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Federal Income Taxation

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In the year 2019, the federal courts within the Eleventh Circuit handed down several notable opinions on federal tax issues.[1] This Article surveys two of those opinions involving the taxation of shareholder loans to S corporations and the application of gross valuation-misstatement penalty to partnerships.

I. *MERUELO V. COMMISSIONER*

The S corporation regime, instituted by Subchapter S of Chapter 1 of the Internal Revenue Code (the Code),[2] allows certain electing "small business corporations" to pass corporate income, losses, deductions, and credits through to their shareholders for federal income tax purposes.[3] This permits qualifying S corporations to fuse the advantages of the legal treatment afforded to corporations under state law with the benefits of partnership flow-through taxation. A particular advantage is that an S corporation shareholder may deduct its pro rata share of the S corporation's losses.[4] As with partnerships, this flow-through treatment also necessitates close scrutiny of dealings between S corporations and their shareholders to prevent potential abuses of the S corporation

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1. For an analysis of federal income taxation during the prior survey period, see Gregory S. Lucas & Nikolai Karetnyi, *Federal Income Taxation, Eleventh Circuit Survey*, 70 MERCER L. REV. 1037 (2019).

2. I.R.C. §§ 1361–1379 (2020).

3. For 2019, the top marginal tax rate for ordinary income was 37%. I.R.C. §§ 1(a)–(d) (2020).

4. I.R.C. §§ 1366(a), (d) (2020).

regime's benefits. Such safeguard limits a shareholder's ability to deduct the S corporation's losses to the extent of its adjusted basis in the stock of the S corporation and the adjusted basis of any indebtedness of the S corporation owed to such shareholder.[5] This safeguard is further strengthened by Treasury Regulations section 1.366-2(a)(2) (as amended in 2014) specifying that only "bona fide indebtedness of the S corporation that runs directly to the shareholder" can give rise to such basis.[6] In *Meruelo v. Commissioner*,[7] the United States Court of Appeals for the Eleventh Circuit tackled these rules and examined whether a complex web of transfers between an S corporation, its shareholder, and several other affiliated S corporations resulted in bona fide indebtedness that ran directly to the shareholder, ultimately affirming the Tax Court's decision to partly disallow the shareholder's claimed deductions stemming from these loans.[8]

Homero Meruelo (Meruelo), a Florida real estate developer, conducted his business through a bevy of S corporations, partnerships, and limited liability companies. One of these entities was Merco of Palm Beaches, Inc. (Merco), an S corporation incorporated in 2004 in which Meruelo held 49% of the stock. Merco was initially formed to purchase a South Florida condominium complex in a bankruptcy sale. The bankruptcy court approved the sale and required Merco to pay a $10 million non-refundable deposit to secure the property.[9] Meruelo financed his share of the deposit by obtaining a personal loan. Meruelo then transferred $4,985,035 of the loan proceeds to Merco Group at Akoya, Inc. (Akoya), an S corporation where each of Meruelo and his mother owned 50% of the stock. Akoya then transferred $5 million into Merco's escrow account, of which $4,985,035 constituted proceeds from Meruelo's personal loan and $14,965 constituted Akoya's own funds. The remaining $5 million of the $10 million deposit was previously transferred by Akoya to Merco.[10]

Subsequently, from 2004 to 2008, Merco entered into numerous transactions with affiliated entities (such as partnerships and other S corporations) in which Meruelo held an equity interest. Aiming to simplify accounting practices and enhance liquidity, these affiliated entities often paid expenses on behalf of each other or Merco. Typically, these payments were recorded by the payor entity as accounts

5. *Id.*
6. Treas. Regs. § 1.1366-2(a)(2) (2020).
7. 923 F.3d 938 (11th Cir. 2019).
8. *Id.* at 939–40.
9. *Id.* at 940.
10. *Id.*

receivable, whereas the payee entity recorded them as accounts payable. During this time, affiliated entities paid more than $15 million on behalf of Merco, with Merco repaying its affiliates less than $6 million. On its tax returns, Merco netted its accounts receivable and payable from its affiliates. If Merco had net accounts payable, then this amount was reported as a "shareholder loan" on its tax return, and a percentage of this indebtedness was subsequently allocated to Meruelo based on his interest in the affiliated entities that had transferred funds to Merco.[11]

