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January 7, 2014

Supreme Court Rules on Partnership Tax Shelter Penalties

In *United States v. Woods*,[1] the U.S. Supreme Court ruled unanimously for the government on two long-brewing disagreements over penalty jurisdiction in the partnership context and over the breadth of valuation misstatement penalties. In an opinion by Justice Antonin Scalia, the Court resolved the thorny question of when courts can make penalty determinations in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership context: in partnership-level proceedings, courts may "determine the applicability of any penalty that could result from an adjustment to a partnership item." Turning to the merits, the Court also held that a valuation misstatement penalty applies to a tax "underpayment resulting from a basis-inflating transaction subsequently disregarded for lack of economic substance." These holdings will make it easier for the IRS to assert penalties under TEFRA and more onerous for partners to contest them. In ruling on the valuation penalty, the Supreme Court also stated that Blue Books are not legitimate tools of statutory interpretation and are instead relevant only to the extent that they are persuasive.

Background

Woods engaged in options transactions with partnerships and then claimed large losses due to high outside basis in the partnerships. The IRS disregarded the partnerships after concluding that they lacked economic substance. Accordingly, the IRS contended that the partners had zero basis in the partnerships and that any resulting tax understatement would be subject to the 40 percent gross valuation misstatement penalty.[2] The penalty applies to "the portion of any understatement which is attributable to" situations where the claimed "value of any property (or the adjusted basis of any property)" exceeds by 400 percent or more "the correct amount of such valuation or adjusted basis."

The district court held that the transactions lacked economic substance but refused to apply the 40 percent penalty. The Fifth Circuit affirmed. In granting *certiorari* on the penalty issue, the court ordered the parties to address the threshold issue of whether the TEFRA granted jurisdiction in a partnership-level proceeding to consider the penalty question, or if instead the penalty had to be addressed in a subsequent partner-level proceeding.

Jurisdiction Over Penalties In Partnership-Level Proceedings

TEFRA grants jurisdiction to courts in partnership-level proceedings to determine "the applicability of any penalty … which relates to an adjustment to a partnership item."[3] After the partnership level proceeding, the IRS may make computational adjustments to the tax liability of individual partners, which partners also can judicially contest.

1 134 S.Ct. 557 (2013). The December 3, 2013, opinion is available at http://www.supremecourt.gov/opinions/13pdf/12-562_k5fl.pdf.

2 Code Section 6662(b)(3).

3 Code Section 6226(f).

Woods argued for a narrow statutory reading that jurisdiction over penalties in the partnership-level proceeding could not exist if any partner-level determinations were necessary to impose the penalty. The Court considered the structure of TEFRA, and the fact that all penalties require some partner-level determinations and concluded that Woods' position "would render TEFRA's authorization to consider some penalties at the partnership level meaningless." The Court held that "TEFRA gives courts in partnership-level proceedings 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 the partnership-level determination was "provisional," and that partners separately could contest the penalty in later proceedings.

The practical problem with the Court's determination is that, following partnership-level proceedings, the IRS can assess and collect many penalties directly from TEFRA partners without issuance of a deficiency notice. The partners' only recourse is to pay and challenge the penalty in a refund case. Partners confronted with an immediate obligation to pay the penalty may find cold comfort from the Court's promise that the penalty determination is merely "provisional."

Valuation Overstatement In Economic Substance Context

With respect to the merits, the Court held that the plain language of the penalty applied to the transactions. Any underpayment resulting from the inflated basis claimed in sham partnerships was "'attributable to' the partner's having claimed an 'adjusted basis' in the partnerships that exceeded 'the correct amount of such … adjusted basis.'"

The Court rejected Woods' two primary arguments. First, Woods argued that the term "valuation misstatement" applied only to factual errors (such as incorrectly stating an asset's worth or cost) rather than legal ones (such as the use of sham partnerships). The Court held that "the valuation-misstatement penalty encompasses legal as well as factual misstatements of adjusted basis." Second, Woods argued that any underpayment of tax was "attributable to" the economic substance determination, not to the misstatement of basis. The Court gave this argument the back of the hand: "[T]he partners underpaid their taxes because they overstated their outside basis, and they overstated their outside basis because the partnerships were shams."

The Blue Book As A Tool of Statutory Interpretation

Finally, the Court addressed Woods' reliance on the Blue Book for his interpretation of the penalty statute. Blue Books "are prepared by the staff of the Joint Committee on Taxation as commentaries on recently passed tax laws." The Court stated that Blue Books, like other forms of "post-enactment legislative history," are "not a legitimate tool of statutory interpretation" and are relevant, "like a law review article" only to the extent they are persuasive. The Court relied on its recent treatment of post-enactment legislative history in non-tax cases and deemed outdated its own reliance on "similar documents in the past" to interpret the Internal Revenue Code.

In so doing, the Court again determined that interpretation of the Internal Revenue Code is governed by the same standards as interpretation of other federal statutes. Previously, in *Mayo Foundation v. United States*, 131 S. Ct. 704 (2011), the Supreme Court unanimously held that its general doctrine of deference to agency resolution of statutory ambiguity (known as *Chevron* deference) applies in determining the validity of Treasury Regulations. *Mayo Foundation* overruled cases that evaluated some Treasury Regulations under a less deferential standard.

Given *Mayo Foundation*'s deference to the Treasury's resolution of ambiguity in the Internal Revenue Code, one might have expected *Woods* to mention Treasury Regulation Section 1.6662-4(d)(3)(iii), which lists Blue Books as a form of authority that can establish a substantial authority defense to penalties. *Woods* thus poses an interesting dilemma for taxpayers who find helpful language in a Blue Book: The language may provide the substantial authority needed for a return position (or an adviser's opinion) only to be deemed irrelevant if the position is later challenged. Blue Books thus may now have a status similar to that of private letter rulings, which also can establish a substantial authority defense but are deemed non-precedential by Code Section 6110(k)(3). It will be worth observing how courts treat Blue Books in the penalty context given *Woods*' language about their legitimacy as a tool of statutory interpretation.

Woods and *Mayo Foundation* established that, with respect to statutory interpretation, tax law will be treated the same as other areas of administrative law. Although both cases were decided unanimously against the taxpayers, the alignment of tax law with other areas of administrative law presents both risks and opportunities for taxpayers in challenging agency pronouncements and actions. Additional guidance in this area may come soon: On January 14, 2014, the U.S. Supreme Court will hear argument in *United States v. Quality Stores, Inc.*, No. 12-1408, in which the court may address the level of deference to be given to revenue rulings.