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POINTS TO REMEMBER

What Is the Value of a "Should" Opinion?

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Canal Corporation v. Commissioner

The Tax Court's August 2010 decision in *Canal Corporation v. Commissioner*, and in particular, its imposition of penalties under section 6662 despite the taxpayer's receipt of a "should" opinion from PricewaterhouseCoopers (PwC) has attracted significant commentary, much of it negative, in the blogosphere. The Tax Court (Judge Diane L. Kroupa) recharacterized the contribution of assets and liabilities by a Canal Corporation subsidiary to a newly formed limited liability company and the simultaneous receipt of a $755 million distribution under the disguised sale rules of section 707(a)(2)(B) and held that Canal Corporation was liable for a penalty of over $36 million with respect to the resulting understatement. PwC had been Canal Corporation's financial statement auditor and tax preparer for many years, assisted in negotiating and structuring the transaction, and then finally prepared the "should" opinion for the transaction that occurred in 1999.

Scrutiny of the Fixed Fee

Critics homed in on a couple of details they found particularly problematic. In particular, they discussed the court's focus on the $800,000 fixed fee PwC received for its opinion. PwC's opinion (submitted into evidence in draft form) was, according to the court, so littered with typographical errors, so poorly organized, and so lacking legal support that the court concluded that the opinion, in light of the substantial fee, more resembled "a *quid pro quo* arrangement than a true tax advisory opinion." 135 T.C. No. 9, at 38 (emphasis added). Commentators have observed that lawyers do not always charge an hourly rate, and some clients may prefer to negotiate a fee for the job rather than pay a lawyer at an hourly rate. They have wondered, does this mean that all opinions for which there is a flat fee will be suspect?

This outrage seems disingenuous. A judge (or any person, really) naturally will inquire whether what was received was worth what was paid. When the fee paid is so dramatically larger than the fee that normal hourly-rate billing would have produced, one wonders whether what is being acquired is something more than the ordinary service. Why else would one pay the premium? In *Canal Corporation*, the court posited that the advisory opinion was an "insurance policy," and the protections provided by that insurance policy justified the high fee. Commentators have suggested that the section 6662 penalty is not appropriate in a situation where a taxpayer has a "should" opinion from a well-regarded tax advisor, at least if the transaction has economic substance (within the meaning of section 7701(o)). They seem to buy into this idea of an insurance policy. But, as in a number of other cases in which the taxpayers held "should" opinions from reputable tax advisors, the judge in *Canal Corporation*

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concluded that the opinion meant very little—in other words, there is no such thing as a sure-fire insurance policy in this context.

The Substantial Understatement Penalty

The law generally stands behind the judges in such cases. The Code and the regulations are at odds with the idea of such an insurance policy. Section 6662 creates an accuracy-related penalty for underpayments attributable to a variety of factors, including a substantial understatement of income tax. For a corporation, a substantial understatement exists if the amount of the understatement exceeds the lesser of 10% of the tax required to be shown on the return (or, if greater, $10,000) or $10 million. Under section 6664, no penalty is imposed if there was reasonable cause for, and the taxpayer acted with good faith with respect to, the underpayment. The determination of whether a taxpayer acted with reasonable cause and good faith is made on a case-by-case basis. The regulations explicitly state that reliance on a professional tax advisor does not necessarily shield a taxpayer from the penalty, but that all facts and circumstances must be considered in determining whether a taxpayer has reasonably relied in good faith on advice.

The language of the statute and the regulations seems entirely consistent with the Tax Court's holding in *Canal Corporation*, where the PwC opinion at issue was "riddled with questionable conclusions and unreasonable assumptions" (*Id.* at 34) and "tainted by an inherent conflict of interest." *Id.* at 32. Accepting those as the facts, why then the surprise? It could be that the penalties went too far, but even if they did, the case serves as an important reminder to tax professionals and tax litigators of lessons we should have learned in the past. It is possible that we have. The underlying transaction in this case occurred over a decade ago, prior to the changes to Circular 230 and prior to the enactment of Sarbanes-Oxley, and was a relative contemporary of other large penalty cases. The outcry, however, suggests that some of the practices may persist.

Lessons Learned?

Many people likely remember *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), which featured a hedge fund run by an all-star team of the financial elite, including two Nobel laureates. The economics of the transaction were simple: no rational investor would have invested in the shelter transaction but for its tax savings. Long Term, however, argued that it should not be subject to penalties because it had "should" opinions from two prominent law firms.

If we examine *Canal Corporation* and *Long Term Capital Holdings*, we see certain similarities. Both feature sophisticated taxpayers relying on tax advice that lacked any legal support. In *Canal Corporation*, the tax advisor wore so many hats the court became concerned about conflicts of interest. In *Long Term Capital Holdings*, the transaction was a bad deal but for the tax consequences, and witnesses for the taxpayer provided unreliable, self-serving testimony. These two cases present some of the most common pitfalls for taxpayers and tax advisors. The brief list of tips below may help tax advisors whose clients wish to avoid the imposition of penalties (and the ire of any judges who may examine the opinion).

Tips for Avoiding the Section 6662 Penalty

1. Legal opinions should be grounded in legal analysis. That legal analysis, including careful discussion of relevant legal authorities, should be discussed in the opinion. If you can't find relevant authorities, carefully consider what that means for the level of comfort you are willing to issue.
2. Take care with your assumptions, both legal and factual. Important legal issues should not be assumed away. Are those factual assumptions really reasonable? If a reasonably diligent analysis of the facts and circumstances would reveal them to be unreasonable and/or unsupportable, the answer is no.
3. Do what you can to avoid burden of proof problems down the line.
4. Self-serving explanations and justifications will get you nowhere.
5. If the opinion serves only to avoid penalties, reconsider.
6. If you know the transaction you are blessing with a "should" is "aggressive" but another reasonable person might consider it "abusive," should you reconsider that "should"? We can all come up with examples of aggressive opinions winning the day, but if you suspect that your opinion would not be sustained by a court, then does it really warrant a "should"?
7. All taxpayers are not created equal. When a multinational company or tax attorney or hedge fund run by Nobel-prize winners is the taxpayer who relies on an opinion without substantive legal analysis, "reasonable cause" and "good faith" may be found wanting where they wouldn't for a less sophisticated taxpayer.
8. Beware the presence, or even the appearance, of conflicts of interest. If you were involved in the planning of the transaction, or your firm was, your familiarity with the transaction may make you seem like a good choice to write the opinion. In the end, you may be the right choice, but carefully consider whether it would be reasonable for a taxpayer to rely on your opinion, given your connection with the transaction. Similarly, carefully consider your fee arrangement and whether it creates, or may appear to create, a conflict of interest. ■