

TAX UPDATE

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The Case of the Missing Cattle—Overvaluation Penalty Podcast of March 2, 2009

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Can Nonexistent Assets Be Overvalued?

Today's case allows us to look at the Ninth Circuit Court of Appeals attempt to deal with what initially sounds like a ridiculous question—can assets that don't exist be overvalued? The problems arose due to a taxpayer investing in a tax shelter that turned out to have even less real substance than tax law substance. In this case, the taxpayer invested in a cattle feeding project that lacked one key item—cattle.

In the case of *Keller v. Commissioner*, (<http://www.ca9.uscourts.gov/datastore/opinions/2009/02/26/0675441.pdf>) 2009 TNT 37-17 the Ninth Circuit reviewed the Tax Court's prior opinion in T.C. Memo 2006-131. The Ninth Circuit took issue with the Tax Court's finding that taxpayer was liable for a penalty under § 6662(h) for gross valuation misstatements—and the reason because it found there existed no assets to undervalue.

Gross Valuation Understatements

The Internal Revenue Code imposes a series of underpayment penalties for negligence under §6662. Today's issue involves one part of that section, the penalty for gross valuation misstatements under §6662(h).

That provision provides:

(h) Increase in penalty in case of gross valuation misstatements

(1) In general

To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Gross valuation misstatements

The term "gross valuation misstatements" means--

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting--

(i) in paragraph (1)(A), "200 percent" for "150 percent",

(ii) in paragraph (1)(B)(i)--

(I) "400 percent" for "200 percent", and

(II) "25 percent" for "50 percent", and

(iii) in paragraph (1)(B)(ii)--

(I) "\$20,000,000" for "\$5,000,000", and

(II) "20 percent" for "10 percent".

(B) any substantial overstatement of pension liabilities as determined under subsection (f) by substituting "400 percent" for "200 percent", and

(C) any substantial estate or gift tax valuation understatement as determined under subsection (g) by substituting "40 percent" for "65 percent".

Note that the 20% penalty rises to 40% in the case of a deficiency attributable to a "gross valuation misstatement" as opposed to the 20% penalty due to most items under the accuracy related provisions of §6662. The definition references the basic undervaluation definition for this section found at §6662(e) which provides:

(e) Substantial valuation misstatement under Chapter 1

(1) In general

For purposes of this section, there is a substantial valuation misstatement under chapter 1 if--

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or

(B)

(i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

(ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of \$5,000,000 or 10 percent of the taxpayer's gross receipts.

(2) Limitation

No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

These provisions are meant to discourage the use of unreasonable valuations of assets that allow a taxpayer to get a tax benefit. That may be because, for instance, by using an unreasonably high value for an item a taxpayer may derive deductions in excess of what would be allowed if a proper value had been used.

But what if rather than having an asset whose value was overstated, we have an asset that does not exist but to which a value is assigned? Is that a substantial overstatement for this provision, or does the lack of an actual asset mean that it cannot be overvalued?

The Missing Cattle Shelter

Michael Keller is the taxpayer in the case today, having invested in a cattle investment program promoted by Walter J. Hoyt, III. However, unlike other partnership cases that have involved Hoyt investors, in this case Micheal contributed money as a solo investor.

Michael discovered this structure from his co-workers at the Military Sealift Command. The Ninth Circuit notes:

Keller's colleagues informed him the investment scheme, which afforded significant tax savings, was found to be legitimate by the tax court in the *Bales* case and gave him promotional materials to review. He found the promotional materials persuasive -- Hoyt was described as one of the top cattlemen in the industry who had been in business for forty years. In Keller's opinion, if the investment scheme were not legitimate, it would already have been shut down by the Securities and Exchange Commission. Although Keller recognized he would receive significant tax savings through depreciation deductions at the beginning of the investment, he also claims to have expected a long-term profit.

Mr. Keller decided to go head and invest in the program, and the Court continues:

In February 1995, Keller requested additional information from Hoyt and was contacted by Dave Barnes, a Hoyt representative. Barnes provided promotional materials and asked Keller to fill out a credit application and attach tax returns from the previous years. Eventually the two met at a Hoyt ranch in Elk Grove, California. The meeting lasted several hours and covered the investment opportunity generally and also included a description by Barnes of the outcome in *Bales*. Keller was additionally given independent media publications and cattle count reports.