In connection with the purchase of the condominium complex in 2004, Meruelo granted to Merco a promissory note making available a $10 million unsecured line of credit at a 6% interest rate. Merco's tax returns from 2004 to 2008 included an annual charge to this line of credit equal to Meruelo's calculated share of Merco's net accounts payable to its affiliates for the preceding taxable year.[12]

In 2008, banks foreclosed on the condominium complex causing Merco to incur a loss of $26,605,840. Meruelo was allocated 49% of this loss ($13,036,861), which he took as an ordinary deduction on his 2008 tax return. Meruelo reported a net operating loss of $11,793,865 (accounting for other income and deductions) on his 2008 tax return. In 2009, Meruelo was granted a refund to carry back these net operating losses to 2005, thereby reducing his tax liability for 2005 by $3,897,470.[13]

In examining Meruelo's tax returns from 2005 through 2008, the Internal Revenue Service (IRS) disallowed $8,051,826 of the carried back net operating losses for lack of sufficient basis and sent Meruelo a notice of deficiency for 2005. The IRS limited Meruelo's basis in the Merco stock to the $4,985,035 of the proceeds of the bank loan contributed by Meruelo through Akoya.[14]

In response, Meruelo petitioned the Tax Court for redetermination of the IRS's alleged tax deficiency. Meruelo argued that he possessed sufficient basis in Merco stock to fully deduct his share of Merco's losses. In Meruelo's view, his basis in Merco stock consisted of (1) $2.7 million of the first $5 million Akoya deposit; (2) the entirety of Akoya's second $5 million deposit; and (3) his $6,616,857 share of the intercompany transfers. Meruelo's argument was predicated upon two theories, each purportedly establishing that the transfers from the

11. *Id.* at 940–41.
12. *Id.* at 941.
13. *Id.*
14. *Id.*

affiliated entities to Merco were shareholder loans from Meruelo to Merco.[15]

Under the first "back-to-back loan" theory, Meruelo argued that the affiliated companies should have been treated as lending him funds that he then lent back to Merco.[16] Based on an example in the Treasury Regulations, where both of the back-to-back loans constitute bona fide indebtedness that run directly to the applicable creditor, the debt from the first shareholder creditor to the ultimate S corporation debtor would constitute a shareholder loan (effectively disregarding the intermediate debtor/creditor S corporation).[17]

Under the second "incorporated pocketbook theory," Meruelo contended that because the affiliated companies were a mere conduit for paying Merco's expenses on his behalf, Meruelo should be treated as directly making these payments to Merco.[18] This theory concludes that a "taxpayer can obtain debt basis in an S corporation through payments made by a wholly owned corporate entity if that entity functions as the shareholder's 'incorporate pocketbook,' meaning that the taxpayer has a 'habitual practice of having his wholly owned corporation pay money to third parties on his behalf.'"[19]

The Tax Court dismissed both of Meruelo's arguments and ruled for the IRS, determining that Meruelo was not entitled to any of the $8,051,826 of the disputed basis in Merco stock.[20] In reaching this conclusion, the Tax Court reiterated that a shareholder may increase his basis in S corporation stock by the amount of the adjusted basis of any indebtedness owed by the S corporation to the shareholder.[21] After assessing earlier decisions and legislative history, the Tax Court further asserted that in order to increase basis, the loan requires an "actual economic outlay" by the shareholder. That is, the shareholder must demonstrate that "he incurred a cost in making a loan or that he was left poorer in a material sense after the transaction."[22] The Tax Court interpreted Treasury Regulations section 1.1366-2(a)(2)[23]

15. *Id.* at 941–42.

16. *Id.* at 942. *See* Meruelo v. Comm'r, 115 T.C.M. (CCH) 1060(2018).

