1-1-2013

Give Taxpayers a Break: Putting the Reliance Element Back into the Reasonable Reliance and Good Faith Defense, 28 Akron Tax J. 123 (2013)

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GIVE TAXPAYERS A BREAK: PUTTING THE RELIANCE ELEMENT BACK INTO THE REASONABLE RELIANCE AND GOOD FAITH DEFENSE

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I. INTRODUCTION

Federal income tax laws under the Internal Revenue Code (hereinafter the "Code" or the "I.R.C") are inherently complex and strikingly ambiguous when applied to specific taxpayer situations.[1] Due to the complexity and uncertainty of the law, taxpayers often seek out expert opinions and advice from tax attorneys regarding potential tax consequences. Taxpayers seek professional advice for several reasons and in a variety of contexts. One, taxpayers "wish to know what the law

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1. "The income tax laws, as every citizen knows, are far from a model of clarity. Written to accommodate a multitude of competing policies and differing situations, the Internal Revenue Code is a sprawling tapestry of almost infinite complexity. Its details and intricate provisions have fostered a wealth of interpretations. To thread one's way through this maze, the business or wealthy taxpayer needs the mind of a Talmudist and the patience of Job." United States. v. El Paso Co., 682 F.2d 530, 534 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984).

is and whether they may take a particular position on a tax return."[2] Two, taxpayers "want to know how far they can go in aggressively planning and minimizing their tax liabilities."[3] Finally, taxpayers seek advice from tax professionals in order to protect themselves from tax penalties imposed by the Internal Revenue Service, should the IRS challenge the taxpayer's position.[4]

Taxpayers often call upon tax professionals for advice prior to taking a planned course of action. For example, a corporate taxpayer planning to dispose of a subsidiary or other corporate assets will often seek out the advice of a tax professional prior to consummating the proposed transaction. First, the taxpayer will want to obtain an opinion from its tax advisor as to the likely tax consequences of such a sale, for example, how much taxable gain will be recognized on the sale. If the tax consequences of the transaction are significant, the planned disposition may be undesirable. Second, the taxpayer will want to know what the tax law is, how the sale will be characterized, and when such gain will be recognized for tax return purposes. Third, the taxpayer may seek the tax attorney's advice and opinion as to how to structure the transaction so as to avoid undesirable tax consequences.[5] Fourth, and most importantly, the taxpayer will want to obtain a professional opinion that it can rely upon as a defense to IRS penalties, should the IRS disagree with the taxpayer's position.[6]

The IRS and the courts have taken the position that a taxpayer's reliance on a tax professional's opinion is not always risk free. Such position creates serious problems for taxpayers. Because the administration of the Federal income tax is based on a system of self-reporting, a taxpayer will usually seek professional tax advice and opinions in order to accurately determine his tax liability,[7] especially

2. Scott A. Schumacher, *Section 6694 Preparer Penalties and Tax Advice: The Latest on the Constantly Moving Target*, 23 No. 2 PRAC. TAX LAW 19, 19 (2009).

3. *Id.*

4. *Id.*; *see also* Treas. Reg. § 1.6664-4 (2013) (establishing that good faith and reasonable reliance on professional advice may constitute a defense to the imposition of I.R.C § 6662 (2012) penalties).

5. As Judge Learned Hand made clear: "a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

6. *See generally* United States v. Boyle, 469 U.S. 241 (1985).

7. *See generally* 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

involving complex transactions, i.e., a corporate restructuring. Additionally, given the complexity of the tax law and the potential for substantial penalties, if a taxpayer fails to file a return or fails to accurately compute his tax liability, a tax advisor is usually the *only* reliable source for information regarding whether filing a return is necessary, what information must be disclosed, the manner in which taxable gains or losses are characterized, and when such taxable gains or losses are recognized.[8]

The courts and the IRS have significantly reversed course regarding a taxpayer's ability to rely on an advisor's tax opinion since *U.S. v. Boyle*,[9] wherein the Supreme Court stated that "when 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."[10] The Court noted that because most taxpayers are unable to discern error in the substantive advice from a tax professional, to "require [a] 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."[11] As the Court was undoubtedly aware, the Code is anything but simple to understand and apply.

Tax Courts have consistently denied taxpayers, confronted with the complexity of the Code, the right to reasonably rely on a tax professional's opinion regarding tax liability. Recently, the *Canal*[12] court expressly denied the taxpayer's assertion that it could reasonably rely on the tax opinion from its well-regarded, long-time return preparer and auditor, PricewaterhouseCoopers (hereinafter, "PwC"), in connection with the IRS' imposition of tax-related penalties. Essentially, the court held that where a taxpayer consults his advisors regarding the tax consequences of a proposed transaction, and such advisor issues a favorable opinion regarding such tax consequences for "a high price tag,"[13] and where the advisor was actively involved in planning and implementing the transaction, the taxpayer may not reasonably rely on such favorable opinion.[14] The *Canal* decision is completely at odds with the Supreme Court's opinion that "ordinary

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TAX LAW. 169, 170 (2009).

8. *Id.*
9. *Boyle*, 469 U.S. at 251.
10. *Id.* (emphasis in original).
11. *Id.*
12. Canal Corp. v. Comm'r, 135 T.C. 199 (2010).
13. *Id.* at 220.
14. *See generally id.* at 218.

business care and prudence" do not demand that a taxpayer challenge, "second guess," or monitor tax counsel's substantive tax advice.[15]

Given the *Canal* court's rejection of the taxpayer's reliance on its long-time attorney-accountant's substantive tax opinion regarding the proposed transaction at issue, the question necessarily arises as to whether and when a taxpayer may reasonably rely on his tax advisor's advice and opinion in structuring and consummating a proposed transaction. Additionally, given the Tax Court's stance on taxpayer reliance on tax advisor opinions, what is required of a tax professional to ethically and legally render a favorable opinion to a taxpayer on which it may rely?

This Article considers the present law regarding the accuracy related penalties pursuant to I.R.C § 6662 and the reasonable reliance and good faith defense provided for in I.R.C § 6664 using *Canal* as a prime example of how the courts have treated and penalized taxpayers for relying on tax advisors in planning proposed transactions and in taking positions on returns and proposes a new analysis of a taxpayer's good faith and reasonable reliance. Section II of this Article discusses the current state of the law regarding the Section 6662 penalties, the function and regulations imposed on tax attorneys in advising taxpayer-clients, the Section 6664 good faith and reasonable reliance defense, and provides an overview of the facts and legal analysis underlying the Tax Court's holding in *Canal*. Section III analyzes the current law and presents a new analysis of a taxpayer's good faith and reasonable reliance on his attorney's advice and opinions that should be implemented by the IRS and the courts, which comports with all current law, including the Circular 230 requirements imposed on tax practitioners generally. Section IV will conclude this Article.

II. BACKGROUND

A. *Taxpayer Penalties*

Taxpayers are subject to a number of penalties for the understatement and underpayment of Federal income taxes.[16] IRS

15. *Boyle*, 469 U.S. at 251. While the Court held that a taxpayer may reasonably rely on tax counsel's professional opinion regarding substantive tax advice, a taxpayer may not rely on a tax professional where compliance with an unambiguous statute can be accomplished by a lay person, such as discerning *when* tax returns must be filed. *Id.* The Court stated: "one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due." *Id.*

16. I.R.C. § 6662(b)(1) (2013) ("negligence or disregard of rules or regulations"); §

penalties exist and are imposed in order to encourage voluntary compliance[17] by supporting the standards of behavior expected by the IRS.[18] "Penalties encourage voluntary compliance[19] by: (1) demonstrating the fairness of the tax system to compliant taxpayers; and (2) increasing the cost of noncompliance."[20]

I.R.C § 6662 imposes an accuracy-related penalty for underpayment of Federal income tax liability.[21] For the portion of underpayment of tax required to be shown on a return, Section 6662 imposes an additional amount equal to twenty percent of the portion of underpayment.[22] This penalty applies to the portion of underpayment which is attributable to either: (1) negligence or disregard of rules or regulations; or (2) any substantial understatement of income tax.[23]

1. Negligence or Disregard of Rules of Regulations

The I.R.C defines the term "negligence" to include any failure to make "a reasonable attempt to comply with the provisions of the tax law,[24] exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records."[25] "Negligence is strongly suggested if a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item 'which would seem to a reasonable and

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6662(b)(2) ("substantial understatements of federal income tax"); § 6662(a) (understatements with respect to reportable transactions); §6662(b)(6) (understatements with respect to "transactions lacking economic substance or failing to meet the requirements of any similar rule of law").

17. "Taxpayers in the United States assess their tax liabilities against themselves and pay them voluntarily." Byran E. Gates, *Encouraging Voluntary Compliance*, 5 I.R.M. ABR. & ANN. § 20.1.1.2.1 (Oct. 25, 2011). "This system of self-assessment and payment is based on the principle of voluntary compliance. Voluntary compliance exists when taxpayers conform to the law without compulsion or threat." *Id.*

18. Arthur H. Boelter, *Tax Penalties and Interest*, 1 TAX PEN. & INT. § 1:5 (2011). *See also I.R.S. Penalty Policy*, I.R.M. 20.1.5.1, ¶ 5 (Jan. 24, 2012), *available at* http://www.irs.gov/irm/part20/irm_20-001-005.html#d0e1800 ("All penalties including the accuracy-related penalties, the fraud penalty, and the erroneous claims for refund or credit penalty are important deterrents to non-compliance.").

19. "Voluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code." Gates, *supra* note 17, at § 20.1.1.2.1.

20. I.R.S. Penalty Statement 20-1 (Formerly P-1-18), I.R.M. 1.2.20.1.1, ¶ 3 (June 29, 2004), *available at* http://www.irs.gov/irm/part1/irm_01-002-020.html.

21. I.R.C. § 6662 (2013).

22. *Id.* at § 6662(a).

