2012

Penalty Protection Opinions and Advisor Conflicts of Interest

David T. Moldenhauer

PENALTY PROTECTION OPINIONS AND ADVISOR CONFLICTS OF INTEREST

David T. Moldenhauer[*]

I. INTRODUCTION

When taxpayers underreport their federal income taxes, they are subject to a complex set of penalty regimes.[1] The type of penalty that may be imposed depends on factors such as the taxpayer's state of mind and efforts to correctly calculate its taxes, the type of issue that results in an underreporting, the type and level of authority supporting the taxpayer's position, and whether the taxpayer disclosed the issue on its tax return. However, there is a common exception for almost all the

∗ © Partner, Clifford Chance US LLP, Adjunct Professor, New York Law School.

1. I.R.C. § 6663 (2006) (fraud); *Id.* § 6662(b)(1) (2006) (negligence or disregard of rules or regulations); *Id.* § 6662(b)(2) (substantial understatements of federal income tax); *Id.* § 6662(a) (understatements with respect to reportable transactions); *Id.* § 6662(b)(6) (understatements with respect to transactions lacking economic substance or failing to meet the requirements of any similar rule of law).

penalty regimes where the taxpayer shows reasonable cause for its position, and that it acted in good faith in taking the position.[2] In many cases, a taxpayer can establish reasonable cause and good faith by showing that the taxpayer reasonably relied in good faith on professional tax advice.[3]

The penalty system serves a crucial role in fostering voluntary compliance with the tax law.[4] However, Congress generally has rejected the automatic imposition of penalties for understatements of tax because of the complexity and uncertainty of many tax rules and principles.[5] A

---

2. *Id.* § 6664(c)-(d) (2006). The reasonable cause and good faith exception does not apply to understatements arising from transactions that lack economic substance or fail to meet the requirements of any similar rule of law. Also, as discussed below, a modified version of the reasonable cause and good faith exception applies to understatements arising from so-called "reportable transactions."

3. Treas. Reg. §§ 1.6664-4(c), 1.6664-4(f)(2) (as amended in 2003). *Cf.* I.R.C. § 6664(d)(4)(B) (defining circumstances where advice may not be relied upon to establish the taxpayer's reasonable belief about a position in a reportable transaction).

4. *See* STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) 31 (Comm. Print 1999) [hereinafter STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS]:

> Penalties for the failure to comply with tax laws are a necessary component of any system of tax laws if broad compliance with the tax laws is to be expected. Penalties for the failure to comply with laws serve to establish and validate the standards of behavior set forth by the tax laws themselves, as well as to punish specific departures from such laws. Furthermore, the application of penalties in specific instances will help to promote the continued compliance with the tax laws by the currently law-abiding. In the absence of penalties, the tax laws would, at best, represent a suggested code of behavior. Anyone who disagreed with such code would be able to violate it without consequence.

COMMISSIONER'S EXECUTIVE TASK FORCE ON CIVIL PENALTIES, INTERNAL REVENUE SERVICE, REPORT ON CIVIL TAX PENALTIES II-2 (1989) [hereinafter REPORT ON CIVIL TAX PENALTIES]:

> Given the wide-ranging responsibilities of the IRS and the ultimate reliance of our taxation system on voluntary compliance, penalties have a relatively limited, though important role. The compliance function of IRS is principally concerned with protecting and enhancing voluntarily compliant conduct by taxpayers. Penalties constitute one important tool for IRS to use in pursuing its mission of encouraging voluntary compliance. In line with IRS's mission, IRS believes that penalties are positively related to the accomplishment of IRS's mission only if they operate to encourage voluntary compliance, and that penalties can and should be evaluated solely on the basis of whether they do the best possible job of encouraging compliant conduct.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, REPORT ON CIVIL TAX PENALTIES: THE NEED FOR REFORM 2-3 (2009) [hereinafter AICPA REPORT].

5. *See generally* GENERAL EXPLANATION OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 216-17 (Comm. Print 1982) ("Congress recognized that taxpayers and the Government may reasonably differ over the sometimes complex Federal tax laws, and that a penalty is not appropriate in many cases in which there is a large underpayment because there was substantial authority for the taxpayer's position"); H.R. REP. NO. 97-760, at 575 (1982) (Conf. Rep.):

regime that penalizes taxpayers that incorrectly claim benefits they legitimately believe are available risks creating the public perception that the tax law is arbitrary and unfair.[6] Thus, the penalties for misreporting tax return information do not penalize the misreporting *per se*, but the taxpayer's failure to adhere to a standard of behavior in determining and reporting its tax liability.[7]

> [t]he conferees did not adopt an absolute standard that a taxpayer may take a position on a return only if, in fact, the position reflects the correct treatment of the item because, in some circumstances, tax advisors may be unable to reach so definitive a conclusion. Rather, the conferees adopted a more flexible standard under which the courts may assure that taxpayers who take highly aggressive filing positions are penalized while those who endeavor in good faith to fairly self-assess are not penalized.

Congress has imposed strict liability penalties for understatements arising from transactions lacking economic substance or failing to meet the requirements of any similar rule of law, and from "reportable transactions" that are not disclosed to the Internal Revenue Service ("IRS"). I.R.C. §§ 6664(c)(6), (d)(2), (d)(3) (2006).

6. *See* REPORT ON CIVIL TAX PENALTIES, *supra* note 4, at VIII-36:

> A strict liability penalty would be simple, easy to comprehend, and easy to administer. Because of the certainty of its application, such a penalty might be adequately severe even at lower rates. On the other hand, the penalty would apply regardless of whether the taxpayer met the proposed standard of behavior. Thus, the penalty would treat similarly situated taxpayers differently. Given the complexity of the factual situations involved and the complexity of the tax law, the Task Force believes that the number of such penalties imposed on compliant taxpayers would be unacceptably high. The Task Force was concerned that regularly penalizing taxpayers who comply with the standard would be considered unfair, would destroy the moral and ethical connotations of the penalty, and would ultimately undermine the standard of behavior. Thus, the Task Force rejected a strict liability penalty.

See also Clinton Stretch, Matthew Lay & John Galotto, *Economic Substance and Strict Liability Do Not Mix*, TAX NOTES 1357 (2009); AMERICAN BAR ASS'N TAX SECTION, STATEMENT OF POLICY FAVORING REFORM OF FEDERAL CIVIL TAX PENALTIES 9 (2009) [hereinafter ABA STATEMENT]; AICPA REPORT, *supra,* note 4, at 9-10.

7. *See* STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS, *supra* note 4, at 156:

> [t]he accuracy-related and return preparer penalties are designed to delineate (1) whether an erroneous position should be considered innocent and not subject to penalty, (2) when taxpayers should specifically notify the IRS that they are adopting controversial positions, and (3) when taxpayers are taking unduly aggressive positions and should be penalized for any resulting tax deficiency regardless of disclosure

REPORT ON CIVIL TAX PENALTIES, *supra* note 4, at II-4:

> Our general definition of a "penalty" as an adverse consequence imposed for violating a federal tax rule takes as a starting point a distinction between the consequence i.e., the penalty) imposed for violating a rule and the rule itself. This distinction between a rule and the consequence of violating it establishes the fact that penalties operate in the service of a set of other rules or expectations. The identification of the set of rules protected by penalties becomes, then, a critical issue, for each penalty should be evaluated based on its success in protecting or improving compliance with the rule to which it relates.

See also REPORT ON CIVIL TAX PENALTIES, *supra* note 4, at III-1-III-2 (penalties should set and validate standards of behavior, deter departures from those standards of behavior, and provide taxpayers who depart from those standards their just desserts).

The penalty standard of taxpayer behavior has evolved,[8] but the modern penalty system generally has allowed a taxpayer to avoid penalties by establishing a bona fide belief that its position had a minimum likelihood of succeeding if challenged by the IRS and litigated.[9] Because most taxpayers cannot independently determine the likelihood of success of a complex position, the current penalty system recognizes that a taxpayer often must rely on professional tax advice to determine its proper tax liability.[10] However, the penalty system also recognizes that taxpayers should not be able to avoid penalties simply by obtaining favorable tax advice if that advice does not meet minimum standards of relevance and reliability, or if the taxpayer's reliance is not reasonable and undertaken in good faith.[11]

---

8. *See* Peter A. Prescott, *Taxpayer Civil Penalty Protection: Long Term Capital Holdings and its Wake*, 81 TEMP. L. REV. 995, 1010-14, 1026-28 (2008); ABA STATEMENT, *supra* note 6, at 2-4; REPORT ON CIVIL TAX PENALTIES, *supra* note 4, at VIII-2-VIII-10.

9. I.R.C. § 6664(c)-(d) (2006); Treas. Reg. § 1.6664-4 (as amended in 2003).

10. *See* REPORT ON CIVIL TAX PENALTIES, *supra* note 4, at VIII-12 ("[t]he advisory and executory functions provided by practitioners is important to the preparation of returns in many situations and must be taken into account in identifying the appropriate standard.").

11. A number of commentators have discussed the standards that opinions should meet to permit a taxpayer to avoid penalties. *See, e.g.*, Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111 (2009); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017 (2009); Henry P. Bubel, *Avoiding Penalties with Tax Opinions After Long Term Capital*, 817 PLI/TAX 785 (2008). *See generally* Prescott, *supra* note 8.
More generally, many viewpoints have been expressed about the responsibilities of tax advisors in providing penalty protection opinions. *See, e.g.*, BERNARD WOLFMAN, JAMES P. HOLDEN & KENNETH L. HARRIS, STANDARDS OF TAX PRACTICE § 101.2 (6th ed. 2006) (The "practitioner's obligation to the client, however, is not unrestricted. The practitioner also owes a duty, albeit less well-defined, to the tax system as a whole."); Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583 (2006); Michael C. Durst, *The Tax Lawyer's Professional Responsibility*, 39 U. FLA. L. REV. 1027 (1987); Theodore C. Falk, Tax Ethics, *Legal Ethics and Real Ethics: A Critique of ABA Formal Opinion 85-352*, 39 TAX LAW 643 (1986); Linda Galler, *The Tax Lawyer's Duty to the System*, 16 VA. TAX REV. 681 (1997) (reviewing Bernard Wolfman, James P. Holden & Deborah H. Schenk, *Ethical Problems in Federal Tax Practice* (1995)); Myron C. Grauer, *What's Wrong with This Picture?: The Tension Between Analytical Premises and Appropriate Standards for Tax Practitioners*, 20 CAP. U. L. REV. 353 (1991); Gwen Thayer Handelman, Reply, *Counseling Ordered Liberty*, 9 VA. TAX REV. 781 (1990); Gwen Thayer Handelman, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 77 (1989); James P. Holden, *Practitioners' Standard of Practice and the Taxpayer's Reporting Position*, 20 CAP. U. L. REV. 327 (1991); James P. Holden, Commentary, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 771 (1990); David J. Moraine, *Loyalty Divided: Duties to Clients and Duties to Others–the Civil Liability of Tax Attorneys Made Possible by the Acceptance of a Duty to the System*, 63 TAX LAW 169 (2009); Loren D. Prescott, Jr., *Challenging the Adversarial Approach to Taxpayer Representation*, 30 LOY. L.A. L. REV. 693 (1997); Deborah H. Schenk, *Tax Ethics*, 95 HARV. L. REV. 1995 (1982) (reviewing Bernard Wolfman & James P. Holden, *Ethical Problems in Federal Tax Practice* (1981)); Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 CONN. L. REV. 431, 468-76, 483-85 (2008); Camilla E. Watson, *Tax Lawyers, Ethical Obligations, and the Duty to the System*, 47 U. KAN. L. REV. 847, 909 (1999).

In determining whether a taxpayer's reliance on professional tax advice is reasonable and undertaken in good faith, courts have considered whether the tax professional has a conflict of interest.[12] The focus on conflicts of interest is understandable—if the tax professional has a personal interest in whether the taxpayer claims a position, the tax advice may not reflect an objective assessment of the position's merits. If the advice is not an objective assessment, but rather a self-interested assertion, there is little reason to permit the taxpayer to rely on the advice to avoid penalties, assuming that the taxpayer knew or should have known of the tax advisor's own interest.

In many of the relevant court cases, the tax professionals' conflicts of interest were clear and egregious: tax professionals who developed or marketed artificial tax shelters, prepared documents that created the illusion of legitimate business transactions, based their opinions on inaccurate factual assumptions, and were paid based on whether the taxpayer entered into the transaction, or claimed the alleged tax savings. However, in other cases, the factors suggesting a conflict of interest

12. Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1381-83 (Fed. Cir. 2010), *aff'g* 82 Fed. Cl. 636, 714-15 (2008); Am. Boat Co. v. United States, 583 F.3d 471, 481-83 (7th Cir. 2009); Mortensen v. Comm'r, 440 F.3d 375, 387-88 (6th Cir. 2006); Van Scoten v. Comm'r, 439 F.3d 1243, 1253-54 (10th Cir. 2006); Chamberlain v. Comm'r, 66 F.3d 729, 732-33 (5th Cir. 1995); Goldman v. Comm'r, 39 F.3d 402, 408 (2d Cir. 1994); Pasternak v. Comm'r, 990 F.2d 893, 903 (6th Cir. 1993); Iles v. Comm'r, 982 F.2d 163, 164-66 (6th Cir. 1992); Klamath Strategic Inv. Fund v. United States, 472 F. Supp. 2d 885, 904-05 (E.D. Tex. 2007), *aff'd on other grounds*, 568 F.3d 537 (5th Cir. 2009); Maguire Partners-Master Invs., LLC v. United States, No. CV 06–07371–JFW(RZx), 2009 WL 4907033 (C.D. Cal. Dec. 11, 2009); Murfam Farms, LLC *ex. rel.* Murphy v. United States, 94 Fed. Cl. 235, 247-48 (2010); Alpha I, L.P. v. United States, 93 Fed. Cl. 280 (2010); Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 56-57 (2007); 106 Ltd. v. Comm'r, 136 T.C. 67 (2011); Canal Corp. v. Comm'r, 135 T.C. 199 (2010); New Phoenix Sunrise Corp. v. Comm'r, 132 T.C. 161, 193-95 (2009); Kerman v. Comm'r, 101 T.C.M. (CCH) 1241 (2011); Palm Canyon X Inv., LLC v. Comm'r, 98 T.C.M. (CCH) 574 (2009); Santa Monica Pictures, LLC v. Comm'r, 89 T.C.M. (CCH) 1157 (2005); CMA Consol., Inc. v. Comm'r, T.C.M. (RIA) 2005-16.

See also Mark W. Everson, *IRS Penalty Policy Statement*, 2003 TNT 249-9 (Dec. 29, 2003):

> [t]axpayers may not rely on the advice of a tax advisor who has a financial arrangement or a referral agreement with a tax shelter promoter. The tax advisor's independent judgment is compromised by these arrangements and agreements. Accordingly, the Service will question the reasonableness and good faith of taxpayers who know or have reason to know that the tax advisor is not independent. The Service will not accept reliance on an opinion from a non-independent tax advisor as proof of reasonable cause and good faith on the part of the taxpayer.

In a number of other cases, courts have considered whether non-tax professionals have a conflict of interest precluding taxpayers' reliance on their statements for purposes of a establishing reasonable cause and good faith defense to penalties.

See, e.g., Neonatology Assocs., P.A. v. Comm'r, 299 F.3d 221, 234 (3d Cir. 2002) (insurance agent); Anderson v. Comm'r, 62 F.3d 1266, 1271 (10th Cir. 1995) (independent broker); Allison v. United States, 80 Fed. Cl. 568, 594, 598, 600 (2008) (investment advisor and accountant).

were more subtle: the tax advisor developed or implemented the tax strategy; the tax strategy was separable from the underlying business transaction; the tax advisor influenced the facts on which his opinion was based; the tax advisor did not charge standard hourly rates, or agreed to receive a fee that was contingent on the completion of the transaction; or the tax advisor's legal analysis contained omissions or errors.

Most of the cases fail to articulate a test for determining whether a tax advisor has a disqualifying conflict of interest, other than stating generalities about a tax advisor developing, promoting, or implementing a tax shelter in which he has a financial interest. In only one case has the court defined the circumstances when a tax advisor will be treated as a "promoter," by postulating a contrasting paradigm of the disinterested and objective tax advisor.[13] Under that paradigm, the tax advisor has a long term and continual relationship with the taxpayer, the advisor does not give unsolicited advice to the taxpayer, the advisor advises only within his field of expertise, the advisor follows his regular course of conduct in rendering the advice, the advisor charges only his regular hourly rate, and the advisor has no other stake in the transaction.[14]

What the court decisions leave unclear is how to evaluate a taxpayer's reliance on tax advice when features of the ideal paradigm are missing. In practice, one frequently finds cases where a taxpayer engages a tax advisor for the first time to handle a transaction; where a tax advisor brings a transaction to his client or alerts the client of the need for tax advice; where a tax advisor takes a role in negotiating the commercial terms of a transaction on which he is providing tax advice; where a tax advisor makes relevant factual inquiries that are beyond the his specific area of expertise; and where a taxpayer and a tax advisor agree a fixed fee, or a fee that depends on whether the transaction completes.

When one or more of the ideal features is missing, we need a framework for analyzing whether to deny the taxpayer the ability to rely on the tax advice to avoid penalties. How to define that framework depends ultimately on the purpose of the reasonable cause and good faith standard. If the purpose is to make predictions of the proper tax treatment more reliable, the framework should identify each factor that may induce an advisor to express overconfidence, and to balance the potential distortive effects against the cost to a taxpayer of obtaining

13. *See 106 Ltd.*, 136 T.C. 67.
14. *Id.* at 80.

advice without that factor. On the other hand, if the purpose of the reasonable cause and good faith standard is to avoid penalizing taxpayers who did not have reason to know that their tax return positions were incorrect, the framework should focus on whether a particular conflict has distorted the advice and whether the taxpayer should have known of the potential distortion.[15]

The reasonable cause and good faith test contains elements of both purposes. To be relied upon, an opinion must satisfy certain objective requirements that are likely to increase its predictive value: the advice must be based on all pertinent facts and circumstances and the related law; it must take into account the taxpayer's purposes and their relative weight; it must not be based on unreasonable assumptions or rely unreasonably on factual sources; it generally must be supported by certain types of legal authority and reach conclusions at a minimum level of confidence. However, assuming those requirements are satisfied, the regulations do not require that an opinion be rendered under objectively perfect conditions. Instead, the regulations focus on the taxpayer's attempts to determine its proper tax liability.

