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No. 12-562

In The
Supreme Court of the United States

UNITED STATES OF AMERICA,

Petitioner,

v.

GARY WOODS, AS TAX MATTERS PARTNER OF TESORO DRIVE PARTNERS, ET AL.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

BRIEF OF *AMICUS CURIAE* PROFESSOR DAVID J. SHAKOW IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICUS CURIAE*

Amicus is a teacher and scholar of the tax law. The issues in this case involve a subject in which he has a special interest and about which he has been engaged for some time in writing. Except for that academic interest, he has no interest in the outcome of this case.[1]

As can be seen from the "Summary of Argument," *Amicus* takes a view of the issues involved in this case and their proper resolution that is wholly different from that taken by the courts below. The issues are important, and in resolving them the Court

[1] The parties have consented to the filing of this brief. Pursuant to Rule 37.3(a), letters consenting to the filing of this brief are on file with the Clerk of the Court. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae* made a monetary contribution to its preparation or submission. Besides being Professor of Law, Emeritus, at the University of Pennsylvania Law School, *Amicus* is also counsel at Chamberlain, Hrdlicka, White, Williams & Aughtry. Chamberlain Hrdlicka is filing an *amicus* brief in this case on behalf of a number of clients. The brief *Amicus* is filing reflects the findings of an article that *Amicus* submitted for publication prior to the granting of *certiorari* in this case. *See* David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, 139 TAX NOTES 1283 (6/10/2013), *available at* http://ssrn.com/abstract=2281915 (with appendices). The time spent preparing the article, and the additional time spent on this *amicus* brief, will not be charged to any client.

should have the benefit of a presentation of all the competing views.

INTRODUCTION AND SUMMARY OF ARGUMENT

In 1999, taxpayer participated in a tax shelter called Current Options Bring Reward Alternatives ("COBRA"). In simplified form, taxpayer purchased and sold offsetting short-term options on a foreign currency, and contributed the options, plus a relatively small amount of cash, to a partnership. The taxpayer claimed that it had a basis in the partnership equal to its basis in the "long" option, with no reduction for the obligation inherent in the "short" option. The partnership purchased an asset with a portion of the cash and then liquidated, distributing the asset to the taxpayer. Under a mechanical application of the partnership rules, this resulted in a high basis in the distributed property, which was then sold for a substantial loss.

As it has been framed by the courts below, the question is how to apply the valuation misstatement penalties, 26 U.S.C. § 6662(e) and (h), when the taxpayer had no business purpose for entering into the transaction.[2] The Government contends that the penalties can be applied in this context.

[2] The Court has also directed the parties to consider the jurisdiction of the district court under 26 U.S.C. § 6226 to

(Continued on following page)

In so addressing the issue, the government, like the court below, presumes that the transaction at issue may be subject to "valuation misstatement" penalties although no issue was raised relating to any valuation asserted by the taxpayer in structuring the transaction. My examination of the sections at issue reveals that these "valuation misstatement" penalties are properly applied only if the taxpayer has made a valuation misstatement. Since the taxpayer has not done so, those penalties cannot in any event apply.

It follows that the Court should sustain the decision below on the basis that the penalty cannot apply in this situation in any event.

ARGUMENT

I. THE CODE REQUIRES A VALUATION MISSTATEMENT IF A VALUATION MISSTATEMENT PENALTY IS IMPOSED

Section 6662(e)(1)(A) of the Internal Revenue Code states:

> (e) Substantial Valuation Misstatement Under Chapter 1. –
>
> > (1) In General. – For purposes of this section, there is a substantial valuation misstatement under chapter 1 if –

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consider the substantial valuation misstatement penalty. *Amicus* takes no position on that issue.

> (A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be). . . .

Section 6662(a) applies a 20% penalty if there is a "substantial valuation misstatement." Under section 6662(h), the penalty is increased to 40% when the value (or adjusted basis) is 200% or more of the correct amount, because there is then a "gross valuation misstatement."