Keller ultimately decided to invest in late February or early March 1995. He signed a 15-year promissory note to repay \$956,980 in exchange for 146 heifers -- half of which were only in the embryonic stage at purchase. Other sales documents included a bill of sale, a certificate of warranty, a sales order, and a security agreement. At no time in the purchasing process did Keller ever consult a tax expert or attorney regarding his investment.

Keller made no initial payments, other than a \$50 application fee, to Hoyt to finance his investment. Instead, he agreed to allocate 75 percent of the tax savings he enjoyed from the investment back to Hoyt. He did, however, eventually begin making payments on the promissory note of a little over \$1,000 each month. Upon finalization of the investment, Hoyt's accounting department immediately began preparing Keller's tax returns for 1994 and 1995.

However, not all was well in this case—the Ninth Circuit goes on to note that it appears that there weren't enough cattle to go around, a fact the US government argued in a criminal trial for Mr. Hoyt and other individuals associated with him, did not prevent them from continuing to sell either nonexistent cattle or the same animal multiple times.

As it turns out, Keller may not have acquired any cattle in the first instance. During Hoyt and his co-conspirators' criminal trial, the government described the cow shortage as "severe and pervasive." The shortage was growing, and yet nonexistent "phantom" cows continued to be sold to new investors. Additionally, the same cows -- as identified by name and ear tag number -- were often sold to more than one investor.

But it turns out that the promoters didn't even wait until the date of the phantom sale to begin preparing returns for Mr. Keller claiming the benefits:

Regardless, and although the purported cattle purchase did not occur until 1995, Keller's 1994 return contained a Schedule F -- the schedule on which profits or losses associated with farming are reported -- as did the 1995 return. The 1994 return reported a net loss of \$302,818 and the 1995 return a loss of \$107,951. Depreciation schedules showed the cost basis of the cattle to be \$880,423 in 1994 and \$625,100 in 1995.

For 1994, Mr. Keller benefitted from the tax loss and substantial carryback:

Because Keller's losses for 1994 were so large and eliminated the totality of his 1994 income taxes with some loss leftover, he was able to carry back losses to eliminate any taxes that had been owed for 1991, 1992, and 1993. Keller was issued a refund of \$11,773 for 1994 and a total of \$40,740 for the carry back years. Hoyt collected \$10,500 for 1994 and \$30,500 for the carry back years for his services. Including the allocation of tax savings and the payments made on the promissory note, Keller ultimately paid Hoyt a total of \$67,225.

However, Mr. Keller discovered before he could file a return to claim another set of benefits that the IRS had issues with Mr. Hoyt:

Prior to the filing of the 1995 return, the Commissioner sent Keller notice that deductions stemming from the Hoyt tax shelter were unlikely to be allowable. Any return claiming a refund was to be reduced by the amount generated from the Hoyt investment scheme. It also warned of the accuracy-related penalties under § 6662 that would be applied in appropriate cases. The 1995 return was nonetheless filed, including Hoyt-related deductions, and requested a refund of \$8,788. A refund was never issued.

Mr. Keller would find that the IRS, in addition to not sending him the check for \$8,788 was now also going to have an interest in his 1994 and 1995 returns:

(On February 24, 1997, the Commissioner sent Keller a letter informing him that his 1994 and 1995 returns were under examination. A Notice of Deficiency, dated May 3, 2001, was later sent indicating a deficiency of \$11,106 for 1994

and \$17,410 for 1995. The Commissioner also assessed accuracy penalties under § 6662(h) of \$4,442.40 for 1994 and \$6,931.60 for 1995 -- that is, an additional amount equal to 40 percent of the underpayment. The deficiency was based on the Commissioner's conclusion that the cattle were not actually being used in a trade or business or to generate income. The 40 percent penalty was applied due to alleged gross valuation misstatements in the claimed value of the cattle.

Mr. Keller took the matter to Tax Court. However, prior to trial Mr. Keller agreed that he should not have been allowed any deductions related to this activity—but he disputed the penalties that the IRS sought to impose.

The issue at trial was thus reduced to the imposition of accuracy-related penalties. The tax court determined that if Keller had in fact not acquired any cattle, his basis in the cattle would be zero for the relevant tax years, far below the claimed bases, and thus supported the 40 percent penalty for gross valuation misstatements. The court also found the 20 percent penalty for negligence applicable and rejected Keller's other defenses. Accordingly, it upheld the deficiency and penalty amounts in full. This appeal followed.

