Holding a Bad Hand: The Third Circuit Addresses Economic Substance, Part II.

In part I, I covered the Third Circuit's discussion of economic substance in *Neal Crispin v. Commissioner*, No. 12-2275 (3d Cir. Feb. 25, 2013). This post will address the Court's treatment of penalties.

Mr. Crispin was assessed with a forty percent gross valuation penalty because he had claimed a basis that was inflated by 400 percent or more; this penalty was sustained by the Tax Court. There is a Circuit split on the applicability of valuation misstatement penalties in economic substance cases, but the Third Circuit previously concluded that the penalty was applicable in *Merino v. Commissioner*, 196 F.3d 147 (3d Cir. 1999).

In *Crispin*, the Court commenced its analysis of the penalty by noting that its position on the availability of valuation penalties in economic substance cases had recently been bolstered by the Eleventh Circuit's opinion in *Gustashaw v. Commissioner*, 696 F.3d 1124 (11th Cir. 2012). *Crispin v. Comm'r*, No. 12-2275, slip op. at 19-21, n.18 (3d Cir. Feb. 25, 2013). The Court then considered how to properly calculate the extent to which Mr. Crispin's basis was inflated, noting that the Tax Court had alluded to two different approaches: treating the basis as zero because the transaction lacked economic substance, or dividing 9.4 million dollars (the basis claimed on the return) by 1.8 million dollars (the cost of the currency he actually acquired). The Court concluded that it did not have to decide which method was correct, since treating the basis as zero was deemed to yield a 400 percent overstatement under Section 1.6662-5(g) of the Treasury Regulations, and the alternative method also exceeded the 400 percent level. *Crispin v. Comm'r*, No. 12-2275, slip op. at 21-23.

Next, the Court of Appeals focused upon the tax opinion that Crispin had submitted in support of the return, which was relevant to the reasonable cause defense on the penalty under Section 6664(c). As an aside, it is worth noting that in economic substance cases governed by the codified standard, the reasonable cause defense is not available. *See* I.R.C. § 6664(c)(2) (providing that the reasonable cause exception will not apply in cases described in Section 6662(b)(6) of the Code); *see also* I.R.C. § 6662(b)(6) (providing for penalties in cases where the transaction fails to satisfy Section 7701(o) of the Code, which is the codified economic substance test).

Under the relevant Treasury Regulations, the issue whether a tax payer acted in good faith based on reasonable cause is determined on the basis of the "facts and circumstances." Treas. Reg. § 1.664-4(b)(1). Applying this test, the Court concluded that Crispin's reliance on the tax opinion was not reasonable. The opinion itself included references to an IRS notice indicating that losses on CARDS transactions could not be deducted from ordinary income. *Crispin v. Comm'r,* No. 12-2275, slip op. at 24. And it didn't help that Mr. Crispin was a former CPA and chief financial officer; the Court concluded that this background suggested sufficient familiarity with tax matters to understand the significance of the warnings contained in the opinion. *Id.* at 24-25.

The Court also noted that Crispin's reliance on the tax opinion was objectively unreasonable because he had made misrepresentations to the law firm that issued it. *Id.* at 25. In the Court's view of the record, Crispin misrepresented his business purpose in entering into the transaction. *Id.* at 25-26. Crispin was also faulted for stating that he had not received promotional materials touting the tax benefits associated with the transaction, when in fact, he had. *Id.* at 26.

I will wrap up my discussion of *Crispin* in another post.

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