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How Many Tax Opinions Will You Need: And Where Will You Get Them?

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The American Jobs Creation Act of 2004 (the "Act"), which provided and extended many corporate tax benefits, also introduced onerous new rules limiting the ability of taxpayers to rely on "tax opinions" to avoid penalties.

Background

The Internal Revenue Code (the "Code") has long contained penalties to discourage taxpayers from taking improper positions that substantially understate their tax liability.[1] Prior to the Act, in the case of an understatement attributable to a "tax shelter," *i.e.*, a partnership, plan, or arrangement a significant purpose of which was the avoidance or evasion of Federal income tax, the penalty would be waived for a corporate taxpayer if there was "substantial authority" for its treatment of the item, the corporation reasonably believed that its tax treatment was more likely than not the proper treatment, there was reasonable cause for the underpayment, and the corporation had acted in good faith. To show "reasonable belief," corporations would often seek tax opinions of counsel – sometimes of their own counsel and sometimes of counsel who had promoted, or represented the promoters of, a transaction.

New Penalty

The Act created a new penalty (Code section 6662A) for "reportable transaction understatements." Although its nominal rate – 20% of the understatement – is identical to the rate previously applicable to substantial understatements of income tax, the impact of this new penalty is much more severe. It can apply in the absence of an actual underpayment of tax; for example, in a year in which the taxpayer's reporting of a transaction simply increases a net operating loss, an assumed 35% tax rate is employed to compute a hypothetical underpayment to which the penalty is applied. And from a broader perspective, the number of hoops through which a taxpayer must jump before the penalty can be waived on the grounds of reasonable cause and good faith has been significantly increased.

What Is A "Reportable Transaction Understatement"?

A "reportable transaction understatement" is an understatement attributable either to a "listed transaction" or to a "reportable transaction (other than a listed transaction) *if a significant purpose of such transaction is the avoidance or evasion of Federal income tax*." A "listed transaction" is one of the thirty transactions identified by the IRS in Notice 2004-67[2] and in

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[1] These include penalties of 20% for valuation overstatement, substantial understatement of income tax, or negligence, and 40% for gross valuation/basis overstatement.

[2] 2004-41 I.R.B. 600.

subsequent releases as being a tax avoidance transaction, as well as any transaction “substantially similar” to such an identified transaction. “Reportable transactions,” which can give rise to “reportable transaction understatements,” include the following: transactions offered to a taxpayer under conditions of confidentiality; transactions with “contractual protection” tying the fees paid to sustaining the tax consequences of the transaction; “loss transactions”; transactions with a significant book-tax difference; and certain transactions involving a brief asset holding period.[3] Although the IRS has published lists of transactions for which special tax return disclosure is not required and which thus will not be subject to this new penalty, many ordinary, *bona fide* commercial transactions will be subject to these rules. One such example would be a sale of a partnership interest at a large loss.

How Can You Avoid This Penalty?

If there is a reportable transaction understatement, a penalty can be avoided only if *all* of the following eight “requirements” are met:

1. There was reasonable cause.
2. The taxpayer acted in good faith.
3. The relevant facts affecting the tax treatment of the transaction were adequately disclosed.
4. There is “substantial authority” for the taxpayer’s treatment of the item.
5. The taxpayer reasonably believed *at the time the return was filed* that such treatment was *more likely than not* the proper treatment.
6. The taxpayer’s reasonable belief relates solely to chances of success on the merits, without giving effect to the “audit lottery” or to the possibility that an issue will not be raised on audit or might be settled.
7. The taxpayer’s reasonable belief is not based on the opinion of a “disqualified tax advisor.”
8. The taxpayer’s reasonable belief is not based on an opinion that is itself based on unreasonable factual or legal assumptions, unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person, or does not identify and consider all relevant facts.

The Penalty Can Increase to 30%

If the transaction is adequately disclosed (Requirement #3, above), but fails any of the other requirements, the penalty is 20%. But, if the transaction is not adequately disclosed, the penalty rate increases to 30%. In such a case, the taxpayer is also likely to be subject to a new “strict liability” penalty enacted by the Act in new Code section 6707A, under which the mere fact that a taxpayer has failed to make special tax return disclosure of the existence of a “reportable transaction” can result in a penalty of up to $200,000, even if the taxpayer’s treatment of the reportable transaction is correct as a substantive matter, and even if the taxpayer’s failure to make disclosure was due to reasonable cause and the taxpayer acted in good faith.

[3] The definitions and special rules applicable to these categories are set out in Treasury Regulation section 1.6011-4.

Focus on Tax Opinions

The first six requirements for avoiding a "reportable transaction understatement" penalty are not novel. But the last two, which relate to the source and nature of "tax opinions" secured to protect a corporation from penalties, open up a whole new world of concerns.

