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IRS will not let investors off the hook in overvaluing assets

Concessions in tax shelter cases will no longer apply in Tax Court.
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by Steven L. Walker, J.D.

Individuals should exercise prudence in evaluating transactions designed to generate paper losses on federal income tax returns—so-called tax shelters. And in particular, taxpayers should focus on the value of the underlying asset reported on the return and ask whether that valuation makes sense. In an unusual move, the U.S. Tax Court recently overturned its precedent to side with the IRS and hold that an investor is not off the hook for steep penalties if valuation is wrong.

Valuation plays a key role in tax shelter cases, as valuation is one of the major devices used in abusive tax shelters (*McCrary*, 92 T.C. 827, 863 (1989), (Gerber, J., dissenting)). Courts look at the fair market value of an asset claimed on a tax return to determine whether a business transaction has economic substance and will be respected for tax purposes. As explained by the Ninth Circuit, "[a] fundamental issue in tax shelter cases is whether the property has been 'acquired' at an artificially high price, having little relation to its fair market value" (*Estate of Franklin*, 544 F.2d 1045, 1046 n. 1 (9th Cir. 1976), aff'g 64 T.C 752 (1975)).

There are large penalties for incorrectly reporting an asset's value (or its adjusted basis) on a tax return. The IRS can impose a 20% penalty for an underpayment of tax that results from a "substantial valuation misstatement" (Sec. 6662(b)(3)). A substantial valuation misstatement exists if, for example, the value of any property (or its adjusted basis) claimed on a tax return is 150% or more of the amount determined to be the correct amount (Sec. 6662(e)).

The penalty jumps to 40% if the taxpayer claims a value in property (or adjusted basis) on a tax return that is 200% or more of the correct amount. This is known as a "gross valuation misstatement" (Sec. 6662(h)). The IRS may not impose a penalty if a taxpayer acted in good faith, and there was reasonable cause for the underpayment (Sec. 6664 (c)).

The First Circuit explained the purpose of the gross valuation misstatement penalty well in the following example:

> Basis, in a typical business purchase and sale transaction, equates to the cost (reduced by any depreciation). Thus, a taxpayer might claim that the cost of a widget was $10—when its actual cost was $1—and report its sale for $1. Overstating the cost of the widget allowed the taxpayer to claim a loss of $9, then used to reduce taxes on other income. So falsely asserting, or increasing, a basis translates into reducing gain or enlarging loss by the amount falsely asserted or increased. [*Fidelity Int'l Currency Advisor A Fund, LLC*, 661 F.3d 667, 670 (1st Cir. 2011)]

Recently, the IRS, federal courts, and even Congress have become more aggressive about penalties in tax shelter cases. In 2010, Congress amended the Code to impose a new strict liability penalty for transactions lacking in economic substance that applies to transactions entered into after March 30, 2010 (Sec. 6662(b)(6)). There is no reasonable cause exception for this new penalty (Sec. 6664(c)(2)).

Significantly, a recent opinion by the Tax Court, in adopting the majority view of the U.S. courts of appeals, has made it more difficult for taxpayers to avoid the gross valuation misstatement penalty short of trial. The opinion represents a victory for the IRS in a battle stemming back over 25 years. (See *AHG Investments, LLC*, 140 T.C. No. 7 (2013).)

This decision follows other recent government victories in the federal courts of appeals in tax shelter cases. In *Alpha I, L.P.*, 682 F.3d 1009 (Fed. Cir. 2012), the Federal Circuit reversed a Court of Federal Claims ruling that the gross valuation misstatement penalty did not apply when a taxpayer conceded the adjustments on grounds other than basis or valuation. In *Gustashaw*, 696 F.3d 1124 (11th Cir. 2012), the Eleventh Circuit affirmed a Tax Court decision that held the taxpayers liable for the gross valuation misstatement penalty.

The Tax Court's opinion in *AHG Investments* may make transactions that the IRS determines to be abusive tax shelters an even riskier investment for investors, given the increased chance of being held liable for a 40% gross valuation penalty. The IRS often disallows a transaction on several alternative bases, not all of which involve a misstatement in the value of property (or adjusted basis). For example, the IRS may disallow the taxpayer's losses claimed on a tax return because the transaction lacks economic substance. A taxpayer may no longer simply agree that the transaction lacks economic substance, and thus avoid the gross valuation penalty—a litigation maneuver that had found support in Tax Court jurisprudence, before being overturned by *AHG Investments*. Taxpayers now must prove that they are not liable for the 40% penalty.

Defending a taxpayer against a gross-valuation misstatement penalty in court can be tricky business, and the taxpayer bears the burden of proof that he or she acted with reasonable cause and in good faith. The Tax Court's opinion in *AHG Investments* may lead to more trials on complex and difficult valuation issues, as the value of the underlying assets used in the transaction is often the fundamental issue in abusive tax shelter cases. Taxpayers may need to retain an expert witness to opine on valuation to mount a viable defense to the 40% gross valuation penalty. The original appraisal report relied upon by the taxpayer to determine fair market value on the tax return—a report that is often many years old—may not be sufficient to withstand scrutiny in federal court.