23. *Id.* at §§ 6662(b)(1)-(2). For purposes of this article, only § 6662(b)(1) (negligence or disregard of rules or regulations) and § 6662(b)(2) (substantial understatement of income tax) are relevant.

24. *Id.* at § 6662(c).

25. Gates, *supra* note 17, at § 20.1.5.7.1, ¶ 1.

prudent person to be 'too good to be true' under the circumstances.'"[26] For example, "[t]he accuracy-related penalty attributable to negligence may be applicable if the taxpayer fails to make a *reasonable attempt* to ascertain the correctness of claimed losses or deductions by thoroughly investigating the bona fide economic or other relevant aspects of the transaction."[27] In determining whether the taxpayer made a "reasonable attempt," "[c]onsultation with a tax advisor . . . is not, standing alone, conclusive evidence of a thorough investigation by the taxpayer."[28] A taxpayer's actions are reviewed under the totality of the circumstances standard of review, which considers all relevant facts, "including the nature of the tax investment, the independence of the tax advisor, the competence of the tax advisor, the quality of the opinion, and the sophistication of the taxpayer."[29]

The I.R.C defines the term "disregard" to include any careless, reckless, or intentional disregard of the Federal tax law.[30] "Disregard of rules or regulations relates to the taxpayer's failure to follow the appropriate law in completing the return, and reflects a disregard of the IRC, temporary or final regulations, revenue rulings, or IRS notices."[31]

Disregard of rules or regulations are:

- "Careless" if the taxpayer does not exercise reasonable care to determine the correctness of a tax return;
- "Reckless" if the taxpayer makes little or no effort to determine if a rule or regulation exists, under circumstances demonstrating a substantial deviation from a reasonable standard of conduct;
- "Intentional" if the taxpayer knows of a rule or regulation and ignores such rule or regulation.[32]

2. Substantial Understatement of Income Tax

"For purposes of [§ 6662], there is a substantial understatement[33] of income tax for any taxable year if the amount of the understatement for

26. *Id.* ¶ 2; *see also* Treas. Reg. § 1.6662-3(b)(1)(ii) (2013).

27. Gates, *supra* note 17, at ¶ 2 (emphasis added).

28. *Id.*

29. *Id.*

30. I.R.C. § 6662(c) (2013).

31. *Disregard of Rules or Regulations*, I.R.M. 20.1.5.7.2, ¶ 1 (Jan. 24, 2012), *available at* http://www.irs.gov/irm/part20/irm_20-001-005.html#d0e1800.

32. *Id.* at ¶ 3.

33. "[T]he term 'understatement' means the excess of (1) the amount of the tax required to be shown on the return for the taxable year, over (2) the amount of the tax imposed which is shown on the return." I.R.C. § 6662(d)(2)(A).

the taxable year exceeds the greater of—(1) 10% of the tax required to be shown on the return for the taxable year, or (2) $5,000."[34] For corporations, "there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10,000,000."[35] For example, a corporate taxpayer is required to show $5,000,000 on its tax return for the year. It only shows $4,000,000. Ten percent of $5,000,000, which is the tax required to be shown, is $500,000, which is the amount of the understatement. However, because $500,000 is greater than $10,000, there is only a substantial understatement if the understatement exceeds $10,000,000.

Section 6662(d)(2)(B) provides, however, that the amount of the understatement shall be reduced by that portion of the understatement attributable to: (1) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment; or (2) any item if (a) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and (b) there is a reasonable basis[36] for the tax treatment of such item by the taxpayer.[37]

B. Tax Advisors

1. Function of Professional Advice

Due to uncertainties that may arise in specific situations, taxpayers often, and indeed should, seek out tax planning[38] advice from professional advisors in the form of a tax opinion regarding the potential tax consequences of proposed transactions.[39] "Tax opinions describe the

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34. *Id.* at § 6662(d)(1)(A).

35. *Id.* at § 6662(d)(1)(B). In other words, there is a substantial understatement if the understatement exceeds the lesser of either ten percent of the tax required to be shown on the return, or if ten percent of the tax required to be shown is greater than $10,000, there is a substantial understatement of income tax for a corporation if the understatement exceeds $10,000,000.

36. *See* Treas. Reg. § 1.6662-3(b)(3) (2013).

37. I.R.C. § 6662(d)(1)(B). "However, for purposes of subsection (b), above, in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation." *Id.*

38. "Tax planning includes, both with respect to prospective and completed transactions, recommending or expressing an opinion on (a) a tax return position, or (b) a specific tax plan developed by a professional, a taxpayer, or a third party." *See* INTERPRETATION NO. 1-2, "TAX PLANNING," STATEMENT ON STANDARDS FOR TAX SERV. NO. 1: *TAX RETURN POSITIONS* 6 (2003).

39. Obtaining tax advice is especially important because of the IRS treatment—one might

application of the tax laws to an actual or proposed situation faced by the taxpayer."[40] Three types of opinions are of particular importance: (1) planning opinions, (2) penalty protection opinions, and (3) tax shelter marketing opinions.[41] Planning opinions are rendered by an advisor to a taxpayer for purposes of planning a proposed transaction and give the advisor's opinion regarding the tax consequences of such transaction; such opinions are rendered prior to commencing a proposed transaction.[42] A taxpayer may obtain a penalty protection opinion[43] to be used to defend against the assertion of tax penalties were the IRS to successfully challenge the positions taken by a taxpayer on the return.[44] To be distinguished from planning opinions and penalty protection opinions, which are sought by and rendered to a taxpayer-client, a tax shelter marketing opinion is rendered by an advisor for the purpose of marketing a tax shelter transaction *to a non-client*, such as a prospective investor, or to be used by a tax shelter promoter in marketing a tax shelter.[45]

In general, a tax opinion's function is to give a party to a proposed transaction comfort[46] that the tax consequences that were assumed when structuring the transaction will in fact be realized, to a varying degree of certainty.[47] For example, a party selling an asset may accept a lower

call it a "crackdown"—of tax shelters. *Id.* at 5. There is a crucial (crucial to the taxpayer) distinction between tax shelters and abusive transactions, which are illegal, and aggressive transactions, which are legitimate. *Id.* The American Institute of Certified Public Accountants ("AICPA") notes: "it must be recognized that taxpayers have a legitimate interest in arranging their affairs so as to pay no more taxes than they owe. It must be recognized that tax professionals . . .have a role to play in advancing these efforts." *Id.*

40. M. JOHN STERBA, JR. & DAVID T. MOLDENHAUER, LEGAL OPINION LETTERS § 7.1 (2011).

41. *See id.* (noting five types of tax opinions: (1) taxpayer planning opinions, (2) tax return position opinions, (3) penalty protection opinions, (4) financial audit opinions, and (5) tax shelter marketing opinions).

42. *Id.*

43. *See generally id.* (noting that penalty protection opinions are a subset of tax return position opinions). Tax return position opinions are rendered by "a practitioner to his or her client for purposes of assessing the positions that the client may take on a tax return." *Id.* Such opinions are normally rendered after a taxpayer has commenced a transaction.

44. *Id.*

45. *Id.*

46. A taxpayer cannot always rest assured that the IRS will agree with the tax opinion:

> Legal opinions classically predict judicial outcomes, because courts are the final arbiters of legal issues. Furthermore, opinions are understood to assume that the arbiter has all of the relevant facts, and will properly apply the law to the facts; that is, an opinion is based on a hypothetical perfect judge and is not a warranty that a judge won't go off the reservation and make an unsupported decision.

Jasper L. Cummings, Jr., *Reorganization Tax Opinions*, 641 PLI/TAX 451, 483 (2004).

47. Robert Rothman, *The Least Fun Part of the Job or a Tax Lawyer's Guide to Acquisition*

price for such asset if the seller can defer or avoid recognizing a taxable gain from the disposition.[48] In such a scenario, the seller would likely not want to proceed with the proposed transaction if the assumed tax benefits were not fairly certain to be realized. A favorable tax opinion regarding the tax consequences of the sale can comfort the seller that the sales price is reasonable in light of the predicted favorable tax consequences.[49]

2. Regulation

Attorneys are subject to a variety of regulations in rendering tax advice.[50] They are subject to the regulations under Treasury Department Circular 230, which sets forth standards that a tax practitioner must comply with in providing certain tax opinions.[51] Circular 230 regulations apply to "covered opinions"[52] involving transactions having tax avoidance as their principal purpose and transactions with a

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Agreements, 55 TAX LAW 711, 741 (2002).

48. *See, e.g.*, Canal Corp. v. Comm'r, 135 T.C. 199, 203-04 (2010).

49. *See generally*, Rothman, *supra* note 47.

50. Attorneys are generally governed by state model rules of professional conduct. In addition, tax attorneys are governed by American Bar Association ("ABA") Standards of Practice, which address matters concerning income tax advice, taxpayer representation before taxing authorities, and preparation of income tax returns. Kip Dellinger, *Thinking about Tax Practice Standards and Conduct*, TAXES: THE TAX MAGAZINE, Feb. 2012, at 20; *see* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352(1985). Accountant professional conduct, on the other hand, is governed by the American Institute of Certified Public Accountants ("AICPA"), which publishes and enforces a code of professional conduct against its members. Dellinger, *supra* at 20.

51. I.R.S. Circular 230 (June 3, 2011) (containing the rules governing practice before the IRS and is codified at 31 C.F.R. Subtitle A, Part 10) [hereinafter I.R.S. Circular].

52. *See id.* at § 10.35(b)(2).

> A *covered opinion* is written advice . . . by a practitioner concerning one or more Federal tax issues arising from:
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> (A) A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 CFR 1.6011–4(b)(2);
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> (B) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code; or
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> (C) any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code if the written advice—
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> (1) Is a reliance opinion;
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> (2) Is a marketed opinion;
>
> (3) Is subject to conditions of confidentiality;
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> or
>
> (4) Is subject to contractual protection.