17. Treas. Regs. § 1.1366-2(a)(2)(iii), Example (2) (2020).

18. *Meruelo*, 923 F.3d at 942. *See Meruelo*, 115 T.C.M. (CCH) 1060.

19. Broz v. Comm'r, 727 F.3d 621, 627–28 (6th Cir. 2013).

20. *Meruelo*, 115 T.C.M. (CCH) 1060, at *6.

21. *Id.* at *9.

22. *Meruelo*, 923 F.3d at 942.

23. Treas. Regs. § 1.1366-2(a) was amended in 2014 to limit debt basis to "bona fide indebtedness of the S corporation that runs directly to the shareholder." This Treasury Regulation with respect to debt between an S corporation and its shareholder occurring in

(amended in 2014 to limit debt basis to "bona fide indebtedness of the S corporation that runs directly to the shareholder") as essentially codifying the "actual economic outlay" doctrine and requiring a shareholder to prove that an S corporation's indebtedness ran directly to him in order to deduct his proportionate share of the S corporation's net operating loss. This sweeping interpretation has proven to be controversial as the preamble to the final Treasury Regulations promulgating Treasury Regulations section 1.1366-2(a)(2) instructed that the new "bona fide" standard was meant to provide a new test for courts "[i]nstead of applying the actual economic outlay standard."[24]

The Tax Court first rejected Meruelo's back-to-back loan theory on formalistic grounds, finding that there was no evidence that the funds were first lent to Meruelo and then lent back to Merco.[25] Bona fide back-to-back loans (from an affiliated company to a shareholder and then from the shareholder to an S corporations) can increase a shareholder's basis in S corporation stock. However, the Tax Court also noted that shareholders are bound by the form of the loan transactions initially chosen and cannot simply reclassify transactions directly between affiliated companies (especially when such transactions do not involve the shareholder) as back-to-back loans for tax purposes. As a result, because the Merco affiliates did not initially treat the transactions amongst themselves as shareholder loans, the Tax Court reasoned that such treatment would be inappropriate in this instance. Rather, these transactions were initially labelled as accounts receivable and payable, wage payments, or capital contributions, and then subsequently re-labelled as shareholder loans on Meruelo's tax returns.[26] The Tax Court also incorporated the actual economic outlay doctrine into its analysis because per Treasury Regulations section 1.1366-2(a)(2), "bona fide indebtedness" is determined by "general Federal tax principles," which, in the Tax Court's view, includes the actual economic outlay doctrine. Here, Meruelo incurred no costs with respect to the monetary transfers from the Merco affiliates to Merco, and thus "could not claim that these transfers amounted to a shareholder loan."[27] Arguably, this broad interpretation of the "bona fide" standard explicitly ignored the mandate in the preamble to the

a year that was still open for assessment on July 23, 2014. *See* Treas. Regs. § 1.1366-5(b) (2020).

24. T.D. 9682, 2014-2 C.B. 342 (July 23, 2014).

25. *Meruelo*, 115 T.C.M. (CCH) 1060, at *13–17.

26. *Id.* at *16.

27. *Meruelo*, 923 F.3d at 942–43; *see Meruelo*, 115 T.C.M. (CCH) 1060, at *16.

final Treasury Regulations and resulted in an unfavorable result for S corporation shareholders.

Meruelo's incorporated pocketbook theory was likewise rejected by the Tax Court. The Tax Court distinguished its earlier rulings upholding the incorporated pocketbook theory by emphasizing that in these cases a taxpayer habitually used a single wholly-owned corporation to pay third parties on his behalf. In Meruelo's case, the Tax Court observed that the Merco affiliates had co-owners other than Meruelo, did not "habitually" pay Meruelo's expenses, and did not contemporaneously book the transfers as shareholder loans.[28]