The taxpayer's attempts to determine its proper tax liability must satisfy both an objective reasonableness standard and a subjective good faith standard. Therefore, a court must consider both whether a reasonably prudent taxpayer would recognize the temptation for an advisor to give distorted advice, and whether the specific taxpayer intentionally overlooked the potential distortion. Because it frequently is difficult to know exactly what a taxpayer or an advisor was thinking, the cases have tended to confuse the objective potential for distortion with the distortion itself and create *per se* rules that disqualify advice where the advisor has a conflict of interest.

In creating a *per se* rule, a court effectively makes a subjective judgment about the level of temptation that a tax professional can resist. There are two problems with this approach. First, what counts is not whether a hypothetical tax advisor could resist the temptation, but how the real, live tax advisor responded. Even without perfect knowledge of the tax advisor's subjective response, there usually is some evidence of the manner in which the tax advisor behaved, and that information will be more informative than a court's speculations about a hypothetical advisor.

15. *See* Doran, *supra* note 11, at 122 (tax penalties serve the instrumental function of promoting tax compliance, and the function of defining tax compliance); Richard J. Wood, *Accuracy-Related Penalties: A Question of Values*, 76 IOWA L. REV. 309, 320 (1991) ("noncompliant taxpayers should be subject to penalty only if it would enhance compliance.").

Second, and more importantly, the focus of the reasonable cause and good faith exception is not on the behavior of the tax advisor but rather on that of the taxpayer. The most important factor is whether, under all the pertinent facts and circumstances, the taxpayer has made a reasonable effort to assess its proper tax liability.[16] Therefore, the proper analysis should be the extent to which the taxpayer is aware of a potential temptation for the tax advisor to distort his advice, and the extent to which the circumstances indicate that the advisor has resisted those potential temptations.

This article has five parts. The second part describes the statutory and regulatory standards for taxpayers seeking to rely on tax advice to avoid penalties. The third part describes the cases where a taxpayer has sought to rely on the opinion of a tax advisor with a conflict of interest. Those cases involve three types of situations: (1) tax advisors acting as promoters or brokers of a tax shelter; (2) tax advisors with referral arrangements with tax shelter promoters; and (3) tax advisors that are developers or implementers of a tax strategy. Typically, in the first two types of situations, it is easy to conclude that the taxpayer should have known of the temptation for the tax advisor to provide distorted advice and to determine that the advisor did not sufficiently resist such temptation. However, in the third type of situation, the temptations facing a tax advisor often are much more subtle, and it often is difficult to isolate those temptations from many typical conditions facing a tax advisor with a transactional practice. It likewise is difficult for a taxpayer receiving advice in a transactional context to evaluate how the advisor has responded to any temptation.

The fourth part of this article proposes a framework for analyzing how a conflict of interest may affect the reliability of a tax advisor's opinion. It first argues that the analysis should not apply a *per se* rule, but rather should determine reasonableness and good faith from the perspective of what the taxpayer knew or should have known of the tax advisor's conflict and how the conflict may have affected the reliability of the opinion. In the absence of a *per se* rule, a court first should consider whether a conflict is relevant to the reliability of the opinion. If the conflict is relevant, the court should consider both (1) the inducement that the apparent conflict may have created to distort the advice ("temptation"), and (2) the advisor's apparent response to such inducement ("resistance"). These two variables can be used to create a framework where the level of apparent temptation is compared to the

16. Treas. Reg. § 1.6664-4(b)(1) (as amended in 2003).

level of apparent resistance. Thus, for example, a court should be more vigilant in a case involving a high level of apparent temptation and a low level of apparent resistance, than in a case involving a low level of apparent temptation and a high level of apparent resistance. Finally, the article explores common forms of temptation that tax advisors face when advising on tax-motivated transactions, and considers the circumstances when an advisor's response to those temptations can make an opinion unreliable.

II. STANDARDS FOR RELYING ON TAX ADVICE TO AVOID PENALTIES

Section 6664(c) of the Code and the associated Treasury Regulations provides an exception to the penalties for fraud, negligence, or disregard of rules or regulations, and substantial understatements of federal income tax where the taxpayer shows that it had reasonable cause for the position, and acted in good faith with respect to the position.[17] Treasury Regulation Section 1.6664-4(b)(1) states that:

> the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge and education of the taxpayer. . . . Reliance on professional tax advice constitutes reasonable cause and good faith only if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.[18]

All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on such advice.[19]

Treasury Regulation Section 1.6664-4(c)(1) states that a taxpayer will not be considered to have reasonably relied on tax advice unless the advice satisfies various requirements.[20] First,

> the advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example,

17. *Id.* § 6664 (c).
18. *Id.* §1.6664-4(b).
19. *Id.* § 1.6664-4(c)(1). For example, the taxpayer's education, sophistication, and business experience will be relevant.
20. *Id.* § 1.6664-4(c)(1).

> the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, [the advice] will not qualify if the taxpayer fails to disclose a fact that it knew, or reasonably should have known, was to the proper tax treatment of the transaction.[21]

Second,

> the advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knew, or had reason to know, was unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.[22]

Third, "a taxpayer may not rely on an opinion or advice that a regulation is invalid unless the taxpayer adequately disclosed the position that the regulation in question is invalid."[23] If the underpayment is attributable to a reportable transaction, failure by the taxpayer to properly disclose the transaction is a strong indication that the taxpayer did not act in good faith.[24]

Treasury Regulation Section 1.6664-4(f) contains special rules for purposes of applying the reasonable cause and good faith exception to tax shelter items of corporations.[25] A corporation's legal justification may be taken into account only if (1) there is substantial authority for the tax treatment of the item, and (2) based on all facts and circumstances, the corporation reasonably believed, at the time the tax return was filed, that the tax treatment of the item was more likely than not the proper treatment.[26] The reasonable belief requirement will be considered satisfied if either:

- The corporation analyzed the pertinent facts and authorities in the manner described in Treasury Regulation Section 1.6662-

21. *Id.* § 1.6664-4(c)(1)(i).
22. *Id.* § 1.6664-4(c)(1)(ii) (as amended in 2003).
23. *Id.* § 1.6664-4(c)(1)(iii).
24. *Id.* § 1.6664-4(d).
25. *Id.* § 1.6664-4(f). In the case of reportable transactions subject to the penalty in I.R.C. § 6662A, the rules in Treas. Reg. § 1.6664-4(f) are effectively superseded by the rules contained in I.R.C. § 6664(d), discussed below.
26. *Id.* § 1.6664-4(f)(2)(B).

4(d)(3)(ii) (relating to the substantial authority test), and in reliance upon that analysis, reasonably concluded in good faith that there was a greater than 50% likelihood that the tax treatment of the item would be upheld if challenged by the IRS; or

- The corporation reasonably relied in good faith on the opinion of a professional tax advisor that meets the requirements of Treasury Regulation Section 1.6664-4(c), described above, the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treasury Regulation Section 1.6662-4(d)(3)(ii) (relating to the substantial authority test), and the opinion unambiguously states the tax advisor's conclusion that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS.[27]

The analysis must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled.[28]

Although satisfaction of the foregoing requirements

> is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, it is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.[29]

Section 6664(d) of the Code provides special rules for applying the reasonable cause and good faith exception to the penalty under Section 6662A of the Code for understatements arising from "reportable transactions," which include "listed transactions" and other transactions having certain characteristics that are commonly found in abusive tax shelters.[30] The exception will not apply unless (A) the position is adequately disclosed (or the penalty for non-disclosure was rescinded),

27. *Id.* § 1.6664-4(f)(2)(i)(b)(1)-(2).
28. *Id.* § 1.6664-4(f)(2)(i)(b) (as amended in 2003).
29. *Id.* § 1.6664-4(f)(3).
30. *See* I.R.C. § 6664(d) (2006); Treas. Reg. § 1.6011-4(b) (as amended in 2003).

(B) there is or was substantial authority for the position, and (C) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.[31] A taxpayer will be treated as having a reasonable belief with respect to the tax treatment of a position only if such belief (i) is based on the facts and law that exist at the time the relevant return is filed, and (ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.[32]

In addition, under section 6664(d)(4)(B) of the Code, an opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if the tax advisor is a "disqualified tax advisor," or the opinion is a "disqualified opinion."[33] A tax advisor is disqualified if the tax advisor:

> (I) is a material advisor"[34] . . . and participates in the organization, management, promotion or sale of the transaction or is related to any

31. I.R.C. § 6664(d)(3).
32. *Id.* § 6664(d)(4).
33. *Id.* § 6664(d)(4)(B).
34. A material advisor is a person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and who directly or indirectly derives gross income in excess of a threshold amount for such aid, assistance or advice. *Id.* § 6111(b)(1).

Notice 2005-12, 2005-7 I.R.B. 494, clarifies when a material advisor will be treated as participating in the organization, management, promotion, or sale of the transaction. A material advisor participates in the organization of a transaction if the advisor (1) devises, creates, investigates, or initiates the transaction or tax strategy, (2) devises the business or financial plans for the transaction or tax strategy, (3) carries out those plans through negotiations or transactions with others, or (4) performs acts relating to the development or establishment of the transaction, including preparing documents that (A) establish the structure used in connection with the transaction, (B) describe the transaction for use in the promotion or sale of the transaction, or (C) register the transaction with any federal, state, or local government body. A material advisor participates in the management of a transaction if the material advisor is involved in the decision-making process regarding any business activity with respect to the transaction. Participation in the management of the transaction includes managing assets, directing business activity, or acting as general partner, trustee, director, or officer of an entity involved in the transaction. A material advisor participates in the promotion or sale of a transaction if the material advisor is involved in the marketing of the transaction or tax strategy. Marketing activities include (1) soliciting, directly or through an agent, taxpayers to enter into a transaction or tax strategy, (2) placing an advertisement for the transaction, or (3) instructing or advising others with respect to marketing of the transaction or tax strategy. 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 the tax advisor may not suggest material modifications to the transaction that assist the taxpayer in

> person who so participates, (II) is compensated directly or indirectly by a material advisor for the transaction, (III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits of the transaction being sustained, or (IV) as determined under regulations, has a disqualifying financial interest with respect to the transaction.[35]

An opinion is disqualified if the opinion (I) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person, (III) does not identify and consider all relevant facts, or (IV) fails to meet any other requirement as the IRS may prescribe.[36]

Section 10.35 of Treasury Department Circular 230 sets forth standards that a tax advisor must apply in providing certain tax opinions.[37] These standards apply to tax advisor opinions addressing tax issues arising from listed transactions, transactions having tax avoidance as their principal purpose, and transactions with a significant tax-avoidance purpose, provided the opinion meets certain qualifications.[38] These qualifications are: (1) the opinion reaches a level of confidence that permits the taxpayer to rely on the opinion to avoid penalties,[39] (2)

---

obtaining the anticipated tax benefits. Merely performing support services or ministerial functions such as typing, photocopying, or printing will not be considered participation in the organization, management, promotion, or sale of a transaction.

35. I.R.C. § 6664(d)(4)(B)(ii); *see also* Notice 2005-12. Notice 2005-12 states that a tax advisor will be treated as a disqualified tax advisor, even if not a material advisor, if the tax advisor has a referral fee or a fee-sharing arrangement by which the advisor is compensated directly or indirectly by a material advisor. In addition, an arrangement will be treated as a disqualified compensation arrangement if there is an agreement or understanding with a material advisor pursuant to which the tax advisor is expected to render a favorable opinion regarding the tax treatment of the transaction to any person referred by the material advisor. A tax advisor will not be treated as having a disqualified compensation arrangement if a material advisor merely recommends the tax advisor who does not have an agreement or understanding with the material advisor to render a favorable opinion regarding the tax treatment of the transaction.

36. I.R.C. § 6664(d)(4)(B)(iii).

37. Circular 230 contains the rules governing practice before the IRS and is codified at 31 C.F.R. Subtitle A, Part 10.

38. 31 C.F.R. §§ 10.35(b)(2)(i)(A)-(B) (2011).

39. *Id.* §§ 10.35(b)(2)(i)(C)(*1*), (b)(4) (2011). Specifically, the standards apply if the opinion concludes that there is a greater than 50% likelihood that the tax treatment of an item will be upheld if challenged by the IRS and does not include a prominent statement that the opinion may not be used by the taxpayer for the purpose of avoiding penalties. *Id.* The presence of such a statement does not in itself prevent a taxpayer from relying on the opinion to avoid penalties. *See also* David T. Moldenhauer, *Circular 230 Opinion Standards, Legal Ethics and First Amendment Limitations on the Regulation of Professional Speech by Lawyers*, 29 SEATTLE U. L. REV. 843, 858 (2006).

the opinion will be used to market the transaction,[40] (3) the tax advisor requires the taxpayer to maintain the confidentiality of the advisor's tax strategies,[41] or (4) the advisor's fees are conditioned on the taxpayer obtaining the intended tax benefits.[42] The standards include a requirement that the opinion prominently disclose any compensation arrangement or referral agreement that the tax advisor (or his firm) has with a third party with respect to the promotion, marketing, or recommendation of the relevant transaction,[43] and in the case of an opinion used to market a transaction, that the opinion was written to support the promotion or marketing of the transaction.[44]

III. JUDICIAL TREATMENT OF CONFLICTS OF INTEREST

The regulations under the general reasonable cause and good faith exception do not explicitly preclude a taxpayer from relying on advice from an advisor having a conflict of interest.[45] However, the courts have developed the principle that a taxpayer's reliance on advice will not be considered reasonable and undertaken in good faith where the taxpayer knew or should have known that the advisor had a significant conflict of interest.

In a number of cases, the tax advisor's conflict of interest is obvious. Those cases generally involve situations where the

---

40. 31 C.F.R. §§ 10.35(b)(2)(i)(C)(*2*), (b)(5). Specifically, the standards apply if the tax advisor knows or has reason to know that the opinion will be used or referred to by a third party in promoting, marketing, or recommending the relevant transaction, and the opinion does not include prominent statements that the opinion may not be used by the taxpayer for the purpose of avoiding penalties, the opinion was written to support the promotion or marketing of the transaction, and the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

41. *Id.* §§ 10.35(b)(2)(i)(C)(*3*), (b)(6). Specifically, the standards apply if the tax advisor imposes a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of the advisor's tax strategies, regardless of whether the limitation on disclosure is legally binding. A claim that a transaction is proprietary or exclusive is not a limitation on disclosure if the advisor confirms to all recipients of the opinion that there is no limitation on disclosure of the tax treatment or tax structure of the relevant transaction.

42. *Id.* §§ 10.35(b)(2)(i)(C)(*7*), (b)(7). Specifically, the standards apply if the taxpayer has the right to a full or partial refund of fees if all or a part of the intended tax consequences from the matters addressed in the opinion are not sustained, or if the fees are contingent on the taxpayer's realization of tax benefits from the transaction.

43. *Id.* § 10.35(e)(1).

44. *Id.* § 10.35(e)(2). The legend for an opinion used to market a transaction also must disclose that the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

45. I.R.C. § 6664(d)(4)(B) (2006). As discussed above, under Code § 6664(d)(4)(B), a taxpayer may not rely on the opinion of a "disqualified tax advisor" to establish a reasonable cause and good faith defense to the penalty for reportable transaction understatements.

professional tax advisor was a promoter of a tax shelter,[46] a broker,[47] or had a referral arrangement with a promoter.[48] In many of those cases, the advisor also developed or implemented the tax shelter. In other cases, the conflicts of interest are less apparent. Those cases generally involve tax advisors that were developers or implementers of a tax strategy, but had not engaged in marketing activity and had no relationship with a tax shelter promoter.[49] As discussed below, many of the cases where a tax advisor was a promoter or broker, or had a referral arrangement with a promoter, are interesting for their facts, which illustrate tax advisors confronting the tension between their roles as advisors and their roles as promoters or brokers. However, with one exception, those cases fail to articulate a test for determining whether a tax advisor has a disqualifying conflict of interest, other than stating generalities about a tax advisor developing, promoting, or implementing a tax shelter in which he has a financial interest. The cases where a tax advisor is merely the developer or implementer of a tax strategy are interesting because of the courts' attempts to identify and analyze more subtle conflicts of interest.

A. Tax Advisors as Promoters or Brokers

The most obvious conflict of interest is where a tax advisor also is the promoter of a tax shelter, or acts essentially as a broker, and is compensated as such by the tax shelter promoter. In those cases, the tax advisor has a direct financial interest in the tax savings being promoted, frequently through compensation based on the amount of the purported

46. *See* Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1381-83 (Fed. Cir. 2010); Mortensen v. Comm'r, 440 F.3d 375, 387-88 (6th Cir. 2006); Van Scoten v. Comm'r, 439 F.3d 1243, 1253-54 (10th Cir. 2006); Pasternak v. Comm'r, 990 F.2d 893, 903 (6th Cir. 1993); Iles v. Comm'r, 982 F.2d 163, 164-66 (6th Cir. 1992); Maguire Partners-Master Invs., LLC v. United States, No. CV 06–07371–JFW(RZx), 2009 WL 4907033 (C.D. Cal. Dec. 11, 2009); Murfam Farms, LLC *ex. rel.* Murphy v. United States, 94 Fed. Cl. 235, 247-48 (2010); Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 56-57 (2007); 106 Ltd. v. Comm'r, 136 T.C. 67, 79 (2011); New Phoenix Sunrise Corp. v. Comm'r, 132 T.C. 161, 193-95 (2009); Kerman v. Comm'r, 101 T.C.M. (CCH) 1241 (2011); Palm Canyon X Inv., LLC v. Comm'r, 98 T.C.M. (CCH) 574 (2009).

47. *Stobie Creek*, 608 F.3d at 1381-83; Goldman v. Comm'r, 39 F.3d 402, 408 (2d Cir. 1994); Neonatology Assocs., P.A. v. Comm'r, 299 F.3d 221, 234 (3d Cir. 2002) (insurance agent).

48. Klamath Strategic Inv. Fund v. United States, 472 F. Supp. 2d 885, 904-05 (E.D. Tex. 3007)), *aff'd on other grounds*, 568 F.3d 537 (5th Cir. 2009); Alpha I, L.P. v. United States, 93 Fed. Cl. 280 (2010).