The Missing Cattle

In the original Tax Court case Mr. Keller argued that as he never truly owned cattle (or it appeared he did not) that no overvaluation penalty should apply. The Tax Court in the original opinion in the case, noted:

"It is Petitioner's position that he never received the benefits and burdens of ownership of the purported cattle -- if such cattle even existed, thus the overvaluation penalty cannot apply."

However, the Tax Court bluntly stated that his position was simply "without support." The Court explained:

If we accept petitioner's assertion that he never received the benefits and burdens of ownership of the cattle, or that the cattle never existed, then his bases in the cattle would be zero. See *Zirker v. Commissioner*, 87 T.C. 970, 978-979 (1986) (finding that no actual sale of cattle took place and the correct adjusted basis of cattle was zero); *Massengill v. Commissioner*, T.C. Memo. 1988-427 (same as *Zirker*), *affd.* 876 F.2d 616 (8th Cir. 1989). This conclusion is supported by petitioner's concession that he was not entitled to cost basis or depreciation deductions. If petitioner's correct bases are zero, then the bases claimed on his returns are considered to be 400 percent or more of the correct amount, and are thus gross valuation misstatements. See sec. 1.6662- 5(g),

Income Tax Regs.; see also *Zirker v. Commissioner*, supra at 978-979.

The Tax Court held that even though the asset did not exist, the taxpayer had asserted a value for that asset. The actual value of the nonexistent asset was zero, and thus any claimed basis in the cattle was going to be more than 400% of the correct zero amount, making the liability arising from that overstatement subject to the 40% penalty.

The Ninth Circuit arrives at a different conclusion. The Court notes that Mr. Keller doesn't disagree with the math (any value is going to be 400% more than a zero value), but rather that the section itself cannot be applicable if no asset exists to be valued the understatement cannot be "attributable to" a valuation overstatement.

The Ninth Circuit looks back to another time the Tax Court and the Ninth Circuit dealt with "attributable to" and valuation issues when, in fact, no deduction was allowable. The Court notes:

We previously have had occasion to consider the meaning of the words "attributable to" in a similar context. *Gainer v. Commissioner* interpreted "attributable to" in § 6659, now repealed, which also imposed a penalty on taxpayers who underpaid their taxes by overvaluing an asset. In *Gainer*, the taxpayer purchased a 10 percent interest in a refrigerated shipping container for \$26,000 (thus, the shipping container's total value was \$260,000) by paying \$4,500 up front and executing a non-recourse promissory note for the balance. 893 F.2d at 226. The actual fair market value of the container was somewhere between \$52,000 and \$60,000, leaving the taxpayer's interest truly valued between \$5,200 and \$6,000. *Id.* Nonetheless, in the 1981 tax year, a depreciation deduction was taken based on the \$26,000 purchase price. *Id.* Prior to trial before the tax court, the parties agreed the deduction was improper in the first instance because the container was not placed in service during the 1981 tax year. *Id.* The Commissioner nonetheless sought to impose a penalty for overvaluing the container. *Id.* The tax court refused, reasoning that the taxpayer was not entitled to any deduction regardless of the stated value and thus any underpayment was attributable to taking an unwarranted deduction, not overvaluing the containers. *Id.*

The IRS in that case appealed the decision that the penalty did not apply to the Ninth Circuit—but found no relief there. The Court notes:

On appeal, this court rejected the Commissioner's argument that "attributable to" actually means "capable of being attributed," as there was no support for such a reading, and in any event, it would just move the inquiry to the meaning of "capable," which could be equally ambiguous. *Id.* at 227. In trying to divine a proper reading of the statute, the court consulted the plain language, dictionary definitions, and legislative history, all without success. *Id.* It ultimately found

instructive the General Explanation of the Economic Recovery Tax Act of 1981, prepared by the staff of the Joint Committee on Taxation. The General Explanation provides a formula for determining when an underpayment is attributable to an overvaluation:

The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

Gainer, 893 F.2d at 227 (citation omitted) (emphasis in original).

