# "IT'S NOT MY FAULT": SCOPE OF REASONABLE CAUSE AND GOOD FAITH EXCEPTION TO TAX PENALTIES


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## INTRODUCTION

Presenting a successful penalty defense is an increasingly complex and multi-faceted challenge. The reasonable cause defense is further complicated by recent decisions holding taxpayers may be liable for penalties arising from transactions entered into before the transaction was subject to penalty.[1] However, with the exception of the new penalties for transactions lacking economic substance[2], Congress recognizes that taxpayers often have a good faith belief in the tax position taken on their return and its likelihood of success if challenged, and Congress therefore refuses to impose strict liability on taxpayers

[1] *See, e.g.*, *Soni v. Comm'r*, T.C. Memo 2013-30 (imputing knowledge of changes in the law to taxpayers); *McGehee Family Clinic, P.A. v. Comm'r*, T.C. Memo 2010-202. In *Soni*, the taxpayers engaged in a certain transaction beginning in 2001, which transaction in the IRS later identified as a "listed transaction" in a revenue ruling issued and effective three years later. T.C. Memo 2013-30. Despite the issuance of the revenue ruling, the taxpayers continued to engage in such transaction, even after it was classified as a "listed transaction." For the taxable year ending after the revenue ruling was effective, the IRS sought to impose a penalty under section 6662A (for understatements with respect to reportable transactions) on the taxpayers for engaging in such listed transaction. Part of the taxpayers' defense to such penalty was that they relied upon a favorable IRS determination letter issued in 2002, before the revenue ruling was issued. In upholding the penalty, the court found that the revenue ruling should have put the taxpayers on notice that they could no longer rely upon such determination letter and that the transaction was now a listed transaction—"[i]gnorance of the law is no excuse for noncompliance with the applicable law." *Id.* At *10.

[2] *See* § 7701(o). Unless otherwise indicated, all references to "section", "§", and "Code" are to the Internal Revenue Code of 1986, as amended (Title 26 of the United States Code) and all references to "Treasury Regulation §" or "Treas. Reg. §" are to the Treasury regulations promulgated thereunder.

for accuracy-related penalties.[3] Because most taxpayers cannot independently determine if their tax position is correct, taxpayers can rely on professional advice to determine their proper liability.[4] As a policy matter, the penalty regime recognizes that obtaining favorable tax opinions cannot serve as an insurance policy against penalties. Thus, tax advice must meet minimum standards of relevance and reliability in order to be reasonably relied on. Tax professionals are also subject to penalties and professional disciplinary action if they render advice that lacks the necessary level of authority and support.[5]

It is this interplay between substantive accuracy standards and the ethical rules and professional standards governing professional advice and the taxpayer-adviser relationship that has long puzzled many tax professionals and most taxpayers, and muddied the waters for some courts when reviewing a taxpayer's reasonable cause defense to accuracy-related penalties. The attached Levels of Certainty Chart demonstrates the distinctions between the various comfort levels of tax advice and compares the standards enforced on taxpayers versus the penalty and disciplinary standards imposed on practitioners under the various ethical and professional authorities.[6]

The professional and ethical standards imposed on tax practitioners focus on the **adviser**. Particularly, Circular 230 specifies a set of ethical standards for engagements in which a tax practitioner issues written advice on federal tax issues and imposes mandatory requirements on written advice in many circumstances.[7]

By contrast, the clear focus of the reasonable cause defense is on the **taxpayer**. The regulations make plain that the focus is the individual taxpayer, and not the adviser: "[t]he 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."[8] And, "[g]enerally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."[9] The regulations further provide that reliance on professional tax advice demonstrates reasonable cause and good faith if the taxpayer's reliance was, under the circumstances, reasonable and in good faith.[10] All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice, including the taxpayer's education, sophistication, and business experience.[11] The advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer.[12] Moreover, a taxpayer may not rely on advice that a regulation is invalid unless the taxpayer adequately disclosed the position that the regulation in question is invalid.[13] Taxpayers reasonably rely on advice that is based on all relevant facts and circumstances, not based on unreasonable factual or legal assumptions the taxpayer knows or has reason to know are untrue.[14]

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[3] *See* § 6664(c)-(d).
[4] Treas. Reg. § 1.6664-4(b)(1).
[5] *See generally* Circular 230; § 6694(a); AICPA Statement on Responsibilities in Tax Practice (SSTS) No. 1; ABA Formal Op. 85-352 (1985); ABA Formal Op. 314 (1965); MODEL RULE OF PROF'L CONDUCT R. 3.3.
[6] These rules have undergone significant changes in the past decade. We are advised that additional revisions to Circular 230 are forthcoming.
[7] *See* discussion *infra* at Part I.
[8] Treas. Reg. § 1.6664-4(b)(1).
[9] *Id.*
[10] *Id.*
[11] Treas. Reg. § 1.6664-4(c)(1).
[12] Treas. Reg. § 1.6664-4(c)(1)(ii).
[13] Treas. Reg. § 1.6664-4(c)(1)(iii).
[14] Treas. Reg. § 1.6664-4(c)(1)(ii).

Several courts have recognized this necessary distinction. For example, the Seventh Circuit in *American Boat* criticized the government's "great effort to shine the spotlight on the [tax adviser]" and focus on the adviser's history of providing faulty advice.[15] The focus of the inquiry instead, the court stated, is "on [the taxpayer]" and "whether, from the [taxpayer]'s perspective and in light of all the circumstances," the taxpayer had reasonable cause.[16] The Fifth Circuit in *Southgate* similarly acknowledged, "[the court's] focus is on the taxpayer's knowledge, not the tax advisor's."[17]

Generally, focusing on the taxpayer and taking into account all pertinent facts and circumstances in each case, no one fact is determinative. Discussed herein is an analysis of some of the pertinent facts and circumstances courts have considered in recent litigation. When asserting a penalty defense, counsel should consider the implications of each of these issues with respect to the particular facts of each case.

[15] *Am. Boat Co. V. United States*, 583 F.3d 471, 484 (7th Cir. 2009).
[16] *Id.*
[17] *See Southgate Master Fund LLC v. United States*, 569 F.3d 466, 494 (5th Cir. 2011).

DENTONS

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## I. ETHICAL STANDARDS FOR PROVISION OF TAX ADVICE

The provision of tax advice is generally governed by the professional and ethical standards imposed on tax practitioners under the penalty provisions of the Code, Circular 230 (Regulations Governing Practice Before the Internal Revenue Service), and AICPA Statement on Responsibilities in Tax Practice ("SSTS"). Additionally, lawyers are subject to the Rules of Professional Conduct of the state(s) in which they practice, and the ABA Guidance and opinions.[18]

### A. Penalty Provisions of the Code

Tax practitioners can be subject to civil penalties under several provisions of the Code, including sections 6694, 6700, 6701, 6707, and 6708. Most notably for purposes of this discussion are the return preparer penalties for an understatement of tax liability under section 6694. Under section 6694, a return preparer may be liable for penalties where he is chargeable with (i) causing the taxpayer to take "unreasonable positions" on the return or claim of refund, or (ii) willful or reckless misconduct in the preparation of a return or refund.[19] The penalty is equal to the greater of $1,000 or 50% of the income derived (or to be derived) by the preparer with respect to the return or claim.

For purposes of this statute, a position is unreasonable if (1) the position was unsupported by substantial authority; (2) the adviser lacked a reasonable belief that the position would be sustained on its merits; or (3) the position was not adequately disclosed.[20] Stated differently, a preparer will avoid penalties if there was substantial authority for the position,[21] if a reasonable basis for a position exists and the position is disclosed,[22] or if it was reasonable to believe that the position would be more likely than not sustained on the merits.[23]

A determination of whether there was "substantial authority" or a reasonable belief that the position would "more likely than not" survive an IRS challenge is the same determination as made with respect to the section 6662 accuracy-related penalties imposed on taxpayers.[24] The return preparer may also have a reasonable cause defense to the section 6694 penalties if, considering all the facts and circumstances, the understatement was due to reasonable cause and good faith.[25]

If the preparer acts willfully or with reckless or intentional disregard of the rules and regulations, the penalty is increased to the greater of $5,000 or 50% of the income derived by the preparer with respect to the return or claim.[26]

### B. Circular 230

Circular 230 imposes duties on tax practitioners representing taxpayers before the IRS.[27] Circular 230 generally governs four aspects of tax advice: best practices, general requirements, covered opinions, and all written advice. Although Circular 230 currently contains detailed requirements for covered opinions, a discussion of those rules is not included here because proposed changes have been issued that remove the

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[18] *See* the attached Levels of Certainty Chart.
[19] § 6694(a)-(b).
[20] § 6694(a)(2).
[21] § 6694(a)(2)(A).
[22] § 6694(a)(2)(B) (except with respect to tax shelters and reportable positions).
[23] Treas. Reg. § 1.6694-2(a)(1)(i).
[24] *See* Notice 2009-5, 2009-1 CB 309; Treas. Reg. §§ 1.6662-4(d)(3)(iii), (iv)(A), 1.6694-2(b)(2)-(3).
[25] § 6694(a)(2)(B)
[26] § 6694(b).
[27] Circular 230, 31 C.F.R. § 10.0 *et seq.*

"covered opinion" classification. Practitioners whose conduct falls short of the mandatory standards set forth with respect to the general requirements for all written advice remain subject to disciplinary sanctions, including disbarment, under both the current and proposed versions of Circular 230. This discussion will focus on those requirements.