49. Am. Boat Co., LLC v. United States, 583 F.3d 471, 481-83 (7th Cir. 2009); Canal Corp. v. Comm'r, 135 T.C. 199 (2010).

tax savings.[50] Because the tax advisor has a personal interest in the purported tax savings, a taxpayer reasonably should discount the advice when seeking to determine its proper tax liability.[51]

For example, in *Stobie Creek*, the court held that the taxpayers could not rely on the advice of two law firms because they knew or should have known that both law firms participated in the promotion and implementation of a tax shelter, and received fees based on the amount of purported tax savings.[52] In reaching its conclusion, the court stated the principle that "[a]dvice hardly qualifies as disinterested or objective if it comes from parties who actively promote or implement the transaction in question."[53]

The taxpayers in *Stobie Creek*, all members of a family, agreed to sell a 50% interest in the family business.[54] They turned to the relationship partner of the law firm ("SLK") that had regularly advised the family and the business, to negotiate and document the sale.[55] Because the transaction would be taxable, the family asked if SLK was familiar with any strategies that could reduce the taxes.[56] SLK previously had assisted other clients in connection with a tax shelter promoted by another law firm ("J&G").[57] An SLK tax lawyer contacted a J&G tax partner, arranged for confidentiality agreements to be prepared and signed by family members, and proposed a fee arrangement, based on the amount of tax savings, to be shared by SLK and J&G.[58]

---

50. Treas. Reg. § 1.6011-4(b)(4) (as amended in 2003). If the advisor's fees are conditioned on the taxpayer deriving the intended tax benefits, or are refundable to the taxpayer if such benefits are denied, the transaction generally will be a reportable transaction. In that case, the more stringent rules of I.R.C. § 6664(d) will prevent the taxpayer from relying on the advisor's opinion to establish reasonable cause and good faith. Also, the opinion will be subject to the standards of Circular 230 § 10.35 discussed above.

51. If the tax advisor complies with Circular 230, the taxpayer will have been informed in the opinion of any compensation arrangement that the advisor has with a third party promoter or broker, and whether the opinion was prepared to support the marketing of the transaction by a third party promoter or broker.

52. *Stobie Creek*, 608 F.3d at 1382-83. The court also concluded that the taxpayers could not rely on the opinion because they should have recognized that the purported tax benefits were "too good to be true." *Id.* at 1383.

53. *Id*. at 1382.

54. *Id.* at 1369-70.

55. *Id.* at 1369.

56. *Id.* at 1370.

57. *Id.*

58. *Id.* at 1371.

At a family meeting, the SLK relationship partner made a presentation on the proposed tax shelter.[59] When asked whether he would engage in the strategy if he were in the family's position, he confirmed that he would, and the family agreed to pursue the strategy with SLK's assistance.[60] The relationship partner later sent a sample opinion that would be rendered by J&G.[61] In a cover letter, he noted that the IRS was attacking tax shelters generally, but distinguished the tax shelter being proposed by SLK and J&G.[62] He nevertheless discussed the possibility of penalties being imposed if the transaction were disallowed.[63] He noted that J&G had offered to SLK a portion of J&G's fee, and stated that SLK was "not recommending" that the family pursue the strategy.[64] He explained that SLK was prohibited under a confidentiality agreement with J&G from rendering an opinion on the tax shelter, and therefore SLK had no occasion to determine whether it would be prepared to issue such an opinion.[65] Finally, the relationship partner pointed out that the opinion would be based on representations from the family, notably about its profit motive and non-tax business reasons for entering into the tax shelter.[66]

SLK and J&G prepared the tax shelter documentation, which included certain undated or backdated documents, and draft tax returns.[67] Following the closing, the SLK relationship partner reminded the family of the fee arrangement, but expressed willingness either to waive a portion of the fee or to make a charitable contribution.[68] He also indicated that if the family decided not to claim the purported tax benefits, SLK would not charge its fee.[69] Ultimately, SLK received the entire fee but made a charitable contribution of a small fraction of the fee.[70]

Before tax returns were filed, the IRS issued a notice describing and rebutting certain similar tax shelters, and qualifying them as "listed transactions."[71] SLK tax lawyers prepared an internal memorandum that

59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.* at 1371, 1373.
68. Stobie Creek Invs. LLC v. United States, 82 Fed. Cl. 636, 651-52 (Ct. Cl. 2008).
69. *Id.* at 652.
70. *Id.*
71. *Id.* at 653.

attempted to distinguish the tax shelter entered into by the family from the transactions described in the IRS notice.[72] The relationship partner hand wrote on the memorandum the comments, "B.S.," "we don't qualify," "looks like us," and "I wouldn't count on this."[73] The relationship partner called the family to alert them about the notice, shared his concerns, and related his tax colleagues' analysis.[74] He recommended that a conference call be scheduled with J&G, to have that firm's view.[75] In that call, the J&G tax partner stated that J&G's opinion committee had reviewed the notice and determined that it did not affect transactions of the type entered into by the family, and that J&G would provide an opinion to that effect.[76] She gave three reasons for the conclusion that the notice was inapplicable, and said that other taxpayers were continuing to pursue transactions of that type.[77] The SLK relationship partner stated at the end of the call that he had heard enough and was satisfied with J&G's opinion.[78]

An SLK tax lawyer sent to the family a draft of the J&G tax opinion, and a family member discussed with him the various representations from the family that were included in the draft opinion, notably about the family's profit motive and non-tax business reasons for entering into the tax shelter.[79] The draft opinion also contained a statement that J&G had been informed that an objective investment analysis indicated a substantial probability that the transactions would generate a profit before taxes.[80] SLK tax lawyers considered that statement, assumed that J&G had received such an analysis from someone else, and made no further inquiries.[81]

In *New Phoenix Sunrise*, the court held under a similar set of facts to those in *Stobie Creek* that the taxpayers could not rely on a tax opinion of a law firm that actively participated in the development, structuring, promotion, sale, and implementation of a tax shelter, in circumstances where the taxpayers' independent lawyers expressed concerns about that the tax shelter, and the taxpayers should have known

72. *Id.*
73. *Id.* at 653-54.
74. *Id.* at 654.
75. *Id.*
76. *Id.*
77. *Id.* at 654-55.
78. *Id.* at 655.
79. *Id.*
80. *Id.*
81. *Id.*

that the law firm had a personal stake in the tax shelter.[82] In reaching its conclusion, the court stated its conclusions as follows:

> We find petitioner's reliance on Jenkens & Gilchrist and the tax opinion to be unreasonable rather than reasonable. Jenkens & Gilchrist actively participated in the development, structuring, promotion, sale, and implementation of the BLISS transaction. Petitioner was not reasonable in relying on the tax opinion in the face of such a conflict of interest.[83]

The taxpayers in *New Phoenix Sunrise* were members of a family that sold a family-owned business at a substantial gain.[84] A partner in the law firm ("B&E") that was handling the sale introduced the family to the same J&G law firm that appeared in *Stobie Creek*, and provided information to J&G to assist in preparing a proposal for a tax shelter.[85] J&G prepared documents for the tax shelter transaction, many of which were undated or backdated.[86] After the tax shelter transaction closed, the B&E partner communicated to J&G that he felt incapable of advising the accountants regarding the proper reporting of the transaction.[87] The B&E partner also forwarded to a family member a news article about IRS actions to challenge abusive tax shelters.[88] The B&E partner advised the family member that in view of the news article and possible IRS action, it was important to prepare and file the tax returns as soon as possible.[89] Subsequently, the Treasury Department issued regulations requiring the disclosure of certain tax shelters.[90] The B&E partner discussed those regulations with J&G, which indicated that the new regulations applied to the tax shelter "and that not disclosing it was an aggressive position to take."[91] J&G nevertheless issued a favorable tax opinion regarding the shelter.[92] The B&E partner discussed the new regulations with the family member and informed him "that not disclosing the transaction was an aggressive position requiring approval

82. New Phoenix Sunrise v. Comm'r, 132 T.C. 161, 193-95 (2009). The court also concluded that the taxpayers could not rely on the opinion because they should have recognized that the purported tax benefits were "too good to be true." *Id.* at 195.
83. *Id.* at 193.
84. *Id.* at 164.
85. *Id.* at 164-65.
86. *Id.* at 165.
87. *Id.* at 170.
88. *Id.* at 171.
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*

of the tax return preparer."[93] The family member later responded that he intended to take "as aggressive a position as possible in filing the tax return."[94] The B&E partner subsequently discussed with J&G the possibility that the transaction was "substantially similar" to certain listed transactions described in an IRS notice, the possibility of being audited if the taxpayer disclosed the transaction, and penalties that might apply.[95]

In *Murfam Farms*, the court held that the taxpayers could not rely on the tax opinion of a national accounting firm that sold them a tax shelter and received a fee equal to a percentage of the purported tax loss, in circumstances where the accounting firm took actions to shield itself from liability after the IRS announced that it would challenge similar tax shelters.[96] The taxpayers were members of a family that disposed of the family business in a partially taxable transaction.[97] The business had regularly used the accounting firm for tax advice.[98] The Chief Financial Officer ("CFO") of the business asked the accounting firm about strategies to reduce taxes on the sale.[99] Partners of the accounting firm met with the CFO to propose a tax shelter, and there was a subsequent meeting with family members.[100] The accounting firm's policies required prospective clients for the shelter to need a desired loss of at least $50 million, and to be "[a]ggressive, willing to assume tax risk."[101] No marketing documentation could be left with the client and clients were required to sign nondisclosure agreements.[102] The engagement letters with clients referred to a "desired loss" of a specified amount.[103] Fees were calculated as a share of the purported tax loss.[104] The accounting firm would arrange to have law firms issue legal opinions that it believed would provide clients with "penalty protection."[105]

93. *Id.*
94. *Id.*
95. *Id.*
96. Murfam Farms, LLC *ex rel.* Murphy v. United States, 94 Fed. Cl. 235, 247-48 (Ct. Cl. 2010). The court also concluded that the taxpayers could not rely on the opinion because they should have recognized that the purported tax benefits were "too good to be true." *Id.* at 247.
97. *Id.* at 237-38.
98. *Id.* at 238.
99. *Id.* at 239.
100. *Id.*
101. *Id.*
102. *Id.*
103. *Id.* at 240.
104. *Id.* at 239.
105. *Id.*

The family members received engagement letters from the accounting firm shortly after the IRS had issued a notice warning taxpayers that certain loss-generating strategies were ineffective, and could subject taxpayers to penalties.[106] After the IRS challenge to tax shelters received press attention, the accounting firm held a meeting in which it decided not to further market the tax shelter.[107] The accounting firm acknowledged internally that it saw a problem with the tax shelter because of a "lack of meaningful potential for an economic profit or other business purpose to justify the transaction."[108] The accounting firm instructed its personnel to advise clients who previously had shown willingness to enter into the shelter of the heightened risk of IRS scrutiny and penalties.[109] Nevertheless, the accounting firm instructed its personnel to express confidence in earlier transactions, and to try to avoid losing existing clients to competitors offering similar shelters. It reiterated internally the importance that the tax shelter clients be "sophisticated investors who fully understood the economic and tax risks of the transaction, and who would not be likely to seek compensation from the accounting firm if the anticipated tax benefits were not ultimately realized."[110]

The accounting firm informed the CFO of the IRS notice, and communicated that the transaction was very risky. But, the CFO responded that if he did not do a transaction with the accounting firm; he had other opportunities to do similar transactions with others.[111] As a condition to proceeding with the transaction, the accounting firm required the family members to sign addenda to their engagement letters holding the accounting firm harmless from penalties that might be assessed against them.[112] The accounting firm made another presentation regarding the shelter in which it characterized the shelter as aggressive, and arranged for a law firm to prepare the documentation and a tax opinion.[113] The law firm did not interact directly with the family.[114] The family paid a fee equal to two percent of the purported tax loss generated by the transaction to the accounting firm, and a large

106. *Id*. at 240.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.* at 241.
113. *Id.*
114. *Id.* at 242.

fee to the law firm, even though the law firm's tax opinion had not yet been sent.[115]

After the family entered into the tax shelter transaction, but before tax returns were prepared, the accounting firm became increasingly uneasy with the shelter, which was receiving further press attention.[116] During this period, the IRS issued a notice describing and rebutting similar tax shelters, and qualifying them as "listed transactions."[117] The head of the accounting firm's tax shelter marketing team recognized that the notice essentially described the shelter, and directed the team members inform clients of the notice, and indicate that the accounting firm would be considering its potential impact.[118] When senior accounting firm executives expressed concern about the tax shelter entered into by the family, the team head assured them that the family had agreed to hold the accounting firm harmless from any penalties, that the transaction had completed, and that the law firm was planning to issue its opinion.[119] When told of another client interested in the shelter, the team head refused the opportunity, noting the IRS' intention to impose penalties on any taxpayer engaging in the shelter.[120]

After the family completed the tax shelter transaction, the accounting firm prepared tax returns and charged additional fees, resulting in a total of 2.5 percent of the purported tax loss.[121] The tax returns did not include specific disclosures of the strategy.[122]

In *106 Ltd*., the court held that the taxpayer could not rely on the opinion of a lawyer who solicited the taxpayer's involvement in a tax shelter, structured and implemented the transaction, and conditioned his fee on the taxpayer going through with the transaction.[123] The court also held that the taxpayer could not rely on the advice and tax return preparation work of accountants who had marketed similar tax shelters and charged a premium for preparing the relevant tax returns.[124] The taxpayer was a businessman and investor who received a pitch from his long-time lawyer to enter into a purported investment transaction that in fact was a highly structured tax shelter. The taxpayer understood that

115. *Id.*
116. *Id.*
117. *Id.* at 242-43.
118. *Id.* at 243.
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.* at 252.
123. *See* 106 Ltd. v. Comm'r, 136 T.C. 67, 81 (2011).
124. *Id.*

the real benefit of the transaction was the purported tax reductions, not to generate an economic profit, and agreed to enter into the transaction after receiving confirmation from his accountants that they had used the same transaction, and after the lawyer personally promised to cover any taxes, penalties, or litigation costs if the transaction blew up.[125] The lawyer provided a tax opinion that the accountants referred to in preparing the relevant returns.[126] The opinion stated that the taxpayer had made various representations, that in fact were inaccurate.[127] The lawyer received a large fee, and the accountants received a fee substantially greater than what they normally charged.[128]

The court articulated a three-factor test for determining whether the taxpayer properly relied on the advice of the lawyer and the accountants: (1) whether the advisors were competent professionals who had sufficient expertise to justify reliance; (2) whether the taxpayer provided the necessary and accurate information to the advisors; and (3) whether the taxpayer actually relied in good faith on the advisor's judgment.[129] The court found the first two factors present, but concluded that the taxpayer did not actually rely in good faith on the advice of the lawyer and the accountants for three reasons.[130] First, the court found that the taxpayer's high level of business sophistication and expertise "ma[de] it harder to believe that he didn't know the transaction was improper."[131] Second, the court found that the taxpayer should have been alerted by the inaccurate statements in the opinion that purported to set forth the taxpayer's representations. As the court stated, "[o]ne doesn't need look very hard to find problems with Garza's opinion."[132]

Third, the court determined that the lawyer and the accountants were "promoters" of the transaction, whose advice was inherently unreliable.[133] In making this determination, the court sought to articulate the factors characterizing a promoter.[134] It defined a promoter as "an advisor who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the

125. *Id.* at 70.
126. *Id.* at 72.
127. *Id.*
128. *Id.* at 73.
129. *Id.* at 77.
130. *Id.* at 77-78.
131. *Id.* at 78.
132. *Id.* at 79.
133. *Id.* at 81.
134. *Id.* at 79-80.

transaction."[135] The court noted that "[o]ne might need to be careful in applying the definition to some kinds of transactions," stating that a tax lawyer asked by a businessman for advice on how to sell the family business through a tax-favored stock redemption might be said to have "participated in the transaction."[136] However, the court found the definition workable "when the transaction involved is the same tax shelter offered to numerous parties."[137] Finally, court stated that a tax advisor is not a "promoter" of a tax shelter transaction where the advisor:

- Has a long-term and continual relationship with the client;
- Does not give unsolicited advice regarding the tax shelter;
- Advises only within the advisor's field of expertise (and not because of the advisor's regular involvement in the transaction being scrutinized);
- Follows the advisor's regular course of conduct in rendering the advice; and
- Has no stake in the transaction besides what the advisor bills at the advisor's regular hourly rate.[138]

Factually, it is not difficult to conclude that the tax advisor's opinion in *106 Ltd*. was unreliable. The lawyer solicited the taxpayer to enter into the transaction, which had no meaningful purpose other than to avoid taxes. The lawyer's opinion contained misleading statements to disguise the weakness of the taxpayer's position, and the lawyer and the accountants were paid substantial sums to implement and report the transaction. However, the Tax Court's narrow definition of the circumstances where a tax advisor will not be treated as a promoter reaches substantially beyond the facts of the case.[139]

135. *Id.* at 79 (quoting Tigers Eye Trading, LLC v. Comm'r, 97 T.C.M. (CCH) 1622 (2009)).

136. *Id.* at 80.

137. *Id.*

138. *Id.* (citing Countryside Ltd. P'ship v. Comm'r, 132 T.C. 347, 352-55 (2009)).

139. The circumstances articulated by the Tax Court in *106 Ltd*. *v. Commissioner*, 136 T.C. 67 (2011), where a tax advisor is not a "promoter," was based on its opinion in *Countryside Ltd. Partnership v. Commissioner*, 132 T.C. 347 (2009). In that case, the court held that the so-called federally authorized tax practitioner ("FATP") privilege set forth in Code § 7525(a) applied to advice because it was not provided in connection with promoting corporate participation in a tax shelter. The IRS asserted that the accountant in question was involved in organizing, structuring, and assisting with respect to certain tax shelter transactions. The court found that the accountant had a long, close relationship with the taxpayer, preparing returns, assisting with tax planning when asked, answering questions when asked, and responding to notices and inquiries from federal and state tax officials. The court further found that his advice with respect to the transactions in question was furnished (as was similar advice with respect to similar transactions) as part of a long-standing, ongoing, and hence, routine relationship with the taxpayer. The accountant provided tax advice to the taxpayer when requested to do so, and his advice provided in connection with the

The definition articulated by the court in *106 Ltd*. implies that a tax advisor who provides advice regarding a marketed tax shelter will be treated as a promoter if any of the requirements listed above are missing. For example, if a taxpayer seeks out a tax advisor with whom the taxpayer has had no prior relationship, that tax advisor apparently would be treated as a promoter under the court's test, even if the tax advisor serves in purely an advisory role to the taxpayer, charges standard hourly rates, and has no other connection with the transaction. This *per se* approach is troubling because it does not consider whether, under the specific facts and circumstances of the case, the advisor was subject to any meaningful temptation to provide distorted advice, or how the advisor may have responded to any such temptation. As discussed below, other courts have specifically rejected a *per se* rule because the determination of whether a taxpayer acted with reasonable cause and in good faith is to be made on a case-by-case basis, taking into account all pertinent facts and circumstances.[140] A *per se* test of the type articulated by the court in *106 Ltd*. is inconsistent with the purpose of the reasonable cause and good faith exception to shield taxpayers that did not have reason to know their positions were incorrect. Specifically, a *per se* test does not evaluate the taxpayer's efforts to assess its proper tax liability, or the reasonableness of the taxpayer under the circumstances to rely on the tax advisor's opinion.

