American Bar Association

TAX LAW OPINIONS IN TAX SHELTER INVESTMENT OFFERINGS

January 29, 1982

Copyright (c) 1985 by the American Bar Association

An opinion by a lawyer analyzing the tax effects of a tax shelter investment is frequently of substantial impor-
tance in a tax shelter offering. [FN1] The promoter of the offering may depend upon the recommendations of the
lawyer in structuring the venture and often publishes the opinion with the offering materials on uses the lawyer's
name in connection with sales promotion efforts. The offerees may be expected to rely upon the tax shelter opinion
in determining whether to invest in the venture. It is often uneconomic for the individual offeree to pay for a sepa-
rate tax analysis of the offering because of the relatively small sum each offeree may invest.

Because the successful marketing of tax shelters frequently involves tax opinions issued by lawyers, concerns
have been expressed by the organized bar, regulatory agencies and others over the need to articulate ethical stan-
dards applicable to a lawyer who issues an opinion which the lawyer knows will be included among the tax shelter
offering materials and relied upon by offerees. [FN2]

A responsibility of the Committee is to express its opinion on proper professional conduct of lawyers and to do
so by a formal opinion where the subject is of widespread interest. ABA Bylaws, Art. 30.7; Rules of Procedure of
Standing Committee on Ethics and Professional Responsibility, Rules 1 and 3 (Aug. 1980). Accordingly, the Com-
mittee expresses its opinion as to the standards applicable to lawyers who issue tax shelter opinions.

A 'tax shelter opinion,' as the term is used in this Opinion, is advice by a lawyer concerning the federal tax law
applicable to a tax shelter if the advice is referred to either in offering materials or in connection with sales promo-
tion efforts directed to persons other than the client who engages the lawyer to give the advice. The term includes
the tax aspects or tax risks portion of the offering materials prepared by the lawyer whether or not a separate opinion
letter is issued. The term does not, however, include rendering advice solely to the offeror or reviewing parts of the
offering materials, so long as neither the name of the lawyer nor the fact that a lawyer has rendered advice concern-
ing the tax aspects is referred to at all in the offering materials or in connection with sales promotion efforts. In this
case the lawyer has the ethical responsibility of assuring that in the offering materials and in connection with sales
promotion efforts there is no reference to the lawyer's name or to the fact that a lawyer has rendered tax advice. The
term also does not include the case where a small group of investors negotiate the terms of the arrangement directly
with the offeror of securities and depend for tax advice concerning the investment entirely upon advisors other than
the lawyer engaged to represent the offeror.

Disciplinary Standards

A false opinion is one which ignores or minimizes serious legal risks or misstates the facts or the law, knowingly
or through gross incompetence. The lawyer who gives a false opinion, including one which is intentionally or reck-
lessly misleading, violates the Disciplinary Rules of the Model Code of Professional Responsibility. Quite clearly,
the lawyer exceeds the duty to represent the client zealously within the bounds of the law. See DR 7-101; EC 7-10.
Knowingly misstating facts or law violates DR 7-102(A)(5) and is 'conduct involving dishonesty, fraud, deceit, or
misrepresentation,' a violation of DR 1-102(A)(4). The lawyer also violates DR 7-102(A)(7) by counseling or assisting the offeror 'in conduct that the lawyer knows to be illegal or fraudulent.' In addition, the lawyer's conduct may involve the concealment or knowing nondisclosure of matters which the lawyer is required by law to reveal, a violation of DR 7-102(A)(3).

The lawyer who accepts as true the facts which the promoter tells him, when the lawyer should know that a further inquiry would disclose that these facts are untrue, also gives a false opinion. It has been said that lawyers cannot 'escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen.' United States v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964). Recklessly and consciously disregarding information strongly indicating that material facts expressed in the tax shelter opinion are false or misleading involves dishonesty as does assisting the offeror in conduct the lawyer knows to be fraudulent. Such conduct violates DR 1-102(A)(4) and DR 7-102(A). We equate the minimum extent of the knowledge required for the lawyer's conduct to have violated these Disciplinary Rules with the knowledge required to sustain a Rule 10b-5 recovery, see Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), rather than the lesser negligence standard. Compare SEC v. Coven, 581 F.2d 1020, 1025 (2d Cir. 1978) cert. denied, 440 U.S. 950, rehearing denied, 441 U.S. 928 (1979); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-47 (2d Cir.) cert. denied, 439 U.S. 1039 (1978); Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (E.D. Pa. 1978).