### 1. General Requirements

Generally, Circular 230 has been revised to include, among other things, standards that are consistent with the penalty provisions of section 6694. Thus, Circular 230 prohibits practitioners from willfully, recklessly, or through gross negligence, signing a tax return or claim the practitioner knows contains a position that lacks a reasonable basis.[28] Additionally, a practitioner may not advise a client to take a position on a document, affidavit, or other paper submitted to the IRS (or advise the client to submit it) unless the position is not frivolous.[29] Further, a practitioner has an affirmative duty to inform a client of any penalties that are reasonably likely to apply to a position taken on a return if the practitioner advised the client about the position or prepared or signed the return.[30] And, a practitioner must inform a client of any penalties that are reasonably likely to apply to the client involving any document, affidavit, or other paper submitted to the IRS, and has an affirmative duty to inform the client of any opportunity to avoid penalties by disclosure, if relevant, as well as the requirements for adequate disclosure.[31]

### 2. Written Advice

Additional requirements are imposed on practitioners under Circular 230 with respect to all written advice. Circular 230 prohibits practitioners from giving written advice concerning one or more federal tax issues if the practitioner (i) bases the written advice on unreasonable factual or legal assumptions, (ii) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person, (iii) does not consider all relevant facts that the practitioner knows or should know, or (iv) takes 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.[32] Additionally, a heightened standard of care will apply in determining if the practitioner failed to comply with the requirements above if the practitioner knows or has reason to know that an opinion will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending an investment plan which has a significant tax avoidance or evasion purpose.[33]

## C. Statements on Standards for Tax Services

The American Institute of Certified Public Accountants (AICPA) also issues guidance for tax return preparers in the Statements on Standards for Tax Services ("SSTS").[34] Most relevant to this discussion are SSTS Nos. 1, 3, and 7.

SSTS No. 1 provides detailed standards for tax return positions or signing tax returns. Generally, a practitioner should not recommend a position that he knows "serves as a mere arguing position advanced solely to obtain leverage in a negotiation."[35] A practitioner also cannot prepare or sign a return unless she concludes the position has a reasonable basis and it is adequately disclosed. Whereas, the practitioner

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[28] Circular 230 § 10.34(a)(1).
[29] Circular 230 § 10.34(b)(1)-(2).
[30] Circular 230 § 10.34(c)(1)(i).
[31] Circular 230 § 10.34(b), (c)(2).
[32] Circular 230 § 10.37(a).
[33] *Id.*
[34] AICPA, Statements on Standards for Tax Services (Oct. 20, 2011).
[35] *Id*. At No. 1.

should not recommend a tax position unless there is a reasonable basis for the position and the practitioner advises the taxpayer to disclose the position. Further, the practitioner should not recommend a position or prepare a return unless he has a good faith belief that the position has at least a realistic possibility of being sustained on the merits. A realistic possibility of success generally requires a likelihood of success approaching 33%.[36] This is a significantly higher standard than imposed under the penalty regime or Circular 230.

SSTS No. 3 provides standards for certain procedural aspects of preparing a return, including standards for obligations to examine or verify supporting data or to consider information related to another taxpayer when preparing a return.[37] Under this provision, the preparer may in good faith rely, without verification, on information furnished by the taxpayer or third parties. The preparer should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent.

SSTS No. 7 provides standards concerning the form and content of advice to taxpayers.[38] The taxpayer should be informed that the advice reflects the adviser's professional judgment based upon the adviser's understanding of the law existing as of the date of the advice and that subsequent developments could affect the advice. The adviser generally has no obligation to communicate when subsequent developments affect the advice previously provided.

### D. Legal Ethics

Attorneys that represent taxpayers are also regulated under the ethical obligations imposed by the state Rules of Professional Conduct. The ABA opinions of the Committee on Professional Ethics explain these obligations. ABA formal opinions 85-352, 314, and 346 directly address the tax lawyer's ethical obligations. In Formal Opinion 315, the ABA first acknowledged the role of an attorney before the IRS as distinct from that of an attorney appearing before a tribunal. The Opinion provides that the lawyer may freely urge positions most favorable to the client as long as there is a reasonable basis for the position taken. The ABA restated the standard in Opinion 85-352, requiring a non-frivolous basis to "bring or defend a proceeding, or assert a controvert as issue therein." The Opinion provided that the lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no substantial authority in support of the position, and there will be no disclosure of the position in the return, so long as it is a position the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument.

Formal Opinion 346, issued in 1982, significantly heightened the standards of due diligence on attorneys in connection with the attorney's overall evaluation of a realization of tax benefits by requiring the lawyer to make additional inquiries of the relevant facts, where appropriate. The Opinion requires the lawyer to state whether the benefits "probably will be realized."

## II. POTENTIAL CONFLICTS OF INTEREST

As a general principle, a taxpayer need not challenge an independent and competent adviser, confirm for himself that the advice is correct, or seek a second opinion.[39] As the Supreme Court noted, "[m]ost taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney . . . would nullify the very purpose of seeking the advice of a presumed expert in the first place."[40] Thus, "[w]hen an accountant or attorney *advises* a taxpayer on a

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[36] *Id.*
[37] *Id*. at No. 3.
[38] *Id*. at No. 7.
[39] *United States v. Boyle*, 469 U.S. 241, 251 (1985).
[40] *Id*. at 251.

matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice."[41]

Where the adviser's independence is challenged, the taxpayer's reasonable reliance defense is also challenged if the taxpayer knew or had reason to know of the adviser's conflict of interest. The taxpayer's reliance on an adviser burdened with an inherent conflict of interest, which the taxpayer knew or should have known of, is likely unreasonable and will not support a penalty defense.[42] "What exactly constitutes an 'inherent' conflict of interest is somewhat undefined."[43] The focus of most courts is the adviser's independence[44] and whether it has been tainted, particularly where the adviser was a "promoter." Courts, however, have generally found no conflict of interest when a long-term relationship exists between the taxpayer and tax adviser, the advice is within the adviser's expertise, the adviser charges an hourly rate for the advice, and the adviser has no interest in the outcome of the transaction.[45]

Consistent with the regulations, the focus of this analysis is on what the taxpayer knew or should have known, such that an inherent conflict of interest in and of itself is not determinative of the taxpayer's reasonable reliance on a tax professional's advice.[46] In every case, it is the taxpayer's subjective and objective knowledge of a conflict of interest that matters.

### A. Adviser was a "Promoter"

Several courts have found that the independence of the adviser is compromised when the adviser also promoted the investment.[47] Thus, some courts have found the advice "must be from competent and independent parties, not from the promoters of the investment" or advisers who have a conflict of interest.[48] Whether an adviser was a "promoter" is not always clear. Until recently the term was not well-defined. In *Tigers Eye*, in dicta, the Tax Court defined "promoter" as "an adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction."[49] Several courts have since adopted that definition and found reliance on a promoter unreasonable.[50]

For example, in *106 Limited*, the court found that the taxpayer could not reasonably rely in good faith on the tax advice given by their advisers because they were "promoters" who structured the transaction and

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[41] *Id.*

[42] *See, e.g., Neonatology Assocs., P.A. v. Comm'r*, 299 F.3d 221, 234 (3d Cir. 2002); *Chamberlain v. Comm'r*, 66 F.3d 729, 73233 (5th Cir. 1995); *Pasternak v. Comm'r*, 990 F.2d 893, 902 (6th Cir. 1993). *Cf. Carroll v. LeBoeuf, Lamb, Greene & MacRae, LLP*, 623 F. Supp. 2d 504, 511 (S.D.N.Y. 2009) ("[I]f a law firm had an interest in the sale of a particular tax product, a court could conclude that its opinion would not provide protection from IRS penalties.").

[43] *American Boat*, 583 F.3d at 482.

[44] *See, e.g., Stobie Creek Invs. v. United States*, 82 Fed. Cl. 636, 715 (2008), *aff'd*, 608 F.3d 1366 (Fed. Cir. 2010).

[45] *See, e.g., Countryside Limited P'ship v. Comm'r*, 132 T.C. 347, 352-55 (2009).

[46] Teas. Reg. § 16664-4(b)(1).

[47] *See, e.g., Stobie Creek*, 82 Fed. Cl. at 715; *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11, 60 (2007), *aff'd in part and vacated in part*, 598 F.3d 1372 (Fed. Cir. 2010); *Mortenson v. Comm'r*, 440 F.3d 375, 387-88 (6th Cir. 2006); *106 Ltd.*, 136 T.C. at 79-80; *6611, Ltd. v. Comm'r*, T.C. Memo 2013-49.

[48] *Swanson v. Comm'r*, T.C. Memo. 2009-31 (citing *LaVerne v. Comm'r*, 94 T.C. 637, 652-653 (1990), *affd. without published opinion*, 956 F.2d 274 (9th Cir. 1992)); *see also Fletcher v. Comm'r*, T.C. Memo 2011-27 (finding that taxpayers did not establish a reasonable reliance defense where taxpayers relied on the advice of a tax preparation company connected with the promoter of the transaction and did not seek advice of independent tax professional); *Canal Corp. v. Comm'r*, 135 T.C. 199, 220-221 (2010).

[49] *Tigers Eye Trading, LLC v. Comm'r*, T.C. Memo. 2009-121, *57.

