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A Tax Opinion Is Not A Bulletproof Vest

By Richard A. Levine

Perhaps at some point you have secured a "tax opinion." The reasons for doing so vary, but usually involve a significant transaction. Often there is not enough time to get an advance ruling from the IRS as to the tax treatment of the transaction. Sometimes the law is unclear or the positions of the Treasury and the courts are in conflict, and you feel you should proceed with the transaction and argue your position upon examination.

In order to keep taxpayers from taking frivolous positions, substantially underreporting income, and then running the audit lottery that their position might not be discovered, the Internal Revenue Code contains steep penalties to discourage such action. Section 6662 includes penalties of 20% for valuation overstatement, 20% for substantial understatement of income tax, 20% for negligence, and 40% for gross valuation/basis overstatement.

No penalties are imposed if the taxpayer can show that there was substantial authority for the position and it acted in good faith. Generally, a "tax opinion" from a tax professional, be it an attorney or CPA, is secured to demonstrate that the taxpayer sought the advice, which confirmed the validity of its position, and it relied on the opinion.

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A recent case in the District Court of Connecticut reviewed criteria as to the scope and nature of what a tax opinion should contain, and also considered the level of sophistication of the taxpayer in determining its right to rely on the tax opinion. Although this case involved a tax shelter, the Court's analysis of the tax opinion at issue should sound an alarm to corporate counsel and other executives who secure tax opinions in significant transactions in an effort to avoid tax penalties, as well as the law firms that provide those opinions.

Complicated Fact Pattern

Tax cases usually involve complicated fact patterns and detailed analyses of obscure tax regulations and previously decided cases. The recent decision in *Long Term Capital Holdings*[1] does not disappoint – it has all of that and more. The facts in this case involved complicated transactions, involving high-basis, low-value preferred stock which resulted from a series of prearranged transactions related to the acquisition of nine cross-border leasing transactions, five of which involved master or wraparound leases of computer equipment and four which involved the sale/leaseback of trucks. The preferred shares were worth approximately $1 million and had a claimed tax basis of more than $100 million. At issue was a reported long term capital loss claimed by a partnership of about $100 million on the sale of the preferred stock.

Understanding the facts involved in this case is not nearly as important as understanding the impact of the Court's analysis of the taxpayer's circumstances and actions in dealing with the transaction. Although this was a tax shelter case, its impact may well apply to normal corporate transactions that have nothing to do with tax shelters.

How The Court Viewed The Transaction

Upon sifting through the facts, the Court concluded that LTC had no business purpose for engaging in the transaction other than tax avoidance, and the transaction itself did not have economic substance beyond the creation of tax benefits. The Court concluded that the transaction was a tax shelter for purposes of the understatement penalty. This meant that penalties applied unless the taxpayer had both "substantial authority" and a reasonable belief that "more likely than not" the basis of the preferred shares was as claimed.

Tax regulations provide that substantial authority exists if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. They also provide that a taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper treatment if the taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if that opinion is based on the tax advisor's analysis of the pertinent facts and authorities and unambiguously states that the tax advisor concludes that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS.

Tax Opinions Secured

As is true in most tax shelter transactions, the partnership insisted upon a tax opinion to protect against civil penalties.

Accordingly, the partnership obtained separate tax opinions from two prominent law firms. LTC engaged Sherman & Sterling, which had advised on the underlying lease transactions, for an opinion that the preferred stock in the hands of the contributing partner had a high basis. It also retained King & Spalding to provide an opinion that the high basis in the preferred stock carried over to the LTC partnership.

Penalties Asserted

Having found that LTC was not entitled to claim a loss on the sale of the preferred shares, the Court turned its attention to the matter of penalties. It focused on the 40% penalty for gross valuation/basis overstatement under IRC §6662(a), (b)(3), and (h). In the alternative, it considered the 20% penalty for valuation overstatement, and the 20% penalty for substantial understatement of income tax under IRC §6662(a) and (b).

Reliance On Opinions

LTC contested the penalties on the ground that it relied on the legal opinions of Sherman & Sterling and King & Spalding and that reliance satisfied the reasonable cause exception to those penalties set forth in IRC §6664(c)(1).