Upon appeal to the Eleventh Circuit, Meruelo claimed that the Tax Court erred in disallowing his deduction and that Merco's bona fide indebtedness ran directly to him under the back-to-back loans and unincorporated pocketbook theories.[29] Reviewing Meruelo's arguments *de novo,* the Eleventh Circuit reaffirmed the Tax Court's finding that these claims failed to establish that Merco's debt ran directly to Meruelo and thus could not be treated as shareholder loans giving rise to basis in Merco stock.[30]

The Eleventh Circuit rejected Meruelo's back-to-back loan theory on the dual basis that the Merco's debt never ran directly to Meruelo, both in substance and in form.[31] Citing the example in the Treasury Regulations, the Eleventh Circuit recognized the legitimacy of the theory where both back-to-back loans constitute bona fide indebtedness and run directly to the applicable creditor.[32] However, Meruelo's alleged back-to-back loans to Merco through its affiliates failed to clear this hurdle, even if a portion of the funds transferred to Merco through its affiliates could be considered (as argued by Meruelo) profits that Meruelo would be entitled to receive or otherwise pay Merco's business expenses.[33] First, the Eleventh Circuit deferred to long-standing Supreme Court precedent leaving taxpayers bound by the form of their transaction and liable for its ultimate consequences, regardless of whether the taxpayers believe that the "economic substance" of the transaction triggers different tax consequences.[34] In doing so, the Eleventh Circuit rejected Meruelo's claims that the back-to-back loans from Meruelo to the Merco affiliates and then to Merco were "in

28. *Meruelo*, 115 T.C.M. (CCH) 1060, at *19.
29. *Meruelo*, 923 F.3d at 940.
30. *Id.*
31. *Id.* at 944.
32. *Id.*
33. *Id.* at 945.
34. *Id.* at 944.

substance" direct loans from Meruelo to Merco.[35] Meruelo further argued, based on a single Eleventh Circuit decision, that an exceptional circumstance could warrant assessing a transaction's substance instead of its form to determine tax consequences.[36] But the Eleventh Circuit distinguished this decision, noting that genuine issues of material fact existed as to whether a loan to an S corporation guaranteed by its shareholder's assets ran directly to the shareholder, and held that no such exceptional circumstances occurred in Meruelo's case to justify deferring to the substance of the transaction.[37] Second, Meruelo's reclassification of the intercompany transfers on his tax returns and annual adjustments to the line-of-credit the 2004 promissory note were insufficient to establish that, in form, these transfers were back-to-back loans. These transfers were contemporaneously classified as between Merco and its affiliates and thus the end-of-year re-designation of the transfers as shareholder loans on Meruelo's tax returns could not govern. Moreover, the uniform annual adjustments to the "notional line of credit" established by the 2004 promissory note could not create actual indebtedness to Meruelo.[38]

Similarly, Meruelo's invocation of the incorporated pocketbook theory failed to persuade the Eleventh Circuit that the Merco affiliates served as Meruelo's incorporated pocketbook.[39] The Eleventh Circuit distinguished Tax Court cases upholding this theory by observing that the shareholders in question routinely used a single wholly-owned entity to make payments on their behalf.[40] In contrast, Meruelo used a multitude of distinct Merco affiliates, most of which were only partially owned by Meruelo, as his incorporated pocketbook. The Merco affiliates also acted more like ordinary businesses by disbursing and receiving funds for Merco's business expenses. As explained by the Tax Court and reaffirmed by the Eleventh Circuit, "no court has ever ruled that a group of non-wholly owned entities that both receive and disburse funds in this fashion can constitute an incorporated pocketbook."[41] Moreover, considering that these entities also paid the expenses of other Merco

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35. *Id.* at 944–45.

36. *Id. See* Selfe v. United States, 778 F.2d 769 (11th Cir. 1985).

37. *Meruelo*, 923 F.3d at 945.

38. *Id.* at 945–46.

39. *Id.* at 946.

40. *Id. See Broz*, 727 F.3d at 628 (affirming Tax Court's rejection of taxpayers' "incorporated pocketbook" argument where the taxpayers failed to establish that they habitually paid third parties through the entities); Messina v. Comm'r, 114 T.C.M. (CCH) 477, at *32–33 (2017) (rejecting theory on the same ground); Ruckriegel v. Comm'r, 91 T.C.M. (CCH) 1035 [2006 RIA T.C.M. 2006-078] (same).