[50] *See, e.g., 106 Ltd. v. Comm'r*, 136 T.C. 67, 79-80 (2011) (quoting *Tigers Eye*, T.C. Memo. 2009-121), *aff'd*, No. 11-1242, 2013 U.S. App. LEXIS 12835 (D.C. Cir. June 24, 2012).

profited from its implementation by charging a flat fee contingent upon "mak[ing] the deal happen."[51] In that case, the advice was of a lawyer who solicited the taxpayer's involvement in a tax shelter and engaged accountants that had marketed similar tax shelters. The court noted, however, that courts "need to be careful in applying the [promoter] definition to some kinds of transactions", as the definition is likely only applicable "when the transaction involved is the same shelter offered to numerous parties."[52]

Similarly, in *Stobie Creek*, the court imposed penalties on the taxpayers due to a conflict of interest arising from the advisers' involvement in structuring the transaction.[53] In *New Phoenix*, the court found that because the tax advisers "actively participated in the development, structuring, promotion, sale, and implementation of the [tax shelter] transaction", the advisers had a conflict of interest.[54] Notably, though, in that case, the taxpayer expressed multiple concerns about the proper reporting of the transaction before the firm issued an opinion letter and the taxpayer knew of recent developments in tax law that called the firm's advice into question.[55]

By comparison, courts have found reliance on the advice of the taxpayer's long-time adviser more reasonable and often sufficient to establish the defense.[56] For example, in *Multi-Pak Corp.* the taxpayer was reasonable in relying on the CPA firm that prepared the taxpayer's returns for several decades.[57]

The *Rawls* decision highlights this distinction. In *Rawls*, the court concluded that the taxpayer could not have reasonably relied on the advice of its attorney-adviser, who promoted the transaction.[58] As in *106 Limited*, the Rawls court found the attorneys "were being paid to make the transactions happen", not simply to evaluate or tweak them and, as such, the taxpayer could not rely on their advice because they were promoters of the transactions involved. The court, however, held that the taxpayer's reliance on its CPA was reasonable and the CPA was not a promoter since he advised the taxpayer within his field of expertise, he followed his regular course of conduct in rendering his advice, and his compensation did not depend upon the outcome of the transaction but was based on his normal hourly rate.

A long-term relationship with the adviser, however, will not preclude penalties. In *Canal Corp.*, for example, the court held it unreasonable for a taxpayer to rely on the tax adviser despite the long-term relationship between the taxpayer and adviser.[59] In that case the taxpayer had a long-term relationship with PricewaterhouseCoopers and argued it was reasonable to rely on the trusted adviser with respect to

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[51] *Id.*; *6611, Ltd. v. Comm'r*, T.C. Memo 2013-49 (another case involving the same adviser where the court rejected taxpayer's reliance defense because the adviser was a promoter who arranged the entire deal for a flat fee); *see also Blum v. Comm'r*, T.C. Memo 2012-15, *50-52 (holding taxpayers' reliance on a large accounting firm unreasonable because the adviser was a promoter of the OPIS transaction at issue and structured, facilitated, and reported the deal for taxpayers and numerous other clients); *Rovakat, LLC v. Comm'r*, T.C. Memo 2011-225 (finding that the taxpayer did not reasonably rely on three different tax opinions where the opinions were procured by the promoter of the transaction at issue, the opinions made no specific mention of the taxpayer and the taxpayer had no personal contact with the attorneys rendering such opinions).

[52] *106 Ltd.*, 136 T.C. at 80.

[53] *Stobie Creek*, 82 Fed. Cl. at 715.

[54] *New Phoenix Sunrise Corp. v. Comm'r*, 132 T.C. 161 193-94 (2009), *aff'd*, 408 Fed. App'x. 908 (6th Cir. 2010).

[55] *Id.* at 194.

[56] *See, e.g., Allison III v. United States*, 80 Fed. Cl. 568 (2008) (although the advisers received a fee from the promoter, the court nonetheless found the taxpayer's reliance on his advisers to be reasonable where the taxpayer had a long, pre-existing relationship with the advisors and the taxpayer could "reasonably expect loyal, honest service from those reputable advisers"); *Multi-Pak Corp. v. Comm'r*, T.C. Memo. 2010-139, *8 (CPA firm that provided the advice in issue had prepared the taxpayer's returns since 1965); *Caterbury Holdings LLC v. Comm'r*, T.C. Memo. 2009-175.

[57] *Multi-Pak*, T.C. Memo 2010-139 at *8.

[58] *Rawls Trading, LP v. Comm'r*, T.C. Memo 2012-340.

[59] *Canal Corp.* 135 T.C. at 220-221.

the issuable transaction. The Tax Court, however, found an inherent conflict of interest because the adviser was involved in the developing, planning, structuring, and implementing of the transaction. The court found the adviser lacked the independence necessary to objectively analyze the merits of the transaction. As such, the court held the taxpayers did not act reasonably in relying on the advice. Similarly, in *Murfam Farms*, the court rejected the reasonable cause defense and reliance on advice from a long-time adviser from E&Y.[60] In that case, E&Y had served as the taxpayer's tax preparers and auditors for over twenty-five years.

A long-term adviser, although facially independent from the promoter, may have their independence challenged. In *Kerman* penalties were imposed against a taxpayer when the long-time accountant calculated the claimed loss based on the promotional materials provided instead of an independent analysis of the transactions at issue.[61] Under those circumstances the court found no basis for reasonable reliance on the accountant.

And, an in-house professional tax adviser may not qualify as an independent tax adviser.[62] In *Seven W. Enterprises*, the court held that the corporation acted with reasonable cause and in good faith in relying on the advice of its outside CPA and consultant, but that when the same adviser became employed by the corporation as vice president of tax, the advice was no longer independent and the corporation could not rely on it for penalty protection.[63] The court found that because the adviser-employee was not a person "other than the taxpayer" under Treas. Reg. section 1.6664-4(c)(2), the reasonable cause defense was not available to the corporation for the years he was employed. The court specifically noted, however, that it was not opining on "whether reliance on an in-house professional tax advisor may establish reasonable cause in other circumstances."[64]

In any event, because a court must consider all the facts and circumstances, the fact that the adviser was a promoter is not necessarily determinative. In *American Boat* the court refocused on the totality of the particular facts and circumstances of the case and found that the taxpayer's reliance on the advice was not *per se* unreasonable simply because the adviser was a promoter.[65] The court refused to find an inherent conflict on those grounds.[66] The court further refused to adopt a bright-line rule that a taxpayer could never rely upon the legal advice of the same adviser who counseled the taxpayer on the structuring. Although the court's finding of no inherent conflict did not depend on it, it is worth noting that the adviser had a long-term relationship with the taxpayer and the taxpayer did not approach the adviser seeking a tax shelter but approached the adviser to restructure his business. The court found the taxpayer had no reason to know that the adviser and its firm had structured similar transactions for thousands of other taxpayers.

Likewise, in *Klamath* the court accepted the reasonable cause defense and found no conflict of interest despite the fact that the attorney-adviser represented the investment firm that implemented the transactions.[67] The court found that the tax advice provided a "reasonable interpretation of the law" and

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[60] *Murfam Farms, LLC v. United States*, 94 Fed. Cl. 325, 293 (Fed. Cl. 2010). *But see 106 Ltd.*, 136 T.C. at 81 (taxpayer could not rely on the pitch of his long-time lawyer to enter into the tax shelter transaction), discussed *supra*.
[61] *Kerman v. Comm'r*, 713 F.3d 849 (6th Cir. 2013).
[62] *See Seven W. Enterprises v. Comm'r*, 136 T.C. 539 (2011).
[63] *Id.* at *13.
[64] *Id.* at *14.
[65] *American Boat*, 583 F.3d at 483.
[66] *Id.*
[67] *Klamath Strategic Inv. Fund v. United States*, 472 F. Supp. 2d 885, 904-05 (E.D. Tex. 2007), *aff'd in part and vacated in part*, 568 F.3d 537 (5th Cir. 2009).

complied with standards common to the profession and with the administrative standards of conduct under Circular 230.[68]

Similarly, in *NPR Investments*, where the court disallowed the penalties and upheld the taxpayer's reasonable reliance defense, the court found the adviser was a promoter.[69] In fact, at the time of the court's ruling, the adviser was convicted of tax evasion in connection with tax opinions he rendered. Because all the facts and circumstances still weighed in favor of reasonable cause and good faith reliance on that promoter, the court found the taxpayer successfully asserted his defense.

Further, in *Southgate*, the court reviewed the entirety of the circumstances and found the advisers competent and qualified, and not burdened by a conflict of interest.[70] In that case, the taxpayer sought legal advice from qualified accountants and tax attorneys concerning the legal implications of their investments and the resulting tax deductions. The Court noted that the taxpayer did not "shop" for an opinion to justify the tax positions but hired two professionals to write separate detailed tax opinions on the appropriate tax treatment.[71] The advisers did not originate the idea for the transactions at issue and neither marketed nor sold the transactions as pre-packaged product to the taxpayers.[72] Noting the sophistication of the taxpayer and his reliance on a literal and narrow reading of the law and the effort to comply with the black-letter law, the district court refused to "unduly penalize creative dealmaking and stymie financial innovation."[73] For all of these reasons, the court found the partnership acted in good faith and with reasonable cause in calculating the taxes, and ultimately denied penalties.[74]

Moreover, any review of the independence or a conflict of the adviser, including whether it was a "promoter" should always be a consideration of the facts and circumstances at the time of the transaction when the advice was received, and not at the time of trial, often years later.[75] Whether an adviser later engages in promoter-like business is irrelevant to the reasonable cause defense. Once more, the focus of the reasonable cause defense is the taxpayer and what the taxpayer knew or should have known about the adviser's competence and reasonableness of the advice at the time the taxpayer reviewed and relied upon the advice.[76] Thus, whether the adviser is later investigated or convicted of tax fraud is largely irrelevant.[77] Courts have consistently rejected the government's continued efforts to stay the proceedings where the promoter is under a criminal investigation.[78]

