Department of the Treasury | Internal Revenue Service | Office of Chief Counsel

Notice

CC-2012-001

October 5, 2011

Subject: Procedures for Responding to Taxpayer Concessions Intended to Avoid the Application of Valuation Misstatement Penalties

Cancel Date: Effective until further notice

Purpose

This notice provides direction for handling docketed Tax Court cases in which a taxpayer attempts to avoid the application of valuation misstatement penalties by conceding the merits of the underlying tax dispute on a ground that is unrelated to the valuation or basis of the relevant property.

Background

In many cases, the Service determines multiple grounds for the disallowance of items of deduction or credit. For example, in a typical Son of BOSS case, the Service disallows losses based on, among other grounds, (1) sham, (2) lack of economic substance, (3) lack of profit motive for purposes of section 165(c)(2), and (4) the "at risk" provisions of section 465. Typically, the Service also determines that accuracy-related penalties under section 6662(a) apply to the resulting underpayments.

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment of tax that is attributable to, among other things, negligence or disregard of rules or regulations, as well as to any substantial valuation misstatement under Chapter 1 of the Code.[1] A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 150 percent (formerly 200 percent) or more of the amount determined to be the correct amount of the value or adjusted basis.[2] If, however, the value or adjusted basis of any property claimed on a return is 200 percent (formerly 400 percent) or more of the amount determined to be the correct amount of the value or adjusted basis, then the valuation misstatement constitutes a "gross valuation misstatement," and the 20-percent accuracy-related penalty is increased to 40 percent.[3]

[1] Sections 6662(a), (b)(1), and (b)(3).
[2] Section 6662(e)(1)(A).
[3] Sections 6662(h)(1) and (h)(2)(A)(i).

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In Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988), the Fifth Circuit held that an overvaluation penalty under former section 6659 (which contained an overvaluation penalty that was similar to the overvaluation penalty under section 6662(b)(3)) was not applicable because the understatement at issue was not attributable to a valuation overstatement within the meaning of that section. In essence, the Fifth Circuit concluded that when a court disallows a taxpayer's claimed deductions or credits on a ground that does not require the court to determine the value or adjusted basis of the relevant property, the underpayment is not attributable to a valuation overstatement and, thus, valuation misstatement penalties are inapplicable. The Ninth Circuit reached the same conclusion in Gainer v. Commissioner, 893 F.2d 225 (9th Cir. 1990).

In Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990), the Fifth Circuit interpreted its holding in Todd broadly, stating that whenever the Service totally disallows a deduction or credit, the resulting underpayment is not due to a valuation overstatement but rather to an "improper deduction" and, thus, overvaluation penalties cannot apply. In response to Heasley, the Service issued an action on decision stating that the oversimplified approach of the Fifth Circuit does not properly reflect the language or purpose of the statute because it precludes the application of an overvaluation penalty even when the grounds for disallowance were based upon or integrally related to a valuation overstatement.[4] Likewise, the Ninth Circuit in Keller v. Commissioner construed its Gainer holding as being "when a deduction is disallowed in total, an associated penalty for overvaluing an asset is precluded."[5]

The broad holdings of Heasley and Keller conflict with the holdings of the circuit courts in the Second, Third, Fourth, Sixth, and Eighth Circuits regarding this issue.[6] Those circuit courts concluded that when overvaluation is intertwined with a tax avoidance scheme that lacks economic substance, an overvaluation penalty can apply.

In cases in which the Service has determined multiple grounds for the disallowance of items of deduction or credit, the Service has consistently maintained the position that when the grounds for disallowing the deduction or credit are an integral part of, or inseparable from, the overvaluation, the resulting underpayment is attributable to overvaluation and, thus, valuation misstatement penalties should be imposed.[7] In LGM TL-68 (rev.), Counsel advised its litigators that "it follows from the holdings of Irom, Todd, and Gainer that where a taxpayer establishes that a deduction or credit is not allowable for reasons unrelated to valuation . . . , [valuation penalties] should not be imposed with respect to underpayments related thereto, if the taxpayer concedes the underlying deduction or credit prior to trial on a ground unrelated to overvaluation." At that time, Counsel effectively adopted a bright line rule that valuation misstatement penalties should not be pursued if the taxpayer, prior to trial, concedes the merits of the underlying tax dispute on a ground unrelated to valuation.

Permitting taxpayers to escape the application of valuation misstatement penalties by conceding, prior to trial, the merits of the underlying tax dispute on a ground that is unrelated to the valuation

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[4] AOD-1991-13, 1990 WL 692281 (July 3, 1991).
[5] Keller v. Commissioner, 556 F.3d 1056 (9th Cir. 2009).
[6] See Merino v. Commissioner, 196 F.3d 147, 155 (3d Cir. 1999); Zfass v. Commissioner, 118 F.3d 184, 190-91 (4th Cir. 1997); Illes v. Commissioner, 982 F.2d 163, 166-67 (6th Cir. 1992); Gilman v. Commissioner, 933 F.2d 143, 149-52; (2d Cir. 1991); Massengill v. Commissioner, 876 F.2d 616, 619-20 (8th Cir. 1989).
[7] See 1992-LGM TL-68 (rev.), 1992 WL 1355877 (Aug. 12, 1992); see also Irom v. Commissioner, 866 F.2d 545 (2d Cir. 1989).

