What Is Advice for Penalty Protection Purposes?

By Patrick J. Browne Jr. and Lori Hellkamp

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Some taxpayers and practitioners have expressed uncertainty as to the form of advice that can be relied on for the reasonable cause and good-faith defense to specific tax penalties. Their concern is based, at least in part, on a few relatively recent cases that suggest that advice for penalty protection purposes may be more limited than once thought. However, these cases generally involved tax shelters, and the courts’ penalty analyses were inexorably interwoven with, and tainted by, the unfavorably perceived facts. In short, the tax advice in these cases was found wanting because it failed to satisfy the threshold requirements for penalty protection — not because it was otherwise qualified advice that happened to be conveyed via an impermissible format. Tax advice rendered by an independent professional and based on an accurate description of the facts can generally give rise to penalty protection, regardless of the advice’s form. Indeed, this protection is important for taxpayers who reasonably rely on tax advisers to help them navigate our complex tax system, and qualifying advice should not be limited to formal, written legal opinions. While this formal advice may make it easier to demonstrate reliance, the law does not require it.

The Accuracy-Related Penalty Rules

Section 6662(a) generally imposes a 20 percent penalty on any portion of an underpayment of tax that is required to be shown on a tax return (the section 6662 penalty). The provision covers multiple types of underpayments, including those attributable to negligence or disregard of the rules and substantial understatements of income tax.1 However, the section 6662 penalty generally does not apply to any portion of an underpayment if a taxpayer can show there was reasonable cause for, and that it acted in good faith regarding, this portion (the reasonable cause defense).2 Whether a taxpayer acted with reasonable cause and in good faith is a fact-specific determination made on a case-by-case basis, taking into consideration all the facts and circumstances.3 The most important factor in determining whether reasonable cause exists is the taxpayer’s efforts to assess its proper tax liability in light of the circumstances, including the taxpayer’s experience, knowledge, and education.4

While reliance on professional tax advice does not per se entitle a taxpayer to relief under the

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1Section 6662(b).
2Section 6664(c)(1). Current section 6664 was incorporated into the code by the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239). Before 1989, the IRS had discretionary authority to waive all or part of an underpayment penalty under former section 6661(c) upon a showing of reasonable cause and good faith. Denial of a waiver under former section 6661(c) was reviewable by a court on an abuse-of-discretion basis.
3Reg. section 1.6664-4(b)(1).
4Id.; Salem Financial Inc. v. United States, 786 F.3d 932 (Fed. Cir. 2015); Slobie Creek Investments v. United States, 608 F.3d 1366 (Fed. Cir. 2010).
reasonable cause defense, it does entitle the taxpayer to relief if, under the circumstances, the reliance was reasonable and undertaken in good faith. For reliance on tax advice to be reasonable, a taxpayer must generally show that (1) the advice was based on all the pertinent facts and circumstances and on the law governing those facts and circumstances; (2) the advice was not based on any unreasonable factual or legal assumptions and did not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or another person; and (3) reliance on the advice was objectively reasonable.6

The reasonableness of a taxpayer’s reliance generally depends upon the quality and objectivity of the advice.7 Reliance is not reasonable if the taxpayer knew or should have known that the transaction was too good to be true. Reliance is also not reasonable if the adviser had a conflict of interest about which the taxpayer knew or should have known.8 For example, in Salem Financial Inc. v. United States, the Federal Circuit concluded that the taxpayer could not avail itself of the reasonable cause defense in connection with a structured trust advantaged repackaged securities (STARS) transaction9 because the taxpayer knew or should have known that the law firm that provided the taxpayer with a tax opinion had an inherent conflict of interest.10 In support of its conclusion, the court explained that (among other things) (1) the law firm and the accounting firm, the taxpayer’s principal advisers, were responsible for putting the STARS transaction together; (2) the taxpayer had selected the law firm on the accounting firm’s recommendation; (3) the law firm had been the tax adviser in a prior STARS transaction marketed by the same accounting firm; and (4) the law firm had sent the taxpayer a redacted copy of a favorable opinion prepared for another STARS transaction before the taxpayer had formally retained the firm.11 Thus, the court concluded that the taxpayer’s reliance on the law firm’s advice was not objectively reasonable.12

For purposes of the reasonable cause defense, advice is defined as:

Any communication, including the opinion of a professional tax adviser, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.13

Thus, a taxpayer can generally invoke the reasonable cause defense when it has provided an independent, competent tax professional with all of the relevant information and, in a manner consistent with ordinary business care and prudence, relies on that professional’s advice (in whatever form rendered) — as long as the reliance is reasonable and the taxpayer acts in good faith.14

Fundamentally, the facts of each case determine if reliance on any particular advice is reasonable.