Similarly, facts regarding the adviser's professional or personal history that develop long after the transaction and after the advice was received are irrelevant to the taxpayer's reasonableness.[79] Thus, in American Boat, the fact that the adviser was later indicted for promoting invalid tax shelters had no

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68 *Id.* at 905.
69 *NPR Invs. LLC v. U.S.*, 732 F. Supp. 2d 676 (E.D. Tex. 2010).
70 *Southgate*, 651 F. Supp. 2d at 612-13, 636.
71 *Id.*
72 *Id.* at 633.
73 *Id.* at 668.
74 *Id.* at 668-69.
75 *See Esgar Corp. v. Comm'r*, T.C. Memo. 2012-35, *15-16 n.9. *But see supra* note 1.
76 *See American Boat*, 583 F.3d at 484 (reviewing the facts and reasonableness of the taxpayer as of 1998, when the advice was rendered).
77 *See, e.g., id.* at 474-75; *Esgar Corp*. T.C. Memo 2012-35 at *15-16 n.9.
78 *See, e.g., Hawk v. Comm'r*, T.C. Memo 2012-154.
79 *See, e.g., American Boat*, 583 F.3d at 474-75; *Esgar Corp.* T.C. Memo 2012-35 at *15-16 n.9.

impact on the taxpayer's reasonable cause defense.[80] Further, in *Esgar Corp.* the court disregarded the fact that the adviser's license was later suspended, and ultimately found no conflict of interest.[81]

### B. Adviser Profits Considerably

In determining whether a conflict of interest existed, some courts have placed significance on whether the adviser received considerable profits from the advice. The government often argues an inherent conflict of interest and unreasonable reliance on an adviser exists when an adviser profits considerably from rendering the advice, such as where he is compensated through a percentage of the gains sheltered or a flat rate. Some courts have adopted the government's approach and consider it sufficient to bar the defense, while other courts, more appropriately, consider it along with all other factors relevant to the entire analysis.

#### 1. Percentage of Gains Sheltered

Where the adviser's fees are conditioned on the taxpayer deriving the intended tax benefits, the transaction generally will qualify as a reportable transaction which cannot be relied upon to establish the reasonable cause defense.[82] Many courts have still considered the reasonable cause defense in those cases and found that such arrangement creates the type of conflict of interest discussed herein.

In *Stobie Creek*, the court found that even though "prior to the events leading to its public disgrace and dissolution of the law firm, . . . [the advisers] enjoyed a vaunted reputation in legal and tax matters," their involvement in structuring the tax shelters constituted an inherent conflict of interest.[83] Important to the court's decision was that the taxpayer's advisers received fees calculated as a percentage of the capital gains sheltered by their strategies.[84] The court noted the taxpayer's knowledge that the firms were financially interested in the implementation of the strategy diminished the reasonableness in relying on their advice.[85] In that case, the promoters further agreed to refund the taxpayers should they decide not to follow through with the shelter transaction.[86]

Similarly, in *Murfam Farms* the legal fees were calculated as a share of the purported tax loss supported in the tax advice.[87] The taxpayers understood that the more taxes they avoided by following the advice, the more they would pay the advisers. The taxpayers also failed to disclose the transactions on their returns despite several conversations with the advisers about the IRS Notice issued qualifying the transaction as a listed transaction.[88]

Because the taxpayer must know or should know about the conflict of interest, however, if the taxpayer is misinformed about the financial arrangement, a promoter fee will not discredit the taxpayer's reasonable reliance defense.[89]

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[80] *American Boat*, 583 F.3d at 474-75.
[81] *Esgar Corp.* T.C. Memo 2012-35 at *15-16 n.9.
[82] Treas. Reg. § 1.6011-4(b)(4).
[83] *See Stobie Creek*, 82 Fed. Cl. at 715.
[84] *Id.*
[85] *Id.*
[86] *Id.* at 652.
[87] *Murfam Farms*, 94 Fed. Cl. at 239.
[88] *Id*. at 242-43.
[89] *See, e.g., NPR Inv.*, 732 F. Supp. 2d at 681.

### 2. Flat Fee

The government often argues an inherent conflict of interest and unreasonable reliance on an adviser exists when an adviser profits considerably from rendering the advice, such as where he is compensated through a flat rate. Because professionals generally always have an interest in getting paid for their services, the compensation of the adviser should only be considered along with all other factors relevant to the entire analysis of the taxpayer's knowledge of a conflict of interest.

In *Canal Corp.*, the Tax Court emphasized the $800,000 flat fee the taxpayers paid for the legal services related to the opinion.[90] The court accused the taxpayers of attempting to purchase "an insurance policy as to the taxability of the transaction."[91] Significant to the court was the fact that the $800,000 flat fee was contingent on the advisers issuing a protective opinion and the transaction ultimately closing. The court found the advisers' interest in getting paid for their work created an inherent conflict of interest. The court's analysis was largely limited to this one factor.

This bright-line rule was squarely rejected in *American Boat*.[92] In that case, the government argued that an inherent conflict of interest existed because the taxpayer paid a large fee to the adviser to structure the transactions, which ultimately provided a large tax benefit for minimal risk. The court noted that, practically, "one in need of legal advice almost always has to pay something for it."[93] The court refused to accept the bright-line rule that a taxpayer may *never* rely upon the legal advice of the same adviser who counsels the individual on restructuring. Instead the court refocused on the totality of the particular facts and circumstances of the case and found that the taxpayer's reliance on the adviser's advice was not *per se* unreasonable simply because the adviser received a significant fee for the advice. The court found significant the fact that the taxpayer paid his counsel a flat fee for his services, which included restructuring work as well as in connection with the Son of Boss transaction. Further, the compensation was not calculated as a percentage of the tax benefits from the transaction and the client did not approach the attorney seeking a tax shelter. Focusing on the taxpayer's knowledge at the time, the court noted that the taxpayer "did not pay that fee thinking that as consideration he was getting a tax shelter."[94]

Similarly, in *Southgate*, the court noted that the taxpayer did not "shop" for an opinion to justify his tax position and did not seek the advice of anyone other than the law firm engaged to opine on the transaction.[95] There, the adviser was not a promoter and did not market the transaction to other taxpayers. Relevant to the court's analysis was the fact that the adviser provided ongoing oral and written tax advice to the partnership regarding the transaction, and also drafted transactional documents, participated in negotiations, and provided ordinary tax planning advice regarding every aspect of the transaction.

## C. Adviser Engaged in a Similar Transaction

In some instances the adviser may have arranged his personal finances to engage in a transaction similar to the transaction with respect to which the adviser provided advice to the taxpayer. In our experience, the government takes the position that this fact weighs against the adviser's reliability. Yet, the effect of the adviser's involvement in a similar transaction should be considered only to the extent that it bears on the taxpayer's reasonable reliance on the adviser. The reality is many taxpayers interpret the adviser's

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[90] *Canal Corp.*, 135 T.C. at 219-21.
[91] *Id*. at 221.
[92] *American Boat*, 583 F.3d at 483 ("We find no such bright-line rule in the case law and decline to implement one here.").
[93] *Id.*
[94] *Id.* at 485.
[95] *Southgate*, 651 F. Supp. 2d at 633.

personal financial participation in a transaction as confidence in the transaction and support for the reliability of the transactions.

### D. "Canned" Opinions

Where the taxpayer relies on an opinion that is not 100% custom drafted for that particular taxpayer, the government has argued that a "canned" or "pattern" opinion exists, and that taxpayers cannot reasonably rely on such opinions. The terms "canned", "pattern", or "cookie-cutter" typically refer to opinions issued as a pattern of a tax adviser and to multiple taxpayers with little distinction. The government often argues that a "canned" opinion is unreliable because it does not provide a basis for the reporting position taken by the taxpayers on their returns.

As a practical matter, although the requirement that the opinion take into account the particular motivations and circumstances of the taxpayer makes reliance on a canned opinion questionable, the canned opinion is not inherently unreliable. Courts certainly have not foreclosed a reliance defense merely because a canned opinion exists.[96] Instead, courts review the entirety of the facts and circumstances to consider whether the regulations' requirements are satisfied.

In *American Boat*, for example, the court set aside the fact that the adviser had provided similar opinions to thousands of other individuals often formulated using a template that ignored the specific economic realities of the transactions.[97] The court found the taxpayer had no reason to know that the advisers had structured similar transactions for other taxpayers. Instead, the taxpayer was merely returning to the same reputable attorney who restructured his business in prior years.

Similarly, in *Tigers Eye*, the court did not foreclose reasonable reliance on professional advice where the taxpayer relied upon a canned opinion and the adviser issued identical opinions to many other taxpayers.[98] Instead, the court noted that it will be necessary to evaluate the totality of the facts and circumstances including the circumstances in which the tax advice was arranged, provided, prepared, and produced to determine if it was unreliable.[99]

The relevant question, therefore, is not whether a canned opinion existed, but whether the opinion—and the tax advice as a whole—adequately addressed the facts and circumstances of the particular taxpayer. In many instances, what is labeled a "canned" opinion for one reason or another actually addresses the taxpayer's particular motivations and other pertinent circumstances.