Actually valuing the asset at trial may prove challenging, if the data or other information that an expert witness needs to rely on to form an opinion under Fed. Rul. Civ. Proc. 26(a)(2)(B) is no longer available or is difficult to locate. This can be the case when the tax years at issue before the court are quite old, which is not uncommon in tax shelter litigation. In *AHG Investments*, for example, the tax years at issue were more than 10 years old, dating to 2001 and 2002.

Factual background of *AHG Investments*

In *AHG Investments*, the Tax Court held that a taxpayer may not avoid the 40% gross valuation penalty under Sec. 6662(h) merely by conceding adjustments in the notice of final partnership administrative adjustment (FPAA) on alternate grounds. In reaching its holding, the Tax Court departed from its precedent and followed the majority rule in the U.S. courts of appeals.

The IRS had issued an FPAA to the petitioner, a partner of AHG Investments. The major adjustment in the FPAA was to disallow approximately $10 million in losses allocated to petitioner for tax years 2001 and 2002.

The IRS's FPAA enumerated 14 alternative grounds in support of the adjustments and asserted 40% accuracy-related penalties under Sec. 6662(a) for the portions of the underpayments of tax resulting from adjustments of partnership items attributable to a gross valuation misstatement.

In the Tax Court petition, Alan Ginsburg, a partner in AHG Investments, conceded the FPAA adjustments were correct on the ground that the petitioner was not at risk under Sec. 465 and thus was not entitled to deduct certain attributed losses. Ginsburg also conceded that the FPAA adjustments were correct on the ground that the transaction at issue did not have substantial economic effect under Regs. Sec. 1.704-1(b).

Ginsburg then filed a motion for partial summary judgment regarding the 40% gross valuation misstatement penalty, arguing that the penalty did not apply as a matter of law because he conceded the correctness of adjustments proposed in the FPAA on grounds unrelated to valuation or basis. The statute requires that any underpayment of tax on which a valuation misstatement penalty is based be "attributable to" the valuation misstatement. Sec. 6662(b)(3). Ginsburg conceded the IRS adjustments in the FPAA solely on the grounds of Sec. 465 and Regs. Sec. 1.704-1(b) and not on any grounds relating to valuation.

Tax Court departs from long-standing precedent

The Tax Court denied Ginsburg's motion for partial summary judgment and held that a taxpayer may not avoid the application of the gross valuation misstatement penalty merely by conceding on grounds unrelated to valuation or basis.

In reaching its holding, the Tax Court departed from its precedent stemming over 25 years to 1987, which had allowed a taxpayer to avoid the gross valuation penalty by conceding the case on alternate grounds (*McCrary*, 92 T.C. 827 (1989); and *Todd*, 89 T.C. 912 (1987), aff'd, 862 F.2d 540 (5th Cir. 1988)).

The Tax Court did not overrule its precedent easily. Although *stare decisis* generally requires a court to follow the holding of a previously decided case, the Tax Court found that the IRS had sustained its heavy burden of persuading the court to overrule its precedent in *McCrary* and *Todd*. A majority of U.S. courts of appeals had expressed disagreement with the logic of the Fifth Circuit in *Todd*, which the Tax Court had adopted and followed in *McCrary*. That logic, according to the appellate courts, was based upon a misreading of the legislative history behind the statute, Sec. 6662.

The Tax Court also considered other factors in overturning its long-standing precedent. The court had supported its decision in *McCrary* in part by noting that it would encourage taxpayers to settle cases involving valuation misstatement penalties and thus avoid trials on difficult valuation issues. Yet concerns about judicial economy are not a sufficient basis to incorrectly apply the legislative history. The Tax Court also noted that over the years, a number of taxpayers have purposely used the holdings in *Todd* and *McCrary* to avoid gross valuation misstatement penalties and that these actions have frustrated the purpose of the penalty, which is to penalize and discourage gross value misstatements.

The Tax Court lastly turned to the question of appellate jurisdiction. A Tax Court decision generally is appealable to the court of appeals for the circuit in which the principal place of business of the partnership is located, unless the parties stipulate appeal will be to another specific court. Since the parties had not established where AHG Investments's principal place of business was at the time the petition was filed (or indeed whether AHG had a principal place of business at that time) and there was no stipulation, an appeal of the case would lie to the D.C. Circuit, which had not ruled on the gross valuation misstatement penalty. Thus, the Tax Court was free to overrule its precedent.

Conclusion

Having determined that it was not bound by its own precedent and that the D.C. Circuit has not ruled on the issue, the Tax Court held that Ginsburg's pretrial concessions under Sec. 465 and Regs. Sec. 1.704-1(b) did not prevent the application of the gross valuation misstatement penalty to the underpayment of tax as a matter of law. Thus, the Tax Court denied Ginsburg's motion for partial summary judgment.

In summary, investors in tax shelters are no longer allowed to make concessions prior to trial in the hope of sidestepping the 40% gross valuation misstatement penalty. This adds another significant potential cost that investors should consider when entering into business transactions that purport to offer tax benefits based on questionable property valuations.

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