---

transactions followed the same regular course of procedure as did his other tax advice, including with respect to similar transactions. The accounting firm with which he was employed had no stake in the outcome of the transactions other than the continued retention of the taxpayer as a client. It did not receive a fixed fee or a fee based on a percentage of some claimed tax saving. It was paid by the hour pursuant to the accountant's normal rate schedule. On that basis, the court stated that:

> [t]here may be a point at which an FATP's actions cross the line, and will no longer be encompassed within the routine relationship between an FATP and his client and will amount to tax shelter promotion. Respondent has, however, failed to show us that Mr. Egan's communications with the Winn organization with respect to the partnership redemptions and associated transactions before us crossed that line.

In making its decision, the court referred to the legislative history of the FATP privilege, which expressed the Conference Committee's anticipation that the tax shelter limitation to the FATP privilege would not adversely affect "the routine relationship between a tax practitioner and a client." *Id*. at 353-54 (quoting H.R. REP. NO. 105-599, at 269 (1998) (Conf. Rep.)). The court did not articulate a specific test defining when such a routine relationship would exist, or assert that it would only exist under circumstances similar to the facts found in *Countryside*. Given the highly factual determination of the court in *Countryside*, and that the case did not address whether a taxpayer could rely on an opinion to avoid penalties, the decision provides little support for the precise test articulated by the court in *106 Ltd*.

140. *See also* Allison v. United States, 80 Fed. Cl. 568, 587-88 (Ct. Cl. 2006) (rejecting a *per se* rule in the context of advice provided by an investment advisor and an accountant who assisted in due diligence of a tax shelter investment).

B. *Tax Advisors Having Referral Relationships with Promoters*

When a tax shelter promoter refers a taxpayer to a tax advisor, it is reasonable to assume that the promoter is confident that the tax advisor will provide favorable advice. The tax advisor may have an explicit agreement or an implicit understanding with the promoter that the tax advisor will provide favorable advice, and that in exchange the promoter will make additional referrals.[141] In those circumstances, courts generally have found the tax advisors' opinions unreliable.

For example, in *Alpha I*, a tax shelter promoter referred the taxpayer to a lawyer to obtain an opinion.[142] The promoter had promised the taxpayers that the strategy would eliminate taxes, and that by receiving the opinion the taxpayers would avoid any penalties if the strategy was ineffective. The court held that the taxpayers could not rely on the opinion because (1) the opinion was obtained under an assurance from the promoter that it would protect the taxpayers from penalties, (2) the taxpayers failed to inform the law firm that the promoter had promised that the strategy would eliminate taxes, and (3) the opinion recited that the taxpayers would not pay fees to any adviser based on tax savings from the strategy when in fact the promoter would receive 25% of the tax savings.[143] In this decision, the court did not specifically conclude that the law firm had intentionally included the misrepresentation, recognizing the possibility that the taxpayers had failed to provide that information to the law firm regarding the fees charged by the promoter. However, the court noted the fact that the law firm received a flat fee of $300,000 for the opinion and concluded that given the taxpayers' level of education and sophistication, they failed to establish that their reliance on the opinion was reasonable and undertaken in good faith.[144]

Reading between the lines, the court in *Alpha I* seems to have thought it likely that all participants—the taxpayers, the promoter, and the law firm—intended the opinion to be window dressing to protect against penalties in case the strategy was discovered by the IRS and disallowed. The misrepresentation in the opinion about fees not being based on the claimed tax savings suggested an intention to mislead the

141. If the tax advisor complies with Circular 230, the taxpayer will have been informed in the opinion of the referral arrangement.

142. Alpha I, L.P. v. United States, 93 Fed. Cl. 280 (Ct. Cl. 2010).

143. *Id.* at 315-18, 324-26.

144. *Id.* at 317.

IRS and the courts on the part of the taxpayers, if not on the part of the law firm.

By contrast, in *Klamath Strategic Investment Fund, LLC v. United States*,[145] the court held that the taxpayers could rely in part on an opinion furnished by a law firm that also represented the tax shelter promoter.[146] The court noted that the opinion "provided a reasonable interpretation of the law," and that the taxpayers provided expert testimony that the opinions had complied with standards common to the profession and with the administrative standards of conduct for tax practitioners under Circular 230.[147] The court dismissed the conflict of interest resulting from the law firm's representation of the promoter by noting that the taxpayers (themselves lawyers) "concluded that there would be no conflict of interest with Holland & Hart's representation of Presidio because their interests in the tax treatment of their investments were the same."[148]

The court's analysis of the conflict of interest issue in *Klamath* reflects a fundamental misunderstanding. Obviously, both the taxpayers and the promoter stood to gain if the strategy was upheld, or if the opinion succeeded, in preventing the imposition of penalties. However, that very fact made it less likely that a law firm associated with the promoter could be counted on to provide a fair assessment of the likelihood that the tax shelter would successfully reduce the taxpayers' tax liability.[149]

145. Klamath Strategic Inv. Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 2007), *aff'd on other grounds*, 568 F.3d 537 (5th Cir. 2009).

146. *Id.* at 904-05.

147. *Id.* at 905.

148. *Id.*

149. There also are a number of other points in the opinion where one could ask whether the court failed to apply a sufficient level of skepticism. For example, the court's acceptance of the taxpayers' claims that they only discovered that the highly structured tax shelter generated significant purported tax losses after they had completed the transaction. *Id.* at 893. In *NPR Investments, LLC v. United States*, 732 F. Supp. 2d 676 (E.D. Tex. 2010), the same group of ultimate individual taxpayers plus a third partner in their law firm entered in to another, similar, tax shelter in the subsequent year. The IRS asserted penalties and the matter was tried before the same U.S. federal judge as had decided *Klamath*. The court again held for the taxpayer finding facts that strain credulity particularly in light of facts that the court previously had found in *Klamath*. For example, in *Klamath*, the court found that the taxpayers learned of the tax benefits from the first tax shelter in a discussion with their accountants near the end of 2000. *Klamath*, 472 F. Supp. 2d at 893. Nevertheless, in *NPR Investments*, the court found that the taxpayers did not discuss tax benefits in a conversation with the same accountants about the second tax shelter that occurred sometime in 2001, but no later than the summer. *NPR Invs.*, 732 F. Supp. 2d at 679.

C. Tax Advisors that are Developers or Implementers of a Tax Strategy

In cases where a tax advisor has developed a tax-reduction strategy, or implements the strategy, the tax advisor in some sense is committed to a position that the strategy is effective. The tax advisor may have invested considerable resources in developing the strategy, or may have committed to the taxpayer at the outset of the transaction to provide a favorable opinion. The tax advisor also may have a financial interest in providing a favorable opinion, either because the advisor is charging a premium fee for the tax strategy, or because the tax advisor will receive lower fees if the transaction does not complete.[150] Finally, the tax advisor may be in a position to modify the relevant facts in a way that helps support a favorable opinion. As discussed below, courts have taken different views on how those circumstances affect the reliability of the tax advisor's opinion.

In *American Boat*, the taxpayer engaged a lawyer to restructure his ownership of towboats following a nearly catastrophic marine accident.[151] The lawyer, who later was indicted for promoting invalid tax shelters, had previously assisted the taxpayer by developing and implementing an estate plan that included a highly structured tax shelter.[152] In restructuring the taxpayer's towboat holding structure, the lawyer again included a highly structured tax shelter, and provided an opinion to the taxpayer.[153] The taxpayer provided the opinion to a national accounting firm for purposes of preparing the tax returns of the relevant entities, and the accountants informed the taxpayer both that they considered the legal position taken in the opinion to be accurate, and that they had implemented the same strategy for some of their other clients and could have done the same for the taxpayer.[154] The taxpayer claimed not to know or have reason to know at the time of the transaction that the taxpayer or the law firms with which he was

150. The fact that a tax advisor's fee is payable only if the advisor is able to render a favorable opinion does not in itself cause the fee to depend on the taxpayer realizing the intended tax benefits. Therefore that fact should not cause the transaction to be a reportable transaction and subject the opinion to the more stringent rules of I.R.C. § 6664(d) (2006) discussed above.

151. Am. Boat Co. v. United States, 583 F.3d 471 (7th Cir. 2009).

152. *Id.* at 474-75.

153. *Id.* at 475-76.

154. *Id.* at 476. The taxpayer and his companies later changed their accounting firm to a regional firm, which raised no concern regarding the tax position taken on the relevant returns. *Id.* at 477.

associated during the course of the transaction[155] had structured similar transactions for other taxpayers.[156] Moreover, the District Court found that, at the time of the transaction, the taxpayer had no reason to suspect the quality of the tax opinion, and the Court of Appeals held that the opinion met the specific requirements of Treas. Reg. § 1.6664-4(c).[157]

The government argued that the taxpayer's reliance on the opinion was not reasonable for a number of reasons: (1) he paid a large flat fee to the lawyer to structure the transactions, (2) the tax advice provided by the lawyer was distinct from any advice regarding tort liability, (3) the opinion contained representations that the taxpayer knew or should have known were false, and (4) the transactions provided a large tax benefit for minimal risk, which the taxpayer should have known was too good to be true.[158] The court held that the large fee paid to the lawyer was not sufficient reason to treat the taxpayer's reliance on the opinion as unreasonable, and rejected the position advanced by the government that advice is *per se* unreliable when the tax advisor incorporates a potential tax shelter into a restructuring plan.[159] The court acknowledged that in many instances, a taxpayer might be unreasonable in relying on an advisor who stands to gain significantly from a transaction, but noted that the flat fee covered not only the tax shelter but also significant work restructuring the taxpayer's various business entities in response to liability concerns.[160] The court specifically accepted the District Court's finding that the taxpayer did not pay the fee thinking that as consideration he was getting a tax shelter.

The court refused to find the taxpayer's reliance on the opinion to be unreasonable because the tax advice from the lawyer was distinct from any advice the lawyer may have provided regarding tort liability. The District Court found that taxpayer had approached the lawyer to reorganize his business to reduce potential liability, not to implement a tax shelter, and that the shelter was never marketed to the taxpayer.[161] On that basis, the Court of Appeals concluded that the lawyer's overarching counsel was to reorganize, and that the taxpayer relied in

155. During the course of the transaction, the lawyer moved his practice to the same J&G law firm that appeared in *Stobie Creek Investments LLC v. United States*, 608 F.3d 1366, 1383 (Fed. Cir. 2010), and *New Phoenix Sunrise v. Commissioner*, 132 T.C. 161, 194 (2009).

156. *Am. Boat*, 583 F.3d at 477.

157. *Id.* at 485-86.

158. *Id.* at 484-85.

159. *Id.* at 483.

160. *Id.*

161. *Id.* at 485.

part on the lawyer's recommended means of doing so, which included the tax shelter.[162]

The court refused to accept the government's position that the tax opinion was unreliable in that it contained representations that the taxpayer knew or should have known were false, particularly that the transactions in the tax shelter had a non-tax business purpose and that the taxpayer sought an economic profit.[163] The court acknowledged that the tax shelter transactions were unlikely at best to realize a profit.[164] However, the court accepted the District Court's finding that the taxpayer did not know the transactions held no profit potential, or that specific factual assertions in the opinion were incorrect.[165]

Finally, the court refused to accept the government's position that the taxpayer's reliance was unreasonable because the tax benefits were too good to be true, and accordingly the taxpayer should have known that something was awry.[166] The court noted that a national accounting firm had specifically agreed with the position and had informed the taxpayer that it was structuring similar transactions, that the taxpayer had engaged in a similar tax shelter transaction in connection with his earlier estate planning that had not been challenged by the IRS, and that the taxpayer had engaged in another tax-motivated business reorganization.[167]

The conclusion to be drawn from *American Boat* seems to be that a tax advisor will not be treated as providing inherently unreliable advice merely because the advisor encourages the taxpayer to incorporate aggressive tax planning in a legitimate business transaction, and receives a large fee for doing so, where the taxpayer did not seek out the advisor to reduce taxes. However, the Tax Court's decision in *Canal Corp.*,[168] discussed below, makes clear that a disqualifying conflict of interest may be found even in circumstances where the tax advisor assists in structuring and implementing a legitimate business transaction.

In *Canal Corp.*,[169] the taxpayer engaged an investment bank and an accounting firm with which it had a long-term relationship to jointly develop a strategy for disposing of a business that had a fair market value substantially in excess of its tax basis. The investment bank and

162. *Id.* at 484.
163. *Id.*
164. *Id.*
165. *Id.* at 484-85.
166. *Id.* at 485-86.
167. *Id.*
168. *See* Canal Corp. v. Comm'r, 135 T. C. 199 (2010).
169. *Id.*

accounting firm proposed a structure where the taxpayer and a party that wanted to purchase the business would contribute their respective businesses to a joint venture, the joint venture would borrow funds that would be distributed to the taxpayer, and the taxpayer would provide a limited indemnity covering the joint venture's borrowing.[170] The structure was intended to avoid treatment as a "disguised sale"[171] and thus defer the recognition of gain on the cash distribution to the taxpayer. The accounting firm assisted in structuring and negotiating the joint venture, and rendered an opinion that the cash distribution would not be treated as a disguised sale.[172] The taxpayer agreed to pay the accounting firm an $800,000 fixed fee at the closing of the transaction, and the taxpayer indicated that it would proceed with the transaction only if it received a favorable tax opinion from the accounting firm.[173]

The court concluded that the transaction would be treated as a disguised sale because the limited indemnity did not impose meaningful economic risk of loss on the taxpayer, and was structured primarily to create an appearance of shifting risk of loss to the taxpayer.[174] The court upheld the imposition of a substantial underpayment penalty, holding that the taxpayer had not established that it had reasonable cause, and had acted in good faith, in claiming tax deferral.[175] Specifically, the court held that the taxpayer could not rely on the accounting firm's opinion to establish reasonable cause and good faith because the opinion was based on questionable conclusions and unreasonable assumptions,[176] showed a lack of care in its preparation,[177] and was prepared by a tax advisor with inherent conflicts of interest.[178]

The *Canal Corp.* decision does not articulate a specific test for determining when a tax advisor will have an impermissible conflict of interest for purposes of the reasonable cause and good faith exception. However, the case considers many of the same factors identified in *106 Ltd.* as relevant to determining "promoter" status. In favor of allowing the taxpayer to rely on the opinion were the facts that the accounting

170. *See generally id.*
171. I.R.C. § 707(a)(2)(B) (2006).
172. *Canal Corp.*, 135 T.C. at 205-08 (rendering of PWC Tax Opinion).
173. *Id.* at 206.
174. *Id.* at 216-17.
175. *Id.* at 221-22.
176. *Id.* at 219.
177. *Id.* The Court questioned how much time could have been devoted to the draft opinion because it was littered with typographical errors, and was disorganized and incomplete.
178. *Id.* at 218. A professional tax advisor with a stake in the outcome has a conflict of interest.

firm had a long-term relationship with the taxpayer, and was engaged to structure a legitimate business transaction.[179] On the other hand, the accounting firm structured the transaction with an objective of reducing taxes. The advisor helped negotiate and implement the transaction, and made certain factual determinations to which he referred in the opinion.[180] The opinion relied on agreements with the other party to the transaction where there was little commercial negotiation, because the provisions were viewed as important only to supporting the taxpayer's tax strategy by creating the appearance of economic substance.[181] The accounting firm's fee was a fixed amount, not calculated based on time spent,[182] and was effectively payable only if the accounting firm was able to render a favorable opinion because the fee was payable only on the completion of the transaction, and the taxpayer would not close the transaction without receiving a favorable opinion.[183] The court characterized fee as the "exorbitant price tag" for "an insurance policy as to the taxability of the transaction."[184] More generally, the court found the opinion unpersuasive and result-oriented.[185]

Nevertheless, as other commentators also have noted, there is something troubling about the *Canal Corp*. decision.[186] This was not a case where a taxpayer sought to derive benefits that it should have

179. *See* Bubel, *supra* note 11, at 844-45 (discussing cases where courts found the taxpayer's long-standing relationship with a tax advisor as a factor justifying the taxpayer's reliance on the tax advisor's opinion).

180. *Canal Corp.*, 135 T.C. at 220 ("[w]e would be hard pressed to identify which of the hats Mr. Miller was wearing in rendering that tax opinion. There were too many.").

181. *Id.* at 221 ("[i]n essence, Mr. Miller issued an opinion on a transaction he helped plan without the normal give-and-take in negotiating terms with an outside party.").

182. The court expressed doubt that the fee charged reflected the amount of work involved, noting that the opinion was "littered with typographical errors, disorganized and incomplete." *Id.* at 219. The court questioned whether "any firm would have had such a cavalier approach if the firm was being compensated solely for time devoted to rendering the opinion." *Id.* Also, the court noted that the author of the opinion failed to recognize several parts of the opinion. *Id.*

183. As the court noted, the accounting firm "therefore had a large stake in making sure the closing occurred." *Id.* at 221.

184. *Id.*

185. The court found it "unreasonable that anyone, let alone an attorney, would issue the highest level opinion a firm offers on such dubious legal reasoning [as was contained in the opinion]." *Id.* at 219. (The author of the opinion was a licensed attorney, though he was not a practicing attorney at the time he gave the legal opinion). The court concluded that "no lesser level of comfort would have commanded the $800,000 fixed fee that Chesapeake paid for the opinion." *Id.* at 220.