Id.

significant tax-avoidance purpose,[53] provided the opinions meet certain conditions.[54] Circular 230 applies if: (1) the opinion reaches a level of confidence that permits the taxpayer to rely on the opinion to avoid penalties,[55] (2) the opinion will be used to market the transaction,[56] (3) the tax advisor requires the taxpayer to maintain the confidentiality of the advisor's tax strategies, or (4) the advisor's fees are conditioned on the taxpayer obtaining the intended tax benefits.[57] If an advisor fails to comply with Circular 230 regulations, he may be subject to censure, suspension, or disbarment from practice before the IRS if he is shown to be incompetent or disreputable,[58] or fails to comply with any regulation under Circular 230.[59]

If the above conditions are met, and Circular 230 applies, an attorney providing a covered opinion must abide by the following requirements. First, the attorney must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and determine which facts are relevant. The

53. "For purposes of [§ 10.35], the principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is the avoidance or evasion of any tax imposed by the Internal Revenue Code if that purpose exceeds any other purpose." *Id.* at (c)(10).

54. The focus here is only on advisors engaged in tax planning, meaning experts providing tax advice *prior* to the taxpayer engaging in a transaction.

55. I.R.S. Circular, *supra* note 51 at §§ 10.35(b)(2)(i)(C)(1). These standards apply if the opinion concludes that there is a greater than fifty percent 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.*

56. *Id.* at (b)(2)(i)(C)(2), (b)(5)(i).

> Written advice is a *marketed opinion* if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

Id. at (b)(5)(i).

57. *Id.* at (b)(2)(i)(C)(7), (b)(7). These 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. Section 10.35(b)(7) provides that "[a]ll the facts and circumstances relating to the matters addressed in the written advice will be considered when determining whether a fee is refundable or contingent, including the right to reimbursement of amounts that the parties to a transaction have not designated as fees or any agreement to provide services without reasonable compensation." *Id.* at (b)(7).

58. Incompetence and disreputable conduct for which a practitioner may be sanctioned under Circular 230 § 10.50 includes, *inter alia*, "[g]iving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws." *Id.* at § 10.51(a)(13).

59. *Id.* at § 10.50(a). Tax preparers are also subject to penalties for understatement of taxpayer's liability. *See* I.R.C. § 6694(a)(1) (2008).

opinion must identify and consider all facts that the practitioner determines to be relevant. He must also not base the opinion on any unreasonable factual assumptions. Second, the opinion must relate the applicable law to the relevant facts. In so doing, the attorney must not assume the favorable resolution of any significant Federal tax issue[60] or otherwise base his opinion on any unreasonable legal assumptions, representations, or conclusions. Third, the opinion must consider all significant Federal tax issues,[61] which requires that the opinion provide the advisor's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue considered in the opinion.[62] Regarding a marketed opinion—one used by a promoter in promoting, marketing, or recommending an entity, investment plan, or arrangement to one or more other taxpayer(s)—"the opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant Federal tax issue."[63] Fourth, "the opinion must provide the [attorney's] overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and must state the reasons for that conclusion."[64]

3. Compensation Restrictions

Circular 230 mandates that a tax practitioner, including attorneys, accountants, and enrolled agents, may not charge an "unconscionable fee" for representing a client in a matter before the IRS.[65] Though "no

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60. I.R.S. Circular, *supra* note 51, at § 10.35(b)(3):.

> A Federal tax issue is a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes. . . . *[A] Federal tax issue* is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

Id.

61. Except as otherwise provided in Circular 230 § 10.35(c)(3)(v) (limited scope opinions) and § 10.35(d) (reliance on the opinion of another practitioner).

62. I.R.S. Circular, *supra* note 51, at § 10.35(c)(3)(ii). "In evaluating the significant Federal tax issues addressed in the opinion, the practitioner 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 resolved through settlement if raised." *Id.* at (c)(3)(iii).

63. *Id.* at (c)(3)(iv).

64. *Id.* at (c)(3)(v)(3)(B)(ii).

65. *Id.* at § 10.27(a). Section 10.27 defines "any matter before the IRS" to include tax planning and advice, including rendering written advice with respect to any entity, transaction, plan,

definition is provided in the Circular, 'unconscionable' generally means affronting the sense of justice, decency, or reasonableness, or having no conscience or being unscrupulous."[66] "Absent guidance [from the IRS] . . . , [a practitioner should] assume that 'unconscionable' conveys something more offensive than 'unreasonable.'"[67] Tax attorneys, however, are also subject to the ABA Model Rules of Professional Conduct (hereinafter "Model Rules"). Pursuant to the Model Rules, attorneys may not charge an "unreasonable" fee, which is a more stringent standard than "unconscionable" and applies to all other non-attorney practitioners. The factors to consider in determining the reasonableness of a fee charged by an attorney include:

> (1) The time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly; (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer; (3) the fee customarily charged in the locality for similar legal services; (4) the amount involved and the results obtained; (5) the time limitations imposed by the client or by the circumstances; (6) the nature and length of the professional relationship with the client; (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and (8) whether the fee is fixed or contingent.[68]

No practitioners, however, may charge a contingent fee for services rendered in connection with any matter before the IRS pertaining to tax planning or return preparation.[69] In assessing a fee's reasonableness, what is ultimately at issue is the reasonable value of the services

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or arrangement. *Id.* at (c)(2).

66. JONATHAN G. BLATTMACHR, MITCHELL M. GANS, & DAMEN RIOS, THE CIRCULAR 230 DESKBOOK § 4:9.1 (2012).

67. *Id.* Something may be unreasonable but not severe enough to rise to the degree of being unconscionable. *But cf.* MODEL RULES OF PROF'L RESPONSIBILITY R 1.5 (2012 ed.) [hereinafter MODEL RULES].

68. BLATTMACHR, *supra* note 66, §4:9.1 n.135. *See* Rodriguez v. Ancona, 868 A.2d 807 (Conn. App. Ct. 2005) (holding that by looking solely to amount involved and results obtained in fixing fees as percentage of damage award, "[t]he court abused its discretion by seizing from the full panoply of relevant factors merely one factor, to the exclusion and disregard of the others"); *see also* Heng v. Rotech Med. Corp., 720 N.W.2d 54 (N.D. 2006) (holding that all reasonableness factors must be considered; no single factor controls); *see also In re* O'Brien, 29 P.3d 1044 (N.M. 2001) (holding that a lawyer who charged $5,000 without work product to justify it; "any fee is excessive when absolutely no services are provided").

69. I.R.S. Circular, *supra* note 51, at § 10.27(b). A contingent fee is one which includes a fee based upon whether a position taken on a return or other filing avoids challenge by the IRS or is based on a percentage of a refund of taxes saved or a result obtained or in which a practitioner will reimburse a client for fees paid in the event a position is challenged or not sustained. *Id.*

rendered and value received by the client.[70] However, one should be careful to note that there is no restriction in Circular 230 or in the rules of professional conduct prohibiting an attorney from accepting a general retainer.[71]

C. *Taxpayer Reliance Defense*[72]

Even though the "penalty system serves a crucial role in fostering voluntary compliance with the tax law[,] . . . 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."[73] Section 6664 permits a taxpayer to avoid Section 6662 penalties if the taxpayer shows reasonable cause for its position and that it acted in good faith in taking such position.[74] In some instances, a taxpayer may establish reasonable cause and good faith by showing that the taxpayer reasonably relied in good faith on professional tax advice.[75]

"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."[76] "Generally, the most

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70. Regions Bank v. Automax U.S.A., L.L.C., 858 So. 2d 593 (La. Ct. App. 2003).

71. A general retainer buys a lawyer's availability for a particular representation or a particular time period. It is considered earned when paid. *See, e.g.*, Ryan v. Butera, 193 F.3d 210, (3d Cir. 1999) (holding that a general non-refundable retainer of $1 million for only ten weeks of work enforceable when client offered initial, one-time payment as "carrot" to attract counsel with "special capability"). A general retainer fee is earned when paid whether or not lawyer actually performs services for client. Iowa Sup. Ct. Disciplinary Bd. v. Piazza, 756 N.W.2d 690, 696 (Iowa 2008).

72. This article focuses on tax advice obtained regarding the tax consequences of transactions prior to their occurrence. This is to be distinguished from advice regarding the filing a tax return (i.e., whether one is required or when it is to be filed). *See, e.g.*, U.S. v. Boyle, 469 U.S. 241 (1985) (holding that "[t]he failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not "reasonable cause" for a late filing"), citing Ferrando v. United States, 245 F.2d 582 (9th Cir. 1957) (holding that taxpayers have a personal non-delegable duty to file a return on time, and that reliance on an attorney to fulfill this obligation does not constitute "reasonable cause" for a late filing). "Advice" is "any communication, including the opinion of a professional tax advisor, setting forth an analysis or conclusion by a person other than the taxpayer and on which the taxpayer relied in preparing the return; [it] does not have to be in any particular form." Gates, *supra* note 17, § 20.1.5.6.4, ¶ 3.

73. David T. Moldenhauer, *Penalty Protection Opinions and Advisor Conflicts of Interest*, 27 AKRON TAX J. 55, 56 (2011-2012).

74. I.R.C. §§ 6664(c)-(d) (2013).

75. *See* Treas. Reg. § 1.6664-4(b) (2013). Reliance on professional tax advice is not, however, always determinative. *See also*, Nevada Partners Fund, LLC *ex rel.* Sapphire II, Inc. v. United States, 714 F.Supp.2d 598, 609 (S.D. Miss. 2010) (ruling that there is no reasonable reliance when taxpayers put on notice by IRS notices given to accountant).