As a practical matter, attorneys—as well as CPAs and other professionals—often rely on the legal analysis of other attorneys to avoid "recreating the wheel" when drafting opinions and other legal documents. Clients expect as much. Several law firms use template agreements and form pleadings. Such a practice promotes efficiency. Similarly, in the context of a tax opinion, the use of black-letter law or boiler-plate legal analysis is common. The fact that the adviser cut and paste the black-letter law from another opinion concerning a similar transaction seems to have little bearing on the taxpayer's reasonableness in relying on the adviser. Therefore, in *Southgate*, where the court found the taxpayer's reliance on the advice of counsel reasonable, the fact that the advisers used generic portions of another tax opinion "rather than reinvent[ing] the wheel" by drafting an entirely unique opinion was inconsequential.[100] Similarly, the fact that one opinion was cut and paste from a template, even with

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[96] *See, e.g., American Boat*, 583 F.3d at 477; *Tigers Eye*, T.C. Memo 2009-121 at *63-65. Similarly, practitioners are not prohibited from providing "canned" opinions under professional standards. *See generally* Circular 230.
[97] *American Boat*, 583 F.3d at 477.
[98] *Tigers Eye*, T.C. Memo 2009-121 at *63-65.
[99] *Id.*
[100] *Southgate*, 651 F. Supp. 2d at 634.

respect to the taxpayer's personal motivations for entering into the transaction was irrelevant.[101] The court apparently recognized that these practices are common and often not indicative of the taxpayer's knowledge or reasonableness.

Along those lines, in the real world, clients hire attorneys who have experience with transactions, issues, and cases similar to the client. Clients attribute great value to the likeness of the attorney's other clients and their issues. It follows, then, logically that the fact that an adviser advised many taxpayers regarding similar transactions would actually bolster the client's reliance on that attorney and strengthen the client's reasonable beliefs about the attorney's credibility and expertise.

### E. Stacking Opinions

In many cases, taxpayers have received advice in piecemeal from more than one adviser. Taxpayers are not required to duplicate work and have an adviser opine on all relevant pieces of a transaction. Instead the relevant query with respect to the taxpayer's reasonable cause defense is whether it was reasonable to rely on the opinions and whether it was reasonable for the adviser advising on the total transaction to rely on conclusions contained in a predicate opinion. From an ethical perspective, the reasonableness of the adviser's reliance is also the test: Circular 230 provides that the practitioner should not rely on unreasonable representations from the taxpayer or any other person.[102]

### F. Approval by other Professionals

The involvement of other sophisticated professionals and their acquiescence or outright approval of the transaction can have a significant impact on the taxpayer's reasonable beliefs about the adviser's competence and the transactions at issue.[103] In *American Boat*, the Seventh Circuit recognized that the acquiescence of sophisticated tax return preparers that do not object to the tax treatment of the taxpayer's transactions "is relevant to the overarching inquiry of whether his reliance on [the adviser] was reasonable."[104] In that case, two accounting firms were involved in preparing the taxpayer's personal and business tax documents. Neither firm objected to the tax treatment of the transactions, and one not only agreed with the analysis but also informed the taxpayer that its firm provides similar services. Because the preparers did not opine on the transactions, the taxpayer could not *rely* on the preparers' acquiescence. Nonetheless, the court found that from a taxpayer's perspective, the fact that the return preparers did not raise a red flag or otherwise indicate the transactions or advice were improper, suggested reliability and reasonableness of the taxpayer.

By contrast, in *Gustashaw*, the tax court afforded little weight to the approval of an enrolled agent who affirmed the legal advisers' reputation in the legal community, the quality of the tax opinion letter, and the protection that the letter would provide against penalties.[105] The enrolled agent, however, did not actually opine on the transaction's tax ramifications since the transactions invoked provisions of the Code to which he was unfamiliar.[106] While the enrolled agent reviewed the formal tax opinion letter and read the cited Code sections, he "did not independently consider whether they, or the cited caselaw, supported the opinion letter's conclusions because he did not doubt that they were correct."[107] The Eleventh Circuit explained on appeal that were the enrolled agent "equipped with the relevant tax expertise and rendered

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101 *Id*. at 634-36.
102 Circular 230 § 10.37; *see also* SSTS No. 3 (account's reliance on the statements and work of others).
103 *American Boat,* 583 F.3d 485.
104 *Id.*
105 *Gustashaw v. Comm'r*, T.C. Memo. 2011-195, *33, *aff'd*, 696 F.3d 1124 (11th Cir. 2012).
106 *Id*. at *8.
107 *Id*. at *16.

his own opinion as to the CARDS transaction's tax consequences, this argument would be more persuasive."[108]

## III. EVIDENTIARY ISSUES

### A. Witness Credibility

Because the taxpayer's reasonable cause and reliance on tax advice is a question of fact decided on a case-by-case basis,[109] in each case the judge must be convinced that the particular taxpayer was reasonable in relying on the particular adviser. Thus, when put on the stand or examined at trial, judges carefully weigh the credibility of a testifying witness, whether it is the taxpayer, adviser, or other witness. Because a trial court's "credibility determinations are entitled to the greatest deference" and will rarely be overturned on appeal, a witness' testimony can bear great weight on the entire case.[110]

#### 1. Taxpayers

A testifying taxpayer can leave an incredible impression on a judge and have a huge impact on the outcome of the case. Although the appropriate timing of the analysis of the taxpayer's reasonableness is at the time it received and relied on the advice, the taxpayer's reasonableness when examined and on the date of trial is at least as significant. Generally, where the taxpayer is honest and specific about the facts surrounding the tax advice, the judge is more likely to believe that the taxpayer acted similarly reasonable with respect to the advice, when rendered. Whereas, when a taxpayer comes across as dishonest, evasive, or hostile, the judge is less likely to find that the taxpayer acted reasonably and in good faith.

For example, in *American Boat* the court gave great weight to the taxpayer's testimony and credibility as a witness.[111] Based on the taxpayer's testimony, the court found the taxpayer did not know the transactions held no profit potential. The court admitted that this finding was largely due to the taxpayer's credibility on the stand. The taxpayer's credibility as a witness outweighed the fact that the profit potential of the transactions was highly unlikely. The Seventh Circuit noted that, in retrospect, making a profit on the transaction was "unlikely at best."[112] Still, focusing on what the taxpayer knew or should have known at the time it obtained the opinion letter and deferring to the trial court's credibility determinations, the Seventh Circuit affirmed the trial court's conclusions.

#### 2. Advisers

Likewise, the credibility of an adviser at trial can leave a significant impression on a court. The testimony of the adviser can serve a necessary component of the defense, particularly where there are evidentiary issues concerning the existence of the opinion.[113] For instance, the adviser may need to testify about the content of the advice where the advice was not reduced to writing. And, in some instances, the failure to submit the adviser's testimony can give rise to a presumption that if produced it would be unfavorable.[114]

In *Long Term*, for example, the court discredited the testimony of the adviser because he had an obvious stake in the outcome of the case since he was involved in drafting one of the opinions at issue and was

[108] 696 F.3d 1124, 1140 (11th Cir. 2012).
[109] *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1381 (Fed. Cir. 2010).
[110] *United States v. Erazo*, 628 F.3d 608, 611 (D.C. Cir. 2011).
[111] *American Boat,* 583 F.3d 484-85.
[112] *Id*. at 484.
[113] *See* discussion *infra* Part III.B.
[114] *E.g., Heller v. Comm'r* , T.C. Memo. 2008-232, *aff'd,* 403 Fed. App'x. 152 (9th Cir. 2010); *Wichita Terminal Elevator Co. v. Comm'r*, 6 T.C. 1158, 1165 (1946), *aff'd*, 162 F.2d 513 (10th Cir. 1947).

also a member of the firm representing the taxpayer in the litigation.[115] The court dismissed the adviser's testimony—along with the testimony of all the other witnesses—because the court found the adviser belligerent in responding to the government's cross examination and more adversarial than necessary. But, because much of the advice the clients received prior to filing the relevant returns was oral advice and the taxpayers had little evidence of the advice they actually received, the taxpayers needed the adviser to testify as to the substance of the advice.

Similarly, in *Canal Corp.* the court was greatly impacted by the adviser's inability to adequately respond to questions concerning his opinions.[116] The adviser, even after presumably preparing for trial, could not recognize parts of his opinion when asked about them in court.

Further, in *Gustashaw* the court was not persuaded by an enrolled agent that testified that he did not even understand the particular details of the CARDS transaction and that he did not have any expertise in the tax law involved.[117]

#### 3. Other Witnesses

Additionally, the court is often asked to weigh the credibility of other witnesses. For example, in *106 Limited*, the tax opinion represented that the taxpayer's purpose for entering into the Son-of-Boss transaction was because he believed there was reasonable opportunity to earn a reasonable pre-tax profit from the transaction.[118] The taxpayer testified that he made the investments to make money and entered into the transaction on the advice of a business partner's contact. The taxpayer's banker, however, testified that the taxpayer informed him that he entered into the transaction as a "tax strategy . . . and the intent was to lose money."[119] The Tax Court credited the testimony of the banker and found that the taxpayer participated in the transaction because of the "alluring tax benefit."[120]

### B. Proof of Advice

For purposes of a reasonable cause defense, the regulations clearly provide that advice not need be written in order to be relied upon.[121] Still, where a tax opinion was not reduced to writing prior to the filing of the tax returns, some courts have imposed heightened standards of proof and found the taxpayer unable to prove the advice existed.[122] Where the taxpayer relied on oral advice, the taxpayer may face the additional challenge of proving the existence of the advice.

The regulations specifically define "advice":

> The term 'advice' for this purpose means 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

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[115] *See Long Term Capital Holdings*, 330 F. Supp. 2d 122, 207-08 (D. Conn. 2004), *aff'd*, 150 Fed. App'x. 40 (2d Cir. 2005).
[116] *Canal Corp*. 135 T.C. at 220-21.
[117] 696 F.3d at 1140.
[118] *106 Ltd.*, 136 T.C. at 72-73.
[119] *Id*. at 73-74.
[120] *Id*. at 70.
[121] Treas. Reg. § 1.6664 -4(c)(2).
[122] *E.g., Long Term*, 330 F. Supp. 2d at 206-208; *Blum*, T.C. Memo. 2012-16 at *49-50.

relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty.[123]

Advice does not have to be in written form to be reliable. In the real world, legal advice is often provided orally and in piecemeal as business decisions are made.[124] The applicable regulations seem to recognize this.