186. *See* Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Tax Court Goes Overboard in Canal*, TAX NOTES 185, 193-95 (2011); Richard M. Lipton & Todd D. Golub, *The Tax Court Drains Canal Corporation's Leveraged Partnership Transaction*, 113 J. TAX'N 340, 351-53 (2010).

known were unrealistic. The tax planning related to a legitimate business transaction and the tax deferral strategy, which was well known and accepted within the profession,[187] was proposed by a leading investment bank and a leading accounting firm. Moreover, it is frequently the case that a tax advisor will negotiate tax-sensitive provisions of commercial agreements, and that the other party to the transaction will consider the provisions to have little commercial relevance other than to ensure that the taxpayer achieves a particular tax treatment. Tax-deferred corporate reorganizations and like-kind exchanges are just a few examples of transactions where minor variations in the commercial terms can affect one party's tax treatment while having little commercial or tax effect on the other party.[188] In a number of recent cases where courts have criticized the participation of tax advisors in the structuring and documentation of tax shelters, they have distinguished situations where a legitimate business transaction is structured to minimize taxes.[189]

187. *See, e.g.*, Louis S. Freeman, Dean S. Shulman, Victor Hollender & Jeffrey A. Greenblatt, *The Partnership Union: Opportunities for Joint Ventures and Divestitures*, 910 PLI/TAX 1-1 (2010); Eric B. Sloan, Steven E. Klig & Judd A. Sher, *Through the Looking Glass: Seeing Corporate Problems as Partnership Opportunities*, 869 PLI/TAX 833 (2009); Lewis R. Steinberg & Robert Willens, *Hot Topics & Cutting-Edge Structures*, SP051 ALI-ABA 403 (2009); Lewis R. Steinberg, *The Use of Partnerships to Dispose of Appreciated Corporate Assets*, 569 PLI/TAX 1023 (2003).

188. *See, e.g.*, DeCleene v. Comm'r, 115 T.C. 457, 475-77 (1993) (reliance by taxpayer on accountants and attorneys who structured and implemented purported like-kind exchange sufficient to avoid penalties). *See generally* James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 155-56 (2002) (footnotes omitted):

> At the other end of the spectrum are transactions that, while arguably aggressive (and certainly imaginative), most would agree should not be branded as abusive 'tax shelters' although they certainly were tax savers. Seagram merely followed a published revenue ruling, while Esmark selected the low-tax path to a given end in a situation where two other equally plausible, thought higher taxed, alternative routes also were available; the Service was not allowed to resequence Esmark's transaction into the high-tax channels. Cottage Savings' mortgage pool swaps, while they were tax-motivated and did not result in a meaningful change in its economic position, involved a case where recognition of an actual accrued economic loss merely was being accelerated for tax purposes. Form has always occupied a major role in subchapter C and will no doubt continue to do so. Exploiting the many weaknesses in the mostly mechanical rules of subchapter C is an old sport that is ever new. While many of these transactions are tax-driven (even predominantly so), they probably do not deserve to be stigmatized as abusive tax shelters.

189. *See, e.g.*, Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1383 (Fed. Cir. 2010) ("Jeffrey Welles sought out and selected the J&G strategy because of a desire to avoid taxes that would otherwise be owed on the Therma-Tru deal, not because he wanted to structure the deal itself to minimize taxes"); 106 Ltd. v. Comm'r, 136 T.C. 67, 80 (2011) ("[o]ne might need to be careful in applying the definition to some kinds of transactions–a tax lawyer asked by a businessman for advice on how to sell the family business through a tax-favored stock redemption might be said to

In *Canal Corp.*, the court did not state that a taxpayer may never rely on the opinion of a tax advisor who has participated in structuring and negotiating the relevant transaction, but instead criticized the manner in which the transaction was structured, the manner in which the tax advisor developed the facts on which the opinion was based, and the legal reasoning underlying the opinion.[190] The court's criticisms largely concerned the manner in which the tax advisor approached the question of how much assets the obligor under the indemnity should retain to avoid disguised sale treatment. The tax advisor had recommended that the obligor maintain at least 20% of its maximum exposure under the indemnity.[191] Although the taxpayer followed that advice for as long as the indemnity was outstanding, the court concluded that the opinion was based on unreasonable assumptions because no agreement with the other party to the transaction required the obligor under the indemnity to maintain a specified level of assets or net worth.[192]

The court also criticized the fact that the advisor assumed that the indemnity would be effective, and that the entity granting the indemnity would hold sufficient assets to permit the liabilities covered by the indemnity to be allocated to the taxpayer.[193] The court concluded that the factual analysis in the opinion was tainted by the advisor's "audit" of the assets of the joint venture and the entity granting the indemnity, and by the fact that the tax advisor made legal assumptions separate from the tax assumptions in the opinion and reviewed state law to make sure the assumptions were valid regarding whether a partnership was formed.[194]

The court faulted the legal analysis in the opinion that the indemnity would have substance if the entity maintained assets of at

---

have 'participated in structuring the transaction'–but when the transaction involved is the same tax shelter offered to numerous parties, the definition is workable."). *Cf.* Am. Boat Co. v. United States, 583 F.3d 471, 483 (7th Cir. 2009):

> Mayer received a flat fee for his services–which, importantly, included not only an impermissible transaction, but also significant work restructuring Jump's various business entities in response to concerns about his companies' liability. To accept the government's argument would mean that a taxpayer may *never* rely upon the legal advice of the same adviser who counsels the individual on restructuring . . . Jump's reliance on Mayer's advice was not *per se* unreasonable simply because he also advised Jump on restructuring his business.

190. Canal Corp. v. Comm'r, 135 T. C. 199 (2010).

191. *Id.* at 206.

192. The court considered the fact that the taxpayer extracted assets from the entity in the year that the joint venture terminated as indicating that the arrangements to maintain assets in the entity "served to create merely the appearance, rather than the reality, of economic risk for a portion of the LLC debt." *Id.* at 214.

193. *Id.* at 220.

194. *Id.* at 221.

least 20% of the maximum exposure. Specifically, the court determined that the advisor should not have relied by analogy, in the absence of case law or Code authority, on an obsolete revenue procedure that set forth guidelines under which the IRS would provide a ruling on a different issue, and characterized such conclusions as faulty "legal assumptions" that made the opinion unreliable for penalty protection purposes.[195] The court found it objectionable that the advisor was willing to render a "should" level opinion, which was the highest level of opinion that the accounting firm offered to its clients, and which reflected a position that was materially higher than a "more likely than not" opinion.[196]

It is difficult to see how any of the court's criticisms described above are a basis for denying the taxpayer the ability to rely on the tax advisor's opinion. The absence of a contractual obligation to maintain a minimum level of assets to support the indemnity does not alter the fact that the obligor in fact maintained the recommended amount of assets at all relevant times.[197] The taxpayer clearly understood and accepted that maintaining assets in the entity was necessary to achieve the desired tax treatment, and there is no indication that the taxpayer intended to shield those assets from any liability that might arise under the indemnity.[198]

Likewise, there was no indication that the tax advisor's factual or non-tax legal assumptions *per se* were incorrect. The court's decision contains no suggestion, for example, that the indemnity was legally ineffective or that the taxpayer would not maintain assets of at least 20%

---

195. *Id.* at 219. Rev. Proc. 89-12, 1989-1 C.B. 798, declared obsolete by Rev. Rul. 2003-99, 2003-2 C.B. 388, stated that the IRS generally would rule that an organization lacked limited liability for purposes of determining partnership status under prior regulations, if the net worth of the corporate general partner equaled at least 10% of the total contributions to the limited partnership and was expected to continue to equal at least 10% throughout the life of the partnership.

196. *Canal Corp.*, 135 T.C. at 219.

197. Without an obligation to maintain assets in the entity, the taxpayer had the opportunity to extract assets in the event that facts indicated the indemnity would be called upon. No such event occurred, and the court recognized that such a move would create a potential cause of action for fraudulent conveyance. *Id*. at 216. The court viewed the potential for such a claim as insufficient to create economic risk of loss; however the court did not directly address the fact that a fraudulent conveyance action could interfere with a move, if there were signs of trouble, to extract the assets that it voluntarily maintained in the entity.

198. One commentator has questioned whether there is legal authority to support the position that voluntarily maintaining assets is sufficient. Michael L. Schler, *Questions About the Canal Case*, 130 TAX NOTES 971 (2011). However, assuming that no authority existed either way at the time the opinion was rendered, and that the taxpayer did in fact intend to maintain assets for so long as the indemnity was outstanding, it seems reasonable for the taxpayer to rely on the opinion of the tax advisor that assets maintained voluntarily are sufficient to create economic substance. Although others may disagree, this does not appear to be the type of conclusion that even a sophisticated taxpayer should have considered "too good to be true."

of the maximum exposure under the indemnity.[199] The court's criticism of the tax advisor's actions to verify certain facts and non-tax legal conclusions is particularly difficult to fathom. The facts in question included financial facts and conclusions under relevant state law. There is nothing in the opinion to suggest that the tax advisor, who was a partner in an accounting firm and a licensed attorney, did not have the necessary expertise and institutional resources to review those facts and legal conclusions.

The regulations regarding reliance on an opinion to avoid penalties specifically state that "[t]he advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances,"[200] and "must not be based on unreasonable factual or legal assumptions . . . and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person."[201] If anything, those standards require the tax advisor to consider the veracity and plausibility of the factual material on which the opinion is based, to make relevant inquiries and to draw appropriate conclusions. This approach is consistent with the ethical and regulatory requirements imposed directly on practitioners.[202] Needless to say, an opinion may involve factual issues in which the tax advisor does not have the necessary competence, and must rely on experts. However, the implication in the court's decision that all factual assumptions must be

---

199. The court characterizes the opinion as making the factual assumption that the entity "would hold assets sufficient to avoid the anti-abuse rule." However, the description of the opinion strongly suggests that it did not "assume away the very crux of whether the transaction would qualify as a nontaxable contribution to a partnership." *Canal Corp*., 135 T.C. at 220. Rather, as far as can be gathered from the court's decision, the opinion appears to have made a factual assumption that the entity would maintain assets of at least 20% of the maximum exposure under the indemnity, and concluded based on the analogy to the revenue procedure and the regulatory interpretation discussed above, that such assets would be sufficient.

200. Treas. Reg. § 1.6664-4(c)(1)(i) (as amended in 2003).

201. *Id*. § 1.6664-4(c)(1)(ii).

202. *See, e.g.*, 31 C.F.R. § 10.34(d) (2011):

> [a] practitioner advising a client to take a position on a tax return . . . generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete

31 C.F.R. § 10.37(a) (2011):

> [a] practitioner must not give written advice . . . concerning one or more Federal tax issues if the practitioner bases the written advice on unreasonable factual or legal assumptions . . . unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, [or] does not consider all relevant facts that the practitioner knows or should know . . . .

independently validated appears nowhere in the relevant regulations, and as a *per se* rule would do little to ensure the reliability of opinions.

The court's criticisms of the tax advisor's legal analysis are faulty in two regards. Most importantly, it is well established that a court may not deny a taxpayer the ability to rely on a legal opinion of a qualified advisor merely because it disagrees with the analysis in the opinion, assuming that the taxpayer itself does not know or have reason to know that the analysis is faulty or "too good to be true."[203] The court therefore was not justified in disqualifying the opinion by characterizing the tax advisor's legal conclusions as faulty "legal assumptions."[204] As is frequently the case, there was no directly applicable authority and the tax advisor was required to reach his conclusions by relying on analogous authority and by extrapolating from postulates given in the regulations.[205] To all appearances, the tax advisor reached the legal conclusions in the opinion based on the guidance that he thought was

203. United States v. Boyle, 469 U.S. 241, 251 (1985):

> [w]hen an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. . . . 'Ordinary business care and prudence' does not demand such actions.

204. In *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 210 (D. Conn. 2004), *aff'd* 150 Fed. Appx. 40 (2d Cir. 2005), the court similarly characterized legal conclusions with which it disagreed as "legal assumptions." *See also* Bubel, *supra* note 11, at 871:

> Treas. Reg. § 1.6664-4(c)(1)(ii) includes a proscription against unreasonable legal assumptions. While not explicitly requiring citations to legal authority in the same jurisdiction, it would seem to be somewhat difficult to meet this requirement by ignoring relevant authority within the jurisdiction if it bears directly on the facts at hand.

The Second Circuit's opinion in *Long Term Capital Holdings* concluded that the District Court had faulted the inadequate legal analysis because it demonstrated that the opinion was based on "flawed and outcome-determinative assumptions Long-Term asked it to make," and "not because it expected Long-Term to engage in sophisticated questioning of its expert advice." *Long Term Capital Holdings*, 150 Fed. Appx. at 43 n.1. *See* Prescott, *supra* note 8, at 1009 (discussing the Second Circuit opinion).

205. *See, e.g.*, Lawsky, *supra* note 11, at 1037-38 (noting that the determination whether a technically compliant transaction violates the substance or intent of the law ultimately can only be made by a court and therefore cannot be predicted with certainty by a tax advisor).

most relevant.[206] The regulations specifically contemplate this type of analysis.[207]

Moreover, the court's conclusion that the taxpayer's position "did not warrant a 'should' opinion" is irrelevant because it tests the opinion against a higher standard than the "more likely than not" standard called for in the applicable regulations.[208] Finally, it is doubtful that any better judgment would have been reached by requiring the taxpayer to review the analogous authority (or find its own analogy). Specifically, it is doubtful that a taxpayer knowing the need to leave assets in the entity granting the indemnity, and that there was a very low probability of the indemnity being called upon, would conclude that the tax law required the assets to be more than 20% of the maximum exposure under the indemnity.[209] Likewise, it is doubtful that a taxpayer intending to leave assets in the entity, and knowing it could be exposed to a fraudulent conveyance claim if it extracted the assets when there were signs of trouble, would conclude that the tax law required it also to commit in the indemnity to maintain those assets.[210]

The court's conclusions about the fee arrangements in *Canal Corp.* also are unpersuasive. The court levied three main criticisms: first, the accounting firm charged a high fee for what the court viewed to be a low

---

206. The court criticized the use of the words "it appears" in the opinion's interpretation of the relevant regulation. Canal Corp. v. Comm'r, 135 T. C. 199, 220 (2010). The court appears to have interpreted those words as an abdication of responsibility by the tax advisor for the legal conclusion, but more likely they were an honest expression that the tax advisor reached the conclusions without directly applicable authority, and that other conclusions were possible.

207. *See, e.g.*, Treas. Reg. § 1.6662-4(d)(3)(ii) (2011) ("[t]there may be substantial authority for the treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.").

208. Treas. Reg. § 1.6664-4(f)(2)(i)(B) (2011). *Canal Corp.* is not the first case where a court objected to the willingness of a tax advisor to provide a "should" opinion that it disagreed with. *See Long Term Capital Holdings*, 330 F. Supp. 2d at 210-11:

> Finally, no other evidence such as companion memoranda discussing the application of [various relevant authorities] to the actual facts of the OTC transaction was offered to show research for King & Spalding's legal analysis and opinions. Such background research does not involve obscure or inaccessible caselaw references, is basic to a sound legal product, especially for [a] 'should' legal opinion and a premium of $400,000. With hourly billing totals exceeding $100,000 there could hot have been research time constraints.

209. A financially sophisticated taxpayer would likely discount the maximum exposure by the probability of the indemnity being called upon, similar to the analysis used by insurance companies to establish reserves.

210. Many business and financial transactions involving long-term commitments do not specify the assets that the party giving the commitment must maintain.

quality work product.[211] Second, the fee was not based on the time spent by the accounting firm on the transaction.[212] Third, the fee was effectively payable only if the accounting firm was able to render the opinion.[213]

On the first point, the court's decision strongly implies that the only reason the accounting firm was willing to render an opinion at a "should" level was because it was receiving an $800,000 fee. As the court put it: "PWC crossed over the line from trusted adviser for prior accounting purposes to advocate for a position with no authority that was based on an opinion with a high price tag—$800,000."[214]

This characterization implies that the accounting firm engaged in high priced prostitution, but there is nothing in the court's decision that convincingly establishes that the accounting firm did not believe the conclusions in its opinion. The court appears to base its characterization primarily on the fact that when the advisor was asked how the accounting firm could issue a "should" opinion if no authority on point existed to support the position taken in the opinion, he "demurred that it was what Chesapeake requested."[215] From that response, the court extrapolated that "no lesser level of comfort would have commanded the $800,000 fixed fee that Chesapeake paid for the opinion."[216] However, a conclusion that the taxpayer would not have been willing to pay for a weaker opinion does not necessarily mean that the amount of the fee influenced the accounting firm's belief in its opinion.[217]

The court characterizes the second and third points as two sides of a metaphorical coin:

---

211. Canal Corp. v. Comm'r, 135 T. C. 199, 219 (2010) (noting the opinion, which was in draft form, was littered with typographical errors, disorganized and incomplete).

212. *Id.* An $800,000 flat fee for the opinion was issued which was not based on time devoted to preparation of the opinion.

213. *Id.* The flat fee was to be paid for the opinion, thus, in order to receive the fee, the opinion had to be completed.

214. *Id.* at 220. *See also* Bemont Invs., LLC v. United States, Nos. 4:07cv9, 4:07cv10, 2010 WL 3057437, at *13 (E.D. Tex. Aug. 2, 2010) ("[t]he Court believes that Coscia was no more than a 'puppet' for Plaintiffs and rendered no real independent or objective advice. Coscia said what he was paid to say.").

215. *Canal Corp.*, 135 T.C. at 219.

216. *Id.* at 220.

217. The court notes that the opinion, which was in draft form, was littered with typographical errors, disorganized, and incomplete, and that the author of the opinion failed to recognize several parts of the opinion. Those facts suggest a level of sloppiness that has no place in a top-tier accounting firm. However, they do not in themselves suggest that the accounting firm did not believe the conclusions in the opinion.

> We also find suspect the exorbitant price tag associated with the sole condition of closing. Chesapeake essentially bought an insurance policy as to the taxability of the transaction. PWC received an $800,000 fixed fee for its tax opinion. PWC did not base its fee on an hourly rate plus expenses. The fee was payable and contingent on the closing of the joint venture transaction. PWC would receive payment only if it issued Chesapeake a "should" opinion on the joint venture transaction. PWC therefore had a large stake in making sure the closing occurred.