The question considered by the courts below was whether the valuation misstatement penalty in section 6662(h) applies to the taxpayers. If it does, it applies because the basis used by the taxpayers in calculating the tax on their tax return was more than 200% of the amount determined to be the correct basis. That reflects an understanding that "basis" in section 6662(e)(1)(A) refers to basis determined by a taxpayer in any manner.

Amicus submits that there are three possible ways of understanding the reference to basis in the definition of a valuation misstatement in section 6662(h).

- It could refer to basis used by a taxpayer on a tax return in all circumstances.
- It could refer to basis used by a taxpayer either when the basis is a function of a valuation

misstatement or when the taxpayer is engaged in an abusive tax shelter.

- It could refer to basis used by a taxpayer when the basis is a function of a valuation misstatement.

Amicus will demonstrate below that the first approach, advanced by the Government in its brief,[3] extends the reach of the penalty to many and varied situations under the Internal Revenue Code. Although it purports to rely on the plain meaning of the statute, it does so by ignoring the context in which the provision appears. Moreover, during the thirty-two years since this provision was added to the Code, the Commissioner has ignored this "plain meaning" over and over. The Commissioner has failed to apply the penalty in many situations where the facts warranted

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[3] In its discussion of the "plain text" of the valuation misstatement penalty, the Government's brief states:

> Indeed, in many contexts other than transactions that lack economic substance, a basis overstatement is produced by a misapplication of basis-computation rules rather than by a simple factual error. For example, a corporation may overstate its basis in a subsidiary due to a misapplication of regulations relating to consolidated returns. *See* 26 C.F.R. § 1.1502-32. If the corporation were to determine its gain or loss on the sale of the subsidiary using the overstated basis, resulting in an understatement of the corporation's overall taxable income and ultimately in an underpayment of tax, the overstatement penalty would surely apply.

U.S. Br. 42.

application of the penalty, as so understood, and other penalties were imposed on taxpayers. The common thread in these cases, where the Commissioner failed to act, is that the taxpayer's inflated basis did not flow from valuation misstatements.

The second approach appears to be the IRS's current application of the valuation misstatement penalty. There is no justification for extending the penalty to tax shelter transactions that do not involve valuation misstatements. Congress has included specific provisions in the Code to deal with abusive tax shelters generally, but the valuation misstatement penalties in section 6662 have not been so extended.

The third approach is most consistent with the language of the statute in context and its legislative history, reflects the application of the penalty throughout most of its history, and avoids an extension of the penalty to a wide variety of cases to which it has never been applied. *Amicus*'s review of the case law demonstrates that the Commissioner has generally concluded that a valuation misstatement penalty requires a valuation misstatement. The penalty should be so limited.

II. THE LANGUAGE OF THE PENALTY AND ITS LEGISLATIVE BACKGROUND CONFIRM THAT A VALUATION MISSTATEMENT IS REQUIRED

Section 6659 of the Internal Revenue Code, the original valuation misstatement provision, was titled "Addition to Tax in the Case of Valuation Overstatements for Purposes of the Income Tax." It was added to the Internal Revenue Code in 1981. Section 6659(c) read:

> VALUATION OVERSTATEMENT DEFINED – For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

Section 1012(a) defines "basis" of property as "the cost of such property, except as otherwise provided in this subchapter and subchapters C . . . , K . . . , and P. . . ." Section 1011(a) defines "adjusted basis" as "the basis (determined under section 1012 . . .), adjusted as provided in section 1016." Since these definitions appear to have nothing to do with value, the reader could be confused by the reference to "basis" in the definition of a valuation overstatement. The explanation is that valuation overstatements do not affect tax liabilities only directly, as for example, when a taxpayer claims a deduction for the charitable contribution of an artwork based on an overvaluation.

In many tax-motivated transactions, taxpayers "pay" a substantially inflated price for an item, using mostly non-recourse debt, in order to get the immediate tax benefits of the resulting very high basis. The valuation is not reflected directly on the tax return, but the high basis in the purchased asset results from the inflated valuation. At the time section 6659 was added to the Code, there were "about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance." H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 243 (July 24, 1981). Based on the decided cases (discussed below), the overwhelming majority involved bases inflated through overvaluation.

