transactions at issue should be collapsed because the shareholders of The Diebold Foundation Inc. ("Diebold New York") had constructive knowledge of the tax avoidance scheme, the Second Circuit remanded the case to the Tax Court to determine: (1) whether Diebold New York is a transferee under IRC § 6901, relying upon federal law principles that govern the question of transferee status; (2) whether the Diebold Foundation, Inc. ("Diebold Foundation") is a transferee of a transferee; and (3) which statute of limitations applies, the three-year statute of limitations of IRC § 6901(c)(2), the six-year statute of limitations of IRC § 6501(e)(1)(A), or another statute of limitations.

Double D Ranch, Inc. ("Double D"), a personal holding corporation taxed as a C corporation, owned high value assets with low basis (consisting primarily of publicly traded securities). Double D's shareholders, including Diebold New York, ("Shareholders") wanted to dispose of the assets and receive cash. They were aware of the significant corporate tax liability that would result from a corporate asset sale. In an asset sale, shareholders cause a C corporation to sell the appreciated property, triggering built-in gain, and distribute the remaining proceeds to the shareholders.

In this case, the sale of the assets of Double D would have triggered a tax liability of $81 million, i.e., the amount distributed to the Shareholders would have been reduced by $81 million. The Shareholders chose to pursue a stock transaction with Sentinel, and Sentinel formed a new entity, called Shap Acquisition Corporation II ("Shap II"), to carry out the transaction. Prior to the transaction, Shap II had no assets. Sentinel purchased all of the shares of Double D for 97% of the fair market value of Double D. The Court determined that, had Double D sold the assets directly and liquidated to Shareholders, the Shareholders would have received approximately 74.5% of the assets' fair market value. The Shareholders were aware that Shap II intended to sell Double D's securities to Morgan Stanley. Shap II paid the Shareholder using borrowed funds that were repaid with proceeds from the sale of Double D's securities. Shap II filed a consolidated Form1120 with Double D, reporting all of Double D's built-in gain from its asset sales; Shap II offset the gain using losses from a Son-of-BOSS transaction. Accordingly, Shap II and Double D did not pay any tax on the sale of the Double D stock for $309 million. Upon dissolution, Double D New York distributed all of its assets to three foundations, including the Diebold Foundation.

The IRS determined that the Shareholders' sale of Double D stock was, in substance, an asset sale followed by a liquidating distribution to the Shareholders. However, Double D had no assets from which the Service could collect the $100 million deficiency. Accordingly, the Commissioner sought to collect the additional tax liability from the Shareholders, as transferees of Double D. The Commissioner asserted that Diebold New York was a transferee of Double D and that the Diebold Foundation was a transferee of a transferee. The Diebold Foundation contested the deficiency in the Tax Court, and the Tax Court concluded that Diebold New York was not liable as a transferee and that, consequently, the Diebold Foundation was not liable as a transferee of a transferee.

Following the approach taken by First and Fourth Circuits and the Tax Court, the Second Circuit concluded that the two prongs of IRC § 6901 are independent; whether a party is a transferee is determined by federal law, and whether a party is liable at law or equity is determined by the applicable state law. Therefore, to determine whether there was liability under IRC § 6901, the Second Circuit concluded that the question of whether there was a "conveyance" had to be determined in accordance with applicable state law; in this case, New York law was applicable. Applying the New York Uniform Fraudulent Conveyances Act, the Court found that a transaction may be collapsed if a transferee has actual or constructive knowledge of the entire scheme that renders the exchange with the seller fraudulent, and the consideration received from the first transferee is re-conveyed by the party owing the liability for less than fair consideration.