Considering all the facts and circumstances, PWC's opinion looks more like a quid pro quo arrangement than a true tax advisory opinion.[218]

This may have been the case, but there is another possible, and less venal, explanation of the billing arrangement that was not addressed by the court.[219] As the court found, the taxpayer concluded that a taxable sale of the business would not be advantageous, and therefore engaged the investment bank and the accounting firm to develop "strategic alternatives" for the business.[220] The investment bank recommended to the taxpayer's management that the best alternative for maximizing shareholder value would be a leveraged partnership structure with the other party to the transaction.[221] The taxpayer's board liked the leveraged partnership idea, but the taxpayer made clear to the investment bank and to the accounting firm that it would only approve a nontaxable transaction.[222] Moreover, the taxpayer made clear that it would only approve the transaction if the accounting firm rendered a "should" level opinion, presumably because the taxpayer wanted assurance that the transaction presented a low level of tax risk.[223]

The taxpayer and the accounting firm also agreed to a billing arrangement under which the accounting firm would bill the taxpayer at the close of the transaction.[224] Presumably, this condition was requested by the taxpayer, not the accounting firm, which took the risk that the

---

218. *Id.* at 221.

219. Some commentators have argued that the court's conclusion that the accounting firm would be paid nothing if the transaction did not close was not supported by the record. Lipton & Golub, *supra* note 186, at 352. Based on personal experience, it seems doubtful that an accounting firm would agree to take the entire risk of working for nothing if the transaction does not close; however, the remaining discussion assumes that the court's characterization of the fee arrangement is correct.

220. *Canal Corp.*, 135 T.C. at 203.

221. *Id.*

222. *Id.* at 204.

223. *Id.* at 205.

224. *Id.* at 206.

transaction would not close for any number of possible reasons, such as the failure of the parties to reach a commercial agreement, the failure to receive antitrust clearances, etc. For the taxpayer, the accounting firm's work would be worthless unless the transaction closed, and the accounting firm was willing to accept the financial risk of its work being worthless. The accounting firm recognized that its ability to render a "should" level opinion was one condition to the closing, but presumably the accounting firm had concluded that it would be able to render such an opinion.[225] However, the accounting firm knew that the transaction would require a large amount of work,[226] and wanted to receive a premium for taking the risk that the transaction would not close for reasons unrelated to its ability to render a "should" level opinion.

Needless to say, it is impossible as outsiders to know exactly what went through the minds of the taxpayer and the accounting firm as they negotiated the billing arrangement. However, given the severe reproach levied by the court, one would have hoped for it to first address more innocent explanations.

Looking past the specific faults identified by the court, the *Canal Corp*. decision seems to reflect the view that a sophisticated taxpayer that arranges its affairs to take a knowingly aggressive position, and that pays a tax advisor to develop an opinion that supports the position, should not be entitled to rely on the opinion to avoid penalties. Knowing that the position is aggressive, the taxpayer already has accepted the possibility that taxes may not be avoided, and the opinion thus serves merely to shield the taxpayer from penalties. Effectively, there is a range of possible legal conclusions regarding the taxpayer's position, falling on either side of the line. The advisor's judgment that the position is more likely to be correct than incorrect should be discounted because the advisor is being paid to reach that conclusion. Under this view, a sophisticated taxpayer should not be able to rely on

225. As discussed above, the leveraged partnership tax deferral strategy was well known and accepted within the tax profession.

226. The court was skeptical of the tax advisor's testimony that he and his team "spent hours on the opinion," because the opinion was "littered with typographical errors, disorganized and incomplete." *Id.* at 219. However, it is clear that the tax advisor and his team spent a large amount of time on the transaction as a whole. As noted by the court, they helped the investment bank develop a recommended strategy, were "intricately involved in drafting the joint venture agreement, the operating agreement and the indemnity agreement," reviewed the assets of the joint venture and the entity providing the indemnity, researched state law points, and researched and drafted the opinion. *Id.* at 221. In drafting the transaction documents, the tax advisor coordinated closely with the taxpayer's management in considering the circumstances in which the taxpayer would be called upon to pay the indemnity.

an opinion to avoid penalties on a position the taxpayer has arranged to take unless objectively there is little likelihood that the position is incorrect.[227]

There are two fundamental problems with this view. First, it favors tax positions where the taxpayer has not altered its behavior in order to take the position. Not only does this discourage candor on the part of taxpayers about their motivations, it is not clear that tax planning should be discouraged. By enacting rules that tax certain behaviors less than others, Congress has effectively expressed a judgment that the lower-taxed behaviors are socially desirable.[228]

Second, the view effectively disqualifies a judgment by a tax advisor that under the regulations would be acceptable if made directly by the taxpayer. All that the regulations require of a taxpayer making its own analysis is that its position have substantial authority and that it "reasonably conclude in good faith" that the position is more likely to be correct than incorrect based on the pertinent facts and authorities, and weighing the authorities based on their relevance, persuasiveness, and authoritativeness.[229] Reasonableness and good faith do not require the taxpayer to avoid reporting a position unless there is a minimal level of risk that the position will be incorrect. Rather, the reasonableness and good faith standard require the taxpayer to evaluate its position in a manner that is objectively reasonable, and to believe its analysis.[230]

Obviously, the fact that the taxpayer has a self-interest in paying less tax does not disqualify its evaluation, because the regulations specifically contemplate that the taxpayer makes the evaluation. Accordingly, the regulations permit a taxpayer to take its own self-interest into account in asserting a position that is barely more likely to be correct than to be incorrect. However, the regulations do not permit the taxpayer to take its own interest into account in weighing the probability that the position is correct.[231]

The standard should be no more stringent when the taxpayer pays a tax advisor to undertake the analysis. The tax advisor has a financial interest in reaching a favorable conclusion where there is a range of

227. For a proposal along these lines, see Doran, *supra* note 11, at 154-56.

228. Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, And a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 384-87 (2002).

229. Treas. Reg. §§ 1.6664-4(f)(2)(i)(A), (B)(1) (as amended in 2003).

230. *See* Bubel, *supra* note 11, at 832-35 (discussing the factors taken into account in evaluating good faith and reasonableness).

231. *See* Lawsky, *supra* note 11, at 1059 ("the government also wants the taxpayer to make a 'reasonable' judgment–that is, it wants the taxpayer to judge and report her own chances of success in the same way that a non-self-interested person would judge and report those chances.").

objectively reasonable outcomes, but that financial interest merely reflects the taxpayer's own financial interest in paying less tax. As discussed above, the taxpayer's financial interest will be present any time that the taxpayer makes its own assessment of a position, and the regulations implicitly accept that fact, just as they implicitly accept the fact that a "professional tax advisor" will be paid by the taxpayer.[232] Given the training received by tax professionals and the professional standards to which they are subject, there is little reason to believe that tax advisors overall are more likely to skew their analysis than taxpayers with an equivalent level of tax sophistication.[233]

It may be argued that sophisticated taxpayers engaging in aggressive tax planning should not be able to rely on opinions of paid advisors, because they will be able to find compliant advisors who approve positions that a reasonable analysis would indicate are less likely to be correct than incorrect. That concern largely is addressed by the requirement that the taxpayer's reliance on an opinion be reasonable and undertaken in good faith. If the taxpayer itself has not undertaken an analysis of the position, the regulations do not ask the court to consider whether a reasonable taxpayer would reach the same position as the tax advisor, beyond the general requirement that the position not be "too good to be true."

IV. DEVELOPING A METHOD FOR ANALYZING A TAX ADVISOR'S OBJECTIVENESS

Ultimately, the goal of any method for evaluating potential conflicts of interest should be to illuminate the extent of the taxpayer's efforts to assess its proper tax liability through reasonable reliance on a tax advisor's opinion that is undertaken in good faith. As the cases discussed above have demonstrated, it is possible for an advisor to have a conflict of interest but for a taxpayer to act reasonably and in good faith in relying on the advisor's opinion. Therefore, a *per se* rule is not appropriate. Rather, it is necessary to develop a method for evaluating the reasonableness of the taxpayer's belief that the opinion was reliable, and whether the taxpayer held that belief in good faith.

A contrary view would assert the prophylactic benefit of a *per se* rule. Under that view, a taxpayer should seek alternative advice if it is

232. *See* Am. Boat Co. v. United States, 583 F.3d 471, 483 (7th Cir. 2009) ("one in need of legal advice almost always has to pay something for it.").

233. As the cases discussed above demonstrate, examples of misconduct can be found on the part of both tax advisors and taxpayers. That inevitably is the case in any large population.

aware of a conflict of interest, because that the taxpayer is not in a position to judge the merits of the conflicted tax advisor's opinion. However, there are five principal problems with that argument. First, conflicts of interest are inevitable whenever a paid tax advisor is involved. Even in a strict paradigm where the taxpayer approaches the tax advisor to furnish a neutral view of the legitimacy of a structure, such as that proposed by the court in *106 Ltd*., a paid preparer will have temptations to find the arguments that support the tax reduction potential of a structure. As discussed above, the fact that an advisor is compensated by the taxpayer is implicit in the regulatory structure.

Second, there is little basis to distinguish "acceptable" and "unacceptable" conflicts of interest beyond platitudes and anecdotes. Consider, for example, the paradigm articulated in *106 Ltd*. Why should we believe that a tax advisor is significantly more likely to distort his advice merely because he has been engaged for the first time by the taxpayer, because he has alerted the client of the need for tax advice, because he has made factual inquiries outside his specific tax expertise, because his advice differs in some fashion from his typical practice, or because he charges a fee that is not based on his regular hourly rate? Even if these factors may have some association with aggressive tax planning, there are many situations where tax advisors have acted responsibly in the presence of one or more such factors. Conversely, the cases above demonstrate that the potential for distorted advice exists even where, for example, the tax advisor has a long-term continual relationship with the taxpayer.

Third, a paradigm such as that articulated in *106 Ltd*. is unlikely to reflect the day-to-day relationships of many taxpayers and their tax advisors, and therefore become a trap for the unwary. For example, many taxpayers lack a long-term and continual relationship with any tax advisor, and many others have a long-term and continual relationship only with a relatively unsophisticated tax return preparer. Therefore, on complex matters, they either will be compelled to seek out a new tax advisor, or will be well advised to do so. Likewise, many taxpayers rely on their tax advisors to alert them when tax advice is appropriate, or will seek out a tax advisor specifically to develop a strategy for reducing taxes. Many taxpayers will encourage their tax advisors to make judgments that go beyond the technical tax rules but that may affect the tax analysis of a particular transaction. Finally, many taxpayers find hourly billing arrangements undesirable because the fees are not connected to the taxpayer's own business success or failure, and because the amount of time an advisor will spend often is difficult to control.

Fourth, the notion of a *per se* test is inconsistent with the analysis required under the relevant regulations. The regulations do impose some conditions on the opinion that may be viewed as *per se* requirements: the advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. The advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring it in a particular manner. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. In the case of a tax shelter item of a corporation, there must be substantial authority for the position, and the opinion must unambiguously state 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. However, beyond those specific requirements, the regulation makes clear that "[a]ll facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice . . . ."[234]

More generally, the regulations determine reasonableness and good faith from the perspective of the taxpayer, not the advisor. Thus, for example, the regulations note that "the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith."[235] Likewise, in the case of a tax shelter item of a corporation, the "belief requirement" is satisfied only if, based on all facts and circumstances, "the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment."[236] Consistent with that approach, the regulations frequently refer to facts that a taxpayer knew, or reasonably should have known.[237] In other words, the purpose of the analysis is not to render judgment on the advisor's behavior, but to

234. Treas. Reg. § 1.6664-4(c)(1) (as amended in 2003).

235. *Id.*

236. *Id.* § 1.6664-4(f)(2)(i)(B).

237. *See id.* § 1.6664-4(c)(1) ("reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law"); *Id.* § 1.6664-4(c)(1)(i) ("the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item"); *Id.* § 1.6664-4(c)(1)(ii) ("the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true.").

assess whether the taxpayer made a reasonable and good faith attempt to report its proper tax liability.[238]

Finally, the presence of a statutory *per se* rule for reportable transaction understatement penalties strongly suggests that no such rule should exist for other types of understatement penalties. As discussed above, section 6664(d)(4)(B) of the Code provides that an opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer in respect of a reportable transaction if the tax advisor is a "disqualified tax advisor," which it defines as a tax advisor having certain types of involvement with the transaction, certain compensation arrangements, or certain financial interests with respect to the transaction.[239] The legislative history to this provision clearly indicates that it imposed "more meaningful" and "strengthened" test compared to the general standard for reliance on opinions.[240]

In the absence of a *per se* rule, an advisor's conflict of interest must be evaluated as a fact and circumstance in determining whether the taxpayer has acted reasonably and in good faith. It first is necessary to consider whether the conflict of interest is relevant to this determination. If so, it is necessary to consider what it reveals about the taxpayer's efforts to determine its proper tax liability.

A. *Relevance of a Conflict of Interest*

Assume that a tax advisor has a large conflict of interest. Are there circumstances where the taxpayer should be permitted to rely on what turns out to be an incorrect opinion from the tax advisor because the conflict is irrelevant?

One possible circumstance is where the taxpayer is unaware of, and has no reason to know of, the tax advisor's conflict of interest. For example, assume that the tax shelter promoter learns of the identity of the tax advisor, who was independently selected by the taxpayer, and refers another client to the advisor with the hope of influencing the advisor's analysis. The advisor accepts the referral and fails to disclose it to the taxpayer. One way of analyzing this situation is to ask whether

238. There are various other fora for determining for evaluating a tax advisor's behavior, including, for example, disciplinary actions under Circular 230 by the Treasury Department Office of Professional Responsibility, State ethics proceedings, the imposition of tax return preparer penalties under I.R.C. § 6694, malpractice actions, and actions to enforce the securities laws. *See generally* DAVID T. MOLDENHAUER, TAX OPINIONS IN LEGAL OPINION LETTERS, A COMPREHENSIVE GUIDE TO OPINION LETTER PRACTICE (M. John Sterba ed., 3d ed. 2010).

239. *See supra* Part II.

240. H.R. REP. NO. 108-548, pt. 1, at 263 (2004).

the taxpayer or the government should bear any consequences of the tax advisor's undisclosed conflict of interest, assuming that the opinion otherwise meets the regulatory requirements. However, because the issue does not concern the taxpayer's substantive tax liability, but rather the imposition of penalties, this type of "zero sum" analysis should not apply. Rather, the issue should be determined based on the purpose of the reasonable cause and good faith exception, which looks to the taxpayer's state of mind and behavior. If the taxpayer has been vigilant in selecting and instructing the tax advisor, there is little reason to deny penalty relief because of the tax advisor's own potential misbehavior.

A second possible circumstance is where the conflicted tax advisor has rendered an opinion that demonstrably is equivalent to the opinion that would be rendered by a more independent advisor. Imagine, for example, a case where the tax advisor promotes a common tax credit strategy in exchange for a portion of the tax savings, and where the relevant legal issue has been decided favorably to taxpayers by the relevant circuit court of appeals, but there is a split with another circuit court of appeals that decided adversely to taxpayers. The taxpayer has made no separate analysis. If the opinion is rendered and the tax return is filed before the Supreme Court grants certiorari to decide the circuit split, and if more independent advisors have rendered equivalent opinions, it would seem unfair to deny the taxpayer penalty relief because of the tax advisor's posture as a marketer and implementer of the transaction, or because the tax advisor is paid a portion of the tax savings. Given the low probability of the Supreme Court granting certiorari on any issue, there is little reason to impute to the tax advisor a willful blindness to the possibility that the circuit court of appeals decision could not be relied upon.

Should a conflict be deemed irrelevant because the circumstances under which the conflict arose are not directly related to the flaw in the transaction? For example, assume that a tax advisor develops a tax reduction strategy that would be effective if it were properly implemented, but for reasons unrelated to the tax advisor, and unknown to the tax advisor, the implementation is flawed. If the test of relevance is whether the opinion demonstrably is equivalent to the opinion that would be rendered by a more independent advisor, the fact that the tax advisor is unconnected with the implementation may not be sufficient to ignore the conflict of interest. For example, a more independent tax advisor might have reviewed more carefully the implementation of the strategy.

B. *When a Conflict of Interest is Relevant*

In many situations, the conflict of interest will be relevant and the inquiry becomes what the conflict of interest reveals about the taxpayer's efforts to determine its proper tax liability. Two variables seem relevant for this analysis: (1) the inducement that an apparent conflict may create to distort the advice ("temptation"),[241] and (2) the advisor's apparent response to such inducement ("resistance").

Applying those two variables creates a framework for analysis. Assuming the other requirements of the regulations are satisfied, a taxpayer can reasonably and in good faith rely on an opinion rendered by an advisor subject to a low level of apparent temptation, and who appears to act with a proper level of resistance. Conversely, a taxpayer should not be permitted to rely on an opinion where there is a high level of apparent temptation, and little indication that the advisor is resisting the temptation to distort the advice in favor of tax reduction.

The more interesting cases arise where either the level of apparent temptation is high, but the level of apparent resistance also is high, or where the level of apparent temptation is low, but the level of apparent resistance also is low. Assume, for example, that in *Canal Corp*. the record showed that the taxpayer knew that the accounting firm's opinion committee had approved the opinion after an intense review of the facts and applicable law, and that no member of that committee was aware of the billing arrangements. In that case, the fact that the accounting firm had a financial incentive to render a favorable opinion, and that it arguably colluded in producing the facts on which it based the opinion, should not prevent the taxpayer from relying on the opinion. To all appearances, the financial incentive had been resisted, and as discussed above, it is common for tax practitioners to participate in shaping business transactions to achieve legitimate tax reductions. Under those facts, to deny the taxpayer the ability to rely on the opinion because of the accounting firm's financial incentive and its involvement in the transaction would effectively apply an impermissible *per se* rule.

Now assume that a taxpayer with no tax expertise asks its long-time advisor at a respected firm to review a tax shelter that the taxpayer was offered. The firm has no relationship with the promoter, has not promoted similar strategies, and will be paid hourly rates for its review. The advisor inquires into the relevant facts, but does not participate in

241. As discussed above, if the temptation is not apparent, it is doubtful that the conflict of interest should be considered relevant in determining whether the taxpayer acted reasonably and in good faith in relying on the tax advisor's opinion.

shaping the facts. The opinion that the advisor renders accurately sets for the relevant facts and does not contain any unreasonable assumptions, because among other things it acknowledges the taxpayer's primary motivation to reduce taxes. The taxpayer and the advisor have a friendly relationship, and when the taxpayer first approaches the advisor and describes the shelter, the advisor says "I think I can get there." The advisor spends a considerable amount of time developing an opinion that describes all the facts and issues, but relies on minor factual distinctions and outdated and marginal cases to reach a favorable conclusion. The advisor knows—but does not tell the taxpayer—that the transaction is unlikely to be sustained, but he figures the chances of audit are low.

