Syllabus

SUPREME COURT OF THE UNITED STATES

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UNITED STATES *v.* WOODS

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 12–562. Argued October 9, 2013—Decided December 3, 2013

Respondent Gary Woods and his employer, Billy Joe McCombs, participated in an offsetting-option tax shelter designed to generate large paper losses that they could use to reduce their taxable income. To that end, they purchased from Deutsche Bank a series of currency-option spreads. Each spread was a package consisting of a long option, which Woods and McCombs purchased from Deutsche Bank and for which they paid a premium, and a short option, which Woods and McCombs sold to Deutsche Bank and for which they received a premium. Because the premium paid for the long option was largely offset by the premium received for the short option, the net cost of the package to Woods and McCombs was substantially less than the cost of the long option alone. Woods and McCombs contributed the spreads, along with cash, to two partnerships, which used the cash to purchase stock and currency. When calculating their basis in the partnership interests, Woods and McCombs considered only the long component of the spreads and disregarded the nearly offsetting short component. As a result, when the partnerships' assets were disposed of for modest gains, Woods and McCombs claimed huge losses. Although they had contributed roughly $3.2 million in cash and spreads to the partnerships, they claimed losses of more than $45 million.

The Internal Revenue Service sent each partnership a Notice of Final Partnership Administrative Adjustment, disregarding the partnerships for tax purposes and disallowing the related losses. It concluded that the partnerships were formed for the purpose of tax avoidance and thus lacked "economic substance," *i.e.,* they were shams. As there were no valid partnerships for tax purposes, the IRS determined that the partners could not claim a basis for their partnership interests greater than zero and that any resulting tax underpayments would be subject to a 40-percent penalty for gross valuation misstatements. Woods sought judicial review. The District Court held that the partnerships were properly disregarded as shams but that the valuation-misstatement penalty did not apply. The Fifth Circuit affirmed.

Held:

1. The District Court had jurisdiction to determine whether the partnerships' lack of economic substance could justify imposing a valuation-misstatement penalty on the partners. Pp. 6–11.

(a) Because a partnership does not pay federal income taxes, its taxable income and losses pass through to the partners. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the IRS initiates partnership-related tax proceedings at the partnership level to adjust "partnership items," *i.e.,* items relevant to the partnership as a whole. 26 U. S. C. §§6221, 6231(a)(3). Once the adjustments become final, the IRS may undertake further proceedings at the partner level to make any resulting "computational adjustments" in the tax liability of the individual partners. §§6230(a)(1)–(2), (c), 6231(a)(6). Pp. 6–7.

(b) Under TEFRA's framework, a court in a partnership-level proceeding has jurisdiction to determine "the applicability of any penalty . . . which relates to an adjustment to a partnership item." §6226(f). A determination that a partnership lacks economic substance is such an adjustment. TEFRA authorizes courts in partnership-level proceedings to provisionally determine the applicability of any penalty that could result from an adjustment to a partnership item, even though imposing the penalty requires a subsequent, partner-level proceeding. In that later proceeding, each partner may raise any reasons why the penalty may not be imposed on him specifically. Applying those principles here, the District Court had jurisdiction to determine the applicability of the valuation-misstatement penalty. Pp. 7–11.

2. The valuation-misstatement penalty applies in this case. Pp. 11–16.

(a) A penalty applies to the portion of any underpayment that is "attributable to" a "substantial" or "gross" "valuation misstatement," which exists where "the value of any property (or the adjusted basis of any property) claimed on any return of tax" exceeds by a specified percentage "the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)." §§6662(a), (b)(3), (e)(1)(A), (h). The penalty's plain language makes it applicable here. Once the partnerships were deemed not to exist for tax purposes, no partner could legitimately claim a basis in his partnership interest greater than zero. Any underpayment resulting from use of a nonzero basis would therefore be “attributable to” the partner’s having claimed an “adjusted basis” in the partnerships that exceeded “the correct amount of such . . . adjusted basis.” §6662(e)(1)(A). And under the relevant Treasury Regulation, when an asset’s adjusted basis is zero, a valuation misstatement is automatically deemed gross. Pp. 11–12.

(b) Woods’ contrary arguments are unpersuasive. The valuation-misstatement penalty encompasses misstatements that rest on legal as well as factual errors, so it is applicable to misstatements that rest on the use of a sham partnership. And the partnerships’ lack of economic substance is not an independent ground separate from the misstatement of basis in this case. Pp. 12–16.

471 Fed. Appx. 320, reversed.

SCALIA, J., delivered the opinion for a unanimous Court.

SUPREME COURT OF THE UNITED STATES

No. 12–562

UNITED STATES, PETITIONER *v.* GARY WOODS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

[December 3, 2013]

JUSTICE SCALIA delivered the opinion of the Court.

We decide whether the penalty for tax underpayments attributable to valuation misstatements, 26 U. S. C. §6662(b)(3), is applicable to an underpayment resulting from a basis-inflating transaction subsequently disregarded for lack of economic substance.

I. The Facts

A

This case involves an offsetting-option tax shelter, variants of which were marketed to high-income taxpayers in the late 1990's. Tax shelters of this type sought to generate large paper losses that a taxpayer could use to reduce taxable income. They did so by attempting to give the taxpayer an artificially high basis in a partnership interest, which enabled the taxpayer to claim a significant tax loss upon disposition of the interest. See IRS Notice 2000–44, 2000–2 Cum. Bull. 255 (describing offsetting-option tax shelters).

The particular tax shelter at issue in this case was developed by the now-defunct law firm Jenkens & Gilchrist and marketed by the accounting firm Ernst &

Young under the name "Current Options Bring Reward Alternatives," or COBRA. Respondent Gary Woods and his employer, Billy Joe McCombs, agreed to participate in COBRA to reduce their tax liability for 1999. To that end, in November 1999 they created two general partnerships: one, Tesoro Drive Partners, to produce ordinary losses, and the other, SA Tesoro Investment Partners, to produce capital losses.

Over the next two months, acting through their respective wholly owned, limited liability companies, Woods and McCombs executed a series of transactions. First, they purchased from Deutsche Bank five 30-day currency-option spreads. Each of these option spreads was a package consisting of a so-called long option, which entitled Woods and McCombs to receive a sum of money from Deutsche Bank if a certain currency exchange rate exceeded a certain figure on a certain date, and a so-called short option, which entitled Deutsche Bank to receive a sum of money from Woods and McCombs if the exchange rate for the same currency on the same date exceeded a certain figure so close to the figure triggering the long option that both were likely to be triggered (or not to be triggered) on the fated date. Because the premium paid to Deutsche Bank for purchase of the long option was largely offset by the premium received from Deutsche Bank for sale of the short option, the net cost of the package to Woods and McCombs was substantially less than the cost of the long option alone. Specifically, the premiums paid for all five of the spreads' long options totaled $46 million, and the premiums received for the five spreads' short options totaled $43.7 million, so the net cost of the spreads was just $2.3 million. Woods and McCombs contributed the spreads to the partnerships along with about $900,000 in cash. The partnerships used the cash to purchase assets—Canadian dollars for the partnership that sought to produce ordinary losses, and Sun Microsystems stock

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