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Reliance on Tax Opinion May Not Prevent Penalties

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Recent cases underscore hazards that may plague an attempt to rely on a legal opinion regarding tax matters (tax opinion) as a basis for avoiding penalties asserted by the Internal Revenue Service. The first problem is evident—the Service or a court may find that reliance on the opinion, under all the facts and circumstances, does not evidence the requisite "reasonable cause" and "good faith."

The second problem is more subtle, namely, that disclosure of the existence of the opinion and of the taxpayer's reliance on it may result in waiver of the attorney-client and work product privileges not only with respect to the opinion itself but also with respect to other communications between the taxpayer and its legal advisors.

Canal Corp. v. Commissioner[1]

WISCO, a wholly owned subsidiary of Chesapeake Corporation (since renamed Canal Corporation), manufactured commercial tissue paper products. At the same time, Chesapeake was engaged through other subsidiaries in other paper and packaging businesses. Chesapeake filed consolidated income tax returns with its subsidiaries.

The commercial tissue business was capital intensive, and several of the largest companies in the business underwent consolidation in the late 1990's. Under those circumstances, Chesapeake decided that it preferred to focus on its other businesses and hired Salomon Smith Barney (Salomon) and PriceWaterhouseCoopers (PWC) to explore strategic alternatives for the commercial tissue business.

A sale of WISCO was found to be undesirable, because Chesapeake had a low tax basis in WISCO and the tax cost of an outright sale would therefore be high. Salomon recommended, instead, that WISCO enter into a leveraged partnership structure with Georgia Pacific (GP). GP, a competitor of Chesapeake, was also engaged in the tissue business and had expressed interest in buying WISCO.

Pursuant to a plan, Chesapeake and GP would contribute their respective tissue businesses to a new joint venture (JV); a third party would lend funds to JV; and a "special distribution" of the loan proceeds would be made to WISCO, with WISCO retaining a 5% interest in JV after the distribution. It was intended that receipt of the "special distribution" be tax-free to WISCO.

GP was prepared to guarantee JV's obligation to repay the third party loan, but such a guarantee seemed to create a tax problem: if GP, and not WISCO, bore the "economic risk of loss" with respect to the loan, the special distribution to WISCO would become taxable to WISCO as part of a "disguised sale" of WISCO's assets to JV.[2] PWC, however, assisted Salomon with accounting and tax aspects of the transaction and advised that there would be no "disguised sale," and the distribution would be nontaxable to WISCO, if WISCO agreed to indemnify GP against any losses that GP might incur under GP's guarantee.

However, in order to mitigate the danger to WISCO arising from its exposure to this "economic risk of loss," the indemnity would be only as to the principal amount of the loan made to JV, due in 30 years, and WISCO's obligations would be subject to a requirement that GP proceed against the assets of JV before demanding indemnification from WISCO.

PWC agreed to provide a tax opinion, concluding that the transaction, if structured in this manner, "should" not be taxable to WISCO, and WISCO agreed to pay to PWC a fixed fee of $800,000, to be billed on the closing of the transaction.

The transaction was effected in 1999 just as proposed. It was reported as a sale for financial accounting purposes, but as a nontaxable contribution of assets to a partnership, followed by a nontaxable distribution, for income tax purposes.

Following an audit, the Internal Revenue Service issued a notice of deficiency to Chesapeake. The notice concluded that the transaction was, in fact, a disguised sale, resulting in recognition by WISCO of a $524 million gain, and also asserted a 20% "accuracy-related penalty" under Internal Revenue Code (Code) section 6662 by reason of a

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"substantial understatement of income tax."

Following the filing of a petition with the Tax Court by Chesapeake, the Tax Court agreed with the Service that WISCO's indemnity obligation should be disregarded under an "anti-abuse rule" in the applicable Treasury Regulations, that WISCO thus did not, and GP did, bear the "economic risk of loss" for the third party loan to JV, and that WISCO's transfer of its assets to JV was consequently a taxable disguised sale.

Although Chesapeake was thus found liable for the asserted tax, it might have escaped the "accuracy-related penalty" if it had been able to show that it acted with reasonable cause and good faith.[3] Chesapeake argued that it met this standard because it reasonably relied in good faith on a "should" opinion issued by a qualified tax advisor, but the Tax Court disagreed.