In this example, the level of apparent temptation is low, specifically the advisor's personal desire to accommodate the taxpayer, and presumably to receive future work. However, certain facts in retrospect indicate that the advisor was not resisting the temptation. Specifically, the advisor's quick response that he thought he could "get there," and his considerable effort to do so. A court reviewing the opinion will quickly recognize its flaws; however, as the Supreme Court recognized in *Boyle*, the taxpayer is not competent to discern those flaws.[242] For the same reason, it seems inappropriate to expect the taxpayer to second-guess either the fact that the advisor was quick to indicate that he could reach a favorable result, or the fact that he spent substantial time to do what he quickly said he could do. Although the taxpayer may realize that the issue is more difficult than it first appeared to the advisor, ultimately the advisor stands in a position of apparent authority *vis à vis* the taxpayer. As the Supreme Court stated in *Boyle*, "[t]o require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place."[243]

One can imagine other cases where the advisor more obviously succumbs to a low level of temptation. Imagine, for example, that in the initial conversation the advisor says "I normally wouldn't do this, but I think I can get there for you." At that point, the taxpayer reasonably

242. *See* United States v. Boyle, 469 U.S. 241, 251 (1985).

243. *Id.*; *see also* Bubel, *supra* note 11, at 846:

> [r]easonable reliance does not require a taxpayer to monitor and second-guess the efforts of the practitioners on whom she is relying with respect to an area of the tax law that is beyond her understanding. Rather, the taxpayer is expected to exercise 'ordinary business care and prudence' in selecting a [sic] an advisor with sufficient expertise to justify reliance (and in seeing to it that the advisor is provided with adequate information).

should inquire further, and if the statement is what it appears to be, should decline the offer.

Needless to say, between these four poles (high temptation and high resistance, high temptation and low resistance, low temptation and high resistance, and low temptation and low resistance), there is an infinite number of potential intermediate positions. However, identifying the factors that create apparent temptation for a tax advisor to skew his advice, and evaluating the advisor's apparent resistance to that temptation, creates a framework for courts to consider whether a taxpayer should have been skeptical of the advice.

C. *Forms of Temptation*

In considering how the foregoing framework might apply, it is useful to identify some common forms of temptation that tax advisors have faced when advising on tax-motivated transactions. In the cases discussed above, the tax advisors appear to have been motivated by the following types of temptations:

- An opportunity to earn a large fee without necessarily spending a corresponding amount of working hours;
- An opportunity to build or maintain a practice and a track record;
- An opportunity to deepen ties to the taxpayer as client and exclude competitors;
- An opportunity to handle a challenging transaction and to successfully develop or implement a way to reduce taxes.

These types of temptations can appear in some fashion in any sophisticated transaction, and pursuing these temptations is not in itself illegitimate. Accordingly, it is necessary to consider the circumstances when an advisor's response to those temptations can make an opinion unreliable.

1. Compensation and Hours Worked

Courts generally have viewed compensation based on a percentage of tax benefits generated by a transaction as a strong indicator that an advisor's opinion is unreliable.[244] Also, some courts have viewed high

244. *See, e.g.*, Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1382 (2010) ("J&G's role as a promoter of the strategy was . . . apparent in J&G's fee agreement, which tied the firm's compensation to the gain sheltered by the strategy"); Am. Boat Co. v. United States, 583 F.3d 471, 482 (7th Cir. 2009) ("when an adviser profits considerably from his participation in the tax shelter, such as where he is compensated through a percentage of the taxes actually sheltered, a taxpayer is

levels of compensation that are not based on the number of hours worked as indicating that an opinion is unreliable.[245] The rationale is that a tax advisor who is being paid a premium for delivering a tax strategy is more likely to skew the advice in favor of its success.

The fact that a tax advisor charges a premium over rates charged for other work may be compensation for the tax reduction idea, for other value that the tax advisor provides (e.g., successfully negotiating a difficult commercial transaction, advising under very difficult circumstances, or giving up other profitable opportunities), or because the tax advisor incurs some risk. Among the risks that a tax advisor might consider himself to incur are the professional risks of delivering an opinion that is "at the edge," or commercial risks such as discounted arrangements for his work if the transaction is unsuccessful.

If the compensation arrangements indicate that the advisor is receiving a premium for a tax reduction idea, or for taking the risk of providing an opinion "at the edge," further analysis is clearly merited. The very fact that an advisor is charging a premium based on the tax reduction offered by the strategy is behavior by the advisor that reflects a motivation for the premium. The argument for imputing unreliability is that having shown a desire for the premium, it is reasonable to expect

much less reasonable in relying on any advice the adviser may provide"); Murfam Farms, LLC *ex. rel.* Murphy v. United States, 94 Fed. Cl. 235, 247 (2010):

> [t]he Murphys have conceded that from the beginning they understood that E&Y's fee would be a percentage of their desired tax loss. . . In other words, the Murphys understood that the more taxes they avoided by following E&Y's advice the more they would pay E&Y in fees. The Murphys knew that E&Y stood to earn millions by advising them to participate in COBRA, and they therefore knew or should have known that E&Y's advice lacked the trustworthiness of an impartial opinion

New Phoenix Sunrise v.Comm'r, 132 T.C. 161, 194 (2009) ("Petitioner should have . . . known that Jenkins & Gilchrist had a personal stake in the BLISS transaction and could not be relied upon to provide independent advice.").

245. 106 Ltd. v. Comm'r, 136 T.C. 67, 80-81 (2011):

> Garza charged a flat fee for implementing [the tax shelter] and wouldn't have been compensated at all if Palmlund decided not to go through with it. He wasn't being paid to evaluate the deal or tweak a real business deal to increase its tax advantages; he was being paid to make it happen. And Turner & Stone charged $8,000 for preparing Palmlund's tax returns–$6,500 more than usual. The extra fees were not attributable to an extraordinarily complex return–Palmlund's returns were always complex due to his various business interests–but, we find, were the firm's cut for helping to make the deal happen

Canal Corp. v. Comm'r, 135 T.C. 199, 221 (2010) ("[w]e also find suspect the exorbitant price tag associated with the sole condition of closing. Chesapeake essentially bought an insurance policy as to the taxability of the transaction. PWC received an $800,000 fixed fee for its tax opinion. PWC did not base its fee on an hourly rate plus expenses.").

that the advisor will skew his advice in order to get it.[246] However, that argument confuses the temptation and the resistance—it essentially assumes that tax professionals are willing to alter their analysis in response to financial inducement.

One fundamental problem with this position is any professional tax advisor who is structuring a transaction is being paid for his tax structuring ideas, regardless of the form of compensation. Even at hourly rates, a tax advisor is induced to provide advice, and as many leading tax advisors would be quick to point out, their high hourly rates are based on the intellectual content (i.e., tax saving ideas) they are able to provide. As the court in *American Boat* noted, "one in need of legal advice almost always has to pay something for it."[247]

Because advice cannot be viewed as unreliable merely because an advisor receives compensation, an approach that treats a specific compensation formula as suspect must be based on the grounds that the formula will cause the tax advisor to alter his views. There are two possible justifications for this position, although neither holds up well to probing. One possible justification is that an advisor who receives a premium for a tax idea, rather than charging his regular hourly rate, is being paid because he is able to deliver an idea that other tax advisors who are compensated by the hour are unable or unwilling to provide. The premise is that if other, hourly rate, tax advisors are unable or unwilling to provide the advice, the tax idea itself must be viewed as suspect.

The problem with this premise is that the tax profession attracts intelligent people who sometimes have insights that elude others. One frequently hears in the profession references to the brilliance of one or another tax advisor. There will be circumstances where a sophisticated taxpayer should recognize that the analysis is faulty or "too good to be true," but often the taxpayer is not in a position to determine whether the substantive advice reflects brilliance or wishful thinking. One might argue that a taxpayer paying a higher than normal price for a tax idea should obtain a second opinion to verify the idea. However, if the two advisors disagree, the taxpayer is in no position to determine which advisor is correct. One might further argue that the taxpayer should discount the position of the advisor receiving the premium, but that begs the question.

---

246. *See, e.g.*, *Am. Boat*, 583 F.3d at 485 ("[h]ad Mayer required his compensation to be a percentage of the sheltered capital gains, perhaps our analysis would be different.").

247. *Id.* at 483.

The second possible justification is that a premium payment implicitly depends on the advisor's ability to render favorable advice to the taxpayer. The premium thus creates a temptation to skew the advice. However, the existence of the temptation itself says nothing about how the advisor has responded to it. Also, this justification requires two further assumptions: first, the court must assume that an advisor who charges hourly rates would be paid the same amount (and would not, for example, provide a discount) if the advisor were unable to provide favorable advice. Second, the court must assume that a hypothetical hourly rate advisor who could not resolve the issue favorably to the client would command the same hourly rate as a hypothetical hourly rate advisor who would resolve the issue favorably. It is difficult to imagine how these assumptions could be tested.

In most cases, courts do not need to rely solely on the fee structure to establish a conflict of interest, because the advisors take other actions to enhance their chances of deriving the premium. One obvious example is where the tax advisor markets the strategy, thereby creating the opportunity for himself to benefit from providing the tax strategy. Because the advisor has affirmatively sought out this opportunity, and persuaded the taxpayer to use the strategy, his behavior clearly was influenced by the temptation. There should be a very high hurdle to clear to establish that the advisor reasonably should not be suspected of also skewing his advice.

Another example is where the tax advisor takes on disproportionate risks to ensure that the transaction occurs, for example the lawyer in *106 Ltd*., who personally promised to cover any taxes, penalties, or litigation costs of the taxpayer if the transaction blew up.[248] A court might find evidence of such disproportionate risk-taking where an advisor agrees to be paid only on the closing of the transaction. However, that conclusion assumes that advisor's contingent fee arrangement helps ensure that the transaction occurs, and is not simply motivated by market pressures.

A third example is where the advisor constructs unreal facts or makes unreal assumptions to support his opinion. The choice to take those actions clearly indicates both the desire to have the transaction occur, and the willingness to apply wishful thinking to get there.

248. Under current law, that arrangement would cause the transaction to be a reportable transaction and under the more stringent rules of I.R.C. § 6664(d), the taxpayer would not be permitted to rely on the opinion to establish reasonable cause and good faith. *See supra* note 50.50

2. Developing, Maintaining, and Protecting a Professional Practice

In most of the cases discussed above, the tax advisor had prior involvement with the tax shelter, and presumably had derived fees from that involvement. Those fees normally would be used to cover the operating expenses of the practice, including compensating personnel, and the remainder would be a profit to the owners of the practice. One can assume that like in any business, there would have been a desire to maintain or grow the fees of the practice to continue covering expenses and generating a profit. Also, given the intellectual effort involved in developing a tax strategy, it is likely that the tax advisor would have sought to reuse the knowledge and experience gained in prior transactions.[249] The tax advisor would have had an interest in reaching similar conclusions to those reached in the prior transactions, in order to continue his practice of implementing the tax shelter, and to avoid having to explain any change in position. Finally, the tax advisor would have an interest in limiting the risk that he or his firm may be held responsible if the transactions were challenged by the IRS.

Courts generally have not treated an opinion as unreliable merely because the tax advisor previously advised on a similar product as opposed, for example, to having developed or marketed the tax shelter. However, in certain circumstances, courts have considered whether the tax advisor's firm prepared and framed its advice in a manner intended to protect the firm's reputation and franchise.[250] The implication seems to be that if the tax advisor equivocates, qualifies his advice, or takes other actions to avoid legal or moral responsibility in the event that the transaction is challenged by the IRS, the taxpayer should view the advice as suspect and, presumably, seek advice from another advisor.

In some cases, the behavior of the tax advisor will raise obvious questions. For example, in *Stobie Creek* the taxpayers might have asked

249. If the tax advisor requires the taxpayer to maintain the confidentiality of the advisor's tax strategies and the advisor's fee exceeds certain thresholds, the transaction generally will be a reportable transaction. Treas. Reg. § 1.6011-4(b)(3) (as amended in 2003). In that case, the more stringent rules of I.R.C. § 6664(d) will prevent the taxpayer from relying on the advisor's opinion to establish reasonable cause and good faith. In addition, regardless of the amount of fees charged, the opinion will be subject to the standards of Circular 230 § 10.35 discussed above.

250. *See, e.g.*, Murfam Farms, LLC *ex. rel.* Murphy v. United States, 94 Fed. Cl. 235, 250-52 (2010) (describing accounting firm's internal response to an IRS Notice that challenged the relevant tax shelter, and communications from the accounting firm to the clients regarding such notice); Stobie Creek Invs. LLC v. United States, 82 Fed. Cl. 636, 713 (2008), *aff'd* 608 F.3d 1366 (Fed. Cir. 2010) (noting lawyer's attempt to distance himself from his prior recommendation of a tax shelter transaction).

whether the law firm had second thoughts about the transaction when it volunteered to substantially reduce its fee or make an equivalent charitable contribution.[251] However, in practice, a taxpayer may have difficulty determining whether disclaimers of legal liability, qualifications to the advice, or equivocations are a normal part of the advisor's practice or reflect an advisor's lack of confidence in the opinion. The courts themselves have recognized the fact that in selecting a tax advisor, a taxpayer may rely largely on the tax advisor's market reputation,[252] and therefore may have little basis to evaluate the manner and terms on which the advice is being delivered. More generally, the uncertain outcome of many tax issues, and the litigious nature of modern society naturally encourage tax advisors, like other professional advisors, to seek to protect themselves from legal liability by qualifying their advice.

3. Cementing Relationships with Clients

In several of the cases, the taxpayer was introduced to the tax shelter by lawyers or accountants with whom the taxpayer had long-standing relationships. In *Stobie Creek* and *New Phoenix Sunrise*, the lawyers handling a sale of the taxpayer's business introduced the taxpayers to the tax shelter promoters. In *American Boat*, the lawyer introduced a tax shelter into a business restructuring without the taxpayer fully understanding the nature of the transaction. Presumably, the lawyers and accountants in those cases believed that providing good service to their clients included identifying opportunities to reduce the clients' taxes.

These cases demonstrate that a long-standing relationship between the taxpayer and the tax advisor does not guarantee that the client will receive reliable advice. As previously discussed, it may be particularly difficult for a taxpayer that has a long-standing relationship with a tax

251. The unfortunate truth, in that case and in others, is that the taxpayers were more enthusiastic about the tax shelter than the advisors.

252. *See, e.g.*, Am. Boat Co. v. United States, 583 F.3d 471, 484 (7th Cir. 2009) ("[t]urning back to 1996, when the Son of BOSS was still in its infancy and before all of the publicity and legal trouble, Erwin Mayer was a reputable attorney at Altheimer & Gray"); *Stobie Creek*, 82 Fed. Cl. at 715 ("[t]he premier legal reputation of SLK is well established . . . Also, prior to the events leading to its public disgrace and dissolution of the law firm, and during the relevant time period, J&G enjoyed a vaunted reputation in legal and tax matters"); Klamath Strategic Inv. Fund v. United States, 472 F. Supp. 2d 885, 890 (E.D. Tex. 2007) (finding that "Nix and Patterson knew that Hrdlicka was from one of the premier tax firms in the South.").

advisor to ascertain when the tax advisor is proposing inappropriate strategies for the purpose of expanding the relationship.

Conversely, there is little rationale for treating the opinions of tax advisors with whom a taxpayer does not have a long-standing relationship as inherently unreliable. The apparent justification for that suggestion is that a tax advisor who provides template opinions for tax shelters will have only a brief relationship with the taxpayer. However, as discussed above, there are legitimate reasons why a taxpayer may turn to a new or specialized tax advisor. Therefore, it is doubtful that a tax advisor's manifest desire to create or cement relationships with a taxpayer can itself be a ground for disqualifying an opinion absent a specific indication that the tax advisor is willing to provide distorted advice to achieve that goal.

4. Challenging Transactions

Tax advisors providing opinions on tax shelters typically are highly trained professionals who pride themselves in their ability to maneuver the rules and principles of the tax law to achieve advantages for their clients. Given that orientation, tax advisors generally will muster all the available arguments in favor of tax reduction, and may have a bias against contrary arguments.[253] A good illustration of this tendency is the internal memorandum prepared by the SLK tax lawyers that attempted to distinguish the tax shelter in *Stobie Creek* from the transactions described in the IRS notice, and the J&G tax partner's views (and apparently those of the J&G opinion committee) along the same lines.

Courts have approached that perceived bias in a number of ways. One way is to consider the nature of the transaction on which the tax professional is providing advice. A number of courts and commentators have suggested that a tax opinion may be less reliable when the transaction is being undertaken solely for tax purposes.[254] Presumably, the rationale is that where tax reduction is the only goal, and where a

---

253. *See* Lawsky, *supra* note 11, at 1062-63 (noting that experts making forecasts are often overconfident and identifying factors that may lead to overconfidence).

254. *See also* Bubel, *supra* note 11, at 878-79 ("penalty protection was probably never meant to extend to opinions given on cleverly engineered, structured transactions that would not have been undertaken at all but for the opinion itself . . . there is a significant difference between a structure in search of a transaction to effect a legitimate business end and a transaction in search of a willing structure"); David P. Harriton, *Response to "Old 'Brine' in New Bottles" (New Brine in Old Bottles)*, 55 TAX L. REV. 397, 400 (2002) ("I therefore would limit any definition of 'tax shelter' that triggers higher penalties to transactions that, considered as a whole, would not have been entered into at all but for the desire to claim tax benefits."). *See generally supra* note 189.

transaction cannot be completed without a favorable opinion, a tax advisor is more likely to skew his estimate of the likelihood that the position is correct.

There are two problems with this approach. First, there is an implicit assumption that transactions with an explicit objective of reducing taxes are more likely to be faulty than transactions where the transaction has a separate business purpose and the tax planning involves the manner for effecting the transaction. Although there have been many faulty tax shelters having tax avoidance as their only objective, there also are examples of legitimate transactions where the primary motivation of a participant is reducing taxes, including traditional leveraged lease transactions and tax credit transactions,[255] as well as more original transactions that have been upheld by the courts.[256] Conversely, many highly abusive transactions have been constructed as real business transactions "done in a 'funny' way designed to achieve tax benefits clearly unintended by Congress."[257]

Second, the distinction between a transaction that is undertaken solely for tax purposes and tax planning connected with a legitimate business transaction assumes that the tax planning for a legitimate business transaction is ancillary and that favorable tax advice is not necessary to complete the transaction. However, as illustrated by the *Canal Corp.* case, the tax costs of a legitimate business transaction may determine its viability, in which case the pressure on a tax advisor in such a transaction may be as great as in a purely tax motivated transaction.