For example, in *Provizer v Commissioner*, 65 T.C.M. (CCH) 2531 (1992), *aff'd per curiam without published opinion*, 996 F.2d 1216 (6th Cir. 1993), *cert. denied*, 510 U.S. 1163 (1994), a test case for approximately 1850 docketed and undocketed cases involving a plastics recycling tax shelter, the court said:

> "Here, assets with approximate fair market values of $50,000 were valued by petitioners at $1,162,666 each. Petitioners' valuations are by definition overstated within the meaning of section 6659."

The valuations were relevant because taxpayers had calculated depreciation and tax credits based on the price they paid for the equipment. If "valuation overstatements" were limited to situations where the overstated *value* appeared directly on the return, the penalty might not apply in cases such as *Provizer*.

Therefore, a reference to basis was included by Congress in the definition of a "valuation" overstatement.

III. THERE IS ONLY ONE REASONABLE WAY TO UNDERSTAND SECTION 6659, THE PREDECESSOR OF THE CURRENT PENALTY PROVISION

Although the statute, as originally passed, did not state explicitly that inflated basis must result from a misvaluation, it is hard to interpret it otherwise. The section's title and the operative definition in section 6659(c), quoted above, refer to a *valuation* overstatement. Most recently in 2008, the Court confirmed that statutory titles and section headings "are tools available for the resolution of a doubt about the meaning of a statute." *Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 47 (2008), *quoting Porter v. Nussle*, 534 U.S. 516, 528 (2002). Use of a title to interpret a statute is particularly apt where the title is reinforced by legislative history. *Almendarez-Torres v. United States*, 523 U.S. 224, 234 (1998).

It is clear from the legislative history of this penalty that Congress's target was serious overvaluations of assets and their effect on the courts. The "Reasons for Change" included in the House Committee's report when section 6659 was added to the Internal Revenue Code in 1981 contains the following explanation:

> The Committee believes that a specific penalty was needed to deal with various problems related to valuation of property. This particular need is illustrated by the fact that there are about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance. These cases alone involve approximately $2.5 billion in tax attributable to the valuation issues.
>
> The committee recognizes that valuation issues frequently involve difficult questions of fact. Often these issues seem to be resolved simply by "dividing the difference" in the values asserted by the Internal Revenue Service and those claimed by the taxpayer. Because of this approach to valuation questions, the committee believes that taxpayers were encouraged to overvalue certain types of property and to delay the resolution of valuation issues. . . .
>
> In recognition of the fact that valuation issues often are difficult, especially where unique property is concerned, the committee decided to adopt a "bright line" test for the application of a new penalty. Under this test, only significant overvaluations will be penalized. . . .

H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 243 (July 24, 1981). The House bill was adopted in Conference. H.R. Rep. No. 97-215, 97th Cong., 1st Sess. 262-263 (August 1, 1981). There is no substantive discussion of the reasons for the valuation misstatement

penalties in the legislative history of the 1989 revision of these provisions, which moved the penalty into section 6662. This change is discussed below.

The extension of this penalty by the Commissioner to all transactions that lack economic substance, as detailed in Part VI, below, is inconsistent with Congress's understanding of the provision. The language of the provision, its history and its application demonstrate that it was intended to deal with valuation misstatements.

