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Federal Tax ADVISORY ■

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Supreme Court to Review Economic Substance Case

United States v. Gary Woods, 471 Fed. Appx. 320 (5th Cir. 2012), affirming per curiam, 794 F. Supp. 2d 714 (WD Tex. 2011), will be reviewed by the Supreme Court under its writ of certiorari issued at the request of the United States on March 25, 2013. The question presented for review is the following:

> Section 6662 of the Internal Revenue Code prescribes a penalty for an underpayment of federal income tax that is "attributable to" an overstatement of basis in property. 26 U.S.C. 6662(a), (b)(3), (e)(l)(A) and (h)(l). The question presented is as follows: Whether the overstatement penalty applies to an underpayment resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property.

In addition to the question presented by the petition, the Supreme Court directed the parties to brief and argue the following question: Whether the district court had jurisdiction in this case under 26 U. S. C. 6226 to consider the substantial valuation misstatement penalty.

Facts

The facts of the case were described in the earlier decision on the merits in favor of the IRS at 794 F. Supp. 2d 710 (WD Tex. 2010). The case involved taxpayers that included the former owner of the San Antonio Spurs professional basketball team and the Minnesota Vikings professional football team. A related partnership engaged in a loss-generating transaction called COBRA that was created by the law firm of Jenkins & Gilchrist and was being marketed in 1999 by the accounting firm of Ernst & Young.

While the details of the transaction are complex, its tax benefit was based on an IRS victory in *Helmer*, 34 T.C.M 727 (1975). It held that when a partnership received an option premium for an option it had written for the sale of land it owned, and the premium would be offset against the sale price if the option were exercised, the partnership did not incur a liability for repayment of the premium because its character was deferred and contingent on the exercise of the option.

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This anomalous result later was applied by taxpayers to claim that when they bought a large option for a large fee (and obtained a large basis in the option) and simultaneously sold a large option for a large matching fee (thus being out very little net money), they did not assume a liability; therefore, when they transferred the bought and sold options to a controlled entity like an S corporation, the transferor received a large basis in the stock, unreduced by any liability assumption. Then the high-basis, low-value property could be disposed of at a large tax—but not economic—loss. Several other court cases have ruled against taxpayers in similar transactions. *See* Cummings, "The New Normal: Economic Substance Doctrine First," 126 *Tax Notes* 521 (Jan. 25, 2010).

The Lower Court Decisions

The District Court for the Western District of Texas also decided for the government on the merits in 2010 in the *Woods* case. Its opinion was very brief and made fun of the taxpayer's arguments. It relied entirely on the Fifth Circuit's version of "economic substance" (without reference to a doctrine): "If a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax avoidance motivations." It ignored the possibility of economic profit from the options by finding that they were ancillary to the bifurcated transaction that created the losses. It denied the taxpayer's losses.

The second stage of the litigation involved the penalties. This was perhaps more important than the merits of the case, because by losing on the merits, the taxpayer would be no worse off than if it had not tried to generate losses at all (except for the substantial federal interest). Indeed, this is the reason why Congress has proliferated penalties and why the Solicitor General was willing to seek certiorari for this seemingly isolated and narrow case.

The district court's 2011 opinion on the penalties refused to apply the valuation (and basis) overstatement penalty, but did impose the negligence and substantial understatement penalties. Although the opinion reads as though it approved separate 20 percent penalties, presumably it only approved separate grounds for one 20 percent penalty under Section 6662(a) and (b). The penalty it refused to impose, the subsection (e) substantial valuation misstatement penalty, could be separately imposed because it can be increased to 40 percent if the misevaluation is "gross" in amount, which was alleged here.

The district court rejected the valuation penalty, which is defined so as to apply also to an adjusted basis claimed on a return that is 150 percent or more of the correct basis. It claimed that *Heasley v. Commissioner of Internal Revenue*, 902 F.2d 380, 383 (5th Cir. 1990), ruled that a deduction disallowance could not be penalized for a basis overstatement. The Fifth Circuit agreed, because it affirmed *Ward* per curiam, and cited *Heasley*. *Heasley* reasons that if the IRS denies a deduction because it is not allowable in any amount due to the nature of the transaction, then the amount of the value did not matter. In other words, taxpayer Heasley won because his deduction was "attributable to claiming an improper deduction or credit" rather than overstating an amount.

Significance of This Appeal

Since 2001, the only federal tax cases in which the United States has sought review in the Supreme Court have been *United Dominion Inds., Inc. v. United States*, 532 US 822 (2001); *United States v. Home Concrete & Supply, LLC*, 132 S.Ct. 1836 (2012); *United States v. Clintwood Elkhorn Mining Co.*, 553 US 1 (2008); and *Woods*. The last three all involved procedural issues; the United States lost the first two and won *Clintwood*. All of the cases but *Clintwood* involved conflicts in the circuits.

This pattern suggests that (1) the Court is very likely to grant certiorari in a federal tax case when the government asks; (2) for some reason, procedural issues are of most interest to the IRS these days, perhaps because they are thought to have more general applicability; (3) the general view that a conflict in the circuits is the best way to obtain Supreme Court review is correct; and (4) the United States is very careful about asking for review of tax decisions, so presumably it thinks the issue in *Woods* is of great systemic importance.

The additional question that the Court itself asked to be briefed is revealing: Did the trial court have jurisdiction in a case brought by the tax matters partner to decide the penalty issue, given the fact that the penalty is only collected at the partner level? The continuing confusion over the scope of tax matters partner litigation suggests that that supposedly simplifying regime has partly failed.

This case will not be argued until the fall.

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