41. *Meruelo*, 923 F.3d at 946.

affiliates, Meruelo failed to establish that they habitually paid his personal expenses.[42]

The Eleventh Circuit's decision in *Meruelo* does not support the integration of the actual economic outlay doctrine with the requirements of Treasury Regulations § 1.1366-2(a)(2). The Eleventh Circuit only discussed the actual economic outlay doctrine with respect to the Tax Court's earlier decision, but did not directly reference the doctrine in its analysis of the merits of Meruelo's appeal. The Eleventh Circuit sidestepped discussion of the economic outlay doctrine in favor of emphasizing the formal classification of the loans, as Meruelo's failure to contemporaneously and consistently document the transactions as shareholder loans was a key point in the Eleventh Circuit's dismissal of his back-to-back loan and incorporated pocketbook theories. The Eleventh Circuit's reluctance to clash with the Tax Court on the application of the actual economic outlay doctrine, combined with its divergent focus on formalism with regard to loan documentation, does not provide taxpayers embroiled in complicated S corporation structures with a clear framework for determining basis attributable to shareholder loans by leaving the question of whether the actual economic outlay doctrine applies unanswered.

II. *HIGHPOINT TOWER TECH. INC. V. COMMISSIONER*

In *Highpoint Tower Technology. Inc. v. Commissioner*,[43] the Eleventh Circuit examined the long-standing split of deficiency jurisdiction amongst the Tax Court and district court through the lens of a gross valuation-misstatement penalty imposed on a partner of a sham partnership. The Eleventh Circuit affirmed the Tax Court's denial of Highpoint Tower Tech.'s (Highpoint) Motion to Restrain Collection of the gross valuation-misstatement penalty on the basis that the penalty related to an adjustment to a partnership item and was thus excluded from the Tax Court's deficiency jurisdiction.[44]

The *Highpoint Tower* case involved a tax shelter employing a series of transactions to create artificial financial losses used to offset real financial gains.[45] In 1999, Highpoint joined Arbitrage Trading, LLC (Arbitrage) as a partner. In exchange for a membership interest in the partnership, Highpoint contributed cash and a pair of Euro currency options. A few months later, Highpoint withdrew from the partnership

42. *Id.*

43. 931 F.3d 1050 (11th Cir. 2019).

44. *Id.* at 1065.

45. *Id.* at 1052. With variance, this type of tax shelter is known as "Son-of-Boss." *See, e.g.*, Petaluma FX Partners, LLC v. Comm'r, 591 F.3d 649, 650 (D.C. Cir. 2010).

and received a liquidating distribution of the Euros. Because Highpoint did not include the contributed Euro currency options in its outside basis as a potential liability, its relatively high outside basis[46] enabled Highpoint to claim a relatively large capital loss on its 1999 tax return after selling the Euros.[47]

In October 2005, the IRS issued a Notice of Final Partnership Administrative Adjustment (the FPAA Notice) to Arbitrage determining that Arbitrage lacked economic substance and was a "sham" whose sole tax avoidance purpose was to allow its purported partners to artificially overstate their outside basis. The FPAA Notice imposed a 40% penalty on the portion of any underpayment attributable to the gross valuation misstatement.[48] A gross valuation-misstatement refers to instances where "the value of any property (or the adjusted basis of any property) claimed on any return of tax . . . is [400] percent or more of the amount determined to be the correct amount of such valuation or adjusted basis."[49] A related Treasury Regulation further provides that "[t]he value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount."[50] Since the IRS determined that Arbitrage lacked economic substance, the correct value or adjusted basis on tax returns in connection with its property and related transactions would be zero and, therefore, the applicable penalty rate would be 40%. Highpoint, as a partner of Arbitrage, received the IRS-issued Notice of Deficiency which imposed the gross valuation-misstatement penalty.[51] Highpoint filed a petition in the Tax Court for redetermination of its deficiency in February 2016. Only a few days after Highpoint's filing, the IRS issued to Highpoint a Notice of Tax Due for the same amount