or basis of the relevant property may, however, invite the use of abusive litigation tactics. As one court described the situation:

> To [follow the Heasley and Keller line of cases] is to invite the sort of gamesmanship that may be lurking in the shadows here – to hold forth the prospect that a taxpayer might engage in an abusive transaction that hinges upon the overstatement of an asset's basis; claim on its tax return the tax advantages associated with that transaction; enjoy the financial benefits of the claimed tax treatment while waiting to see if the transaction is discovered by the IRS; aggressively defend the transaction on audit and even in filing suit; only, in the last instance – perhaps in the face of a motion or on the eve of trial – to concede the resulting deficiency on economic substance grounds and thereby avoid the imposition of the penalty. How convenient.

Clearmeadow Investments LLC v. United States, 87 Fed. Cl. 509, 535 (2009).

In several recent cases, taxpayers have attempted to avail themselves of the Heasley and Keller line of case precedents, with the aim of avoiding the imposition of valuation misstatement penalties, by conceding the merits of the underlying tax dispute on a ground that is unrelated to the valuation or basis of the relevant property. Although the concessions in these cases were made before trial, they did not prevent protracted audit and litigation proceedings. The government has successfully resisted, in a number of these cases, taxpayers' abusive use of these tactics.[8] In at least two tax refund suits, however, taxpayers avoided the imposition of valuation misstatement penalties through their use of these tactics.[9] The advice contained in LGM TL-68 (rev.) is clarified in the following procedures for handling docketed Tax Court cases in which a taxpayer attempts to avoid the application of valuation misstatement penalties by conceding, prior to trial, the merits of the underlying tax dispute on a ground that is unrelated to the valuation or basis of the relevant property.

Procedure

In any docketed Tax Court case, a taxpayer can only concede a matter over which the court has jurisdiction. Nonetheless, taxpayers may attempt to concede the merits of the underlying tax dispute prior to trial on a ground that may be unrelated to the valuation or basis of the relevant property, but over which the court does not have jurisdiction. For example, petitioners in partnership-level proceedings have attempted to concede the merits of Son of BOSS cases by arguing that an individual partner lacked a profit motive for purposes of section 165(c)(2) or was not at-risk for purposes of section 465. These partner-level determinations, however, can only be considered in affected items deficiency proceedings.[10] Accordingly, a determination should be made as to whether the court has jurisdiction over the taxpayer's proposed concession. If the

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[8] See, e.g., Clearmeadow, 87 Fed. Cl. at 509.
[9] See Alpha I L.P. v. United States, 84 Fed. Cl. 622 (2008), appeals docketed, Nos. 2011-5024 (Fed. Cir. Nov. 15, 2010) and 2011-5030 (Fed. Cir. Dec. 2, 2010); NPR Investments LLC v. United States, 105 A.F.T.R.2d 2010-1082 (E.D. Tex. 2010), appeal docketed, No. 10-41219 (5th Cir. Nov. 23, 2010).
[10] See, e.g., Hambrose Leasing 1984-5 L.P. v. Commissioner, 99 T.C. 298 (1992) (partner's amount at risk is an affected item); cf. Treas. Reg. §301.6231(a)(3)-1(b) (the term partnership item includes whether partnership activities have been engaged in with the intent to make a profit for purposes of section 183).

court lacks jurisdiction over the ground upon which the taxpayer proposes to concede the adjustments at issue, then the concession should be opposed.

If the court has jurisdiction over the ground upon which the taxpayer proposes to concede the adjustments at issue, then a determination should be made as to whether to accept the concession with respect to the application of valuation misstatement penalties. Although LGM TL-68 (rev.) adopted the litigation position that valuation misstatement penalties should not be pursued if the taxpayer makes the concession prior to trial, LGM TL-68 (rev.) did not elaborate with respect to what was meant by the phrase “prior to trial.” Many cases involve extensive discovery or trial preparation that consumes significant resources, regardless of whether they actually go to trial. Accordingly, LGM TL-68 (rev.) should not be interpreted as simply requiring that the concession be accepted. Instead, the effect of a taxpayer’s pre-trial concession on the application of valuation misstatement penalties should be determined on a case-by-case basis, taking into account the underlying facts, the legal authority governing the applicability of valuation misstatement penalties, and an evaluation of the concession in relation to the overall development of the case from audit to trial. Proposed concessions should be opposed in cases involving abusive tax shelter transactions if the application of valuation misstatement penalties is at issue.

Any questions regarding the applicability of valuation misstatement penalties should be directed to Procedure and Administration, Branch 1 at (202) 622-4910 or Branch 2 at (202) 622-4940. Any questions regarding the evaluation of the concession, particularly with respect to jurisdiction in TEFRA partnership proceedings, should be directed to Procedure and Administration, Branch 6 at (202) 622-7950 or Branch 7 at (202) 622-4570.

/s/

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