IV. SECTION 6659 WAS APPLIED CONSISTENT WITH ITS LANGUAGE AND STATED PURPOSE

The valuation misstatement penalty of section 6659 was applied consistently to cases where there was a valuation misstatement. *Amicus* reviewed the cases (close to 1,000) which cite section 6659. *Amicus* examined the facts of the cases, around 450, that clearly involved substantive attempts by the IRS to exact the valuation misstatement penalty from taxpayers.[4] Issues of valuation were present in virtually

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[4] *See* cases listed in Appendix B of David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, 139 TAX NOTES 1283 (6/10/2013), *supra* note 1. *Amicus* used RIA Checkpoint to identify all the cases that cited section 6659 and attempted to categorize each one. There were many in which section 6659 was cited but not applied, and many in which the facts underlying the transaction were not spelled out with enough detail to allow *Amicus* to determine why the penalty had been asserted. In some cases, the IRS did not assert the penalty

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all of the cases in which the section 6659 penalty was asserted.[5] Sixty-three involved overstated charitable contributions. It is straightforward to apply an overvaluation penalty in such a case, because the taxpayer's underpayment flows directly from the overvaluation. One involved claimed improvements on a farm purchased by a limited partnership, a

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for valuation misstatements under section 6659, but instead imposed the higher interest rate on deficiencies mandated by section 6621(c) when a transaction involves a valuation misstatement as defined in section 6659. It is not clear why the section 6659 penalty itself was not asserted in those cases, although in some it is possible that the penalty under section 6659 would not have led to an additional payment by the taxpayer because of other penalties to which the taxpayer was subject. Section 6621(c) was repealed in the 1989 Act, which redefined the scope of the valuation misstatement penalty and moved it from section 6659 to section 6662.

[5] One possible exception is *Groves v. Commissioner*, 78 T.C.M. (CCH) 1201 (1999). Although the facts are not set out clearly in the opinion, it appears the taxpayer recorded basis of stock he sold without a factual foundation for the numbers used. In *Massengill v. Commissioner*, 56 T.C.M. (CCH) 107 (1988), *aff'd*, 876 F.3d 616 (8th Cir. 1989), the Commissioner argued that the taxpayer had engaged in a transaction without economic substance, and hence had a zero basis in the asset in question. The court applied section 6659 without a clear finding related to valuation. In other cases that applied section 6659 in response to an argument that the taxpayer had zero basis, the courts' findings reflect the overvaluation of the assets in question, and courts often relied on that finding in applying the penalty. *See, e.g.*, *Gilman v. Commissioner*, 93 F.3d 143, 150 (2d Cir. 1991).

transaction which the court does not clearly label as a tax shelter.[6]

The other 380 or so were tax shelters, almost all of which were based on overvaluations of property. In many cases, the overvaluation led directly to an inflated purchase price and an inflated basis, as in *Provizer*, discussed above. Many of these cases, like *Provizer*, involved more than one taxpayer.

As the Government concedes in its brief, its argument is that the "overvaluation" penalty applies whenever a taxpayer has basis in excess of fair market value, and this can happen when there is no overvaluation. U.S. Br. 41-42. The Government does not acknowledge that there are many situations where this would be so; that these situations are not just theoretical, but they have arisen in reported cases; that those cases involved other penalties that the Commissioner asserted, so there is no question that the taxpayer's actions were subject to sanction; but that the Commissioner has not asserted the overvaluation penalty in those circumstances. It strains credulity to maintain that the Commissioner has missed the alleged plain meaning of the statute for over thirty years. It seems similarly unlikely that Congress intended to impose a penalty with such an

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[6] *Weis v. Commissioner*, 94 TC 473 (1990) (limited partnership bought farm; claimed improvements had value 243% of actual value).

expansive scope under the rubric of an "over-valuation" penalty.

Below, *Amicus* identifies some of the circumstances where a taxpayer could claim a basis substantially in excess of actual basis, but valuation is not an issue. The cases cited in the footnotes were decided when the valuation misstatement penalty was in effect, and where asserting that penalty would have resulted in an additional penalty imposed on the taxpayer. The valuation misstatement penalty can be avoided if the taxpayer has "reasonable cause." 26 U.S.C. § 6659(e) ("authority to waive"); § 6664(c) (applies to all penalties under section 6662). However, where the Commissioner asserts another penalty that could be avoided if the taxpayer has "reasonable cause," it is clear the Commissioner could also have asserted the valuation misstatement penalty. In all cases, unless otherwise noted, the IRS did assert a different penalty.[7] Thus, these cases illustrate not only that an overbroad reading of the valuation misstatement penalty would result in it being applied in very many situations, but also that the IRS has limited the provision to situations where there is no valuation misstatement, except in some tax shelter cases such as the instant case:

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[7] Where *Amicus* found no case in which a penalty was asserted, *Amicus* included an illustrative case where the basis issue was present, although the Commissioner did not impose any penalties.