Still, some courts have required more than what is required under the regulations. Some courts have ignored the regulations altogether and required a written opinion.[125] Others have focused on how well organized, written, and edited the opinion was, requiring a final version and discrediting drafts.[126] At the same time, courts have criticized advisers for spending too much time or charging clients for this careful and exhaustive work. This is particularly true when the firm charges a flat fee that is not directly indicative of the time spent on the opinion but conditioned by the closing of the transaction.[127]

For example, in *Long Term*, the court found the taxpayers could not satisfy the burden of establishing the applicability of the reasonable cause defense because it could not prove that it received the advice prior to filing its returns in 1998.[128] The taxpayers, like many, received oral advice from advisers that was later incorporated into a written opinion dated well after the taxpayer filed the returns. The court found there was no reliable basis in the record from which to conclude that, prior to claiming losses from the transaction at issue on its 1997 tax return, the taxpayers actually received the opinions on which it claimed to have relied. The court further held that even assuming the taxpayers "timely received some form of 'opinion,' there is inadequate evidentiary basis for accurately determining what it consisted of and what substantive analysis undergirded it."[129]

The court discredited the taxpayers' note to file the day before the returns were filed, which memorialized oral communications between the taxpayers and the advisers. In part, the email stated that the taxpayers discussed the allocations of the losses with the adviser and that the adviser would "issue an *opinion* that the allocation of such Loss, as described above, should be sustained; that is, it is properly allocable to [the taxpayers]".[130]

The court found that the email contained conclusory statements about the losses and merely parroted the language of Treas. Reg. section 1.6664-4(c) because, for example, the email stated that the advisers "considered all pertinent facts and circumstances and the current U.S. Federal Income tax law and administrative practice as it relates to such facts and circumstances."[131]

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[123] Treas. Reg. § 1.6664 -4(c)(2).
[124] Whether the mere omission or inclusion of an item on a return constitutes "advice" from the return preparer that the item was properly omitted or included is a fact-specific analysis. *Compare Woodsum v. Comm'r*, 136 T.C. 585, 593 (T.C. 2011) (reasoning the failure to include income from a swap transaction on the return was not advice since the taxpayers "knew their Form 1099 income should have been included [and] they lack[ed] reasonable cause for their preparer's failure to include the income" even though all of the information needed to properly report the item was provided to the tax return preparer), *with Hatfried, Inc. v. Comm'r*, 162 F.2d 628 (3rd Cir. 1947) (reasoning the taxpayers received advice that could be relied upon to avoid penalties when the taxpayer disclosed all the necessary facts to its accountant and the accountant failed to properly identify the taxpayer as a personal holding company on the return).
[125] *See Long Term*, 330 F. Supp. 2d at 207-08.
[126] *See, e.g., Canal Corp.*, 135 T.C. at 219.
[127] *See id.*
[128] *Long Term*, 330 F. Supp. 2d at 207-08.
[129] *Id*. at 207.
[130] *Id.*
[131] *Id.*

Additionally, the court discredited the testimony of the taxpayers concerning advice they received in drafts of the opinion prior to its issuance because there was no corroborative evidence offered regarding the existence or timing of the receipt of such drafts. The court found the taxpayer's testimony about advice received from the adviser prior to filing was either too vague or inconsistent to provide a basis for evaluating whether and what advice was actually received, much less whether it was based on unreasonable legal or factual assumptions or covered the law applicable to the transaction. For example, the court noted that the taxpayer made several representations about the adviser's involvement in aspects of the transaction included in the final opinion suggesting that the substance of the opinion was actually provided to the taxpayers before filing, but on cross examination admitted that he did not remember discussing specific representations and assumptions set forth in the final written opinion and on which its conclusions depended. The court noted that the taxpayer testified that he could not recall whether such assumptions were in drafts he reviewed, conceded that he had not read all authorities cited in the final written opinion, and acknowledged that he could not recall whether he was concerned about the absence of Second Circuit authority in the opinion or whether he had even discussed whether Second Circuit authority should be relied upon. The court therefore, rejected the taxpayer's proof of oral communications as a basis for advice relied upon prior to the filing of the return. The court similarly found the testimony of the advisers too vague and unreliable. Notably, though, the court was additionally focused on the idea that the partnership attempted to conceal the losses on its tax returns.[132]

In *Canal Corp.*, as mentioned above, the court focused on the fact that only a draft of the opinion could be found and that the author, even after presumably preparing for trial, did not recognize parts of the opinion when asked about them in court.[133] The court was additionally troubled by the significant amount of time the author spent on an opinion "littered with typographical errors, disorganized, and incomplete."[134]

In *Blum*, the court was troubled by the fact that the opinion was finalized after the filing of the taxpayer's return.[135] Although the taxpayers argued they also received oral advice from the adviser regarding the transaction, they failed to establish what the advice entailed and did not meet the burden of showing reliance on oral advice.

Ultimately, proving the existence of oral advice has been a challenge for many taxpayers. And, proof of the content of that advice and the corresponding analysis necessary to evaluate whether the advice was based on all pertinent facts and circumstances and reasonable assumptions is similarly difficult.

### C. Alternate Advice

It is well established that taxpayers generally must have followed the advice received from the professional adviser in order to rely on it for purposes of establishing reasonable cause.[136] Although seemingly straightforward, this element can become an issue when advisers provide alternative advice. Generally, a taxpayer follows the advice when it carries out the transactions at issue consistently with the transactional documents and descriptions as advised. Where the adviser provides several alternatives the taxpayer is "free to select among 'any of the bona fide alternatives developed by a tax advisor acquainted

[132] *Id.* at 211.
[133] *Canal Corp.*, 135 T.C. at 219.
[134] *Id.*
[135] *Blum*, T.C. Memo. 2012-16 at *49-50.
[136] *Southgate*, 659 F.3d at 494; *see also Barnes v. Comm'r*, T.C. Memo 2013-109 (finding that the taxpayer did not reasonably rely on the accountant's advice where the taxpayer did not respect the structure of the plan or act in accordance with the specific requirements of the plan as stated in the accountant's opinion; "[b]y failing to respect the details of the reinvestment plan set up by PwC, we find that petitioners have forfeited any defense of reliance on the opinion letter issued by PwC.").

with the relevant facts.'"[137] Thus, on appeal in *Southgate*, the Fifth Circuit rejected the government's claim that the taxpayer failed to follow the advisers' advice.[138] For its claim, the government relied on the fact that, in prior correspondence, the adviser provided alternative structures for basis-build. The court found the taxpayer followed the advisers' advice by selecting one of the several alternative structures for the transaction and carrying out the transaction consistently with the advice with respect to that option.

## IV. PRIVILEGE AND JURISDICTION ISSUES

In every case where the taxpayer intends to raise a reasonable cause defense to penalties, the taxpayer is put in the difficult position of determining whether to invoke the attorney-client privilege with respect to tax advice provided and forego any reliance on the legal opinion to support its reasonable cause defense, or to produce the legal opinion and waive the attorney-client privilege as to the subject matter. Asserting a defense of good faith reliance on professional advice to defend against penalties will waive the attorney-client privilege for all advice given on the subject matter.[139] When the penalty defense is raised, the taxpayer must determine if and when to waive the attorney-client privilege between the taxpayer and the adviser. The government often attempts to force a waiver early in litigation. Because the specific facts and the procedural stage of a particular case can have a significant impact on the timing of a waiver, the timing should be strategically considered by counsel based on the facts and theories of the case, as they develop.

### A. Partner-Level v. Partnership-Level Defense

The issues concerning privilege and waiver are particularly important in TEFRA proceedings, where taxpayers must also resolve the predicate jurisdictional issue of whether the defense should be raised at the partner or partnership level. The relevant question is whether the reasonable cause defense is a partnership-level defense (which must be raised in the partnership proceedings) or a partner-level defense (which should only be raised in a subsequent partner level claim).

#### 1. Background

Prior to the passage of the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982, the IRS audited partnership return items at the partner level. This proved to be an administrative nightmare following the syndication of limited partnerships in the 1970s, which sometimes had, literally, hundreds of partners. Thus, pre-TEFRA, the IRS had to locate the individual tax returns of each partner, coordinate those individual audits for consistency, and separately track the statute of limitations for assessment for each partner. This inefficient process placed tremendous burdens on the IRS and the courts while sometimes simultaneously yielding inconsistent results even among partners in the same partnership.

Fundamentally, the TEFRA rules require all partners in a TEFRA partnership to report "partnership items" consistently with the partnership's reporting. If a partner treats such an item consistently with the partnership's return, the IRS generally cannot adjust the treatment of that item on the partner's return except through a partnership-level proceeding. The tax effect of the partnership-level adjustments are then carried over to the partners' taxable income through mathematical computations that are billed to the partners.

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[137] *Id*. (*citing Streber v. Comm'r*, 138 F.3d 216, 221 (5th Cir. 1998)).
[138] *Id*. at 493-94.
[139] *See In re G-I Holdings, Inc.*, 218 F.R.D. 428 (D.N.J. 2003); *see also Long Term*, 330 F. Supp. 2d at 118 (finding the attorney-client privilege was waived with respect to both opinions and rejecting the taxpayer's position basing their reliance of counsel defense on only one of two tax opinions).