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6Reg. section 1.6664-4(b)(1).
7Stobie Creek, supra note 4; see reg. section 1.6664-4(c)(1) (prohibiting a taxpayer from using the reasonable cause defense for reliance on advice that is regulation is invalid unless the position is properly disclosed). Circular 230 imposes similar requirements on practitioners regarding all written advice. In particular, Circular 230 requires practitioners providing written advice to (1) base the advice on reasonable factual and legal assumptions; (2) reasonably consider all relevant facts that the practitioner knows or reasonably should know; (3) use reasonable efforts to identify and ascertain the relevant facts; (4) not unreasonably rely on representations, statements, findings, or agreements; (5) relate the applicable law to the facts; and (6) not take into account audit risk. See Circular 230, section 10.37(a).
8Stobie Creek, supra note 4.
9Id. at 1381-1382.
10Although an explanation of the STARS transaction is beyond the scope of this article, in general it is a multistep transaction that enables a U.S. participant to realize an economic benefit by claiming foreign tax credits. For a more detailed discussion, see, e.g., Ajay Gupta, “Federal Circuit Follows Tax Court in STARS Case,” Tax Notes Int’l, June 15, 2015, p. 984. The Federal Circuit explained that the STARS transaction at issue in this case was “principally developed” by a non-U.S. financial institution and an accounting firm. Salem Financial, No. 2014-5027 at 2.
11Id. at 45-46.
12Id. at 45-46.
13Id. The court also quoted from an internal memorandum regarding the law firm’s compensation package for the transaction in which one of its attorneys indicated that he “intended to continue to exploit ties with [the accounting firm that the Federal Circuit identified as the principal marketer of the STARS transaction] . . . in connection with the development of structured tax products.” Id.
14See id. In addition, the court concluded that the taxpayer’s reliance on its advisers’ opinions (i.e., the tax opinion from the law firm and the advice that the taxpayer received from a second accounting firm) was unreasonable because the taxpayer should have known that the STARS transaction was too good to be true. Id. at 47.
15Reg. section 1.6664-4(c)(2) (emphasis added).
16See Neonatology Associates v. Commissioner, 299 F.3d 221, 234 (3d Cir. 2002), aff ’g 115 T.C. 43 (2000); see also United States v. Boyle, 469 U.S. 241, 250-251 (1985) (“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 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.’’).
under the circumstances. Thus, for example, off-the-cuff oral advice rendered by an expert without knowledge of all the facts is not sufficient, but oral advice conveyed by that same expert in the context of a thoughtful discussion of the facts should not be discounted merely because it is conveyed orally. An early-stage draft of a legal opinion based on incomplete and unverified facts likely does not provide a sound basis for the reasonable cause defense. In contrast, penalty protection should be available if comprehensive advice satisfies the criteria for the reasonable cause defense, even if only informally memorialized in an e-mail.

As a practical matter, a formal written opinion issued on or before the date of a transaction (and certainly by the relevant tax return filing date) is, of course, the ideal scenario. This provides a taxpayer with the most certainty because the content of the advice and the underlying facts and analysis are clearly evidenced in a dated, written document that can be physically produced to a court or the IRS. In reality, however, advice is often sought and rendered in different forms or even piecemeal over time. Practitioners often provide advice more informally, such as over the phone or via e-mail. This article seeks to remind practitioners and taxpayers that notwithstanding some unfortunate language in a handful of tax shelter cases, formal tax opinions do not have a monopoly on advice for purposes of the reasonable cause defense. Competently rendered, substantive advice received from an independent tax professional should never be precluded from penalty protection merely because the advice was conveyed in some form other than a formal, written opinion. Indeed, whether the reasonable cause defense is available is always a matter of fact. Advice conveyed by that same expert in the context of a thoughtful discussion of the facts should not be discounted merely because it is conveyed orally. Admittedly, proving reliance on oral advice can become an evidentiary issue if the matter is challenged or litigated. See, e.g., Wright v. Commissioner, T.C. Memo. 2014-175 (reasonable cause defense not available when tax opinion upon which taxpayer claimed to have relied expressly stated it “may not be relied upon and is not otherwise released” unless and until the taxpayer provided signed factual representations to the authoring law firm); Santa Monica Pictures LLC v. Commissioner, T.C. Memo. 2005-104 (tax shelter case in which the taxpayer attempted to rely on a preliminary and limited-scope basis study provided by an accounting firm. The court held that the reasonable cause defense was not available for the basis study because it was a draft document that expressly stated it could not be relied on “for tax return or other tax filing purposes,” as the scope of its review was limited and incomplete and the study was intended for internal purposes only). Reg. section 1.6664-4(c)(2).