Following the formula, the court held that the taxpayer's underpayment could not be said to be "attributable to" the overvaluation of the shipping container. Because the parties stipulated that no deduction was appropriate in the first instance, the tax underpayment did not vary depending on how much the container was overvalued. The tax liability, "after adjusting for failure to place the container in service, was no different from [the taxpayer's] liability after adjusting for any overvaluation." *Id.* at 228. More broadly, we held "when there is some other ground for disallowing the entire portion of a deduction that otherwise might be disallowed for overvaluation," an overvaluation penalty may not be imposed. *Id.*

The appeals court goes on to note that it finds *Gainer* applicable in this case, noting:

While *Gainer* is arguably distinguishable on its facts -- overvaluing a shipping container but failing to put it into service is different from overvaluing cattle you never actually acquire -- its rationale is directly on point. When a depreciation deduction is disallowed in total, any overvaluation is subsumed in that disallowance, and an associated tax underpayment is "attributable to" the invalid deduction, not the overvaluation of the asset. Moreover, *Gainer* embraces the formula announced by the General Explanation that requires first determining whether any deductions are improper and, only after that, determining whether there is a lingering asset overvaluation. In other words, *Gainer's* holding is such that when a deduction is disallowed in total, an associated penalty for overvaluing an asset is precluded.

Viewing *Gainer* in this light, we conclude the tax court erred in upholding the gross valuation misstatement penalty under § 6662(h) against Keller. Prior to

trial, Keller and the Commissioner stipulated that all of the Hoyt-related deductions he took were unlawful. Once the totality of the deduction was disallowed, the fact that the cattle purportedly acquired by Keller had a claimed basis far in excess of their true value became irrelevant. Keller's tax deficiency was "attributable to" taking a depreciation deduction to which he was not entitled (at all) rather than "attributable to" overvaluation.

And, thus, on what might be viewed as a technicality, the taxpayer escapes this penalty (though he did not escape others). The Ninth Circuit notes that its view is not shared by certain other Circuits, noting in an almost apologetic note:

We recognize that many other circuits have concluded that when overvaluation is intertwined with a tax avoidance scheme that lacks economic substance, an overvaluation penalty can apply. See *Merino v. Comm'r*, 196 F.3d 147, 155 (3d Cir. 1999); *Zfass v. Comm'r*, 118 F.3d 184, 190-91 (4th Cir. 1997); *Illes v. Comm'r*, 982 F.2d 163, 166-67 (6th Cir. 1992); *Gilman v. Comm'r*, 933 F.2d 143, 149-52 (2d Cir. 1991); *Massengill v. Comm'r*, 876 F.2d 616, 619-20 (8th Cir. 1989). This sensible method of resolving overvaluation cases cuts off at the pass what might seem to be an anomalous result -- allowing a party to avoid tax penalties by engaging in behavior one might suppose would implicate more tax penalties, not fewer. Nonetheless, in this circuit we are constrained by *Gainer*.

But in the end the Ninth argues there is a justification for the treatment, noting that there are consequences to Mr. Keller—just not the imposition of this particular penalty provision:

This said, Keller's concession of invalid deductions had significant consequences. He was no longer able to argue in the tax court the merits of his deficiencies in tax payment -- in other words, he agreed that he owed \$11,106 for 1994 and \$17,410 for 1995 in back taxes, plus interest. Moreover, Keller now concedes a 20 percent negligence penalty is appropriate for both tax years -- a total that approaches an additional \$5,700, plus interest. In future cases too, the Commissioner will be able to look to the negligence penalty or other penalties where applicable.

In a footnote the panel noted that while the IRS argued that Mr. Keller's concession was, in their view, "opportunistic" the panel did not agree—first, that the concession had no consequence and second, that the IRS did not have to accept that concession but rather could have left the issue open to be litigated on whether any deduction at all was allowed:

It is for this reason that we find no merit in the Commissioner's argument that Keller's concession of invalid deductions was "opportunistic" and should therefore be rejected. While the concession ultimately allows him to avoid an overvaluation penalty, it also confirmed, without any opportunity in court to

argue otherwise, that he owed over \$28,000 plus interest in back taxes. In any event, the Commissioner agreed to the stipulation at the time and must live with the consequences of that agreement now.

Consequences

The case does show that sometimes handling various penalty issues for a taxpayer that got into a tax shelter or other scheme may be more complicated than it first appears—even the Court noted that this result was not the one you might initially arrive at (and certainly not the one the Tax Court did arrive at).