Since the Court did not need to reach a conclusion on the issues addressed in the Shearman & Sterling opinion, it focused on the King & Spalding opinion and concluded that LTC was not justified in relying on this opinion to avoid penalties for a number of reasons, which it proceeded to analyze in detail.

Court's Analysis Of The Opinion

King & Spalding's written opinion was furnished to the LTC more than eight months after LTC filed the partnership return. The Court found that there was no reliable basis in the record from which to conclude what, if any, opinions from King & Spalding LTC actually received prior to filing its return. Even if an opinion was communicated verbally, there was inadequate evidentiary basis for accurately determining what the verbal opinion consisted of and what analysis supported it. The Court refused to "relate back" the written advice provided by King & Spalding in January, 1999 to the April 15, 1998 filing date of the return. While the Regulations provide that verbal advice may be relied upon to avoid the penalty, the Court's opinion demonstrates the danger in so doing – a failure of proof at trial. The lesson here is to make sure you have received and read the tax opinion before the return is filed.

The Court then dissected the analysis in King & Spalding's written opinion and found that even if it had been received prior to the filing of the tax return, it was inadequate in a number of respects.

It observed that the opinion stated, in its opening paragraph, that it was part of a litigation strategy in anticipation of future litigation over the claimed losses, which caused the Court to suggest that its timing and stated purpose cast doubt upon it serving as a reasoned opinion on the application of the tax law to the facts for client guidance in tax reporting.

The Court criticized King & Spalding's opinion because it made no effort to demonstrate factually or analytically why it was reasonable to rely on assumptions and representations made by LTC that it had entered into the transaction for business purposes other than tax avoidance; that it reasonably expected to derive a material pre-tax profit from the transaction; and that there was no pre-existing agreement on the part of the contributing partner to sell its partnership interest to LTC.

The Court noted that the opinion failed to demonstrate that the advice was based on the law related to the actual transaction at hand and not based on unreasonable assumptions. The Court also observed that the opinion failed to address any Second Circuit authority, even though that is the circuit in which LTC resided at the time the return was filed.

It noted that there was little, if any, legal analysis of the economic substance of the transaction, and what little there was stemmed from a directive from the taxpayer to assume that the transaction had business purpose and that there was a reasonable expectation of profit.

In criticizing the opinion for its analysis of cases on the issue of the application of the step transaction doctrine, it suggested that this was an example of selective discussion of authority which gave it the appearance of an advocacy piece, not a balanced reasoned opinion with the objective of guiding a client's decisions.

What This Means For The Future

From a reading of this case, one easily concludes that this was a sophisticated taxpayer in a very sophisticated financial business. And its executives were fully capable of understanding complicated financial transactions, including the area of taxation.

The Court's discussion of LTC's right to rely on the opinion suggests that the Court imposed a very high standard upon this particular taxpayer to understand the transaction and its business and tax impact. It seemed to place upon those executives the burden to read and understand all the cases cited by its tax advisor in the tax opinion, to make sure that the tax advisor had cited all the relevant cases and other authorities and analyzed them correctly, and to find all the cases or other authorities that might be pertinent to the issues covered by the opinion that the tax adviser did not cite and determine whether they should have been cited. This appears to place a totally unreasonably burden on taxpayers, even sophisticated taxpayers in tax shelter cases, in order to establish good faith reliance on the tax adviser's legal opinion.

This case is a lesson, as well as an omen, for taxpayers hoping to rely on a legal opinion to avoid an accuracy related penalty. Although the same criteria might not be placed on taxpayers with less sophisticated management, how can one determine where to draw the line? This Court has set a high bar, and legal advisors should take notice that their written opinions should contain a complete analysis of the facts, as well as the law.

The IRS appears to believe it has found gold in this opinion. Citing this case, Chief Counsel recently issued a directive to all IRS Appeals Officers and Chief Counsel staff attorneys[2] that henceforth tax cases cannot be settled by trading a taxpayer's concession to a tax adjustment for the IRS concession of the asserted penalties on the general grounds of "hazards of litigation." Instead, the Appeals Officer or attorney must submit separate hazards of litigation analyses supporting the proposed settlement of the tax issues and of the penalty issues.

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[1] *Long Term Capital Holdings, et al., v. United States.* 94 AFTR2d 2004-5666; 2004-2 USTC ¶50,351; August 27, 2004.

[2] *Chief Counsel Notice* 2004-36 (September 22, 2004).