Before 1997, penalties were not considered "partnership items" and, consequently, could not be considered at all until the completion of partnership-level proceedings. This impediment to the administrative efficiencies that were the central goal of TEFRA was changed by the Taxpayer Relief Act of 1997, which amended portions of the TEFRA provisions so that penalties could be considered in the course of a partnership proceeding for partnership taxable years ending after August 5, 1997.[140] Section 6221 now provides that "the tax treatment of any partnership item (*and the applicability of any penalty*, addition to tax, or additional amount *which relates to an adjustment* to a partnership item) shall be determined at the partnership level."[141] Similarly, section 6226(f) describes the scope of a reviewing court's jurisdiction to include the determination of "all partnership items . . . and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item."[142]

A "partnership item" is defined to include items "required to be taken into account for the partnership's taxable year," as well as those "more appropriately determined at the partnership level than at the partner level."[143] This includes "the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc."[144] Whereas, a defense at the partner level is "limited to those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level."[145] One example of a partner-level determination is whether an <u>individual</u> partner has a reasonable cause and good faith defense.[146] A court does not have jurisdiction to consider a partner-level reasonable cause defense in a partnership-level proceeding.[147]

The temporary regulations issued in January 1999 and finalized in October 2001 explicitly state that the reasonable cause exception under section 6664(c)(1) is an <u>example</u> of a *partner-level* defense that is personal to the partner and dependent upon the partner's separate return.[148] The language of the statutory provisions and the underlying temporary and final regulations set the stage for bifurcated proceedings whereby (i) the partnership items would be litigated in a partnership-level proceeding (*i.e.*, the substantive tax phase of the case) and (ii) the reasonable cause defense could be raised in subsequent, computational refund suits initiated by the partners.[149]

Although the Regulation cites section 6664(c)(1) as an example of a partner-level defense, it does not foreclose a similar defense on behalf of the partnership in the partnership-level proceeding.[150] Several courts have considered the reasonable cause defense at the partnership level without even addressing a jurisdictional predicate.[151] More recently, the jurisdictional question has been a major component of the case.

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140 *See* Taxpayer Relief Act of 1997 §§ 1238(a), 1238(b)(1)(A)-(B), 26 U.S.C. §§ 6221, 6226(f).
141 § 6221 (emphases added).
142 § 6226(f).
143 § 6231(a)(3); *Weiner v. United States*, 389 F.3d 152, 154 (5th Cir. 2004).
144 Treas. Reg. § 301.6231(1)(3)-1(b).
145 Treas. Reg. § 301.6221-1(d); *Klamath*, 472 F. Supp. 2d at 904.
146 Treas. Reg. § 301.6221-1(d); *Stobie Creek*, 82 Fed. Cl. at 636.
147 *See New Millennium Trading, LLC v. Comm'r*, 131 T.C. 275, at *7 (2008); *Jade Trading*, 80 Fed. Cl. at 60.
148 *See* Treas. Reg. § 301.6221-1(c), (d) (for tax years beginning on or after October 4, 2001).
149 *See* Temp. Reg. § 301.6231(a)(6)-1T (moving penalties from affected item statutory notice proceeding to computational refund proceeding).
150 *Klamath*, 568 F.3d at 548; *see also Stobie Creek*, 82 Fed. Cl. at 703; *Rawls*, T.C. Memo 2012-340 at *28-30. *But see Clearmeadow Invs., LLC v. United States*, 87 Fed. Cl. 509, *521-22 (2009) (finding the reasonable cause defense unavailable at the partnership level).
151 *See, e.g.*, *Long Term*, 330 F. Supp. 2d at 208; *Santa Monica Pictures, LLC v. Comm'r*, 89 T.C.M. (CCH) 1157 (2005).

### 2. Partnership-Level Defense

Many courts have addressed the jurisdictional question and found a reasonable cause defense appropriate at the partnership level when the adjustment either relates to a partnership item and/or when the defense involves the conduct and reliance of a managing member. Some courts even preclude the defense in a later partner-level proceeding.[152]

#### a. Adjustment to a Partnership Item

Pursuant to the regulations, when the adjustment relates to a partnership item the reasonable cause defense can be raised at the partnership level.[153] Courts have considered the reasonable cause defense in the partnership proceeding, therefore, when the FPAA items are items that flow directly to the partner-level deficiency computation as a computational adjustment.[154] Stated differently, jurisdiction at the partnership level is proper when the defense is not personal to the partners, and does not depend on their separate returns.[155] Thus, for example, courts have found jurisdiction in a partnership proceeding to determine the defense with respect to underpayments attributable to adjustments to the partnership's inside basis in assets distributed to its partners.[156]

Where the penalties imposed in the FPAA require a determination of non-partnership items, however, courts have found the defense properly raised at the partner level.[157] For example, in *Cemco Investors*, the court found no jurisdiction to hear a penalty defense when the penalties required a determination of items of another entity involved in the transaction.[158] Similarly, courts have found no jurisdiction where the penalties related to the outside bases of the individual partners because the general rule is that outside bases are affected items, determined at the partner level.[159]

This general rule does not always apply, however, where "tiered partnerships" are at issue. A "tiered partnership" generally refers to a partnership that has one or more partnerships as partners. In those cases, the outside bases of the lower-tiered partnerships (or partners in the upper-tier partnership) are the inside bases[160] and partnership items of the upper-tier partnership, which is an "item required to be taken into account for the [upper-tier] partnership's taxable year."[161]

The issue is currently being considered by the United States Supreme Court in *United States v. Woods*, 471 Fed. Appx. 320 (5th Cir. 2012), *cert. granted*, 133 S. Ct. 1632 (Mar. 25, 2013) (No. 12-562).[162] Specifically, although neither party or the lower courts raised the issue, the Court directed the parties, without further detail, to brief and argue whether the district court had jurisdiction under 26 U.S.C. §

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[152] *See Alpha I, LP v. United States*, 93 Fed. Cl. 280, 290-300 (Fed. Cl. 2010).
[153] *See 106 Ltd.*, 136 T.C. at 75-76; *6611, Ltd.*, T.C. Memo 2013-49 at *75-76.
[154] *See Petaluma FX Partners LLC v. Comm'r*, 135 T.C. 581, 586 (2010), *remanded*, 2012 U.S. App. LEXIS 4011 (D.C. Cir. Feb. 27, 2012); *Petaluma FX Partners LLC v. Comm'r*, 591 F.3d 649, 655 (D.C. Cir. 2010).
[155] *Tigers Eye*, T.C. Memo 2009-121 at *54; *Arbitrage Trading LLC v. United States*, No. 06-202, 2013 WL 365601, *13 (Fed. Cl. Jan. 30, 2013).
[156] *106 Ltd.*, 136 T.C. at 75-76; *6611, Ltd.*, T.C. Memo 2013-49 at *75-76.
[157] *See Cemco Investors, LLC v. United States*, 515 F.3d 749, 753 (7th Cir. 2008), *cert. denied*, 555 U.S. 823 (2008).
[158] *Id.*
[159] *Petaluma FX Partners LLC v. Comm'r*, 591 F.3d 649, *655-56 (D.C. Cir. 2010), *aff'g* 135 T.C. No. 29.
[160] *See* Treas. Reg. § 1.705-2(a) (explaining the commonly-used terms "inside" and "outside" basis); *see also American Boat*, 583 F.3d at 747 n.1.
[161] § 6231(a)(3).
[162] The Court was petitioned to consider whether section 6662 applies to an underpayment resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in the property.

6226 to consider the substantial misstatement penalty for an underpayment "attributable to" an overstatement of basis.[163] The government argued that the district court had jurisdiction to impose the penalty because the issue was a partnership item.[164] Relying heavily on *Jade Trading* and *Petaluma*, the taxpayers argued that the court lacked jurisdiction to impose the penalty because it relates to a nonpartnership item, i.e., the partner-by partner determination of the partners' tax (or outside) bases in the partnership interests.[165] Interestingly, the government previously conceded this issue.[166]

**b. Conduct of Managing Partner**

Many courts have found jurisdiction to review the reasonable cause defense when the penalty relates to a partnership item and the defense is predicated on the conduct of the managing, general, or tax matters partner of the partnership, acting on behalf of the partnership. In those instances, the defense must be based on facts and circumstances common to all partners and must not rely on an individual partner's tax return or his unique conduct.[167]

Thus, for example, in *American Boat*, the court had jurisdiction to consider the reasonable cause defense in the partnership-level proceeding where the penalty related to a partnership item (inside basis) and the claim arose out of the conduct of the general partner.[168] Similarly, in *Rawls*, a partnership-level proceeding, the court had jurisdiction to determine the validity of partnership-level defenses to accuracy-related penalties attributable to adjustments of partnership items.[169] The court noted that the determination of reasonable cause and good faith is made "at the partnership level, taking into account the state of mind of the general partner."[170] Because the taxpayer was the sole owner of the general partner of the partnerships in question and the only individual with the authority to act on behalf of the partnerships, it was his conduct at the time the transactions were executed that was relevant for the purpose of determining whether the court should sustain the asserted accuracy-related penalties. Furthermore, in *Southgate*, the court, limiting its analysis to partnership items and penalties related to an adjustment in partnership items, found that the basis of the reasonable cause defense was the conduct of both the managing partner and the principal investor and manager of the partnership assets.[171] Finally, in *Alpha I*, the court found that it had jurisdiction and that it "must" consider the defense because it was offered by the partnership and not the individual partners.[172]

Conversely, in *Nevada Partners*, the court drew a fine distinction and refused to hear the defense at the partnership level since the partner was not a managing partner but was a "controlling partner" with final decision-making authority.[173] The court held that the partner would have to raise the defense in a partner-