46. A partner's outside basis is its basis in a partnership interest. It is used to determine gain and loss when the partner sells his/her interest. Distributions and liabilities will decrease a partner's outside basis. The outside basis cannot go below zero. If any distribution or allocation is larger than the partner's outside basis, the partner will recognize gain; conversely, if the distribution a partner receives at distribution is less than his/her outside basis, the partner will realize losses. Therefore, having a large outside basis is advantageous for partners in partnerships to shield themselves from realizing any gain. *See, e.g.*, I.R.C. §§ 705, 752 (2020); Treas. Regs. §§ 1.705-1, 1.752-1 (2020) (discussing effects of partner and partnership liabilities on a partner's outside basis).

47. *Highpoint Tower Tech.*, 931 F.3d at 1053.

48. *Id.* at 1054.

49. Gustashaw v. Comm'r, 696 F.3d 1124, 1135 (11th Cir. 2012).

50. Treas. Regs. § 1.6662-5(g) (2020).

51. Because Arbitrage was an LLC, which is a flow-through entity (unless it makes a valid election to be treated otherwise), all entity-level federal income taxes (and penalties) may be reported and eventually borne by its members.

stated in the Notice of Deficiency. In June 2016, the IRS notified Highpoint of the intention to levy its property to collect the amount due. Highpoint responded to the potential levy almost immediately by filing a Motion to Restrain Collection with the Tax Court.[52]

The central dispute in *Highpoint* is whether a taxpayer may challenge a gross valuation-misstatement penalty (previously determined to be applicable at the partnership level) in partner-level tax deficiency proceedings before the Tax Court. As a general matter, both the Tax Court and district courts have jurisdiction over deficiency proceedings. The difference is that in Tax Court deficiency proceedings, taxpayers are not required to pay the tax deficiency until the final amount is determined by the Tax Court; whereas filing a petition in district court requires taxpayers to first pay the amount due, and, if it is ultimately determined that the IRS has erred in its determination, receive refund for overpayment later.[53] In other words, *Highpoint* presents a dispute as to whether the Tax Court, in partner-level deficiency proceedings, has jurisdiction over the penalty for gross valuation-misstatement previously assessed at the partnership level.[54] The IRS objected to Highpoint's Motion to Restrain Collection and moved to dismiss the portions of the case relating to the adjustment to other income and the valuation-misstatement penalty. In July 2017, the Tax Court denied Highpoint's Motion to Restrain Collection to the extent it related to the penalty. In August 2017, Highpoint filed a Motion for Reconsideration of the Tax Court's order. Finally, in November 2017, the Tax Court denied Highpoint's Motion for Reconsideration and granted the IRS's motion to dismiss in full.[55]

The relevant issue for the Eleventh Circuit's review was whether the Tax Court erred in holding that it lacked deficiency jurisdiction over the gross valuation-misstatement penalty and in turn erred in denying the Highpoint's Motion to Restrain Collection of the penalty. The Eleventh

52. *Highpoint Tower Tech.*, 931 F.3d at 1055.

53. *See* 13 MERTENS LAW OF FEDERAL INCOME TAXATION § 49C:1 (2019) "Upon receipt of a notice of deficiency, a taxpayer may either file a petition with the Tax Court to contest the amount of the deficiency or pay the amount of the deficiency and sue for a refund in either the Claims Court or the appropriate District Court."; *See generally* UNITED STATES TAX COURT, RULES OF PRACTICE & PROCEDURE (2012); I.R.M. 34.5.2 (2012).

54. The rest of the deficiency amount (i.e., the amount not relating to the partnership-level gross valuation-misstatement penalty) was not discussed because both parties agreed that the Tax Court had jurisdiction over adjustments relating to capital gains income and the professional fee deductions. *Highpoint Tower Tech.*, 931 F.3d at 1055.

55. *Id.* at 1055–56.