76. Treas. Reg. § 1.6664-4(b). Reasonableness is a fact-specific determination with many variables, and the question turns on the "quality and objectivity of the professional advice

important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."[77] "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."[78] Though reliance on professional advice does not necessarily demonstrate reasonable cause and good faith, such reliance *may* constitute reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.[79]

The reasonable reliance and good faith defense to the accuracy-related penalty is analyzed from the perspective of the taxpayer.[80] No penalty is imposed for negligence or intentional disregard of rules or regulations or a substantial understatement of income if the taxpayer shows that the underpayment was due to reasonable cause and the taxpayer acted in good faith.[81] "Reasonable cause requires that the taxpayer have exercised ordinary business care and prudence as to the disputed item."[82] "The good faith, reasonable reliance on the advice of an independent, competent [tax] professional as to the tax treatment of an item *may* meet this requirement."[83] Professional advice "may be relied upon reasonably when [the advisor] arrives at that advice independently, taking into account, among other things, the taxpayer's purposes for entering into the underlying transaction."[84]

The Regulations provide that "all facts and circumstances must be

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obtained." *Nevada Partners Fund*, 714 F.Supp. 2d at 639-40.

77. Treas. Reg. § 1.6664-4(b). *See, e.g.*, Illes v. Comm'r, 982 F.2d 163, 166 (6th Cir. 1992) (holding reliance unreasonable absent proof that taxpayer investigated the challenged investment or sought independent professional advice).

78. Treas. Reg. § 1.6664-4(b).

79. *Id.* (emphasis added).

80. "While it is true that actual reliance on the tax advice of an independent, competent professional may negate a finding of negligence, *see, e.g.*, *Boyle*, 469 U.S. at 250, the reliance itself must be objectively reasonable in the sense that the taxpayer supplied the professional with all the necessary information to assess the tax matter and that the professional himself does not suffer from a conflict of interest or lack of expertise that the taxpayer knew of or should have known about." Neonatology Assoc., P.A. v. Comm'r, 299 F.3d 221, 234 (3d Cir. 2002); *see also*. Treas. Reg. § 1.6664-4(c) (2013).

81. *See* I.R.C. § 6664(c) (2013); Treas. Reg. §§ 1.6662-3(a); Treas. Reg. 1.6664-4(a).

82. DeCleene v. Comm'r, 115 T.C. 457, 476 (2000); *see also* U.S. v. Boyle, 469 U.S. 241 (1985).

83. *DeCleene*, 115 T.C. at 476 (emphasis added); *see also Boyle*, 469 U.S. 241.

84. *DeCleene*, 115 T.C. at 477. Reliance is unreasonable, however, when the taxpayer knew, or should have known, that the adviser lacked the requisite expertise to opine on the tax treatment of the disputed item. *Id.*

taken into account in determining whether a taxpayer has reasonably relied in good faith on [professional] advice . . . as to the treatment of the taxpayer . . . under Federal tax law."[85] In making such determination, "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."[86] In order for a taxpayer to reasonably rely upon such advice, negating the accuracy-related penalty, the taxpayer must prove: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment.[87]

In determining whether a taxpayer's reliance on professional tax advice was reasonable and in good faith,[88] courts have generally considered whether the advisor had a conflict of interest in rendering the advice and whether the understatement was with respect to a "reportable transaction."[89] Despite *Boyle*'s holding that it is reasonable for a taxpayer to rely on the advice of an attorney regarding a matter of tax law,[90] "courts have repeatedly held that it is unreasonable for a taxpayer to rely on a tax adviser actively involved in planning the transaction[91] and tainted by an 'inherent' conflict of interest . . .[and that an] adviser with a stake in the outcome has such a conflict of interest."[92]

85. Treas. Reg. § 1.6664-4(c).

86. *Id.* "Reasonable cause has been found when a taxpayer selects a competent tax adviser, supplies the adviser with all relevant information and, in a manner consistent with ordinary business care and prudence, relies on the adviser's professional judgment as to the taxpayer's tax obligations." Canal Corp. v. Comm'r, 135 T.C. 199, 218 (2010); *Boyle*, 469 U.S. at 250-51.

87. *DeCleene*, 115 T.C. at 477 (holding that taxpayers actually relied in good faith on disinterested professional advisers who structured the transactions and prepared their return); 106 Ltd. v. Comm'r, 136 T.C. 67, 77 (2011), *aff'd*, 684 F.3d 84 (D.C. Cir. 2012).

88. "The advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on representations, statements, findings, or agreements of the taxpayer or any other person." *Canal*, 135 T.C. at 218.

89. *See* I.R.C. § 6662A (2013). "Reportable transaction" is a transaction that has as a significant purpose the avoidance or evasion of Federal income tax. *Id.* at 6662(b)(2)(B). The reasonable cause and good faith exception to § 6662 penalties does not apply to any "reportable transaction" unless: " (B) there is or was substantial authority for such treatment, and (C) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment." I.R.C. §§ 6664(d)(3)(B)-(C) (2013).

90. U.S. v. Boyle, 469 U.S. 241, 251 (1985).

91. *See* I.R.C. § 6664(d)(4)(B). Reliance on a "promoter" takes the "good-faith out of good-faith reliance." *106 Ltd.*, 136 T.C. at 79. A promoter is "an adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction." *Id.* (citing Tigers Eye Trading, LLC v. Comm'r, 97 T.C.M. (CCH) 1622 (2009)).

92. *Canal*, 135 T.C. at 218. *See e.g.*, CMA Consol., Inc. & Subsid., Inc. v. Comm'r, T.C. Memo 2005-16 (2005) (holding that advisers involved in the marketing tax avoidance scheme are not objective, thus reliance is unreasonable). The most obvious case of an inherent conflict of

Though "reasonable cause" may be established when a taxpayer shows that he reasonably relied on the advice of an attorney regarding matters of tax law, even when such advice turns out to have been mistaken,[93] the ability to rely on such advice is not unlimited. Indeed, Section 6664 provides that certain opinions *may not* be relied upon to establish reasonable cause under any circumstances.[94] A taxpayer may not rely on a disqualified tax advisor or on disqualified opinions in establishing reasonable cause and good faith. A tax advisor is disqualified if the advisor:

> (I) is a material advisor[95] .. and participates in the organization, management, promotion, or sale of the transaction or is related . . . to any person who so participates,
>
> (II) is compensated directly or indirectly by a material advisor with respect to the transaction,
>
> (III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or
>
> (IV) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.[96]

A disqualified opinion is one that:

> (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events),
>
> (2) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,
>
> (3) does not identify and consider all relevant facts, or
>
> (4) fails to meet any other requirement as the Secretary may pre-

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interest is where the tax professional's fee for a favorable opinion is contingent on a percentage of the intended tax savings. *See generally*, Boelter, *supra* note 18, § 3:155.

93. *Boyle*, 469 U.S. at 250 (advising that it was unnecessary to file a return, even when such advice turned out to have been mistaken, may establish "reasonable cause" for failure to file a return).

94. With respect to a reportable transaction, reasonable cause requires that (1) there is or was substantial authority for such treatment, and (2) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. I.R.C. § 6664(d)(3) (2013).

95. A material advisor is a person "(i) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of a threshold amount . . . for such aid, assistance or advice." I.R.C. § 6111(b)(1).

96. I.R.C. § 6664(d)(4)(B)(ii).

scribe.[97]

In general, courts have held that a taxpayer may not rely on an advisor to establish the reasonable cause defense when such advisor is a promoter[98] of a scheme to avoid tax liability, i.e., a tax shelter,[99] is actively involved in planning the transaction and tainted by an "inherent" conflict of interest,[100] or when the compensation for the advisor's opinion is contingent on the taxpayer-client achieving the anticipated tax savings. Additionally, a taxpayer is unlikely to establish reasonable reliance when he fails to conduct his own independent investigation, seek independent advice, or is negligent[101] in complying with the I.R.C.[102] Furthermore, courts have distinguished advice

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97. *Id.* at § 6664(d)(4)(B)(iii).

98. "[A]n adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction . . . is considered a 'promoter' of the transaction[.]" Tigers Eye Trading, LLC v. Comm'r, 97 T.C.M. (CCH) 1622, 19 (2009).

99. Section 1.6662-4 of the Treasury Regulation states:

For purposes of § 6662(d), the term "tax shelter" means—

> (A) A partnership or other entity . . . ,
>
> (B) An investment plan or arrangement, or
>
> (C) Any other plan or arrangement,
>
> if the principal purpose of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax. The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose. Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. *Id.* The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

Treas. Reg. § 1.6662-4(g)(2)(2013).

100. Canal Corp v. Comm'r, 135 T.C. 199, 218 (noting that an adviser with a stake in the outcome of the transaction has an inherent conflict of interest). *See generally*, Moldenhauer, *supra* note 73, at 59.

> In many . . . 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.

Id.

101. "Negligence may be indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction that would seem to a reasonable and prudent person 'too good to be true' under the circumstances." CMA Consol., Inc. v. Comm'r, T.C.M., T.C. Memo 2005-16, *48 (2005).

