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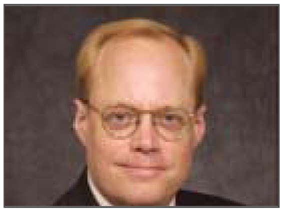

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IRS Wants More Penalties

Image via gizmodo.fr

Sometimes when the IRS loses in court, it announces that it isn't going to follow the court's decision. That may sound like the height of hubris. But since the IRS operates nationwide and most courts have limited jurisdiction, the IRS can choose to keep fighting elsewhere, even if the court decision is binding in one place.

That's what happened when the Ninth Circuit Court of Appeals decided it would not impose a 40% penalty on the taxpayer in *Keller v. Commissioner*. The IRS had sought a special 40% gross valuation penalty, but the court said no. Here's the background.

Penalties on Penalties?

In general, a 20% penalty applies to tax underpayments attributable to a substantial valuation misstatement. See Code Section 6662(a). However, this penalty is ***doubled*** to a whopping 40% if there is a gross valuation misstatement. See Code Section 6662(h)(1). A gross valuation misstatement generally involves a claim for 200% or more of the correct value or basis.

Michael Keller participated in a bad tax shelter deal—he purported to purchase 146 cattle and cow embryos (no kidding) in exchange for a 15-year promissory note. Other than a $50 application fee, Keller made no initial payments to finance his investment, but agreed to allocate 75% of the tax savings from the investment back to the promoter. He eventually began making monthly payments on the promissory note, but otherwise this was pretty much a sham.

But boy did Keller claim tax benefits! He reported large losses and deductions on his '94 and '95 returns (despite not investing until '95!), carried back losses to '91 through '93, and received refunds for '91 through '94. Eventually, the IRS came crashing down on him. Among other taxes and penalties, the IRS imposed accuracy-related penalties, including the 40% gross valuation misstatement penalty.

Keller wasn't arguing that he didn't owe the ***tax***. He clearly did. In fact, before the trial he agreed he wasn't entitled to the deductions. But he didn't think he should have to pay the 40% gross valuation misstatement penalty. Nevertheless, the Tax Court upheld the penalty, so Keller appealed.

In the Ninth Circuit, Keller agreed the tax underpayments were attributable to invalid deductions, but not to any asset overvaluation. Under Ninth Circuit precedent—*Gainer v. Commissioner*—the 40% penalty ***couldn't*** apply. The Ninth Circuit agreed and reversed, holding that "when a deduction is disallowed in total, an associated penalty for overvaluing an asset is precluded."

With one exception, the *Keller* decision conflicts with that of every other circuit court to have addressed the issue. The other court to similarly deny valuation misstatement penalties is the Fifth Circuit. See *Heasley v. Commissioner*.

The IRS issued an Action on Decision (AOD) in regard to the *Heasley* decision in '91. Now the IRS has done the same with *Keller*, announcing that it disagrees with the Ninth Circuit's decision. Thus, IRS will continue to argue in appropriate cases, including those appealable to the Ninth Circuit, 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.

For more, see:

Got A Tax Notice? Here's What To Do

Ten Things To Know About Fighting An IRS Bill

Received An IRS Notice? 10 Simple Tips

Choose Your Ground In Tax Disputes

IRS: The Section 6662(e) Substantial and Gross Valuation Misstatement Penalty

Internal Revenue Manual – 20.1.12 Penalties Applicable to Incorrect Appraisals

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