



## Federal Tax ADVISORY ■

**JANUARY 1, 2014**

### Statutory Interpretation Still Lives

*United States v. Woods*, 571 U.S. \_\_\_\_ (2013)

#### **Summary**

In early December, the Supreme Court of the United States ruled that the substantial valuation misstatement penalty could be determined in a TEFRA audit and applied when the audited partnership was found to violate the economic substance doctrine. To the Fifth Circuit, that meant that the partnership was a sham that did not exist for federal income tax purposes. Because the partnership did not exist, the partners could not have any basis in their partnership interest. When they reported having any basis at all, that basis must have been more than 400 percent greater than zero and the penalty applied.

#### **Significance of Opinion for Statutory Interpretation in Tax Cases**

Justice Scalia wrote the unanimous opinion of the Court. No justice felt the need to write even a concurrence. Therefore, both the outcome and the reasoning of the opinion can be seen as congruent with the thinking of the Court in general.

The TEFRA audit proceeding is authorized by statute to determine the applicability of any penalty that relates to an adjustment to a partnership item. The parties had already agreed that the economic substance doctrine determination related to an adjustment to a partnership item, although that does not seem so obvious. Therefore, the issue was whether the understatement penalty based on the partner's basis in the partnership related to the adjustment of the partnership item. The Court ruled it did.

The opinion applied several entirely standard tools and canons of statutory interpretations, including:

- The overall structure of a part of the code—here, the TEFRA rules—should inform the interpretation of a specific section within the TEFRA rules.
- Specifically, this principle means that the purpose of Congress in enacting TEFRA should be considered in interpreting the statute. The opinion concluded that Congress intended to avoid replicating the determination of the same issue in multiple partner audits and used that purpose to inform its interpretation that the penalty related to the TEFRA audit.

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- This principle also means that other parts of the code should be examined to find clues to the meaning of the part at issue.
- The opinion applied the standard approach of applying normal usage, rather than some special meaning, to the word “or.”
- The opinion applied the canon that no part of the statute should be left without function—that is, no part should be superfluous. It said barring consideration of partner-level penalties just because there would ultimately be some variations in the facts at the partner level would render meaningless the statute’s authorization to consider penalties.
- The opinion applied the plain meaning rule for which Justice Scalia is well known, but not to the extreme of refusing all aids to interpretation.
- The opinion declined to hold against the IRS a failure to make an argument in prior situations and relied on a regulation because the taxpayer had not questioned it.
- The opinion did decline to rely on a Joint Committee Blue Book explanation of the TEFRA language, but stated that such documents could be relevant if persuasive. The particular language relied on by the taxpayer was vague and not directly on point.

In sum, the opinion is a far cry from the opinion in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), which reached a plausible conclusion, but one fairly clearly unintended by Congress.

## Significance of Opinion for Economic Substance Doctrine Cases

The opinion stated that it expressed no view on the economic substance doctrine. By the time the case reached the Supreme Court, only the 40-percent penalty was at issue. The opinion did employ, without comment, the construct argued by the IRS and adopted by the courts that once the economic substance doctrine applies to a partnership, the partnership necessarily is a sham, as that term is normally understood.

The sham result was not an inevitable consequence of the application of the economic substance doctrine. However, the fact that the Court adopted it should not be viewed as an endorsement.

The parties did not argue the economic substance doctrine in the Court and there was no reason for the Court to go out of its way to investigate that issue. It should be noted that the Court’s description of the transaction that created the loss did not contain the derogatory language that often accompanies the economic substance doctrine in lower court opinions, such as calling the tax shelter “illegal.”

## Conclusion

*Woods* is the first full opinion in a tax case in the Court’s 2013 term. Justice Scalia wrote the opinion rather quickly, less than two months after the case was argued. The Court decided to hear the case due to a conflict in the circuits, not necessarily due to the importance of the issue. A much more important issue was passed over the same week: the Court declined to hear appeals of the state tax cases involving online retailers and the sales tax. The good news for taxpayers from the *Woods* opinion is that the Court is applying the Internal Revenue Code pretty much as it always has, with a healthy suspicion of aggressive taxpayer arguments, but using standard methods of statutory interpretation. That is good news for taxpayers because they can do the same.

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