Constructive knowledge may be found if transferee should have known about the entire scheme. Whereas the Tax Court concluded that the Shareholders did not have actual or constructive knowledge of the entire scheme, on de novo review, the Second Circuit concluded that there was sufficient evidence demonstrating that the Shareholders had constructive knowledge. According to the Second Circuit, "the parties 'should have known' that this was a fraudulent scheme, designed

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[2] *See* Notice 2001-16 (I.R.S. 2001), which addresses "intermediate transactions" tax shelters, also referred to as "Midco transactions."

to let both the buyer of the assets and seller of the stock avoid the tax liability inherent in a C Corp holding appreciated assets and leave the former shell of the corporation, now held by Midco, without assets to satisfy that liability." Considering the totality of the circumstances, the Second Circuit concluded that Shareholders had constructive knowledge where (1) the Shareholders were aware of the potential for large corporate tax liability and of the Midco-type transaction that was planned; (2) the Shareholders' representatives knew that Shap II was newly established for the sole purpose of purchasing Shareholders' stock and were on notice that Shap II intended to resell Double D's assets immediately; and (3) the parties were extremely sophisticated actors. Therefore, the Second Circuit decided to collapse the series of transactions, concluding that Double D sold its assets and made a liquidating distribution to the Shareholders, leaving Double D insolvent.

After vacating the Tax Court's state law liability determination, the Second Circuit remanded the case to the Tax Court to consider the outstanding federal law issues, namely the resolution of transferee (and transferee of transferee) status and the determination of the applicable statute of limitations.

Supreme Court Denies Certiorari to a Taxpayers' Petition for Review of a Sixth Circuit Decision Affirming the Dismissal of Their Refund Claim for Lack of Subject Matter Jurisdiction

In *Stocker v. United States*, 705 F.3d 225 (6th Cir. 2013), the United States Court of Appeals for the Sixth Circuit affirmed the decision of the U.S. District Court for the Eastern District of Michigan to dismiss the taxpayers' refund claim for lack of subject matter jurisdiction, finding that the taxpayers could not establish through an "accepted means" that they filed their amended tax return within three years of the date of the filing of their original return.

The Sixth Circuit considered whether taxpayers Robert Stocker and Laurel Stocker ("Stockers") had established the jurisdictional prerequisite of a timely filed claim for refund, in accordance with IRC § 7502. The Sixth Circuit identified two methods to establish timely filing, in addition to the common law physical delivery rule, articulated in IRC § 7502. In accordance with IRC § 7502(a)(1), a return that is delivered by U.S. mail to the Internal Revenue Service ("IRS" or Service") is deemed to have been delivered on the date of the U.S. postmark on the cover of the mailing. Under IRC § 7502(c)(1), if the return is sent by U.S. registered mail, then this registration is prima facie evidence that the return was delivered to the IRS, and the date of the registration is deemed the postmark date.

For their 2003 tax return, the Stockers received a six-month extension to file; the Stockers' original return was timely filed by the extended due date of the return, October 15, 2004. Subsequently, the Stockers determined that they had overpaid their 2003 federal taxes in the amount of $64,058.00. In accordance with IRC § 6511(a), the Stockers' claim for a refund of their 2003 taxes had to be filed within three years of October 15, 2004, i.e., on or before October 15, 2007. The Stocker's accountant's office manager, Karen Fennell ("Ms. Fennell"), prepared postage prepaid, certified mail, return receipt requested envelopes for the Stocker's 2003 amended tax return. However, Ms. Fennell failed to give Mr. Stocker the customer copies of the certified mail receipts for the 2003 amended return for him to present at the post office when he mailed the returns; instead, she mistakenly retained these copies. According to Mr. Stocker's testimony, he mailed the 2003 amended return to the IRS on October 15, 2007, but was unable to get date-stamped receipts because Ms. Fennell had not provided him with the copies of the certified mail receipts.

The Service claimed that it did not receive the Stockers' 2003 amended return until October 25, 2007, ten days after the due date for the refund claim. The IRS's records reflected that the envelope containing the 2003 amended return had a postmark date of October 19, 2007; the IRS, however, acknowledged that it did not retain the envelope in which the 2003 return was mailed. On November 27, 2007, the IRS issued a notice to the Stockers disallowing their refund claim from the 2003 amended return because the return was postmarked after the October 15, 2007 deadline.