These requirements seem to have been drawn from several years of extensive tax shelter litigation that focused on the role played by "advisors," and the reliance that corporations and other taxpayers have placed on their "opinions." In the *Long Term Capital Holdings* case decided in 2004, the District Court critically analyzed the legal opinion upon which the taxpayer claimed to have relied, and found, first, that the opinion was wanting in a number of important respects, and second, that the taxpayer had an independent responsibility to understand the nature of the underlying transaction.[4]

Defining "Advisors"

A "disqualified tax advisor" (Requirement # 7) with respect to a transaction includes, among others, a "material advisor" who participated in the organization, management, promotion, or sale of the transaction. A "material advisor," in turn, is a tax advisor who receives a "minimum fee" (which can range from $10,000 to $250,000, depending on the nature of the transaction and the mix of corporate and noncorporate investors) for all services, including nontax services, in connection with the transaction.[5]

In Notice 2005-12,[6] the IRS provided guidance regarding the definition of "disqualified tax advisor." This guidance, which adopts a literal reading of the statutory provisions, may send corporations that engage in reportable transactions that might be said to have a significant purpose of tax avoidance – and just about every corporation that does tax planning of any sort can be said to engage in such transactions – scurrying for "second opinions" from tax counsel who were not involved in the negotiation of those transactions.

Under the Notice, a "material advisor" will be *disqualified* with respect to a transaction if the advisor does *any* of the following:

- Devises, creates, investigates, or initiates it.
- Devises the business or financial plans for it.
- Carries out those plans through negotiations or transactions with others.
- Performs acts relating to the development or establishment of the transaction, including preparing documents that either establish its structure (*e.g.*, a partnership agreement) *or* describe the transaction for use in promotion or sale (*e.g.*, offering memorandum) *or* register it with a governmental body.
- Is involved in the decision-making process regarding any business activity with respect to it.
- Manages assets, directs business activity, or acts as general partner, trustee, director, or officer of any entity involved in the transaction.

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4 See "A Tax Opinion Is Not A Bulletproof Vest" by Richard A. Levine, *The Metropolitan Corporate Counsel,* November 2004, for a discussion of tax opinions in the case of *Long Term Capital Holdings v. United States*, 94 AFTR2d 2004-5666, 2004-2 USTC para. 50,351 (Aug. 27, 2004).

5 Although the Regulations and Notices provide little guidance regarding the application of these rules to law or accounting firms providing a variety of tax and nontax services that earn the "minimum fee" in connection with a transaction, caution dictates treating all professionals at such a firm as "disqualified" if any of them has "participated in the organization, management, promotion, or sale of the transaction."

6 2005-7 I.R.B. 494 (Feb. 17, 2005).

- Is involved in marketing the transaction, including soliciting taxpayers to enter into a transaction, placing advertising for it, and instructing or advising others with respect to marketing.

Many of these restrictions are obviously aimed at preventing a taxpayer from relying on an opinion from a lawyer engaged by a promoter for purposes of obtaining waiver of the penalty. However, the statutory language, as interpreted by Notice 2005-12, sweeps much more broadly, and seems clearly to "disqualify" an opinion rendered by a firm that the taxpayer itself engaged to evaluate the transaction, negotiate with the promoter and any other counterparties, prepare documents, and otherwise assist in the implementation of the transaction, if, as will frequently be the case in large transactions, the firm's fee exceeds the threshold for "material advisor" status.

So What Can You Do?

What then is a corporation to do if it wishes to obtain a tax opinion that it can rely upon to form the basis of a "reasonable belief" defense to the assertion of a "reportable transaction understatement" penalty?

Notice 2005-12 provides one ray of hope:

> Consistent with the legislative history, a tax advisor, including a material advisor, will not be treated as participating in the organization, management, promotion or sale of a transaction if the tax advisor's only involvement is rendering an opinion regarding the tax consequences of the transaction. In the course of preparing a tax opinion, a tax advisor is permitted to suggest modifications to the transaction, but ...not material modifications ... that assist the taxpayer in obtaining the anticipated tax benefits.

In other words, hire one lawyer to implement the transaction, and another to tell you that it works! And then, don't let your two lawyers talk to each other, particularly if the effect will be to bring the transaction into closer compliance with the tax law!

But the travails are not over once you have identified a "nondisqualified" advisor. In December 2004, the Treasury Department issued new Regulations governing persons who practice before the IRS. Under these rules, which will go into effect on June 21, 2005, a practitioner, in order to give an opinion to his own client that relates to a listed transaction or a transaction that has a significant purpose of tax avoidance, will have to comply with a complex set of substantive and procedural requirements. Unless the practitioner opines with respect to every Federal tax issue that the taxpayer's position is "more likely than not" proper, the practitioner must state clearly in the opinion that it may not be relied upon to avoid penalties.

It all makes no sense, but that's what we've come to in the ongoing war against "tax avoidance" transactions. So a tax opinion that you can rely upon will be a lot harder to come by, and you will need to be more diligent in how you secure one. The tax lawyers are sitting at their telephones, waiting for your call.