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[163] *Woods*, 133 S. Ct. 1632 (Mar. 25, 2013) (No. 12-562).
[164] Brief for the United States, *United States v. Woods*, 133 S. Ct. 1632, 2013 WL 2406246, *28-34, 2012 U.S. Briefs 562 (May 30, 2013).
[165] Brief for Respondents, *United States v. Woods*, 133 S. Ct. 1632, 2013 WL 3816999, *21-24 (July 19, 2013).
[166] *See id*. (citing *Logan Trust v. Comm'r*, No. 12-1148 (D.C. Cir. Oct. 25, 2012) ("We agree that outside basis is an affected item, not a partnership item…").
[167] *See Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 548 (5th Cir. 2009); *Stobie Creek*, 82 Fed. Cl. at 703-04; *see also Long Term*, 330 F. Supp. 2d at 205-12. *Cf. Murfam Farms*, 94 Fed. Cl. at 244 (finding jurisdiction to review the reasonable cause defense to penalties because the adjustments were made to items of gain, loss, and dividends reported by the partnership, which were partnership items.).
[168] *American Boat*, 583 F.3d at 480.
[169] *Rawls*, T.C. Memo 2012-340 at *25-30.
[170] *Id*. at *30.
[171] *Southgate Master Fund v. United States*, 651 F. Supp. 2d 596, 667 (N.D. Tex. 2009), *aff'd*, 659 F.3d 466, 494 (5th Cir. 2011).
[172] *Alpha I*, 93 Fed. Cl. at 290-300.
[173] *Nevada Partners Fund LLC v. United States*, 714 F. Supp. 2d 598, 636 (S.D. Miss. 2010).

level action seeking a refund. Similarly, in *New Millennium*, the court refused to hear the reasonable cause defense since the partner was not the general or managing partner of the partnership, even though the partner was the majority 70% partner who brought the suit to challenge the FPAA.[174]

### 3. Partner-Level Defense Only

Some courts have found that the reasonable cause defense is only a partner-level determination that cannot be considered at the partnership level, presumably even if it arises out of the conduct of the general or managing partner.[175] In *Clearmeadow*, the court found the defense was a partner-level defense not available to the partnership during a review of the FPAA.[176] Citing *Klamath*, the taxpayer argued that the court's jurisdiction extends to penalties that relate to adjustments of partnership items.[177] The court criticized *Klamath* and cited the regulations, reasoning that the language does not provide a jurisdictional grant to consider the defense because it extends to the defense of "taxpayers", and the taxpayers are the partners, not the partnership.[178]

### 4. Preclusion

Where the government takes the position that the reasonable cause defense is a partnership-level defense, the following risk is triggered: if the court by chance agrees with the government and those defenses are not raised in the partnership-level proceeding, then the individual partners could be precluded from raising those defenses in a later, partner-level proceeding.[179] The general rule is that outside of a partnership-level proceeding, "[n]o action may be brought for a refund attributable to partnership items."[180]

Thus, if a partnership-level issue was not raised in that proceeding, or if the issue was resolved there adversely to the taxpayer, there is no jurisdiction to revisit the issue in a partner-level proceeding because section 7422(h) withdraws the waiver of sovereign immunity.[181] Consequently, the inquiry requires consideration of:

> [W]hether the refund action here is attributable to partnership or nonpartnership items. If the refund is attributable to partnership items, section 7422(h) applies and deprives the court of jurisdiction. If, on the other hand, the refund is attributable to nonpartnership items, then section 7422(h) is irrelevant, and the general grant of jurisdiction [for nonpartnership proceedings] is effective.[182]

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[174] *New Millennium*, 131 T.C. at 289-90.
[175] *See, e.g., Clearmeadow*, 87 Fed. Cl. at *521-22 (precluding the defense).
[176] *Id.*
[177] *Id*. at 520-21.
[178] *Id.*
[179] *See* § 7422(h); *see also Fears v. Comm'r*, T.C. Memo 2009-62 (finding that where the FPAA was unchallenged and the notice of deficiency included penalties that were determined at the partnership level, the court lacks jurisdiction to redetermine the applicability of the penalties).
[180] *See* § 7422(h).
[181] *See, e.g.,* Treas. Reg. § 301.6221-1(a); *Monti v. United States*, 223 F.3d 76, 78-9 (2d Cir. 2000); *Kaplan v. United States*, 133 F.3d 469, 473 (7th Cir. 1998); *Blonien v. Comm'r*, 118 T.C. 541, 551-52, 564 (2002) (finding no jurisdiction to consider partnership items in a partner-level case or to consider argument that partnership-level adjudication was incorrect).
[182] *Alexander v. United States*, 44 F.3d 328, 331 (5th Cir. 1995).

### B. Privilege Waiver

It is against this unstable and conflicting jurisdictional precedent that taxpayers must decide whether to forego any reasonable cause defense at the partnership level or instead, waive the attorney-client privilege and produce the adviser's opinions, potentially bolstering the government's argument with a "roadmap" of any weaknesses in the transaction at issue.

The taxpayer must, therefore, balance the advantages of raising the defense at the partnership-level and avoiding any later preclusion issues against the disadvantage of disclosing the privileged information—and roadmap—to the government.

One example of invoking privilege in the partnership proceeding is the taxpayers in *In re G-I Holdings* seeking to delay waiver of the attorney-client privilege to establish a reasonable cause defense until after the substantive tax phase of the case was completed.[183] The DOJ senior trial attorney vigorously litigated the privilege claim and won based on a waiver argument.[184] Following production of the putatively privileged documents, DOJ counsel argued to the court:

> [A] draft memorandum dated January 22, 1990, obtained from [the adviser], GAF's outside tax attorneys, identifies four "potent way[s] that the Internal Revenue Service could attack" [the transaction at issue] . . . Conceptually, the United States could not agree more with [the adviser]'s incisive road map of the many ways the [transaction at issue] can be recast as a transaction that is taxable . . . .[185]

In December 2002, the IRS in a non-authoritative internal coordinated issue paper took the formal position that under certain circumstances, the reasonable cause defense may be determined in the partnership proceeding.[186] The CIP concluded as follows:

> Partner-level defenses may only be raised through subsequent partner-level refund suits. See Treas. Reg. §§ 301.6221-1(d) and 301.6231(a)(6)-3. Good faith and reasonable cause of individual investors pursuant to I.R.C. § 6664 would be the type of partner level defense that can be raised in a subsequent partner-level refund suit. However, to the extent that Taxpayer effectively acted as the general partner and that the intent of the general partner is determined at the partnership level, it is likely that such partnership level determinations may also dispose of partner-level defenses under the unique facts of each case.[187]

Still, the government often attempts to force a waiver early on in the litigation. For example, in *Long Term*, the parties engaged in a meticulous privilege fight over the production of the adviser's opinion and the government's refusal to answer contention interrogatories regarding its position on the issue of whether the reasonable cause defense to penalties could be asserted in the partnership-level proceeding. The government waited until after the close of discovery and following the court's ruling in favor of taxpayer regarding the production of the adviser's opinion to answer the interrogatory directly, stating for the first time its view, which generally parroted the CIP.

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[183] *In re G-I Holdings, Inc.*, 218 F.R.D. at 430.
[184] *Id*. at 434.
[185] *See In re G-I Holdings Inc.*, Civ. No. 2:02cv03082, 2006 WL 381468, United States' Brief in Opposition to Debtor's Conditional Motion for Bifurcated Trial on Adequate Disclosure at 8 (D. N.J. 2006).
[186] *See* I.R.S. Coordinated Issue Paper UIL No. 9300.18-00, "*Basis Shifting*" *Tax Shelter* (Dec. 3, 2002) ("CIP").
[187] *Id*. at Sec. 7.

The government's tactics in *Long Term*—essentially a sword-shield argument—were indicative of a concerted effort to avoid taking a position contrary to its own regulations. Notably, since *Long Term*, the government, particularly the DOJ, has consistently cited the temporary and final regulations to argue that the reasonable cause defense can only be litigated in partner-level proceedings.[188]

The government's tactics themselves evidence an effort to gain the strategic advantage of compelling the production of the opinion for its consumption during the partnership proceeding without having to take a position contrary to its own regulations before the court. The government pulled out all the stops to find a waiver of the attorney-client privilege during the privilege fight. Notably, however, at no point during that fight did the government argue in its pleadings that it was proper to litigate any aspect of the reasonable cause defense in the partnership proceeding. Indeed, the government only took that position after losing the privilege fight.

The government's litigation tactics and pattern of conduct described above have become quite common in tax cases. Our experience is that courts often show the government great deference in the discovery process, and taxpayer litigants are often afraid of the very real risk of losing the goodwill of the court by dragging it into continual discovery disputes that are particularly prevalent in litigation with the government. Given the uncertainty and threat of waiver, many taxpayers choose to waive privilege, and produce the opinions at the partnership-level as part of a reasonable cause penalty defense.

[188] *See, e.g.*, *Clearmeadow Invs., LLC*, 87 Fed. Cl. 509 (asserting in partnership-level proceeding that reasonable cause defense may be invoked only by individual partners and then only in actions brought by those individual partners); *Klamath*, 472 F. Supp. 2d 885 (citing Temp. Reg. § 301.6221-1T, the government argued that the reasonable cause defense is a partner-level defense and TEFRA provides that the exclusive forum for asserting such defenses is through a refund proceeding); *Tigers Eye*, T.C. Memo. 2009-121 (citing Temp. Reg. § 301.6221-1T, the government argued that evidence of reasonable cause and reliance on counsel related solely to partner-level defenses and was jurisdictionally barred).