But even if the lawyer lacks the knowledge required to sustain a recovery under the Hochfelder standard, the lawyer's conduct nevertheless may involve gross incompetence, or indifference, inadequate preparation under the circumstances and consistent failure to perform obligations to the client. If so, the lawyer will have violated DR 6-101(A). ABA Informal Opinion 1273 (1973).

Ethical Considerations

Beyond the requirements of the Disciplinary Rules, the lawyer who issues a tax shelter opinion should follow the Canons and the Ethical Considerations of the Model Code. [FN3] Although not constituting absolute requirements, the violation of which may result in sanctions, these Canons and Ethical Considerations constitute a body of principles which provide guidance in the application of the lawyer's professional responsibility to specific situations, such as the rendering of tax shelter opinions. The guidelines developed here are to be applied to each specific situation reasonably and in a practical fashion.

LAWYER AS ADVISOR

EC 7-22 says 'a litigant or his lawyer may, in good faith and within the framework of the law, take steps to test the correctness of a ruling of a tribunal.' See also EC 7-25. Principles similar to these are applied where the lawyer represents a client in adversarial proceedings before the Internal Revenue Service. In that case the lawyer has duties not to mislead the Service by any misstatement, not to further any misrepresentations made by the client, and to deal candidly and fairly. ABA Formal Opinion 314 (1965); see also Watts, supra note 2 at 651-653.

The lawyer rendering a tax shelter opinion which he knows will be relied upon by third persons, however, functions more as an advisor than as an advocate. See EC 7-3, distinguishing these roles. Since the Model Code was adopted in 1969, the differing functions of the advisor and advocate have become more widely recognized. [FN4]

The Proposed Model Rules specifically recognize the ethical considerations applicable where a lawyer undertakes an evaluation for the use of third persons other than a client. These third persons have an interest in the integrity of the evaluation. The legal duty of the lawyer therefore 'goes beyond the obligations a lawyer normally has to third persons.' Proposed Model Rules, supra note 3 at 117; see also ABA Formal Opinion 335 (1974). Because third persons may rely on the advice of the lawyer who gives a tax shelter opinion, the principles announced in ABA Formal Opinion 314 have little, if any, applicability.
ESTABLISHING LAWYER'S RELATIONSHIP

The lawyer should establish the terms of the relationship with the offeror-client at the time the lawyer is engaged to work on the tax shelter offering. See Proposed Model Rules, supra note 3, Rule 2.3, and discussion at 116-120. This includes making it clear that the lawyer requires from the client a full disclosure of the structure and intended operations of the venture and complete access to all relevant information.

MAKING FACTUAL INQUIRY

ABA Formal Opinion 335 (1974) establishes guidelines which a lawyer should follow when furnishing an assumed facts opinion in connection with the sale of unregistered securities. The same guidelines describe the extent to which a lawyer should verify the facts presented to him as the basis for a tax shelter opinion:

[T]he lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry. The extent of this inquiry will depend in each case upon the circumstances; for example, it would be less where the lawyer's past relationship with the client is sufficient to give him a basis for trusting the client's probity than where the client has recently engaged the lawyer, and less where the lawyer's inquiries are answered fully than when there appears a reluctance to disclose information.

Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion. However, assuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such appropriate documents as are available, are accurate.

* * *

The essence of this opinion . . . is that, while a lawyer should make adequate preparation including inquiry into the relevant facts that is consistent with the above guidelines, and while he should not accept as true that which he should not reasonably believe to be true, he does not have the responsibility to 'audit' the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon. ABA Formal Opinion 335 at 3, 5-6.

For instance, where essential underlying information, such as an appraisal or financial projection, makes little common sense, or where the reputation or expertise of the person who has prepared the appraisal or projection is dubious, further inquiry clearly is required. Indeed, failure to make further inquiry may result in a false opinion. See supra, Disciplinary Standards. If further inquiry reveals that the appraisal or projection is reasonably well supported and complete, the lawyer is justified in relying upon the material facts which the underlying information supports.