102. *See, e.g.*, Goldman v. Comm'r, 39 F.3d 402, 407 (2d Cir. 1994) (ruling that no reasonable reliance where taxpayer accepts promoter's claims of sizeable tax deductions without obtaining objective opinion).

concerning tax law and substantive investment advice.[103]

As a general rule, a taxpayer need not challenge an independent and competent adviser, confirm for himself that the advice is correct, or seek a second opinion.[104] Reliance on an advisor, however, does not necessarily get the taxpayer "off the hook."[105] Courts have consistently rejected the reasonable reliance and good faith defense where the IRS informs a taxpayer that the advisor or promoter is supplying inaccurate advice,[106] where a taxpayer relies on the advice of promoters without seeking independent advice,[107] where a taxpayer is approached by a firm with which a taxpayer had no prior relationship for an investment in a tax shelter,[108] and where a taxpayer was aware that the expected tax benefits were "too good to be true" under the circumstances.[109]

While the regulations under Section 6664 do not explicitly preclude a taxpayer from relying on advice from an advisor having a conflict of interest,[110] the courts have developed the guiding principle that a taxpayer's reliance on advice is not reasonable and in good faith where such taxpayer knew, or should have known, that his advisor had a significant conflict of interest.[111] An advisor has an "obvious" conflict of interest where the advisor is a promoter of a tax shelter,[112] a broker,[113]

103. See, for example, *Klein v. United States*, 94 F.Supp.2d 838, 851 (E.D. Mich. 2000), where the court noted that, "by its terms, the *Boyle* court discussed only accountants and attorneys who were providing advise [sic] about a matter of tax law, such as whether a liability exists. . . . [and did not discuss anything,] even by implication, about substantive investment advice." *Id.*; see *also*, U.S. v. Boyle, 469 U.S. 241, 251 (1985). The *Klein* Court also noted that "the decision to make an investment is legally and analytically distinct from the decision as to what tax consequences one will assert as a result of that investment." *Klein*, 94 F.Supp.2d at 851.

104. *Boyle*, 469 U.S. at 251. A taxpayer is not reasonable, however, in relying on an adviser burdened with an inherent conflict of interest about which the taxpayer knew or should have known. Am. Boat Co., LLC v. United States, 583 F.3d 471, 481 (7th Cir. 2009).

105. *Boyle*, 469 U.S. at 251. (reliance must be reasonable under the circumstances).

106. *See, e.g.*, Mortensen v. Comm'r, 440 F.3d 375 (6th Cir. 2006).

107. Pasternak v. Comm'r, 990 F.2d 893, 903 (6th Cir. 1993).

108. New Phoenix Sunrise Corp. & Subs. v. Comm'r, 132 T.C. 161 (2009).

109. *See, e.g.*, Stobie Creek Invest., LLC v. United States, 82 Fed. Cl. 636, 708 (Fed. Cl 2008), *aff'd*, 608 F.3d 1366 (Fed. Cir. 2010) ("'[Taxpayer] was allegedly told by the promoters of the shelter, who were charging a [ ] $6 million fee for the shelter—calculated as 3% of the income to be sheltered from taxation—that the purchase of options costing $2 million would result in avoiding tax on a $204 million gain.'") (citing Defendant's Brief).

110. *See generally*, I.R.C. § 6664(d)(4)(B) (2013).

111. Moldenhauer, *supra* note 73, at 68.

112. *See, e.g.*, *Stobie Creek*, 608 F.3d at 1381-83; 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 at 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 (Fed. Cl. 2010); Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 56-57 (Fed. Cl.

has a referral arrangement with a promoter,[114] or where the advisor's fees are contingent upon the taxpayer achieving certain tax benefits or savings.[115] In many of these types of situations, the advisor also develops or implements a tax shelter. Sometimes, however, the conflict of interest is less apparent, such as where the advisor develops or implements a tax strategy, but does not engage in marketing activity and has no relationship with a tax shelter promoter.[116] The IRS, Congress, and the courts have failed, however, to provide a practical definition of "inherent conflict of interest" to permit practitioners and taxpayers to determine whether a tax opinion may be relied upon for purposes of the accuracy-related penalties.

D. Canal Corp v. Commissioner of Internal Revenue

In *Canal Corp. v.Commissioner of Internal Revenue*,[117] the Tax Court held that the taxpayer-corporation was subject to accuracy-related penalties, rejecting the taxpayer's reasonable reliance and good faith defense. In *Canal*, the IRS imposed Section 6662 accuracy-related penalties based on the following relevant facts: a wholly owned subsidiary ("W") of Chesapeake, the parent company and taxpayer at issue, proposed to transfer its assets and most of its liabilities to a newly formed partnership (the "LLC") in which W and Georgia Pacific ("GP"), an unrelated corporation, would have ownership interests.[118]

Chesapeake hired Salomon Smith Barney ("Salomon") and PwC, an accounting firm, to advise it on structuring the transaction with GP.[119] "Salomon recommended to Chesapeake's management that the best

2007), *aff'd in part, rev'd in part, vacated in part sub nom.*, Jade Trading, LLC *ex rel.* Ervin v. United States, 598 F.3d 1372 (Fed. Cir. 2010); 106 Ltd.v. Comm'r, 136 T.C. 67, 79 (2011); *New Phoenix*, 132 T.C. at 193-95; 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).

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

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

115. Moldenhauer, *supra* note 73, at 68-69.

116. *Id.* at 69; *see, e.g.*, Canal Corp. v. Comm'r, 135 T.C. 199,199 (2010); Am. Boat Co., LLC v. United States, 583 F.3d 471, 481-83 (7th Cir. 2009).

117. *Canal*, 135 T.C. 199.

118. *Canal*, 135 T.C. at 199 (2010). The impetus of the transaction was for Chesapeake to divest itself of W, its wholly owned subsidiary. *Id.*

119. *Id.* at 203. Chesapeake determined that a direct sale of its subsidiary would not have been advantageous because the after-tax proceeds would have been low compared to the pre-tax proceeds. *Id.*

alternative for maximizing shareholder value would be a leveraged partnership with GP."[120] "PwC assisted Salomon in negotiating and structuring the joint venture."[121] PwC examined the transaction from both an accounting and a tax perspective.[122] PwC determined that the contribution to the LLC was tax-free, but concluded that the transaction should be treated as a sale for accounting purposes.[123] "[Chesapeake] also asked PwC to issue an opinion on the tax consequences of the transaction and conditioned the closing on PwC issuing a 'should' opinion[124] that the transaction qualified as tax free."[125] Chesapeake agreed to pay PwC an $800,000 fixed fee, payable at the closing of the transaction, for issuing the opinion.[126] "PwC issued an ['should'] opinion that the transaction should not be treated as a taxable sale but rather as a tax free [sic] contribution of property to a partnership. . . .[127] W subsequently sold its LLC interest to GP."[128]

Chesapeake reported a gain from the sale on its consolidated Federal income tax return for 2001 when Chesapeake sold its interest in the LLC.[129] "[The IRS] determined that Chesapeake should have

120. *Id.* "Salomon presented the leveraged partnership structure as tax advantageous to Chesapeake because it would allow Chesapeake to get cash out of the business yet still protect Chesapeake from recognizing a gain." *Id.*

121. *Id.* at 204.

122. *Id.* PwC had served as Chesapeake's auditor and tax preparer for many years. The PwC partner, Mr. Compton, with the long-term relationship to Chesapeake assigned the duty of writing the opinion regarding the transaction he helped structure to another PwC advisor, Mr. Miller, a licensed attorney. *Id.*

123. *Id.*

124. *Id.* at 205. "A 'should' opinion is the highest level of comfort PwC offers to a client regarding whether the position taken by a taxpayer will succeed on the merits [if challenged by the IRS]." *Id.* at 206.

125. *Id.* at 199. "Chesapeake made [it] clear to PwC and Salomon that the asset transfer . . . had to be non-taxable for it to approve the transaction. Tax deferral enabled Chesapeake to accept a lower price [for its subsidiary]." *Id.* at 204.

126. According to the court, the $800,000 fee did not depend on time spent or expenses incurred by PwC. *Id.* at 206.

127. *Id.* at 199. "Mr. Miller and his PwC team reviewed the transaction's structure and approved each item that could affect the tax consequences." *Id.* at 206. Mr. Miller reviewed the transaction using a test he created using his own analysis of then existing rulings and procedures; there was no legal foundation for the test used. *Id.* The transaction closed on the same day PwC issued the "should" opinion. *Id.*

128. *Id.* at 199.

129. *Id.* On its 1999 tax return:

> Chesapeake disclosed the transaction on Schedule M of the return and reported $377,092,299 book gain, but no corresponding tax gain. Chesapeake treated the special distribution as non-taxable on the theory that it was a debt-financed transfer of consideration, not the proceeds of a sale. . . . Chesapeake reported a $524 million capital gain on its consolidated Federal tax return for 2001.

Id. at 208-209

reported a gain when W contributed its assets to the LLC in 1999."[130] The IRS also asserted a $36,691,796 accuracy-related penalty under Section 6662 for substantial understatement of income tax.[131] In defending the Section 6662 penalties, "Chesapeake claim[ed] it reasonably relied in good faith on PwC's tax advice and 'should' opinion and therefore no penalty should be imposed."[132] The court, however, agreed with the Commissioner in finding "that Chesapeake unreasonably relied on an opinion riddled with improper assumptions written by a tax adviser with a conflict of interest."[133] Because Chesapeake paid PwC an $800,000 flat fee for its "should" opinion, rather than a fee based on time devoted to preparing the opinion, the court questioned, "how much time could have been devoted to the draft opinion because it is littered with typographical errors, disorganized and incomplete" and doubted "that any firm would have had such a cavalier approach if the firm was being compensated solely for time devoted to rendering the opinion."[134] The court found it inherently unreasonable for Chesapeake to have relied on such an opinion.

Additionally, the court found that Chesapeake did not act in good faith by relying on PwC's advice.[135] Though Chesapeake argued that it had every reason to trust PwC's judgment because of its long-term relationship with the firm, the court ruled that "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."[136] Further, the court opined that any advice received from PwC was tainted by an "inherent conflict of interest" because PwC not only researched and drafted the tax opinion but also audited the LLC, and because PwC essentially issued an opinion on a transaction it helped plan "without the normal give-and-take in negotiating terms with an outside party."[137] The court also found the $800,000 price tag

130. *Id.* at 199.

131. *Id.*

132. *Id.* at 218.

133. *Id.* In so finding, the Tax Court only considered a draft of the "should" opinion.