The Tax Court found that Chesapeake's reliance on the opinion was not reasonable because the opinion relied on unreasonable assumptions that effectively assumed away key issues at the crux of the transaction (such as whether the indemnity lacked substance), was disorganized and incomplete, and had many typographical errors.

Beyond the typographical errors and alleged disorganization, the court seems to have concluded that PWC's conclusion that the anti-abuse rule did not apply (a necessary step in its determination that the transaction was not a disguised sale) could not properly have been reached by PWC at a "should" level of certainty, since there was no authority directly on point. Thus, even though the opinion did discuss and rely on authority in analogous areas that PWC thought was at least persuasive, Chesapeake's reliance on the opinion was unreasonable.

The Tax Court also found that Chesapeake did not act in good faith in relying on the opinion because PWC's drafting was assertedly tainted by an inherent conflict of interest. For example, the individual who drafted the opinion was also heavily involved in planning the transaction and in drafting related documents, such as the joint venture agreement and indemnity agreement, thereby becoming more like a "promoter" than an independent tax advisor.

Most of all, the Tax Court seemed troubled by the $800,000 fixed fee for the opinion. The Tax Court's perception was that this fee was grossly in excess of a fee computed at ordinary hourly rates, and, when coupled with the fact that the fee was payable only upon a closing, it caused PWC to have a strong stake in causing the transaction to close. This allegedly constituted a conflict of interest on the part of PWC that precluded Chesapeake from relying in good faith on the tax opinion.

New Phoenix

In support of its conclusions on the penalty issue in *Canal Corp.*, the Tax Court cited its decision in *New Phoenix Sunrise Corporation v. Commissioner*. That decision was recently affirmed in an unpublished, but extensive, opinion by the Court of Appeals for the Sixth Circuit.[4]

New Phoenix Sunrise Corp. (Phoenix) caused its subsidiary Capital Poly Bag, Inc. (Capital) to sell its assets in 2001, resulting in a taxable gain of approximately $10 million. Apparently with a view to recognizing a loss to offset that gain, the principal officer of Phoenix and Capital was introduced to attorneys with Jenkins & Gilchrist (J&G), who proposed a transaction known as the "Basis Leveraged Investment Swap Spread."

This transaction structure, like a number of others that were developed during the 1990's and early 2000's, involves contributions to and distributions from a partnership that are effected in such a manner that, at the end of the day, the taxpayer purportedly holds an asset with an extremely high basis, but little fair market value. The taxpayer than sells that asset and "recognizes" a "loss" that is offset against other gains.[5]

In simplified form, the strategy implemented by Phoenix involved Capital's entering into largely offsetting foreign currency swap contracts with Deutsche Bank (DB), based on the exchange rate between Japanese yen and U.S. dollars. Capital's net investment in these contracts was approximately $262,500, consisting of a $10,631,250 premium paid by Capital to DB and an almost offsetting $10,368,750 premium paid by DB to Capital. All the contracts were then contributed to a newly formed partnership, Olentangy Partners (Olentangy), in which Capital owned a 99% interest.

Eventually, shares of Cisco Systems, an unrelated corporation, were purchased by Olentangy and distributed to Capital in connection with the dissolution of Olentangy. On its tax returns, Capital took the position that it acquired the Cisco shares at a basis of approximately $10,653,000, due to the premium paid by Capital to DB, without reduction for the offsetting premium paid by DB, and that the subsequent sale of the Cisco stock thus resulted in "recognition" of a "loss" by Capital that could be offset against the gain on the sale of its assets.

J&G provided a tax opinion to the effect that the basis that Capital could take into account on its sale of the Cisco shares was, in fact, computed by reference to the initial premium paid by Capital to DB, without reduction for the offsetting premium paid by DB to Capital. The Internal Revenue Service, the Tax Court, and the Court of Appeals all agreed that these transactions offered no opportunity to Capital to realize a profit and lacked economic substance, and that, absent such a profit motivation, no loss could be claimed for tax purposes.

The IRS asserted an accuracy-related penalty against Phoenix on the grounds of a "substantial valuation misstatement," in that the tax underpayment was attributable to a basis overstatement with respect to the Cisco stock of more than 50%.[6] Phoenix claimed that the penalty should not be imposed, because it relied reasonably and in good faith on the tax opinion from J&G in claiming the loss.