An item could be capitalized when it should not have been capitalized.[8]

A taxpayer may claim basis in property sold or depreciated but be unable to substantiate the basis.[9]

A taxpayer could fail to reduce basis by depreciation allowed or allowable.[10]

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[8] *Diaz v. Commissioner*, 104 T.C.M. (CCH) 213 (2012) (portion of overstated basis came from disallowing claimed capital expenditure); *Ashley v. Commissioner*, 80 T.C.M. (CCH) 841 (2000) (taxpayer apparently claimed basis of $356,000 on return; court allowed basis of $145,273.96, less depreciation allowed or allowable (amount not specified)); *Lewis v. Commissioner*, T.C. Summary Opinion 2001-142 (taxpayer calculated gain on property sold based on over $130,000 of capital expenditures, but only $46,000 allowed).

[9] *E.g.*, *Brodsky v. Commissioner*, T.C. Memo. 2001-240, 2001 WL 1078113 (IRS claimed zero basis for items taxpayer had assigned bases of $50,000 and $36,685); *Marcus v. Commissioner*, 71 T.C.M. (CCH) 2823 (1996) (IRS claimed zero basis for item sold for almost $38,000); *Hall v. Commissioner*, 65 T.C.M. (CCH) 2575 (1993) (IRS claimed zero basis for item sold for $33,000); *Riley v. Commissioner*, T.C. Summary Opinion 2007-26 (IRS claimed zero basis for items for which depreciation of $21,500 was taken); *Diaz v. Commissioner*, *supra* note 8 (claimed basis of $553,269 reduced by court to $154,000); *Allnutt v. Commissioner*, TC Memo 2004-239 (bases in various assets overstated by more than $500,000); *Leighton v. Commissioner*, 70 T.C.M. (CCH) 1109 (1995), *aff'd*, 108 F.3d 332 (5th Cir. 1997); *Tabbi v. Commissioner*, 70 T.C.M. (CCH) 836 (1995).

[10] *Lewis v. Commissioner*, T.C. Summary Opinion 2001-142 (taxpayer failed to reduce basis by $26,470 of depreciation allowed or allowable on property sold).

A taxpayer could use basis for loss, rather than basis for gain, for determining depreciation.[11]

A taxpayer could claim too high a basis in measuring a casualty loss.[12]

A liability associated with a property's purchase price could be improperly so associated.[13]

A stockholder could fail to reduce the basis of stock in respect of a return of capital distribution under section 301 or under section 1367.[14]

A homeowner could fail to make the correct basis adjustments in the case of a sale and purchase of a residence under section 1034.[15]

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[11] 26 U.S.C. § 167(c); *cf. Federal Home Loan Mortgage Corp. v. Commissioner*, 121 T.C. 129 (2003) (over $300 million difference in tax liability resulting from IRS claim that taxpayer should have used basis for gain rather than fair market value basis provided under special legislation; no penalty asserted).

[12] *See*, *e.g.*, *Cziraki v. Commissioner*, 76 T.C.M. (CCH) 991 (1998).

[13] *See*, *e.g.*, *Dunnegan v. Commissioner*, 71 T.C.M. (CCH) 2670 (1996), *aff'd on this issue*, 82 F.3d 404 (3d Cir. 1996) (liability improperly associated with purchase inflated basis of property that was repurchased under section 1034).

[14] *D'Errico v. Commissioner*, 103 T.C.M. (CCH) 1802 (2012) ($274,611 basis of S corporation stock reduced to zero under section 1367(a)(2) because of return-of-capital distributions).