134. *Id.* at 219. The court further stated:

> We are also nonplused by Mr. Miller's failure to give an understandable response when asked at trial how PWC could issue a "should" opinion if no authority on point existed. He demurred that it was what Chesapeake requested. The only explanation that makes sense to the Court is that no lesser level of comfort would have commanded the $800,000 fixed fee that Chesapeake paid for the opinion.

Id. at 219-20.

135. *Id.* at 220-21

136. *Id.* at 220.

137. *Id.* at 220-21. *See generally*, Moldenhauer, *supra* note 73, at 59. In many cases

exorbitant and noted that PwC had "a large stake in making sure the closing occurred" because the fee was payable and contingent on the closing of the joint venture transaction.[138] In sum, the court stated: "Considering all the facts and circumstances, PwC's opinion looks more like a quid pro quo arrangement than a true tax advisory opinion."[139] Accordingly, in the courts opinion, PwC lacked the independence necessary for Chesapeake to establish good faith reliance.

III. ANALYSIS

After reviewing the accuracy-related penalties under I.R.C § 6662, the reasonable reliance defense provided for in I.R.C § 6664, the Circular 230 requirements, and after thorough review of the relevant case law, including *Canal*, the tax attorney and his client are still left without any clear answer, or even a clear indication, from the courts, the IRS, or Congress, as to when a taxpayer may reasonably rely on an attorney's tax opinion and what an attorney must do in order to furnish a reliable opinion to the taxpayer-client.

The authorities have presented the taxpayer with a difficult and costly conundrum. For one, the complexity of the Code and the cost of non-compliance with its requirements (i.e., civil and, possibly, criminal liabilities), whether intentional or not, deter even a highly adept businessman from attempting to "go it alone" without the assistance of tax counsel who has been trained on and has worked through the Code's intricate provisions. On the other hand, if the taxpayer *does* consult counsel, and counsel provides the taxpayer with an opinion regarding his tax situation (i.e., regarding tax liability from a completed transaction or tax planning for a proposed transaction), it is unclear when *and* whether the taxpayer can rely on such opinion.

The authorities discussed and relied upon herein consistently make legal *conclusions* as to a taxpayer's "good faith and reasonable reliance," or lack thereof, on an opinion and as to an advisor's "inherent conflict of interest," which, as the courts have concluded, rendered such opinion patently unreliable. Further, as the *Canal* court noted for example, the

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the factors suggesting a conflict of interest were 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.

Id. at 59-60

138. *Canal*, 135 T.C. at 221.

139. *Id.*

Regulations provide that in order to rely on professional advice, such advice "must not be based on unreasonable factual or legal assumptions"[140] and "tainted by an *inherent* conflict of interest."[141] Indeed, an opinion that relies on unreasonable factual or legal assumptions is obviously unreliable. But, how is the taxpayer, who consulted a professional advisor due to the Code's complexity, supposed to recognize that his advisor made "unreasonable factual assumptions," assuming the taxpayer provided all the relevant information that the advisor requested? Moreover, how should the taxpayer be able to recognize an "unreasonable legal conclusion," and *why* would he doubt that *his* advisor gave an opinion based on erroneous law? *Boyle*, to the contrary, stands for the proposition that a taxpayer is not required to "second guess" his own attorney's conclusions of law.[142] Additionally, to require a taxpayer to ask specific questions for the purpose of determining for himself whether the advice is erroneous is unrealistic, not to mention unfair, for it would essentially require the taxpayer to understand all of the various taxes to which he could possibly be subject; if the taxpayer had this knowledge, there would be no need to seek the advice of an expert in the first place.[143] Yet, that is exactly what the courts have required of taxpayers.

Further, it is unclear what exactly constitutes "an inherent conflict of interest," which the *Canal* court plainly *concluded* made the taxpayer's reliance on PwC's "should" opinion flagrantly unreliable.[144] The court does nothing more than conclude that a "professional advisor with a stake in the outcome has [an inherent] conflict of interest,"[145] without any further analysis of what exactly was PwC's *inherent* conflict of interest. The court failed to state how and why the taxpayer should have doubted PwC's tax opinion in light of the fact that the taxpayer "had every reason to trust [PwC's] judgment because of its long-term relationship with the firm."[146] The court subsequently concluded that "[PwC] crossed over the line from trusted advisor 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."[147] But the question still

140. *Id.* at 218.

141. *Id.* (emphasis added).

142. *See* U.S. v. Boyle, 469 U.S. 241 (1985).

143. *See generally* Haywood Lumber & Mining Co. v. Comm'r, 178 F.2d 769, 771 (2d Cir. 1950).

144. *Canal*, 135 T.C. at 218.

145. *Id.*

146. *Id.* at 220.

147. *Id.*

remains: how should the taxpayer have known that its long-time advisors, accountants, and lawyers, crossed "over the line" and became unreliable? The fact is that the court's primary issue with the opinion was the price the taxpayer paid, which the court characterized as "an opinion with a high price tag,"[148] for which "no lesser level of comfort [than 'should'] would have commanded the $800,000 fixed fee that Chesapeake paid for the opinion."[149]

The problem with the court's analysis, if one could characterize it as such, is that the authorities relied upon for its conclusion that the taxpayer "acted unreasonably in relying on the advice of [PwC] given the inherent and obvious conflict of interest,"[150] were cases considering the advice from tax shelter promoters, who were clearly not disinterested or objective advisors.[151] There is an obvious difference between cases in which the tax advisors are promoters of a tax shelter and cases, such as *Canal*, in which the advisors had long-time relationships with the client and where the client contacted the advisors for assistance in structuring a proposed transaction.

There are, of course, two competing fact scenarios that illustrate the reasonableness of a taxpayer's reliance on his advisor's opinion. On the one hand, an advisor will be considered disinterested, objective, and reliable where:

> 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.[152]

This scenario would be considered "ideal." On the other hand, an advisor has a clear conflict of interest, which the taxpayer should recognize, where the advisor develops or markets artificial tax shelters, prepares documents that create the illusion of legitimate business

148. *Id.*
149. *Id.*
150. *Id.* at 221.
151. *See generally* New Phoenix Sunrise Corp. v. Comm'r, 132 T.C. 161, 192-194 (2009) (holding that reliance on opinion by law firm actively involved in developing, structuring and promoting transaction was unreasonable in face of conflict of interest); *see also* CMA Consol., Inc. v. Comm'r, T.C. Memo. 2005-16, *49 (2005) (holding that reliance not reasonable as advice not furnished by disinterested, objective advisers); *see also* Iles v. Comm'r, 982 F.2d 163, 164-66 (6th Cir. 1992) (holding that reasonable reliance precluded where accountant was "not a disinterested source," because he was tax shelter promoter).
152. Moldenhauer, *supra* note 73, at 59-60.

transactions, bases his opinion on inaccurate factual assumptions, and is paid based on whether the taxpayer enters into the transaction or claims the purported tax benefits.[153] Such an opinion would clearly be unreliable and the taxpayer would be hard-pressed to claim good faith and reasonable reliance on such advice. These competing scenarios, however, are on two opposite ends of the spectrum. The problem, of course, is that there is no test, standard, statute, or regulation to guide the taxpayer when his particular situation falls somewhere in the middle of the spectrum. Some conflicts of interest are subtle, while others are obvious or egregious. And, the courts seemingly place the burden on the taxpayer to determine whether his advisor is reliable, essentially requiring the taxpayer to monitor or second-guess his advisor, which the *Boyle* court clearly thought unreasonable.

Though the burden is on the taxpayer to prove that he relied upon his advisor in good faith *and* that his reliance was reasonable, the taxpayer and his advisor are left without any guidance to evaluate the taxpayer's reliance on his advisor's advice when the situation is not "ideal." In practice, the "ideal" situation is surely not the norm. Indeed, in practice there are frequently cases where, for example, a taxpayer engages a tax advisor for the first time to handle a transaction, or where an advisor brings a transaction to his client or alerts the client of the need for tax advice, or where an advisor takes a role in negotiating the commercial terms of a transaction on which he is providing tax advice, or where an advisor makes relevant factual inquiries that are beyond his specific area of expertise, or where a taxpayer and an advisor agree to a fixed fee or a fee that depends on whether the transaction ensues.[154]

As discussed above, the purpose of tax penalties is to promote voluntary compliance with the Federal tax laws. Thus, with such purpose in mind, the reasonable cause and good faith defense serves to encourage taxpayers to make more reliable predictions about their proper tax treatment and to avoid penalizing taxpayers who did not have reason to know that their tax return positions were incorrect. Indeed, the foundation of the attorney reliance defense is based on the principle that:

> To impute to the taxpayer the mistakes of his consultant would be to penalize him for consulting an expert; for if he must take the benefit of his counsel's or accountant's advice cum onere, then he must be held to a standard of care which is not his own and one which, in most cas-

153. *Id.* at 59.
154. *Id.* at 60.

es, would be far higher than that exacted of a layman.[155]

Of course, the taxpayer must act *reasonably* to claim good faith reliance on an opinion. Accordingly, in order to serve the purposes of the reasonable cause and good faith defense, an opinion must: (1) be based on all pertinent facts and circumstances and the related law; (2) take into account the taxpayer's purposes and their relative weight; (3) not be based on unreasonable assumptions or rely unreasonably on factual sources; and (4) be supported by certain types of legal authority and reach conclusions at a minimum level of confidence.[156] If any one of these factors is lacking, an opinion is patently unreliable.

Assuming the advisor satisfies the above requirements, the taxpayer has yet to establish that he reasonably relied on the advice in good faith.[157] This is where the reliance defense becomes an unreasonable burden for the taxpayer. The burden becomes unreasonable at the point when the taxpayer realizes that he needs tax advice and subsequently hires tax counsel. In addition to providing counsel with all necessary information, this should be all that is required on the taxpayer. That is all that was required by the *Boyle* court.