A second approach by courts to perceived advisor bias is to examine the substance of the tax advisor's opinion. In some cases, the courts have simply concluded that the results set forth in the tax opinion are "too good to be true."[258] In other cases, the courts have concluded

---

255. *See, e.g.*, Harriton, *supra* note 254, at 402 (safe harbor leases and leveraged leases pass "legitimate tax benefits that have been conferred by Congress for investment in U.S. business property from one taxpayer to another"); Schler, *supra* note 228, at 329 (not all transactions having a principal purpose of tax avoidance are tax shelters).

256. *See, e.g.*, Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001) (shifting of foreign tax credits and generating capital losses); IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001) (same); United Parcel Serv. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001) (generating deductions for insurance premiums paid to a foreign affiliate).

257. Schler, *supra* note 228, at 337. *See also* Eustice, *supra* note 188, at 168-72 (discussing "intermediary transactions tax shelter.").

258. *See, e.g.*, Stobie Creek Invs., LLC v. United States, 608 F.3d 1366, 1383 (Fed. Cir. 2010), *aff'g* 82 Fed. Cl. 636, 714-15 (2008):

> [b]ased on Jeffrey Welles's education and experience, as well as the reason the Welleses pursued the J&G strategy, the trial court found that Jeffrey Welles should have known

that opinions were unreliable because they failed to address issues or addressed them inaccurately.[259] Finally, in some cases the courts have

> that the J&G strategy was 'too good to be true.' . . . In [his role as manager of the family's complex finances,] he had helped implement a number of sophisticated tax-planning strategies, giving him sufficient knowledge and experience to know when a tax planning strategy was likely 'too good to be true'

Murfam Farms, LLC *ex. rel.* Murphy v. United States, 94 Fed. Cl. 235, 247 (2010) ("[p]ersons of their background would have known that sheltering nearly the exact amount of capital gains that they received from the Smithfield merger, in a barely comprehensible, complicated, transaction, in which there was no real chance of profit, was 'too good to be true'"); Alpha I, L.P. v. United States, 93 Fed. Cl. 280, 317 (2010) ("[e]ven if the taxpayer relied on advice of professionals, the taxpayer will still be liable for a negligence penalty if the purported savings are too good to be true"); Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 56 (2007) ("[t]he spread transaction contributed to Jade was structured to yield and did yield tax benefits which Bergmann should have recognized as being 'too good to be true'"); New Phoenix Sunrise v. Comm'r, 132 T.C. 161, 195 (2009):

> Jenkens & Gilchrist's conflict of interest and petitioner's knowledge of recent developments in tax law should have convinced petitioner of the need for further investigation into the proper reporting of the BLISS transaction. Petitioner claimed a fictional loss of nearly $11 million. This is exactly the type of 'too good to be true' transaction that should cause taxpayers to seek out competent advice from independent advisers

Kerman v. Comm'r, 101 T.C.M. (CCH) 1241 (2011) ("[a]s a capable businessman and prudent investor, Mr. Kerman knew or should have known that the CARDS transaction was just too good to be true"); Robucci v. Comm'r, 101 T.C.M. (CCH) 1060:

> [e]ven if we were to agree with petitioner that Mr. Carson was not a promoter, we agree with respondent that the tax result afforded by implementing Mr. Carson's suggestions, i.e., the dramatic reduction in Dr. Robucci's self-employment taxes, was 'too good to be true'. . . . [In light of the lack of meaningful activities of the relevant entities], it was incumbent upon Dr. Robucci, even though he was not a tax professional, to question the efficacy of the arrangement that purported to minimize his taxes while effecting virtually no change in the conduct of his medical practice

Santa Monica Pictures, LLC v. Comm'r, 89 T.C.M. (CCH) 1157 (2005) (In light of the fact that the relevant transactions lacked economic substance, "we believe that a reasonable and prudent person would recognize that these tax losses were 'too good to be true', especially given that neither SMP, Corona, Somerville S Trust, nor Imperial bore the economic loss associated with these tax losses."). *See also* Neonatology Assocs., P.A. v. Comm'r, 299 F.3d 221, 234 (3d Cir. 2002) ("[w]hen, as here, a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril"); Bubel, *supra* note 11, at 854-55 (discussing courts' assessment of a taxpayer's sophistication in determining whether the taxpayer relied reasonably and in good faith on a tax advisor's opinion).

259. *See, e.g.*, Bemont Invs., LLC v. United States, Nos. 4:07cv9, 4:07cv10, 2010 WL 3057437, at *11 (E.D. Tex. Aug. 2, 2010) ("Coscia did little independent research into the question as to whether the investment vehicle would pass the IRS 'sniff test.' Much of his 'work' was cut and paste from prior opinions used by other tax shelter advocates"); Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 209-11 (finding tax opinion unreliable in part because legal analysis on various issues was shallow and general, rather than specific to the facts of the taxpayer's transactions, and failed to consider relevant case law); Canal Corp. v. Comm'r, 135 T.C. 199, 220 (2010) (tax opinion could not be relied upon because conclusions were based on reasoning by analogy and on unsupported conclusions drawn from a regulation); *Santa Monica Pictures*, 89 T.C.M. (CCH) 1157 (finding various tax memoranda and opinions unreliable in part because of faulty conclusions or incomplete analysis). *But see* Long Term Capital Holdings v. United States,

found that contemporaneous IRS announcements calling into question similar tax strategies placed the taxpayers on notice that the opinion was unreliable.[260]

Each of those approaches implies an obligation on the part of the taxpayer to question the substantive merits of the tax advisor's opinion. Arguably, these approaches can be justified by the *per se* requirements in the regulations that the advice be based on all pertinent facts and circumstances "and the law as it relates to those facts and circumstances."[261] In effect, if the opinion reaches an incorrect conclusion, it is not based on the applicable law.

---

150 Fed. Appx. 40, 43 n.1 (2d Cir. 2005), *aff'g* 330 F. Supp. 2d 122, 210 (D. Conn. 2004) (concluding that the inadequate legal analysis demonstrated that the opinion was based on "flawed and outcome-determinative assumptions Long-Term asked it to make.").

260. *See, e.g.*, *Murfam Farms*, 94 Fed. Cl. at 249, 251:

> Murfam's supposed naivete regarding COBRA cannot be justified in light of all the other warning signs that the partners knew or had reason to know about. By the time the tax returns were filed, there had been numerous unmistakable indications that COBRA was not legitimate. For example, shortly before the Murphys received and signed their COBRA engagement letters, the IRS had issued Notice 99-59, warning taxpayers that artificial losses were not properly allowable. . . . According to Ezzell, he asked pointedly whether COBRA was subject to this ruling, Slagle replied that it was not, and that assurance was good enough for Ezzell. . . . Despite his previous background as a professional tax preparer, Ezzell insists that he did not think it was important to read Notice 99-59 himself. . . . In fact, Ezzell maintains that to this day he has never seen Notice 99-59. . . . If it is true that Ezzell never felt the need to read Notice 99-59 and to make his own determination as to its implications, that is not at all indicative of a good faith effort to assess one's proper tax liability. . . . Even after February 2000, glaring warning signs that COBRA was abusive continued to appear. On August 11, 2000, the IRS announced and, on August 13, 2000, the IRS released Notice 2000-44

New Phoenix Sunrise, 132 T.C. at 192, 194:

> [a]t the time petitioner reported the BLISS transaction on its return, New Phoenix and its advisers knew that reliance on *Helmer* was misplaced. New Phoenix filed its return well after the IRS issued Notice 2000-44, supra, was aware of recent developments in this area of tax law, and did not seek independent advice to guarantee proper reporting of the BLISS transaction. . . . At the time New Phoenix and its advisers were considering the proper reporting of the transaction, Mr. Litt and Mr. Wray were aware that the Government was investigating transactions similar to the transaction at issue. These concerns should have put New Phoenix on notice that the reporting of the BLISS transaction as recommended by Jenkens & Gilchrist was unacceptable

Palm Canyon X Inv. v. Comm'r, 98 T.C.M. (CCH) 574 (2009) ("Palm Canyon received ample warning that respondent was not likely to respect its tax treatment of the MLD transaction. On September 5, 2000, more than a year before the MLD transaction occurred, the IRS published Notice 2000-44"); CMA Consol. v. Comm'r, T.C.M. (RIA) 2005-16 ("given petitioner's experience and expertise arranging lease strip deals and its awareness of Notice 95-53, 1995-2 C.B. 334, petitioner was aware and forewarned but chose to proceed with the transactions and claim the deductions.").

261. Treas. Reg. § 1.6664-4(c)(1)(i) (as amended in 2003). As discussed above, some courts have rejected opinions containing erroneous or incomplete analysis on the ground that they contain faulty "legal assumption." *See supra* note 204. That characterization appears improper in cases

The regulations cannot reasonably be read in this way because a taxpayer will attempt to rely on an opinion to avoid penalties only in circumstances where the taxpayer has taken an incorrect position on its tax return.[262] A requirement that the opinion contain a complete and correct legal analysis would be inconsistent with the basic factual premise that the taxpayer has taken an incorrect position. Because "the most important factor" in determining whether a taxpayer has acted with reasonable cause and in good faith is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability,[263] omissions or inaccuracies in the legal analysis should only disqualify an opinion if the taxpayer knew or reasonably should have known under the circumstances that the opinion contains faulty legal analysis.[264] The opposite conclusion effectively confuses the role of the disciplinary and malpractice standards applicable to tax advisors with the role of the reliance standards applicable to taxpayers.[265]

Moreover, in determining whether the taxpayer knew or reasonably should have known that the opinion contains faulty legal analysis, courts should adhere to the Supreme Court's dictum in *Boyle*.[266] Provided that the taxpayer has made the appropriate inquiries under the circumstances,

---

where an opinion has considered relevant or analogous authorities but reaches an incorrect conclusion.

262. *See* Prescott, *supra* note 8, at 1002 ("[o]bviously, the opinion does not have to be correct for a taxpayer to reasonably rely on it because the only time a taxpayer needs to show reasonable reliance is when the IRS or a court has determined that the opinion was incorrect and the IRS has imposed a penalty on the taxpayer.").

263. Treas. Reg. § 1.6664-4(b)(1) (as amended in 2003).

264. *See* Long Term Capital Holdings v. United States, 150 Fed. Appx. 40, 43 n.1 (2d Cir. 2005), *aff'g* 330 F. Supp. 2d 122, 210 (D. Conn. 2004) (District Court did not "fault Long-Term for failing to detect legal deficiencies in the tax advice it received from K&S" and did not "[expect] Long-Term to engage in sophisticated questioning of its expert's advice"); Prescott, *supra* note 8, at 1023 ("it appears that, prior to Long Term Capital Holdings, courts did not deny penalty protection to a taxpayer simply because the quality of the legal advice provided to the taxpayer by a tax expert was inadequate or wrong.").

265. *But see* Bubel, *supra* note 11, at 873 (arguing that an opinion that fails to address applicable authorities with sufficient objectivity and in sufficient depth to give the taxpayer a realistic picture of the tax law treatment of its position would violate the proscription in Treas. Reg. § 1.6664-4(c)(1)(ii) against unreasonable legal assumptions, and also violate various provisions of Circular 230 prescribing disciplinary standards for practitioners).

266. United States v. Boyle, 469 U.S. 241, 251 (1985):

> [w]hen an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. . . . 'Ordinary business care and prudence' does not demand such actions.

and made use of its own knowledge and experience, the taxpayer should not be imputed tax expertise it does not in fact have. As discussed above, a typical taxpayer will not be in a position to evaluate the tax advisor's legal conclusions, absent a second opinion.[267] Even if the taxpayer were to obtain a second opinion and the two advisors were to disagree, the taxpayer is in no position to determine which advisor is correct. As one commentator has noted in respect of the District Court's opinion in *Long Term Capital Holdings*:

> [T]he court's standard would force a taxpayer who desires penalty protection to become a prognosticating tax expert who can anticipate whether the court will find his or her attorney's advice sufficiently well grounded in the applicable law. Clearly, that standard places too high a burden on taxpayers and could make tax counsel's advice practically useless in the very transactions where penalty protection might be necessary.[268]

On the other hand, the regulations do recognize that the receipt of a tax opinion meeting the specific regulatory requirements may not be dispositive if, depending on the circumstances, "the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter."[269] The emphasis in the regulation to the relevant facts and circumstances, and the reference in the regulations to the taxpayer's "education, sophistication and business experience"[270] strongly suggests that the analysis should be framed from the perspective of the taxpayer. In other words, the question is whether the specific taxpayer should have known that the purported tax benefits are implausible, and the taxpayer's efforts to test any doubts.

It follows from the foregoing that a court should not reject a taxpayer's reliance on a tax opinion merely because the court finds the tax benefits stated in the opinion to be objectively implausible, or because the tax benefits are inconsistent with IRS pronouncements. Rather, the first should consider whether the specific taxpayer under the relevant facts and circumstances should have had reason to doubt the plausibility of the tax benefits, either because they were outsized, or

267. *See* NPR Invs., LLC v. United States, 732 F. Supp. 2d 676, 693 (2010) ("[a]s aptly stated by Mr. Nix at trial, 'at every step, we followed the advice of people we relied on, people who were supposed to have known what they were doing and did know what they were doing. And what else could we have done except follow their advice?'"). As discussed above, in the specific facts of that case the taxpayer's protestations do not come across as being particularly sincere.

268. *See* Prescott, *supra* note 8, at 126 (footnote omitted).

269. Treas. Reg. § 1.6664-4(f)(3) (as amended in 2003).

270. *Id.* § 1.6664-4(c)(1).

because the taxpayer knew or should have known of the IRS' position and its relationship to the taxpayer's transaction. The implausibility of a tax advantage in the eyes of a court may be less obvious to a taxpayer, even one with substantial business or investment experience.

To the extent that the taxpayer should have questioned the purported tax benefits, the court next should consider the taxpayer's attempts to test its doubts and particularly the taxpayer's interaction with the tax advisor. For example, it may be sufficient if the taxpayer raises its concerns with the tax advisor who assures the taxpayer that the purported advantages are available, that the advisor has considered and properly addressed all relevant issues, and that the advisor has addressed any contrary IRS pronouncement. Such assurances should not themselves be treated *per se* as unreliable, because as a number of courts have noted in this context, legitimate structures exist that provide outsized tax benefits,[271] and courts are not bound to follow every IRS announcement.[272]

---

271. *See, e.g.*, Am. Boat Co. v. United States, 583 F.3d 471, 485 (7th Cir. 2009):

> the government points to the substantial tax benefit that Jump received as a result of the short-sale transactions, claiming that such a 'too good to be true' transaction should have put him on notice that something was awry. There is no doubt that the benefit Jump received was large, and this is the argument that gets the government the nearest to undermining Jump's assertion that he had reasonable cause. But, in general, 'it is axiomatic that taxpayers lawfully may arrange their affairs to keep taxes as low as possible'

Southgate Master Fund, LLC v. United States, 651 F. Supp. 2d 596, 667 (N.D. Tex. 2009):

> the Government argues the tax results of Southgate were simply 'too good to be true' and that Plaintiff displayed head-in-the-sand negligence. Plaintiff responds that through careful reading of the Internal Revenue Code and reliance upon tax and legal professionals, it determined that the interaction of Code sections could plausibly create tax losses that exceeded cash losses. As Professor Weisbach verified, citing Crane v. Comm'r, 331 U.S. 1 (1947), and Comm'r v. Tufts, 460 U.S. 300 (1983), a scenario in which the tax losses exceed the cash contributions to the transaction does not necessarily render a transaction illegitimate. Weisbach noted that many transactions–as when a company acquires a bank with distressed loans, like the Wells Fargo acquisition of Wachovia in 2008–produce tax losses in excess of economic losses

Allison v. United States, 80 Fed. Cl. 568, 596 ("there is no *per se* rule that tax benefits of a certain size are presumed impossible."). *Cf.* Stobie Creek Invs., LLC v. United States, 81 Fed. Cl. 358 (2008) (upholding objection to offer of an expert report that, among other things, "recounts the history of aggressive tax planning as a legitimate approach to minimizing taxes and . . . surveys cases in which courts have upheld taxpayers' aggressive tax planning strategies . . . examin[ing] cases in which taxpayers prevailed even where a situation was 'too good to be true,' and where the IRS prevailed even where a situation was 'too bad to be true.'").

272. *See* Ryan Lirette, *Giving Chevron Deference to Revenue Rulings and Procedures*, 129 TAX NOTES 1357 (2010); Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239 (2009); Ryan C. Morris, Comment, *Substantially Deferring to Revenue Rulings After Mead*, 2005 B.Y.U. L. REV. 999 (2005); American Bar Ass'n Section of Taxation, *Report of the Task Force on Judicial Deference*, 57 TAX LAW. 717 (2004);

V. CONCLUSION

Taxpayers normally should not be permitted to rely on the opinions of tax advisors who are tax shelter promoters, brokers of tax shelters, or have referral arrangements with promoters. To allow reliance on opinions that are rendered by persons who are clearly motivated to overstate the merits of a tax structure would undermine the purpose of the penalty regimes and ultimately the tax system as a whole. However, courts should not deny a taxpayer the ability to rely on an opinion merely because the tax advisor delivers the opinion in circumstances that create apparent temptations, for example because the tax advisor has developed or implemented a tax reduction strategy that ultimately proves ineffective. Such an approach is intellectually flawed because it confuses the temptation to distort with the distortion itself. Also, such an approach risks imposing unwarranted penalties on taxpayers who turn to tax advisors to guide them in legitimately reducing their taxes. Rather, in determining whether the taxpayer acted reasonably in relying on a tax opinion, courts should consider the nature of the apparent temptations faced by the tax advisor and the advisor's apparent resistance to those temptations, as they affect the taxpayer's efforts to assess its proper tax liability.

John F. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After Mead*, 55 ADMIN. L. REV. 39, 58 (2003); Paul L. Caron, *Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings*, 57 OHIO ST. L.J. 637 (1996); John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 GEO. WASH. L. REV. 35 (1995); Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 OHIO ST. L.J. 1037 (1995); Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U. L. REV. 841 (1992).