[15] *See*, *e.g.*, *Dunnegan v. Commissioner*, *supra* note 13. Section 1034 was repealed in 1997.

> A parent corporation could make a mistake adjusting its subsidiary's stock in the context of the complicated consolidated return regulations. *E.g.*, 26 C.F.R. § 1.1502-32.[16]

There are other Code sections whose misapplication could lead to overstated basis, but *Amicus* did not find decided cases where this occurred. These include:

> A taxpayer could overstate fair market value in making an election under section 83(b).
>
> A taxpayer could capitalize amounts allowed as research and development deductions under section 174.
>
> A taxpayer could capitalize development expenditures allowed as a deduction under section 616.
>
> A corporation could fail to make adjustments to the basis of stock of a controlled foreign corporation under section 961.
>
> A bondholder could fail to reduce a bond's basis for amortizable bond premium pursuant to section 1016(a)(5).
>
> A farmer could fail to adjust basis for a loan from the Commodity Credit Corporation,

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[16] *Cf. IU International Corp. v. United States*, 116 F.3d 1461 (Fed. Cir. 1997) (disagreement about application of the regulations affected about $10 million of gain; issue raised in refund suit, so no penalties involved).

> pursuant to section 1016(a)(8), to the extent of loans treated as income under section 77.
>
> Basis could be misallocated in the context of basis reduction under section 1017.
>
> A taxpayer could fail to reduce basis by the amount of extraordinary dividends under section 1059.

The fact that *Amicus* could not locate cases illustrating these Code sections should not be taken to mean that such cases do not exist.

V. THE LANGUAGE OF THE CURRENT VERSION OF THE PENALTY CONFIRMS THAT IT APPLIES ONLY IF THERE IS A VALUATION MISSTATEMENT

As originally passed in section 6659, the penalty provision applied when "the value of any property, or the adjusted basis of any property" was inflated. As we have shown, the penalty was applied to cases involving actual overvaluations.

In 1989, the penalty provisions were restructured, and the overvaluation penalty was moved to section 6662. The legislative history of the valuation misstatement penalty, in both 1981 and 1989, is devoid of any discussion of inflated *basis*. The focus is on valuations.

The reenactment of the penalty in 1989 provides further support for the conclusion that it should be applied only when the taxpayer has overstated the

value of an asset. When the penalty was reenacted, the reference to basis overstatements was placed in a parenthetical: "the value of any property (or the adjusted basis of any property)." This affects how the statute should be understood. *See Chickasaw Nation v. United States*, 534 U.S. 84, 94-95 (2001). In interpreting a statute, the use of parentheticals indicates that the parenthetical phrase "*is related to, or dependent upon*" the non-parenthetical phrase it follows. *Disabled in Action of Pennsylvania v. Southeastern Pennsylvania Transportation Authority*, 539 F.3d 199, 212 (3d Cir. 2008) (emphasis added). "[P]arentheses 'reduce[ ] the grammatical import' of the language contained therein." *Id.*, *quoting Peters v. Ashcroft*, 383 F.3d 302, 309 (5th Cir. 2004).[17] In particular, courts may decline to ascribe independent meaning to a parenthetical statutory phrase (such as the one we are considering) beginning with the word "or" because "it can reasonably be construed to illustrate or explain"

[17] *Peters'* full discussion of parentheses is as follows:

> [The court's] approach finds additional support in decisions, cited by this court in *Monjaras-Castaneda*, *supra* at 330, that have construed statutory parentheticals to signify clarifications, non-exclusive identifications, or visual aids. Congress in fact reduced the grammatical import of conspiracy and attempt, and correspondingly emphasized the breadth of "relating to," when it replaced commas cordoning off conspiracy in the predecessor provision with the parentheses that now appear.

383 F.2d at 308-309.

the preceding phrase. *Mizrahi v. Gonzales*, 492 F.3d 156, 166 (2d Cir. 2007).