The IRS, however, has managed to rig the game by forcing the taxpayer to hire counsel because of the complexity of the I.R.C, while simultaneously forcing the taxpayer to know and understand the tax law in order to determine if his counsel's opinion is correct. This undermines the entire reason for obtaining counsel. Instead of forcing the taxpayer to monitor counsel and "check his work" to ensure that counsel did his job correctly, the onus for providing reliable advice should be on tax counsel, not on the taxpayer. If, after being provided with all the necessary information, tax counsel delivers an opinion to the taxpayer that, with a reasonable degree of probability, the predicted tax consequences are likely to come to fruition, the taxpayer should be able to act in reliance on such opinion. *Boyle* firmly established the principle that:

> When 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

155. Haywood Lumber & Mining Co. v. Comm'r, 178 F.2d 769, 771 (2d Cir. 1950).
156. *See generally*, Treas. Reg. § 1.6664-4 (2013).
157. *Id.* at § 1.6664-4(c).

> nullify the very purpose of seeking the advice of a presumed expert in the first place. . . . . "Ordinary business care and prudence" do not demand such actions.[158]

Accordingly, the proper analysis of the taxpayer's reasonable reliance on tax counsel's opinion should look not to the taxpayer's ability to discern counsel's error, but to the tax attorney who provided the opinion. Indeed, a tax attorney is not merely a tax expert; he is also an attorney. As such, the attorney has ethical responsibilities to his client that reach beyond those imposed on non-attorney practitioners. Among the responsibilities imposed is the duty to act in the client's best interests.[159] Additionally, the Model Rules obligate all lawyers to "exercise independent professional judgment and render candid advice."[160] Indeed, the client "is entitled to straightforward advice expressing the lawyer's honest assessment."[161] Therefore, the analysis of whether the taxpayer-client is entitled to rely on his advisor's opinion should begin with the advisor.

As a starting point to the analysis, it must be remembered that in a tax return or in paying Federal income tax, a taxpayer is only required to "exercise ordinary business care and prudence"[162] and engaging an attorney's assistance in complying with the Code's provisions is plainly an exercise of "ordinary business care and prudence."[163] Although a taxpayer has a non-delegable duty to promptly file tax returns, such duty requires *only* that a taxpayer know that tax returns have fixed filing dates and that taxes must be paid when they are due.[164] Such duty does not require, however, that the taxpayer have a working understanding of the Code's provisions, as would be necessary in order to determine that counsel's advice is erroneous. Thus, when a taxpayer engages a tax attorney to assist in planning a transaction, and where such attorney is asked to render an opinion regarding potential tax consequences of a proposed transaction, such a taxpayer has met his burden and it becomes the tax attorney's duty to provide accurate and honest advice to the taxpayer-client, while also abiding by the attorney's primary ethical responsibility to operate in the client's best interest.[165]

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158. U.S. v. Boyle, 469 U.S. 241, 251 (1985) (emphasis in original).

159. MODEL RULES, *supra* note 67, at R 1.4 cmt. 5, Explaining Matters (2010).

160. *Id.* at R 2.1.

161. *Id.* at R 2.1, cmt. 1

162. Treas. Reg. § 301.6651-1(c)(1).

163. *See Boyle*, 469 U.S. at 250.

164. *Id.*

165. Bradley T. Borden & Dennis J. Ventry, Jr., *Giving Legal Advice in the Face of Uncertainty*, 1960 PLI/CORP 425, 470 (2012). The primary ethical responsibility to operate in the

Accordingly, the taxpayer's reasonable reliance defense must be analyzed in light of his attorney's obligation to render a candid, honest, and reliable opinion to the client. The analysis must directly take into account the tax attorney's ethical and professional responsibilities owed to the client and to the tax system generally. In rendering tax advice or opinions, attorneys are subject to the following rules and derivative responsibilities: the Model Rules, Circular 230, and ABA Formal Ethics Opinions interpreting the Model Rules as applied to tax practice. When rendering tax advice, tax counsel must abide by the following guiding principles:

> 1. Attorneys have a broad duty of competence requiring the lawyer to provide "the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." This duty requires the attorney to make "inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners."[166]
>
> 2. Circular 230 requires tax practitioners to exercise due diligence with respect to, among other things, factual representations and valuation issues. A tax professional "must make inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described . . . and assure that any representations as to future activities are clearly identified, reasonable, and complete."[167] This standard is violated if the attorney assumes the facts, conclusions, and opinions that form the basis of his own opinion.
>
> 3. The lawyer "should fulfill reasonable client expectations for information consistent with the duty to act in the client's best interests, and the client's overall requirements as to the character of representation."[168]
>
> 4. A lawyer must exercise independent professional judgment and render candid advice.[169] A client "is entitled to straightforward advice expressing the lawyer's honest assessment," and while legal advice "often involves unpleasant facts and alternatives," a lawyer "should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client." The lawyer violates this Rule by failing to provide the client information with respect to adverse authority or honest prospects for success on the merits pertaining to the

client's best interests includes, at a minimum, protecting clients from liability. *Id.*

166. MODEL RULES, *supra* note 67, at R 1.1.

167. I.R.S. Circular, *supra* note 51, at § 10.33(a)(1)(i).

168. MODEL RULES, *supra* note 67, at R 1.4, cmt. 5.

169. *Id.* at R 2.1

lawyer's advice and opinions.[170]

> 5. A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.[171]

The burden, therefore, is on the attorney to render advice to the taxpayer that can be relied upon in preparing his return and defending IRS accuracy-related penalties should they be imposed. It is the attorney's obligation to provide the taxpayer with an opinion that is not disqualified,[172] to recognize when he is a disqualified tax advisor,[173] and to inform the client when he may not be relied upon. Given that it is a lawyer's duty to act in his client's best interest, such duty would be violated if the advisor gave the taxpayer-client an unreliable opinion, potentially subjecting the client to substantial penalties. Further, even if a client requests a specific course of action, i.e., the "should" opinion requested by the taxpayer in *Canal*, it is the lawyer's obligation to act independently and render candid and honest advice. Accordingly, if the PwC advisor could not reach a "should" opinion regarding the tax consequences of the proposed sale, it was his duty to not give such an opinion.

Beginning the analysis with the advisor also comports with the potential liability arising out of an ill-advised opinion. An attorney may face civil malpractice liability to the client due to an erroneously given tax opinion. Under common law tort principles, a professional has a duty to exercise the level of skill, care, and diligence that is commonly possessed and exercised by other members of the profession under similar circumstances.[174] Contract law, similarly, generally deems an attorney to have made a promise to represent each client competently and diligently.[175] Further, due to the existence of an attorney-client relationship, the duty to exercise reasonable skill and care in representing the client is imposed on the attorney.[176] An erroneous opinion, however, is not necessarily negligent, potentially subjecting the

170. *Id.* at R 2.1, cmt. 1.
171. *Id.* at R 1.2(d).
172. I.R.C. § 6664(d)(4)(B)(iii) (2013).
173. *Id.* at § 6664(d)(4)(B)(ii).
174. Bob Woodward, *Tax Opinions*, 2010 A.B.A. SEC. PUB. TAX'N, ¶ 2(B)(1).
175. *Id.*
176. *Id.*

attorney to a malpractice claim. And certainly, an opinion is not a guarantee of the result. Where the law is uncertain, the fact that a practitioner's opinion turns out to be incorrect does not necessarily establish negligence, provided the attorney's judgment was reasonable and based upon what was known at the time the opinion was rendered.[177] Accordingly, the question in a malpractice case is not whether the attorney's judgment ultimately turned out to be right or wrong; rather, the critical issue is whether the practitioner performed sufficient research to make an informed and reasoned decision.[178]

This analysis also comports with the Circular 230 standards of conduct for practice before the IRS § 10.37 imposes six duties on a tax advisor: the advisor (1) may not make unreasonable legal assumptions; (2) may not make unreasonable factual assumptions; (3) may not unreasonably rely on representations or statements made by others; (4) must consider all relevant facts in formulating the advice; (5) must apply the law to the facts; and (6) must reach conclusions regarding the law and facts.[179] These duties are imposed on the advisor, *not* on the taxpayer. Accordingly, the *Canal* court's conclusion that it was "inherently unreasonable for Chesapeake to have relied on an analysis based on the specious legal assumptions," imposed a burden on the taxpayer that was not its burden to meet. In other words, the taxpayer engaged a tax attorney to render advice regarding the potential consequences of the proposed transaction. Therefore, by reason of the attorney-client relationship that then arose, it became PwC's duty to render candid and honest advice; and, despite the taxpayer's request for a "should" opinion, PwC violated its duties owed to the taxpayer by issuing an opinion that could not be relied upon. It is patently unreasonable for the court to require the taxpayer to recognize the "specious legal assumptions" because, as *Boyle* held, ordinary care and business prudence do not 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, as it would nullify the very purpose of seeking the advice of a presumed expert in the first place.[180]

In light of *Boyle*, and the duties imposed on the attorney in

177. *Id.*; *see also* Smith v. St. Paul Fire & Marine Ins. Co., 366 F.Supp. 1283 (D. La. 1973), *aff'd*, 500 F.2d 1131 (5th Cir. 1974) (holding that, where the attorney's informed and reasoned opinion was invalidated only by a later case, liability for malpractice could not be imposed).

178. *See* Horne v. Peckham, 97 Cal. App. 3d 404, 416 (Cal. Ct. App. 1979) (noting that the existence of uncertainty in the law does not relieve the attorney of the duty to do reasonable research into the law).

