

The Last Word on Valuation Misstatement Penalties in Sham Transaction Cases.

An issue that has divided lower courts was resolved on Tuesday, when the Supreme Court addressed the applicability of the substantial valuation misstatement penalties in the context of sham transactions. *United States v. Woods*, 2013 U.S. LEXIS 8776 (Dec. 3, 2013).

As I have noted previously, courts have been divided on the applicability of the valuation misstatement penalty under Section 6662 of the Internal Revenue Code to cases involving a sham transaction. The majority has taken the view that the penalty applies. *See, e.g., Crispin v. Comm'r*, 708 F.3d 507, 516 n.18 (3d Cir. 2013). Some circuits, however, have taken the view that a sham transaction case does not trigger the penalty because the overstatement is due to an improper deduction and not a valuation misstatement. *See, e.g., Keller v. Comm'r*, 556 F.3d 1056, 1059-11 (9th Cir. 2009).

The Supreme Court agreed with the approach of the majority of courts to consider the issue, holding that the penalty is applicable. *First*, the Court rejected the idea that the statutory term “value” was limited to factual issues relating to valuation and not legal concepts. *Second*, the Court noted that the Section 6662 specifically provided for a penalty where either value or adjusted basis are overstated. *United States v. Woods*, 2013 U.S. LEXIS 8776, slip op. at *22-*25.

Next, the Court rejected the argument that the underpayment of tax was not “attributable” to the overstatement of the taxpayer’s basis in the partnership, but to the determination that the partnerships were shams: “In short, the partners underpaid their taxes because they overstated their outside basis, and they overstated their outside basis because the partnerships were shams.” *Id.* slip op. at *29.

The opinion is also noteworthy because it confirms that district courts have jurisdiction under Section 6226(f) of the Code to assess the penalty in the context of a partnership level proceeding. *United States v. Woods*, 2013 U.S. LEXIS 8776, slip op. at *15-*19.

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