Key Cases Discussing the Form of Advice

Several decisions have raised concerns over the form of advice required for a taxpayer to be able to use the reasonable cause defense. For example, in Long Term Capital Holdings LP v. United States, the court rejected the taxpayer’s reasonable cause defense based on its reliance on oral and written advice in draft form. Similarly, in Blum v. Commissioner, the court discounted advice provided in oral and draft form and focused intently on the completion of the tax adviser’s formal tax opinion. In Canal Corp. v. Commissioner, the Tax Court found the taxpayer’s reliance on an adviser’s legal opinion unreasonable in part because it was “littered with typographical errors, disorganized and incomplete.” In Gerdau MacSteel Inc. v. Commissioner, the court found the taxpayer’s reliance on an opinion unreasonable because it was unsigned. We will discuss each of these cases in more detail below.

In Long Term Capital Holdings, a series of related partnerships (collectively, “Holdings”) engaged in a multistep transaction involving the contribution and sale of high-basis stock in which tax losses were claimed. The IRS denied the losses and assessed penalties. Holdings asserted the reasonable cause defense to the section 6662 penalty based on its reliance on an opinion unreasonable because it was unsigned. For a discussion of the transaction involved in Long Term Capital Holdings, see Alvin C. Warren Jr., “Understanding Long Term Capital,” Tax Notes, Feb. 7, 2005, p. 681.

Sections 6662A (accuracy-related penalty specific to reportable transactions) and 6664(c)(2) (denying the reasonable cause defense to transactions lacking economic substance, within the meaning of section 7701(o)) were not yet in existence for the tax years at issue in Long Term Capital Holdings or the cases generally discussed in this article. Accordingly, the discussion is focused on the general penalty provision of section 6662(a), notwithstanding that tax shelter cases would now (also) generally come within the scope of these new provisions.

1830 F. Supp. 2d 122 (D. Conn. 2004), aff’d, 150 F. App’x 40 (2d Cir. 2005).
19737 F.3d 1303 (10th Cir. 2013).
20Id. at 1317.
21135 T.C. 199 (2010).
22Id. at 219.
23139 T.C. 67 (2012).
24330 F. Supp. 2d 122, aff’d, 150 F. App’x 40.
26Sections 6662A (accuracy-related penalty specific to reportable transactions) and 6664(c)(2) (denying the reasonable cause defense to transactions lacking economic substance, within the meaning of section 7701(o)) were not yet in existence for the tax years at issue in Long Term Capital Holdings or the cases generally discussed in this article. Accordingly, the discussion is focused on the general penalty provision of section 6662(a), notwithstanding that tax shelter cases would now (also) generally come within the scope of these new provisions.
27Interestingly, Holdings attempted to keep the written opinion out of evidence as privileged and protected under the work product doctrine, despite claiming reliance on it for penalty protection. See Long Term Capital Holdings, Dkt. No. 3:01-cv-1290 (D. Conn. 2002).
Holdings received the opinion about nine months after filing the relevant tax return. Although Holdings's in-house tax counsel testified that the company had received drafts before the final opinion was issued, it apparently could not produce copies or offer any evidence regarding the existence or timing of the drafts. Holdings also claimed that the law firm had orally communicated its conclusions, which Holdings had memorialized in an internal file memorandum dated one day before the tax return filing date. At trial, however, the attorney who had communicated the advice to Holdings admitted his oral advice covered only one of the three conclusions set forth in the subsequent written opinion, and Holdings made “no showing it ever saw [the other two] analyses before filing its tax return.”