179. I.R.S. Circular, *supra* note 51, at § 10.37.

180. U.S. v. Boyle, 469 U.S. 241, 251 (1984).

representing the taxpayer-client arising by virtue of the attorney-client relationship and Circular 230, it is unreasonable for the courts to make an after-the-fact finding that the taxpayer could not have reasonably and in good faith relied on his attorney's opinion. By engaging an attorney in the first place, assuming the taxpayer complied with counsel's requests for relevant information and provided the same, the taxpayer has met his burden and should be entitled to rely on his counsel's opinion. The law still stands that: when an 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 because most taxpayers are not competent to discern error in the substantive advice of an attorney.[181] Indeed, in general, the most important factor in determining whether a taxpayer acted with reasonable cause and in good faith is the "extent of the taxpayer's effort to assess the taxpayer's proper tax liability."[182] Under prevailing law, engaging an attorney surely constitutes a considerable effort to assess the taxpayer's proper tax liability. Accordingly, in evaluating the taxpayer's reasonable reliance on an opinion, the taxpayer should be entitled to rely on an expert's opinion as to matters of substantive tax law.

Thus far, this analysis has focused on the reasonable reliance element of the reasonable cause and good faith defense to section 6662 penalties. The second factor, of course, is that the taxpayer must have relied upon the opinion and acted in good faith.[183] The Regulations state, in part, that:

> In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. . . . For example, 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.[184]

The Regulations subsequently state the elements that the *advice* must have been based upon and considered, i.e., all facts and circumstances considered and no unreasonable assumptions. Again, these considerations rest in the province of the attorney's preparation of the advice, not on the individual taxpayer's actions. The Regulations,

181. *Id.*

182. Treas. Reg. § 1.6664-4(b)(1) (2013).

183. Reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. *Id.*

184. *Id.* at § 1.6664-4(c)(1).

however, do not describe what is required of a taxpayer in order to "act in good faith"; rather, the Regulations and cases dealing with the defense merely state what does not constitute good faith. For example, the good faith requirement was not satisfied where an opinion was written after the taxpayer had already filed his income tax return, the opinion was unsigned, and the taxpayer made no inquiries into the firm's qualifications.[185] Good faith was also not satisfied where the taxpayer participated in a tax shelter because of the alluring tax benefit of claiming tax losses. The improbable tax advantages offered by the tax shelter should have alerted a person with the taxpayer's business experience and sophistication as to the shelter's illegitimacy.[186]

Generally, good faith has not been found when: (1) the taxpayer entered into a tax shelter for the purpose of creating artificial losses and knew, or should have known, that the tax results were "too good to be true"; (2) when the opinion was formed *after* the taxpayer had already filed his tax return; and (3) when the taxpayer, not the advisor, decided how to characterize a gain or loss. Neither the Code nor the Regulations define "good faith," and thus reference to the dictionary definition must be considered. Black's Law Dictionary defines "good faith" as: "A state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage."[187]

Thus, once a taxpayer has engaged an attorney to render an opinion, his reliance thereon should be presumed reasonable *unless* the taxpayer knows, or should know, that the opinion facially inaccurate, or that the advisor is obviously not disinterested. The good-faith analysis should turn on whether the taxpayer provided accurate and truthful information as requested by the advisor and whether the taxpayer followed the advisor's advice in structuring the proposed transaction or in preparing his tax return. For example, a taxpayer would not be acting in good faith if he knew that he was participating in a tax shelter with the purpose of generating artificial losses, or if the taxpayer provided the advisor with false factual information. However, where the taxpayer provides the advisor with accurate information and proceeds with structuring a transaction pursuant to the advice, there is no reason for the taxpayer to be deemed to have acted in bad faith. To be sure, complying with expert

185. *See, e.g.*, Dunlap v. Comm'r, T.C. Memo. 2012-126 (2012).
186. *See, e.g.*, 106 Ltd. v. Comm'r, 684 F.3d 84 (D.C. Cir. 2012).
187. BLACK'S LAW DICTIONARY 762 (9th ed. 2011).

advice is completely reasonable. Additionally, because the most important factor in determining the taxpayer's good faith is the extent to which he attempted to accurately determine his proper tax liability, engaging an attorney is surely a good-faith attempt to meet such standard.

Accordingly, applying the above analysis to the situation faced in *Canal*, the conclusion is obvious: the Tax Court should not have held the taxpayer liable for the Section 6662 accuracy related penalty because the taxpayer relied on PwC, its long-time tax advisor's opinion, complied with their requests, and proceeded with the transaction in accordance with PwC's advice and opinion. The taxpayer, Chesapeake, engaged two nationally renowned firms—Salomon, an investment bank, and PwC, an accounting firm—to explore strategic alternatives for the sale of one of Chesapeake's major assets because a direct sale of the asset would have produced significant income tax consequences and would have made the sale disadvantageous. Salomon presented the strategy that the taxpayer subsequently followed in order to *defer* recognition on the sale of the asset. The taxpayer's board of directors liked the strategy presented and engaged PwC to issue an opinion regarding the transaction's Federal tax implications. PwC and the taxpayer agreed that the $800,000 fee would be paid at the closing of the transaction. PwC subsequently issued a "should" opinion to the taxpayer stating that the recommended strategy would produce the desired tax deferral, enabling the taxpayer to accept a lower price for the asset: $775 million. Despite complying with expert advice from two independent firms, each having their own respective duties to act in the taxpayer's best interests and PwC having the duty to give candid and honest advice to the taxpayer because the PwC consultant was an attorney, the IRS asserted a $36,691,796 accuracy-related penalty pursuant to Section 6662 for substantial understatement of income tax.

Although the court noted that "[r]easonable cause has been found when a taxpayer selects a competent tax adviser, supplies the adviser with all relevant information and, in a manner consistent with ordinary business care and prudence, relies on the adviser's professional judgment as to the taxpayer's tax obligations,"[188] the Tax Court concluded that the taxpayer unreasonably relied on "an opinion riddled with improper assumptions written by a tax adviser with a conflict of interest."[189] Further, the court concluded, "the opinion was riddled with

188. Canal Corp. v. Comm'r, 135 T.C. 199, 218 (2010).

189. *Id.*

questionable conclusions and unreasonable assumptions,"[190] and that it was inherently unreasonable for the taxpayer to have relied on an analysis based on specious legal assumptions. The court also found suspect the exorbitant price tag the taxpayer paid PwC for its advice and "should" opinion.[191]

Applying the analysis presented above, the court's conclusions were unreasonable. For one, the court's only authority for stating that the advisors had inherent conflicts of interest were cases dealing with tax shelter opinions, where the *advisor* brought the investment to the taxpayer for the purpose of creating artificial losses where the advisors were tax shelter promoters. Further, even though the court cited *Boyle*, it failed to consider its proposition that a taxpayer is not required to monitor counsel's analysis of substantive tax law as applied to the taxpayer's factual situation. The court's entire analysis focused on the opinion's legal analysis, which was the province of the attorney-advisor, not of the taxpayer. There was no evidence that the taxpayer knew that PwC's legal analysis was ill advised or that the taxpayer provided PwC with erroneous factual information. Moreover, even though the taxpayer was a corporation and, presumably, well experienced in business transactions, there was no evidence that the taxpayer's board of directors were tax experts or that it doubted, or had any reason to doubt, PwC's expertise. Additionally, the court's characterization of the fee as "exorbitant" and as a quid pro quo arrangement is unfounded. First, the fee, $800,000, in relation to the sale price of the asset, $775 million, is not inherently unreasonable (or unconscionable).[192] Second, PwC bore the risk that if its opinion was erroneous, it would potentially be liable for professional malpractice, which would require PwC to pay damages, at a minimum, equal to the amount of the IRS penalty, which was $36,691,796. This risk is most likely what prompted the "large" fee, as the risk to PwC was significant.

The fact is, the court held the taxpayer to an unreasonable standard. On the one hand, it was entirely reasonable for the taxpayer to engage a tax advisory firm to render an opinion. However, on the other hand, the court concluded that it was unreasonable to rely on such firm's advice. The errors the court found unreasonable were all errors in legal analysis for which the taxpayer should not be held responsible. Additionally,

190. *Id.* at 219.

191. *Id.* at 221.

192. The $800,000 fee constituted approximately 0.1% of the total proceeds from the transaction and approximately two-percent of the § 6662 penalties that were imposed, for which PwC could have been held liable for in a malpractice claim.

there was no evidence that the taxpayer lacked good faith in complying with the advice, as it followed Solomon and PwC's strategy to the letter. In sum, the court held the taxpayer liable for its advisor's poor legal analysis. This was patently unreasonable, as the taxpayer was not a tax law expert, engaged competent and reputable independent advisors, and had no reason to question the firm's advice or reliability. Although the legal advice turned out to be erroneous upon an after-the-fact review by the court, all that is required of the taxpayer is that it reasonably relied upon the advice and acted in good faith. There is no evidence that the taxpayer acted to the contrary. Therefore, it should not have been held liable for the accuracy-related penalties.

IV. CONCLUSION

Tax practitioners should remember that they are members of a profession. They should not only abide by the Circular 230 regulations, but should also remember that they are attorneys and must follow the established ethical rules of conduct of their profession and not sell their souls simply to receive a large fee. While non-attorney practitioners have ethical obligations to their taxpayer-clients and to the IRS, attorneys have much broader obligations. Attorneys, as members of the legal profession, are not only representatives of their clients, imposing significant professional and ethical responsibilities, but are also officers of the legal system and have special responsibilities for the quality of justice.[193] And, while attorney-practitioners may encounter conflicting responsibilities between their responsibilities to clients and to the IRS, attorneys must remain zealous advocates of their clients' legitimate interests within the bounds of the law.[194] These ethical and professional obligations may never take a backseat to the prospect of earning a large fee. Because of the dual-obligations to the client and to the legal system, generally, and to the IRS specifically, the taxpayer should be relieved of his responsibilities under the Code if he follows the practitioner's advice in good faith and should not be held to the same legal standards as his advisor.

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193. *See* MODEL RULES, *supra* note 67, at pmbl. ¶ 1.

194. *See id.* pmbl. ¶ 9.