Circuit examined the issue on two levels.[56] First, the Eleventh Circuit analyzed whether the gross valuation-misstatement penalty asserted against Highpoint was applicable if it was determined that the Arbitrage partnership was a sham and therefor did not exist for tax purposes.[57] Second, the Eleventh Circuit assessed whether the gross valuation-misstatement penalty related to an adjustment to a "partnership item" that falls outside of the Tax Court's deficiency jurisdiction.[58]

The first part of the Eleventh Circuit's analysis was relatively straightforward. On whether the gross valuation-misstatement penalty applied to Highpoint's transactions, the Eleventh Circuit analogized the facts with *United States v. Woods*,[59] another tax shelter case.[60] Even though the *Woods* case involved a different type of tax shelter, the result was similar because the underlying transaction (and partnership) was disregarded for lack of economic substance.[61] The Eleventh Circuit accepted the *Woods* analysis that there is no dispute that a determination of a partnership lacking economic substance is grounds for applying the gross valuation-misstatement penalty.[62] Both the *Woods* court and the Eleventh Circuit also agreed with the government's position in *Woods* that "[b]ecause there can be no outside basis in a sham partnership . . . any partner who reports an outside basis greater than zero commits a valuation misstatement."[63]

The second part of the Eleventh Circuit's analysis was more nuanced. To determine whether the Tax Court possessed deficiency jurisdiction over the valuation-misstatement penalty, the Eleventh Circuit first performed a statutory analysis by looking to the Code and related Treasury Regulations.[64] Code section 6230(a)(1) provides that Tax Court deficiency proceedings do not "apply to the assessment or collection of any computational adjustment," unless either section 6230(a)(2) or (a)(3) provides otherwise.[65] Under section 6231(a)(6), a "computational adjustment" is defined as "the change in the tax liability of a partner which properly reflects the treatment . . . of

56. *Id.* at 1056.
57. *Id.* at 1057.
58. *Id.* at 1059.
59. 571 U.S. 31 (2013).
60. *Highpoint Tower Tech.*, 931 F.3d at 1058.
61. *Woods*, 571 U.S. at 37.
62. *Highpoint Tower Tech.*, 931 F.3d at 1061–62.
63. *Id.* at 1062.
64. *Id.* at 1058–59.
65. I.R.C. §§ 6230(a)(1)–(3) (repealed 2017).

a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership . . . to an indirect partner shall be treated as computational adjustments."[66] Consequently, a "partnership item" is defined as "any item required to be taken into account for the partnership's taxable year . . . to the extent . . . such item is more appropriately determined at the partnership level than at the partner level."[67] Considering these statutory definitions in tandem, if a change in the tax liability of a partner reflects the treatment of an underlying partnership item, then the Tax Court's "deficiency proceedings will not apply to the assessment of that adjustment unless otherwise provided for in [Code section] 6230(a)(2) or (a)(3)."[68] The key to this part of analysis, then, hinges on the determination of whether the gross valuation-misstatement penalty at issue relates to an adjustment to a partnership item.[69] Highpoint contended that because the gross valuation-misstatement penalty was an "affected item[] which required partner level determinations,"[70] it could not simultaneously be a "penalt[y] . . . that related to adjustments to partnership items."[71]

However, the Eleventh Circuit reasoned that the "partnership item" definition includes "the legal and factual determinations that underlie the determination of the amount, timing and *characterization* of items of income, credit, gain, loss, deduction, etc."[72] Per case law, the underlying determination that a partnership is a sham plainly falls within this definition of a partnership item.[73] Therefore, the Eleventh Circuit sided with the IRS on the characterization of sham transactions and, as a result, concluded that "[t]he underlying legal determination that a partnership is a sham lacking economic substance—which caused the penalty to be applied in this case—falls within this 'partnership items' definition."[74] Furthermore, the Eleventh Circuit pointed out that the taxpayer overlooked the plain meaning under the treasury regulation, which provides that "[c]hanges in a partner's tax

66. I.R.C. § 6231(a)(6) (2012) (repealed 2017).

67. I.R.C. § 6231(a)(3) (2012) (amended 2017).

68. *Highpoint Tower Tech.*, 931 F.3d at 1057–58.