RELATING LAW TO FACTS

In discussing the legal issues in a tax shelter opinion, the lawyer should relate the law to the actual facts to the extent the facts are ascertainable when the offering materials are being circulated. A lawyer should not issue a tax shelter opinion which disclaims responsibility for inquiring as to the accuracy of the facts, fails to analyze the critical facts or discusses purely hypothetical facts. It is proper, however, to assume facts which are not currently ascertainable, such as the method of conducting future operations of the venture, so long as the factual assumptions are clearly identified as such in the offering materials, and are reasonable and complete.

NON-TAX LEGAL ISSUES
Although the lawyer rendering the tax shelter opinion may not be asked to address the non-tax legal issues, the lawyer should make reasonable inquiries to ascertain that a good faith effort has been expended to comply with laws other than tax laws. Tax counsel need not reexamine the conclusions of other counsel rendering opinions in other specialized areas of law, such as the exemption of the transaction or securities from registration or the validity of a patent. Tax counsel, nevertheless, should be satisfied that competent professional advice on these and similar matters has been obtained where relevant to the offering.

MATERIAL TAX ISSUES

A 'material' tax issue for purposes of this Opinion is any income or excise tax issue relating to the tax shelter that would have a significant effect in sheltering from federal taxes income from other sources by providing deductions in excess of the income from the tax shelter investment in any year or tax credits which will offset tax liabilities in excess of the tax attributable to the tax shelter investment in any year. See definition of 'tax shelter,' supra note 1. The determination of what is material is to be made in good faith by the lawyer based on the information which is available at the time the offering materials are being circulated.

The lawyer should satisfy himself that either he or another competent professional has considered all material tax issues. In addition, the tax shelter opinion should fully and fairly address each material tax issue respecting which there is a reasonable possibility that the Internal Revenue Service will challenge the tax effect proposed in the offering materials. [FN5]

Where some material tax issues are being considered by other competent professionals, the lawyer should review their written advice and make inquiries of the client and the other professionals to assure that the division of responsibility is clear and to reasonably assure that all material tax issues will be considered, either by the lawyer or by the other tax professional, in accordance with the standards developed in this Opinion. If, as a result of review of the written advice of another professional or otherwise, the lawyer believes that there is a reasonable possibility that the Internal Revenue Service will challenge the proposed tax effect respecting any material tax issue considered by the other professional, and the issue is not fully addressed in the offering materials, the lawyer has ethical responsibilities to so advise the client and the other professional and to refuse to provide an opinion unless the matter is addressed adequately in the offering materials. The lawyer also should assure that his own opinion identifies clearly its limited nature, if the lawyer is not retained to consider all of the material tax issues.

OPINION AS TO OUTCOME--MATERIAL TAX ISSUES

Since the term 'opinion' connotes a lawyer's conclusion as to the likely outcome of an issue if challenged and litigated, the lawyer should, if possible, state the lawyer's opinion of the probable outcome on the merits of each material tax issue. [FN6] However, if the lawyer determines in good faith that it is not possible to make a judgment as to the outcome of a material tax issue, the lawyer should so state and give the reasons for this conclusion.

A tax shelter opinion may question the validity of a Revenue Ruling or the reasoning in a lower court opinion which the lawyer believes is wrong. But there must also be a complete explanation to the offerees, including what position the Service is likely to take on the issue and a summary of why this position is considered to be wrong. The opinion also should set forth the risks of an adversarial proceeding if one is likely to occur.

OVERALL EVALUATION OF REALIZATION OF TAX BENEFITS

The clear disclosure of the tax risks in the offering materials should include an opinion by the lawyer or by another professional providing an overall evaluation of the extent to which the tax benefits, in the aggregate, which are a significant feature of the investment to the typical investor are likely to be realized as contemplated by the offering.
In making this evaluation, the lawyer should state that the significant tax benefits, in the aggregate, probably will be realized or probably will not be realized, or that the probabilities of realization and nonrealization of the significant tax benefits are evenly divided.

In rare instances the lawyer may conclude in good faith that it is not possible to make a judgment of the extent to which the significant tax benefits are likely to be realized. This impossibility may occur where, for example, the most significant tax benefits are predicated upon a newly enacted Code provision when there are no regulations and the legislative history is obscure. In these circumstances, the lawyer should fully explain why the judgment cannot be made and assure full disclosure in the offering materials of the assumptions and risks which the investors must evaluate.

The Committee does not accept the view that it is always ethically improper to issue an opinion which concludes that the significant tax benefits in the aggregate probably will not be realized. However, full disclosure requires that the negative conclusion be clearly stated and prominently noted in the offering materials.

