

ACTION ON DECISION

IRB No. 2011-44
October 31, 2011

Subject: Keller v. Commissioner,
556 F.3d 1056 (9th Cir. 2009), rev'g T.C. Memo 2006-131

Issue: Whether the gross valuation misstatement penalty under I.R.C. § 6662(h) applies when a deduction or credit is disallowed in full, regardless of the reason for the disallowance.

Discussion: The taxpayer was one of dozens of individuals who obtained illegitimate tax benefits by investing in a tax shelter organized, promoted, and operated by Walter J. Hoyt III. In 1995, the taxpayer purported to purchase cattle and cow embryos from Hoyt. The taxpayer subsequently reported large losses and claimed deductions from the shelter investment on his 1994 and 1995 returns (even though, as noted, he did not invest in the shelter until 1995), carried back losses to 1991 through 1993, and received refunds for 1991 through 1994. The Service issued the taxpayer a notice of deficiency for the 1994 and 1995 tax years, determining deficiencies based on, among other grounds, the taxpayer's reporting of an overvalued basis in the shelter assets. The Service also imposed accuracy-related penalties under section 6662, including the 40% gross valuation misstatement penalty under section 6662(h), on the tax underpayments attributable to the disallowed shelter benefits. Prior to trial in the Tax Court, the parties stipulated that the taxpayer was not entitled to the shelter-related losses and deductions on the ground that they were unlawful. The Tax Court upheld the Service's imposition of the 40% gross valuation misstatement penalty.

On appeal to the Ninth Circuit, the taxpayer challenged the application of the 40% penalty, arguing that the tax underpayments at issue were attributable to wholly invalid deductions – based on the parties' stipulations – rather than to valuation misstatements and that Ninth Circuit precedent, Gainer v. Commissioner, 893 F.2d 225 (9th Cir. 1990), did not support the application of a valuation misstatement penalty. The Ninth Circuit agreed, reversing the Tax Court and broadly construing its holding in Gainer, holding that “when a deduction is disallowed in total, an associated penalty for overvaluing an asset is precluded.” The Ninth Circuit acknowledged, however, that its holding conflicted with that of every circuit court, other than the Fifth Circuit, to have addressed the issue. 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); but see Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990). Those circuit courts have held that an overvaluation penalty can apply when overvaluation is intertwined with a tax avoidance scheme that lacks economic substance. The government filed a petition for rehearing en banc, urging the Ninth Circuit to adopt what the panel itself described as the “sensible method of resolving overvaluation cases” used by those other circuit

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courts, but the government's petition was denied.

The Ninth Circuit's holding in Keller, like the Fifth Circuit's holding in Heasley, is broader than that of Gainer and arguably precludes the application of valuation misstatement penalties under section 6662 even when the grounds for disallowance are based on, or integrally related to, a valuation overstatement. As stated in the AOD on Heasley, this oversimplified approach does not properly reflect the language or purpose of the statute. IRS AOD-1991-13, 1990 WL 692281 (July 3, 1991).

The Service will continue to argue that the gross valuation misstatement penalty applies if an overvaluation is an integral part of a transaction, regardless of the grounds for disallowance of the related deduction or credit, in appropriate cases, including cases appealable to the Ninth Circuit.

Recommendation:

Nonacquiescence

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