69. *Id.* at 1059.

70. *Id.* at 1058–59 (quoting I.R.C. § 6230(a)(2)(A)(i) (2012) (repealed 2017)).

71. *Id.* at 1058 (quoting I.R.C. § 6231(a)(5) (repealed 2017)). An "affected item" is defined as "any item to the extent such item is affected by a partnership item."

72. *Highpoint Tower Tech.*, 931 F.3d at 1058 (emphasis added). *See also* Treas. Reg. § 301.6231(a)(3)-1(b).

73. *Accord, e.g.*, *Woods*, 571 U.S. at 39–44.

74. *Highpoint Tower Tech.*, 931 F.3d at 1058. *See also* Treas. Reg. § 301.6231(a)(3)-1(b).

liability with respect to affected items that require partner level determinations . . . are computational adjustments . . . ."[75]

To buttress its position, the Eleventh Circuit again looked to *Woods*.[76] Although the jurisdictional issue between *Woods* and *Highpoint* was different—the court in *Woods* considered whether a district court had partnership-level jurisdiction over a gross valuation-misstatement penalty, whereas the Eleven Circuit determined whether the Tax Court had partner-level deficiency jurisdiction over a gross valuation-misstatement penalty—the penalty at issue was the same and the *Woods* line of reasoning was applicable to Highpoint's facts.[77] Most importantly, *Woods* made clear that even though penalties may only be logically imposed after partner-level determinations are made, whether certain penalties apply must be determined at the partnership level, and that these two seemingly contrasting approaches are not mutually exclusive.[78] In our view, this is a crucial conclusion that realistically applies the penalty regime to the flow-through nature of partnership taxation. Building upon that concept, the Eleventh Circuit joined the *Woods* court in rejecting the taxpayer's position that "a penalty does not relate to a partnership-item adjustment if it requires a partner-level determination."[79] Therefore, because Highpoint's gross valuation-misstatement penalty related to partnership-item adjustment, the Eleventh Circuit ruled that the Tax Court correctly found that it lacked jurisdiction over such determination.[80]

Although the Eleventh Circuit's analysis flows from a reasoned understanding of case law and statutory provisions, broader policy questions remain as to whether two distinct procedural pathways are necessary to determine a single taxpayer's deficiency amount, and whether the statutory lines in the sand between Tax Court and district court deficiency jurisdiction are arbitrary or instead grounded in practicality. Highpoint presented its views on these questions, arguing that by preventing it from addressing the penalty in Tax Court deficiency proceedings along with determination of other amounts—"and forcing it to raise challenges to the penalty in refund or Collection Due Process proceedings instead—is duplicative and contrary to the congressional intent behind the 1997 amendments to [the Tax Equity

75. *Highpoint Tower Tech.*, 931 F.3d at 1060.

76. *Id.* at 1062.

77. *Woods*, 571 at 41; *Highpoint Tower Tech*, 931 F.3d at 1064.

78. *Woods*, 571 U.S. at 41.

79. *Id.* at 40; *Highpoint Tower Tech.*, 931 F.3d at 1063.

80. *Highpoint Tower Tech.*, 931 F.3d at 1060–61.

and Fiscal Responsibility Act of 1982] that sought to streamline partnership tax litigation."[81] However, because the Eleventh Circuit found that the statutes clearly excluded the gross valuation-misstatement penalty from the Tax Court's deficiency jurisdiction, there was no need to address the taxpayer's legislative intent arguments.[82] As such, the system apportioning deficiency jurisdiction between the Tax Court and district courts remains unchanged over Highpoint's objections.[83]

81. *Id.* at 1060.

82. *Id.*

83. *See* Manroe v. Comm'r, T.C.M. 2020-16, at *15–16 (cited and reaffirmed the Eleventh Circuit's ruling in *Highpoint*).