Consequently, the district court held that Holdings could not prove it received the opinion before filing its tax return and, in the alternative, held that Holdings had not satisfied its burden to prove the content of any of the advice received before filing its return. Importantly, the court ruled that the advice failed to satisfy the threshold requirements of the reasonable cause defense because of the unreasonable factual and legal assumptions underlying the opinion and because of Holdings's lack of good faith. The Second Circuit affirmed. As with the opinion and because of Holdings's lack of good faith assumptions underlying the reasonable cause defense because of the unreasonable factual and legal assumptions, Holdings could not prove it received the opinion before filing its tax return. Accordingly, this case should not be viewed as limiting, or meaningfully speaking to, the form of advice required for penalty protection under the reasonable cause defense.

In Blum, the IRS had imposed a section 6662 penalty on an individual taxpayer for an offshore portfolio investment strategy transaction marketed by an accounting firm. The taxpayer asserted the reasonable cause defense based on a “more likely than not” tax opinion he received from the same accounting firm. The Tax Court rejected the taxpayer's defense because, inter alia, he had apparently not received a copy of the written opinion before filing his relevant tax return. According to the court, it was only after the taxpayer's tax return had been filed that he signed the representation letter and that the accounting firm finalized its opinion (although the opinion was then backdated to December 31 of the prior year). The Tax Court’s decision states that the “record does not indicate when or if [the taxpayer] received the tax opinion.” Thus, the court concluded that the taxpayer “did not actually rely on the opinion.”

The taxpayer also asserted that he had received oral advice from the same accounting firm, independent of the written tax opinion. However, the Tax Court made factual findings to the contrary, concluding that the firm “did not describe the tax opinion to [the taxpayer] when he was entering into the transaction” and that the taxpayer was unable to recount any oral advice that actually supported his reasonable cause defense. The Tenth Circuit affirmed, ruling the taxpayer could not claim reliance on the advice “because he filed the taxes at issue before receiving any advice.”

Both Blum courts highlighted multiple fatal defects with the advice that precluded section 6662 penalty protection, including material factual misrepresentations on which the opinion was premised, evidentiary shortcomings, and the adviser's inherent conflict of interest. Thus, as in Long Term Capital Holdings, this case does not stand for the proposition that informal writings or oral advice cannot provide penalty protection. To the contrary, the Blum courts concluded that the taxpayer did not satisfy many of the basic statutory and regulatory requirements of the reasonable cause defense, irrespective of the advice’s form.

35Id. at 151 (emphasis added).
36Id. at 159. Neither the Tax Court nor the appellate court discussed whether an earlier draft of the opinion had ever been provided to the taxpayer.
37Id.
38Blum, 737 F.3d at 1319 (emphasis added).
39Id. at 1318-1319.
40See also Crispin v. Commissioner, 708 F.3d 507 (3d Cir. 2013), aff’g T.C. Memo. 2012-70. The taxpayer in Crispin asserted that the reasonable cause defense to a section 6662 penalty was based on a tax opinion received from a law firm regarding a custom adjustable rate debt structure (CARDS). The Third Circuit upheld the penalty on the basis that the taxpayer’s reliance was unreasonable for a number of reasons, including false representations, the taxpayer’s education and background as a CPA, and because, before filing the relevant tax return, the IRS had promulgated guidance identifying the CARDS transaction as a listed transaction. The Third Circuit acknowledged that

(footnote continued on next page)
In Canal Corp., an accounting firm advised the taxpayer (Canal Corp.) and opined on the tax treatment of a multistep transaction involving the contribution of business assets to a leveraged partnership and a related distribution by that partnership to Canal Corp. The IRS argued that the transaction constituted a disguised sale under section 707 and asserted a section 6662 penalty. Canal Corp. asserted the reasonable cause defense, arguing that it had relied on a “should” tax opinion from the accounting firm. The Tax Court sided with the IRS.