It follows that the penalty for a 150% discrepancy in *adjusted basis* should be understood in light of the penalty for a 150% discrepancy in *value* that it follows. In other words, the basis overstatement to which section 6662(e) refers is one that arises from the type of problem that the section was targeted to address, namely subjective overvaluations that allow taxpayers to claim very large deductions or credits on their tax returns.

VI. THE VALUATION MISSTATEMENT PENALTY IS CURRENTLY APPLIED CONTRARY TO ITS LANGUAGE AND STATED PURPOSE

To evaluate where the IRS has, and has not, applied the penalty more recently, *Amicus* looked at the cases that have cited sections 6662(e) and 6662(h) (that is, the cases involving post-1989 tax years).[18] One hundred nineteen reported decisions cite section 6662(h), and another ten cite section 6662(e) without citing section 6662(h). This does not amount to 129

[18] *See* Appendix A of David J. Shakow, *Valuation Misstatement Penalties Require Valuation Misstatements*, 139 TAX NOTES 1283 (6/10/2013), *supra* note 1. RIA Checkpoint identified 73 cases that refer to 6662(e) and 119 that refer to 6662(h). *Amicus* attempted to track down other cases where the reference was in a different form, such as "subsection (h) of section 6662," but surely did not find them all.

separate litigations, since the total includes a number of litigations that are reflected in more than one decided case.

An examination of the cases that cite section 6662(h) or section 6662(e) shows the following:

> Twenty-four cases involved the valuation of easements (such as conservation easements) and other assets contributed to tax-exempt entities;
>
> Two related to other valuation issues
>
> One applied the step transaction doctrine to disallow a step-up in the basis of stock[19]
>
> Twenty-five were "Son-of-BOSS" transactions[20]
>
> Seven were foreign currency shelters[21]
>
> Seven were cattle shelters promoted by Mr. Hoyt[22]

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[19] *G.D. Parker, Inc. v. Commissioner*, 104 T.C.M. (CCH) 627 (2012). This was not a marketed tax shelter.

[20] *E.g.*, *106 Ltd. v. Commissioner*, 684 F.3d 84 (D.C. Cir. 2012) (court concludes that basis of stock was inflated by disregarding a contingent liability).

[21] *E.g.*, *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009) (taxpayer reduces amount of liability related to investment in currency-trading partnership by having very high interest rate on loan).

[22] These were cattle breeding shelters. *E.g.*, *Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009) (cattle overvalued).

Four were CARDS shelters[23]

Twenty-one were other promoted shelter transactions.[24]

If we put aside the cases that directly raised an issue of valuation (26 charitable contribution and other valuation cases) and look only at the basis cases, we find that significantly less than half of them involve a basis inflated because of an overvaluation.[25]

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[23] *E.g.*, *Gustashaw v. Commissioner*, 110 A.F.T.R.2d 2012-6169 (11th Cir. 2012) (taxpayer uses full amount of loan as basis, although taxpayer is only responsible for repayment of principal).

[24] The total of cases identified in the text is smaller than the number of cases that cite 6662(e) or (h). *Amicus* could not determine the nature of the issue raising the section 6662(e) or (h) concern where the issue was not spelled out clearly in the case (often when the issue the court considers is procedural), *e.g.*, *Funk v. Commissioner*, 82 T.C.M. (CCH) 847 (2001). *Amicus* also omitted cases where the IRS conceded there was no penalty under section 6662(e) or (h) after first asserting it, *e.g.*, *Kraus v. Commissioner*, 85 T.C.M. 874 (2003); *Chin v. Commissioner*, 85 T.C.M. (CCH) 874 (2003); *Bradley v. MDC Credit Corp.*, 107 AFTR 2d 2011-1420 (D. S.D. 2011) (indemnity for tax liability; IRS apparently did not collect any penalties when case was resolved by stipulation). *Amicus* omitted them because the Commissioner's unwillingness to pursue the penalty issue might have reflected the Commissioner's conclusion that it was wrong to assert the penalty in the first place. *Amicus* also omitted section 482 cases, *e.g.*, *DHL Corp. v. Commissioner*, 76 T.C.M. 1122 (1998), *aff'd and rev'd*, 285 F.3d 1210 (9th Cir. 2012), because they are subject to a separate provision in section 6662(h). A number of cases cite section 6662(e) or section 6662(h) for purposes of analysis where the section was not an issue in the litigation before the court.