The Tax Court and the Court of Appeals sustained the penalty. Because J&G "actively participated in the development, structuring, promotion, sale, and implementation of the BLISS transaction," there was a conflict of interest that made it unreasonable for the taxpayer to rely on the tax opinion.

Waiver of Privilege. Phoenix argued on appeal that the Tax Court had erred in requiring Phoenix to disclose certain documents that were subject to protection as attorney work product or under the attorney-client privilege. Phoenix had introduced the J&G opinion into evidence in an effort to claim a reasonable cause defense with respect to penalties, and the documents that the Tax Court required Phoenix to disclose generally related to that tax opinion.

The Court of Appeals concluded that the Phoenix's attempt to use the J&G opinion to protect itself from the penalty created a "subject matter waiver" with respect to the other documents. Phoenix had attempted to avoid that waiver by arguing that the opinion was not a privileged communication in the first place, so that its disclosure could not give rise to a waiver.

However, the Court of Appeals found that the tax opinion was a confidential communication subject to attorney-client privilege—even though it was too tainted by conflict of interest to be taken into account in determining Phoenix's reasonable cause and good faith. The opinion recited facts communicated for the purpose of obtaining legal advice, obviously related to legal advice, and included a heading on the first page that labeled the document "CONFIDENTIAL" and "ATTORNEY-CLIENT PRIVILEGED."

Because the opinion was itself subject to the attorney-client privilege, the voluntary disclosure of the opinion constituted a waiver of the privilege not only as to the opinion itself but also as to related documents.

Observations

If these cases are to be taken at face value, the lessons to be drawn from them may be troublesome, especially because many of the circumstances that the courts found to be grounds for denying the taxpayer the ability to rely on a tax opinion are not atypical of how attorneys often advise on tax matters with respect to a transaction. For example, it is very common and often necessary for the attorneys involved in providing tax advice regarding a transaction to review and comment on the transaction documents.

However, a few points seem reasonably clear. Courts are obviously hostile to tax opinions provided for large fixed fees that are not determined by reference to the attorney time incurred. Further, fees the billing for which is contingent upon a closing are perceived to create a risk of conflict of interest between the adviser and the principal that may make "good faith" reliance on the opinion more difficult.

In addition, if a taxpayer anticipates relying, before the Internal Revenue Service or in litigation, on a tax opinion, in order to establish "reasonable cause" or "good faith" and thereby avoid penalties, consideration should be given to attempting to receive the advice in an unprivileged form, so as to mitigate, to some extent, the risk that subsequent disclosure of the written advice to the IRS will waive privilege with respect to other documents

Finally, it may be desirable in some situations—notwithstanding the apparent inefficiency and potential duplication of cost and effort—for a draft tax opinion prepared by one tax advisor, especially an advisor who might be viewed as a "promoter," to be reviewed by an attorney from another firm with appropriate expertise.[7] It's hard to be too careful these days!

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1 135 T.C. No. 9 (2010).

2 See Treasury Regulation sections 1.707-5(a)(2), (b) and 1.752-2. A detailed substantive tax analysis of the plan is beyond the scope of this article.

3 IRC §6664.

4 *New Phoenix Sunrise Corp. v. Commissioner*, No. 09-2354 (6th Cir. 2010), *aff'g* 132 T.C. 161 (2009).

5 Although, in some variations of this structure, the taxpayer continues to hold another asset with a high value, but low basis, thereby preserving an inchoate "phantom gain" that may one day be triggered, it seems to have been more common for taxpayers to assert that these transactions gave rise only to a "loss" significantly in excess of the taxpayer's economic investment, with no offsetting gain to be recognized at any time.

6 In fact, the discrepancy between the claimed basis and the correct basis was so large that there was a "gross valuation misstatement" subject to a 40% penalty.

7 This appears correct notwithstanding the statement in one of the cases discussed above confirming that taxpayers are not required to obtain a second tax opinion to qualify for the reasonable reliance exception under IRC §6664(c). *Canal Corp.*, 135 T.C. No. 9, note 16. *See also Countryside Limited Partnership v. Commissioner*, 132 TC 347 (2009), note 8 (discussing the meaning of "promotion" for purposes of an analogous issue under IRC §7525).