If another professional is providing the overall evaluation, the lawyer should nonetheless satisfy himself that the evaluation meets the standards set forth above.

ACCURACY OF OFFERING MATERIALS

In all cases, the lawyer who issues a tax shelter opinion, especially an opinion which does not contain a prediction of a favorable outcome, should assure that the offerees will not be misled as a result of mischaracterizations of the extent of the opinion in the offering materials or in connection with sales promotion efforts. In addition, the lawyer always should review the offering materials to assure that the standards set forth in this Opinion are met and that the offering materials, taken as a whole, make it clear that the lawyer's opinion is not a prediction of a favorable outcome of the tax issues concerning which no favorable prediction is made. The risks and uncertainties of the tax issues should be referred to in a summary statement at the very outset of the opinion or the tax aspects or tax risks section of the offering materials.

If the lawyer disagrees with the client over the extent of disclosure made in the offering materials or over other matters necessary to satisfy the lawyer's ethical responsibilities as expressed in this Opinion, and the disagreement cannot be resolved, the lawyer should withdraw from the employment and not issue an opinion. See EC 7-8; ABA Formal Opinion 335, supra.

Summary of Ethical Considerations

The general ethical guidelines to be followed by the lawyer who issues a tax shelter opinion are briefly summarized below. However, reference to this summary must not be substituted for a review of the more complete statement of ethical standards contained in this Opinion.

1. Establish in the beginning the lawyer's relationship with the offeror-client, making clear that in order to issue the opinion, the lawyer requires from that client a full disclosure of the structure and intended operations of the venture and complete access to all relevant information.

2. Make inquiry as to the relevant facts and, consistent with the standards developed in ABA Formal Opinion 335, be satisfied that the material facts are accurately and completely stated in the offering materials, and that the representations as to intended future activities are clearly identified, reasonable and complete.

3. Relate the law to the actual facts to the extent ascertainable and, when addressing issues based on future activities, clearly identify what facts are assumed.

4. Make inquiries to ascertain that a good faith effort has been made to address legal issues other than those to be addressed in the tax shelter opinion.

5. Take reasonable steps to assure that all material federal income and excise tax issues have been considered and
that all of those issues which involve the reasonable possibility of a challenge by the Internal Revenue Service have been fully and fairly addressed in the offering materials.

6. Where possible, provide an opinion as to the likely outcome on the merits of the material tax issues addressed in the offering materials.

7. Where possible, provide an overall evaluation of the extent to which the tax benefits in the aggregate are likely to be realized.

8. Assure that the offering materials correctly represent the nature and extent of the tax shelter opinion.

[FN1] A 'tax shelter,' as the term is used in this Opinion, is an investment which has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year. Excluded from the term are investments such as, but not limited to, the following: municipal bonds; annuities; family trusts; qualified retirement plans; individual retirement accounts; stock option plans; securities issued in a corporate reorganization; mineral development ventures, if the only tax benefit would be percentage depletion; and real estate where it is anticipated that deductions are unlikely to exceed gross income from the investment in any year, and that any tax credits are unlikely to exceed the tax on the income from that source in any year.


[FN3] Canon 1 says '[a] lawyer should assist in maintaining the integrity and competence of the legal profession.' Canon 6 says '[a] lawyer should represent a client competently.' The Ethical Considerations used to establish the guidelines in this Opinion are EC 1-5, EC 6-1, EC 6-4, EC 6-5, EC 7-1, EC 7-3, EC 7-5, EC 7-6, EC 7-8, EC 7-10, EC 7-22, EC 7-25. See also Model Rules of Professional Conduct (ABA Commission on Evaluation of Professional Standards, Final Draft, May 30, 1981), Rule 2.3 at 116.

[FN4] See Watts, supra note 2 at 655-658; Wolfman & Holden, ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE (Michie, Bobbs-Merrill 1981) at 1-2, 100-121; see also Proposed Model Rules, supra note 3, Preamble at 1:

As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer asserts the client's position under the rules of the adversary system.

[FN5] It is not necessary that these material tax issues be discussed in a separate opinion letter, so long as the issues are fully and fairly addressed in the offering materials in accordance with the standards expressed in this Opinion.

[FN6] See EC 7-3; Sax, supra note 2 at 34, 35; see also Kennedy, supra note 2 at 1383.

ABA Formal Op. 346 (Rev.)