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Canal Corp. v. Commissioner, 135 T.C. No. 9 (Aug. 5, 2010)

The Tax Court ruled that the taxpayer recognized disguised sale gain under section 707 when its subsidiary contributed its appreciated business assets to a partnership that it entered into with another corporation. The other partner also contributed assets and effectively assumed all of the liability for the partnership's borrowing that funded a large special distribution to the taxpayer. The gist of the taxpayer's plan was to nominally assume enough of the partnership's liabilities so that its basis in its partnership interest would prevent taxation of the cash distribution. The gist of the court's opinion is that taxpayer did not in substance assume the liability, should not get basis for the assumption, and so received cash that was taxable to the extent of its gain in the business assets.

This ruling on the merits is a fairly straightforward application of an anti-abuse rule that can be applied to disregard assumptions of partnership debt by partners. The more surprising aspect of the decision is upholding the \$32 million accuracy-related penalty despite the receipt of an \$800,000 PricewaterhouseCoopers (PwC) "should" opinion (or perhaps because of that fee amount). If the grounds for calling the opinion unreliable for purposes of penalty protection were applied generally, they would call into question many practices currently followed by tax professionals.

The Partnership Interest Basis Issue

Reg. Sec. 1.752-2(b)(6) provides that a partner's obligation to make a payment may be disregarded if (1) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's risk of loss or to create a facade of the partner's bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation. The facts of the case revealed substantial planning around the taxpayer's desire to cash out of its business investment, PwC's advice to use a leveraged partnership to achieve that result on a tax deferred basis and the other partner's intention to bear the cost of the cash payment to the taxpayer.

The partnership terminated two years after it was formed, at which time the taxpayer reported the same taxable gain the court required it to include in the earlier year under audit. Therefore, the crux of the case was the interest and penalty. In addition, the other partner had to pay the taxpayer \$196 million for the lost tax benefit due to the early termination caused by the other partner.

The fundamental problem with the taxpayer partner's effort to get credit for part of the partnership debt through an indemnity agreement was that it had no net worth apart from the partnership interest and a note from its parent. The court did not give any weight to the note because (1) it was only 21 percent of the maximum indemnity amount, and (2) the partner's ownership of the note was at the mercy of the parent, which had the legal right to cause the partner to distribute the note at any time (which it did when the partnership terminated).

The "Should" Opinion

The taxpayer argued it should not be subject to a \$36 million accuracy-related penalty because it acted in good faith in relying on an opinion from PwC and had reasonable cause for its tax position. The court disagreed because of what it viewed as unreasonable assumptions and PwC's conflict of interest as a planner of the transaction, among other reasons.

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The court's opinion states that PwC gave a "should" opinion and that this is the highest level of opinion PwC gives (which does not seem likely, but the court's opinion recites it several times). At least according to this court, the following factors made the opinion unreliable for penalty purposes:

- PwC charged a flat rate of \$800,000, which had no relation to time spent writing the opinion.
- The court disbelieved the testimony of the attorney who wrote the opinion about his extensive time and effort in writing the opinion, based on the court's findings such as that only a draft opinion was delivered and that it had typographical errors.
- The attorney had no firm basis in the law for his conclusion that a partner could be treated as retaining liability for all of the partnership debt if it had net worth equal to at least 20 percent of the debt.
- The court indicated that it should not be possible for an advisor to issue its highest level of opinion (here, a "should" opinion) without direct on-point authority.
- The court believed that the high price of the opinion was the true explanation for why it was issued without direct authority.
- The legal reasoning in the PwC opinion made an unwarranted conclusion about the meaning of the law and assumed facts without testing the substance of those facts.
- Therefore, the client acted unreasonably in relying on the opinion.
- Furthermore, the client should have known that PwC was tainted by conflicts of interest: it determined the financial facts on which it made the assumptions that the court disliked; it made the non-tax determination of law that the partnership was properly formed; it was involved in drafting the various agreements on which it opined; no outside party was involved in the transaction with whom arm's length negotiations occurred because the other partner allowed the taxpayer to plan all of the aspects of the transaction relevant to its tax planning; the receipt of the exorbitant fee was contingent on the partnership being formed, which was contingent on the "should" opinion being issued. The person who wrote the opinion was a licensed attorney, but not "a practicing attorney," at the time he wrote the opinion for PwC.

The conflict of interest point is the most troubling. The court implies that (a) an attorney cannot ascertain facts, particularly financial facts, but must rely on representations or findings from some independent source; (b) a tax attorney (or perhaps a tax accountant) cannot render an opinion on non-tax law, but rather must obtain a legal opinion from another attorney; (c) an attorney becomes a promoter when he devises and documents a tax-advantaged way to do a transaction; and (d) an attorney cannot charge a fee for a legal opinion that reflects any considerations other than time spent, because to charge a premium due to the uncertainty of the issue necessarily makes the attorney a promoter of the transaction.

Perhaps the court would not state these conclusions so starkly, but they are implicit in its statements. Moreover, the court effectively announced that a "should" opinion can never be based on an interpretation of an ambiguous rule, in the absence of other authority (case, regulation) reaching the same conclusion on the point in issue. That is, reasoning by analogy cannot make a "should" opinion. This too seems a stretch for the court to make.

The court cites cases involving marketed tax shelter investments, such as a cattle breeding shelter, in which the only tax advice given was the K-1 provided by the partnership to which the taxpayer had paid its investment (*Mortensen v. Commissioner*, 440 F.3d 375, 387 (6th Cir. 2006)), a master record leasing shelter (*Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993)) or an insurance agent who sold a taxpayer a VEBA plan (*Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43 (2000), affd. 299 F.2d 221 (3d Cir. 2002)). By placing PwC in the same category as these promoters of tax shelters, the court substantially extends the concept of promoter.

Conclusion

This taxpayer did not engage in a "tax shelter" of the sort that generated uneconomic losses. Rather, it sought a deferred tax sale by monetizing its assets through a leveraged partnership. In and of itself, there is nothing wrong with such an effort. Unlike the loss generator "tax shelters," this type of tax planning will be tried again by other taxpayers. This opinion casts a looming shadow over such planning, particularly as it relates to penalty protection.

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