On October 15, 2009, the Stockers formally challenged the IRS's denial of their refund request related to the 2003 return, asserting that the amended 2003 return was timely filed on October 15, 2007. The IRS raised the affirmative defense, under IRC § 6511, of the three-year statute of limitations for refund claims. The Stockers moved for summary judgment and sought to introduce evidence of the timely filing of the amended 2003 return. The Service opposed the Stocker's motion for summary judgment and moved to dismiss the complaint on the grounds that the district court lacked subject matter jurisdiction. The district court agreed with the IRS, concluding that it lacked subject matter jurisdiction over the case.

On de novo review, the Sixth Circuit found that the Stockers were unable to satisfy either of the statutory exceptions to the physical delivery rule contained in IRC § 7502 because the IRS's records indicated that the envelope was postmarked on October 19, 2007 and the Stockers could not produce a date-stamped certified mail receipt. Whereas, the Stockers contended that IRC § 7502 provides safe harbors, the Sixth Circuit concluded that the exceptions embodied in IRC § 7502 (i.e., postmark on envelope or date-stamped certified mail receipt) are exclusive and complete. The Court acknowledged the existence of a circuit split on this issue, but felt compelled to follow the Sixth Circuit precedent of *Miller v. United States*, 784 F.2d 728 (6th Cir. 1986) (holding "the only exceptions to the physical delivery rule available to taxpayers are the two set out in section 7502"). Specifically, in note 5, the Sixth Circuit referenced the following cases: *Philadelphia Marine Trade Ass'n – Int'l Longshoremen's Ass'n Pension Fund v. Comm'r*, 523 F.3d 140, 150 (3d Cir. 2008) (concluding that the intent of Congress in enacting IRC § 7502 "was to supplement, not supplant, [the] means by which taxpayers can timely file documents with the IRS"); *Anderson v. United States*, 966 F.2d 487, 491 (9th Cir. 1992) (declining to read IRC § 7502 as carving out exclusive exceptions to the common law physical delivery rule). Consistent with *Miller*, the Sixth Circuit declined to allow the Stockers to introduce extrinsic evidence to rebut the IRS's claim that the amended return was not filed timely. Accordingly, where the Stockers could not produce evidence to satisfy either of the Code's two specified exceptions, the Sixth Circuit granted the Service's motion to dismiss for lack of subject matter jurisdiction.

In addition, in the district court, the Stockers requested spoliation sanctions against the IRS for its failure to retain the envelope in which the Stockers delivered their 2003 amended federal income tax return, and sought an inference that the lost or destroyed envelope had a postmark of October 15, 2007. The district court declined to draw the requested inference or otherwise impose a sanction on the Service. The Sixth Circuit concluded that the district court did not abuse its discretion in declining to grant an adverse inference of timely filing as a spoliation sanction for the IRS's loss or destruction of the envelope that the Stockers used to mail their amended 2003 federal tax return.

The Stockers challenged the Sixth Circuit's decision, and filed a petition for writ of certiorari on August 29, 2013, requesting that the Supreme Court address the issue of "[w]hether a taxpayer may prove the timely filing of a tax refund claim through evidence other than an actual postmarked envelope or a registered or certified mail receipt, as the Third, Eighth, Ninth and Tenth Circuits and the Tax Court have held, or whether the only evidence admissible to establish timely filing is the envelope or receipt itself, as the First, Second, and Sixth Circuits have held." The Stockers challenged the Sixth Circuit's restrictive evidentiary rule, arguing that the Sixth Circuit's decision ignored the straightforward text of IRC § 7502, the remedial statutory purpose, and settled tenets of statutory construction. Further, the Stockers urged the Supreme Court to resolve the circuit split, which resulted in inconsistent applications of IRC § 7502. On December 16, 2013, the Supreme Court denied the Stockers' petition, thereby declining to resolve the circuit split, in *Stocker v. United States*, 2013 U.S. LEXIS 9106.