In evaluating the reasonableness of the advice, the Tax Court reviewed a draft of the tax opinion. (The court suggests that the “original” opinion — which appears to be a reference to a final opinion — was not admitted into evidence.) The court expressed disdain for the opinion, for which Canal Corp. had paid an “exorbitant” $800,000, and criticized the document as a “haphazard draft” and questioned “how much time could have been devoted to a draft opinion…littered with typographical errors, disorganized and incomplete.” Of course, typos were not the court’s only concern — more fundamentally, the court took issue with the “numerous assumptions and dubious legal conclusions” underlying the opinion.

The court ultimately held that it was “inherently unreasonable” for Canal Corp. to have relied on the tax opinion. Specifically, the court concluded that the opinion did not provide penalty protection for a number of reasons, including unreasonable assumptions, unsupported legal conclusions, Canal Corp.’s bad faith, and the accounting firm’s inherent conflict of interest (because of the fee arrangement and because the firm planned and implemented the transaction on which it was opinioning). Thus, despite a harsh critique of the tax opinion’s form, here again, the court’s holding must be viewed in the proper context. Although the opinion reviewed by the court — which failed to satisfy almost all of the statutory and regulatory requirements of the reasonable cause defense — was not a polished legal opinion free from typos, this cannot be taken to mean that other forms of written advice, including less formal forms, cannot provide penalty protection.

Finally, in Gerdau MacSteel Inc., the Tax Court upheld a section 6662 penalty for a series of interrelated transactions that generated a large capital loss. Three months before filing its relevant tax return, the taxpayer (MacSteel) received a “more likely than not” opinion regarding the transaction from an accounting firm — the same firm that was also MacSteel’s auditor and return preparer, as well as the promoter of the transaction. The opinion was unsigned and labeled “draft,” but the accounting firm partner who later signed off on MacSteel’s tax return for that year referred to the opinion as a “final draft” and stated that he “believed it to be correct.” MacSteel prepared its tax return in accordance with this opinion (in consultation with the accounting firm), which the accounting firm then signed as the paid preparer. The accounting firm, however, never actually finalized or signed the tax opinion.

The court rejected MacSteel’s reasonable cause defense, concluding that MacSteel did not have reasonable cause or act in good faith for a number of reasons, including the “too good to be true” nature of a transaction generating a noneconomic loss, the opinion’s reliance on incorrect factual assumptions, and the accounting firm’s “obvious conflict of interest” as both the drafter of the opinion and promoter of the transaction. The court noted that MacSteel’s reliance on the tax opinion was not reasonable because, inter alia, the opinion was never finalized. The court did not elaborate on this final point.

46 Tellingly, the court suggested that the opinion was “more like a quid pro quo arrangement than a true tax advisory opinion.” Id. at 221.
47 139 T.C. 67.
48 Id. at 125.
49 Id. at 125. Although the engagement letter to MacSteel stated that the accounting firm could not confirm the conclusions it reached until the opinion letter was signed, the firm did state it might “informally indicate prior to that point whether or not . . . [it] anticipate[d] that a position taken by [MacSteel] should be sustained on its merits if challenged by the IRS.” Id. at 88.
50 Id. at 195-197.
51 Id. at 196.
Here again, there were myriad fatal defects with the tax advice at issue, the least bad of which being that the written opinion was never finalized by the accounting firm that both designed the transaction and signed the relevant tax return. Unfortunately, the court did not explain more clearly that this deficiency in form was merely one of many factors considered in an inherently factual analysis. Regardless, the court’s holding should be limited to its facts rather than construed more broadly to suggest that only formal legal opinions can ever constitute advice.

Conclusion

The availability of the reasonable cause defense for penalty protection depends on the particular facts and circumstances. Whether a taxpayer reasonably and in good faith relied on advice is a case-by-case determination that requires consideration of all the relevant facts and satisfaction of multiple requirements. None of these requirements, however, mandates a formal, written legal opinion. The cases discussed above do not change the law in this respect, and the critical language contained in the courts’ decisions should not be read to suggest that only advice communicated in a particular form can provide penalty protection. Rather, these cases should be viewed for what they are: a rejection by the courts of tax shelter transactions in which the advice allegedly relied upon suffered from numerous fatal defects, including unreasonable assumptions, unsupported legal conclusions, and conflicts of interest. While it may be true that it is easier to demonstrate reliance if a formal, written opinion was prepared, this should not be viewed as a requirement for penalty protection.