[25] Twenty-five Son-of-BOSS cases, eight foreign currency cases, and four CARDS cases do not involve overvaluations. On

(Continued on following page)

Instead, the inflated basis stems from a legal argument (for example, the proper treatment of contingent liabilities). "Value" plays no role in those cases.

In addition, the reported cases involve transactions that were promoted by major accounting firms or by other promoters. In only one case that does not involve an actual overvaluation did a taxpayer create inflated basis without the encouragement of promoters.[26] Under its current practice, the Commissioner apparently asserts penalties for inflated basis where there is no overvaluation only in structured transactions.

Given the overwhelming number of tax-shelter cases that were subject to section 6659 penalties, it seems plausible that, in the eyes of the Commissioner, the valuation misstatement penalty came to be viewed as another tax shelter penalty. But it isn't. There are penalty sections of the Code that are specifically intended to deal with tax shelter transactions, such as section 6662(d)(2)(C) (penalties not mitigated in certain circumstances when transaction is a tax shelter), section 6662(b)(6) (penalty in respect of underpayment attributable to disallowance of a tax benefit by reason of a transaction lacking economic

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the other hand, the seven Hoyt shelters do involve overvaluations. Less than half of the twenty-one other structured transactions *amicus* found involve actual overvaluations. The cases that don't involve overvaluations were all decided after 2004.

[26] The exception is *G.D. Parker, Inc.*, *supra* note 19.

substance), and section 6662A (imposition of accuracy-related penalty on understatements with respect to reportable transactions). The valuation misstatement penalties were not introduced into the Code to deal with tax shelters that do not involve overvaluation. They were part of an effort to control the Tax Court's case load.[27] From the reported cases from the 1980s, it appears that the IRS understood this limitation in the application of the valuation misstatement penalty. However, now it is using the valuation misstatement penalty as a surrogate for a "tax shelter" penalty that Congress has not authorized. The Court should reject the IRS's approach.

[27] This is evident from the legislative history quoted above in Part III. *See also Drobny v. Commissioner*, 69 T.C.M. (CCH) 2600 (1995), which quotes from H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 985-986 (June 23, 1984), 1984-3 C.B. (Vol. 2) 239-240, as follows (emphasis added):

> The conferees note that a number of the provisions of recent legislation have been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assessable for instituting or maintaining Tax Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), *the valuation overstatement* and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256).

CONCLUSION

A cursory reading of section 6662(e) and section 6662(h) might suggest that these "valuation misstatement" penalties apply to a wide range of transactions that have nothing to do with valuations. However, when standard rules of statutory interpretation are applied to these provisions, their scope is substantially narrowed. This narrower application is consistent with the legislative history of these penalty provisions and their actual application, with one notable exception: the IRS has recently applied these provisions to tax shelters that involve no issues of valuation. Indeed, the substantial majority of recent cases where the IRS has asserted the 40% penalty of section 6662(h) involve tax shelters with inflated basis and no overvaluation. The IRS does not have the authority to assert a valuation misstatement penalty in those cases.

If this understanding of the misstatement penalties is recognized, the penalty should not be applied in many of the cases in which it has been recently asserted. These cases are tax shelters without economic substance. These shelters inflate basis without reference to any valuation misstatement. Taxpayers have argued that, if their shelter deductions are disallowed because the transaction has no economic substance, they cannot be penalized under section 6662(h) because reducing the inflated basis was not necessary in order to disallow their deductions. If section 6662(h) is properly understood, the penalty does not apply in these situations in any event, and the

issue that was presented to the Supreme Court in this case disappears.

Respectfully submitted,

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