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Michael Lang
Chapman University School of Law
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Appearing at 53 BNA Tax Management Memorandum 3 (January 2, 2012)
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The relationship between substantive federal tax law accuracy standards and the ethical rules and legal doctrines governing the relationship of lawyers and clients, particularly professional malpractice standards, has never been very clear. For example, consider the situation in which a tax lawyer provides a client a substantial authority opinion with respect to the client’s return position on a particular tax issue (assuming that the item would not be subject to a penalty if supported by substantial authority) and explains clearly the confidence level reflected in a substantial authority opinion and the risk of an Internal Revenue Service (“Service”) challenge. If the Service and the courts reject the client’s position, it seems clear that if the position was in fact supported by substantial authority, the lawyer should neither be subject to discipline nor be liable in malpractice to the client. But suppose the lawyer failed to explain the confidence level reflected in a substantial authority opinion. While this is not necessarily inconsistent with the lawyer’s obligation as a return preparer with respect to advising the taxpayer to take the position on the return, it seems like a clear ethical violation, and, depending on a variety of other factors, such as proof of causation and damages, the lawyer might be liable to the client in malpractice.

By contrast, assuming the lawyer clearly explained what a substantial authority opinion means for the client, suppose the return position is rejected by the Service and the courts, with both concluding that the position was not supported by substantial authority. Does this mean the lawyer has violated the ethical duty of competence? Competence in this respect depends on

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1 A taxpayer may avoid a substantial understatement penalty under Internal Revenue Code (IRC) § 6662 to the extent attributable to the tax treatment of an item for which there is or was “substantial authority,” provided the item is not attributable to a “tax shelter.” IRC § 6662(d)(2)(B)(i) & (C) (defining “tax shelter” item exception). Similarly, a return preparer with respect to a tax return position which results in an understatement of tax liability may avoid a penalty under IRC § 6694 with respect to the position if there is or was “substantial authority” for the position provided the position is not with respect to a tax shelter or a reportable transaction. IRC § 6694(a)(2)(A) and (C).

2 The meaning of the phrase “substantial authority” is explained at some length in Treas. Reg. § 1.6662(4)(d). For present purposes it is enough to understand that a position supported by substantial authority is one that could ultimately be resolved either for or against the taxpayer and that the taxpayer’s position does not have to be regarded as more likely that not to prevail.

3 See IRC § 6694(a)(2)(A) (no penalty on preparer if position supported by substantial authority).

4 See Model Rules of Prof. Conduct (hereinafter “MRPC”) 1.4.

5 See MRPC 1.1.
many factors, but “may require some level of expertise in a particular field of law,” whatever that might mean in this context. Might the lawyer be liable in malpractice under a contract theory of malpractice (the court having concluded that the position was not supported by substantial authority) or is the lawyer allowed the leeway to argue that the substantial authority opinion was one that a lawyer in the legal community (general tax lawyers?) of which he was a member could reasonably have given.

It was with these kinds of questions in mind that I read the Tax Court’s 2010 decision in *Canal Corp. v. Commissioner* (hereinafter referred to as “*Canal Corp*” or “*Canal*” when referring to the case, while “Canal” will be used to refer to the taxpayer). The penalty portion of the case, extending the principles of other cases, presents another area of difference between the tax law and the rules of professional ethics or other aspects of the law governing conflicts of interests, such as professional malpractice actions and motions to disqualify counsel. The differences may in some situations prove very costly to the tax professionals involved.

The *Canal* court held that a contribution of assets by Canal’s subsidiary, WISCO, to an LLC followed by the LLC’s distribution to WISCO of borrowed funds nearly equal to the value of the assets transferred was really a disguised sale of the assets, triggering a substantial tax liability and a nearly $37 million substantial understatement penalty. In upholding the penalty, the court rejected Canal’s defense that an opinion provided by PricewaterhouseCoopers (PWC) to the effect that the transaction “should” result in deferral of the gain involved provided Canal a good faith, reasonable cause defense under Internal Revenue Code (IRC) § 6664(c)(1). Both the holding with respect to the taxability of the disguised sale transaction itself and the holding with

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6 Id., Comment [1].
7 Of course, if the lawyer expressly agreed to provide a “substantial authority” opinion, there would seem to have been a breach of contract, but it is quite possible that the lawyer agreed to provide an opinion or to provide advice, without indicating what the level of the advice would be.
8 See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS (ALI 2000) § 52(1) and Comment b, stating that the standard of competence and diligence is one of “reasonableness” under the circumstances, referring to “normal professional practice” in “the professional community ... of lawyers undertaking similar matters in the relevant jurisdiction.”
9 135 T.C. 199.
10 Canal is the successor to Chesapeake Corporation, which actually undertook the transaction; for ease of reference, the taxpayer will be referred as Canal throughout to refer to either. However, those looking at the opinion or other references to the case are cautioned that neither the opinion nor other commentators follow this practice.
11 Much of my discussion applies to tax lawyers as well as CPAs. In fact, the principal tax professional involved in *Canal Corp* was a tax lawyer by training and experience (previously with the now defunct law firm of Jenkins & Gilchrist) who was at the time employed by PricewaterhouseCoopers. Both groups of professionals are subject to the conflicts of interests provision of Circular 230, § 10.29, and, to the extent they provide tax advice or opinions to clients, are subject to similar malpractice standards. Because conflicts rules are more highly developed in the legal profession, references to ethical rules will be those of the legal profession. This also seems appropriate since MRPC 1.7 is the source for Circular 230’s conflicts provision.
respect to the penalty have been the subject of considerable commentary, mostly critical.\textsuperscript{12} Regardless of the merits of such criticism with respect to the particular facts of the case,\textsuperscript{13} the court’s approach to interpreting section 6664(c)(1) has serious implications for both possible tax malpractice litigation and Bar or IRS disciplinary actions. It is these implications that this article will address.

Basically, the Canal court appears to hold that if the taxpayer’s professional tax advisor, albeit otherwise fully qualified to provide tax advice, is intricately involved in planning a transaction and has an “inherent and obvious conflict of interest,”\textsuperscript{14} it is unreasonable for a taxpayer to rely on the advisor and, as a result, reliance on the advisor’s opinion does not establish that the taxpayer acted with reasonable cause and in good faith.\textsuperscript{15} In effect, for penalty purposes, this seems to look to the reasonableness of the taxpayer’s behavior in determining whether the advisor’s opinion may provide a defense. By contrast, case law,\textsuperscript{16} the ethical standards of the legal profession\textsuperscript{17} and Circular 230,\textsuperscript{18} governing practice before the Internal Revenue Service, all address conflicts of interest by placing the burden on the practitioner to ascertain the existence of a conflict of interest, determine whether it is a conflict to which the client may consent, inform the client of the advantages and disadvantages of consenting to


\textsuperscript{13} The court’s apparent reliance on factual conclusions that may have been incorrect is particularly disturbing, for example, that the fee was only payable if the transaction closed (see Rubin et al, supra note 12; Lipton & Golub, supra note 12. On the other hand, the way in which the penalty issue was presented to the court left much to be desired. For one thing, Canal submitted only a draft of the PWC tax opinion. The draft was full of errors and part of the draft was not recognized by the author of the opinion. See Canal, supra, 135 T.C. at 219. The author thinks the case was nonetheless probably decided correctly.

\textsuperscript{14}Canal, supra, 135 T.C. at 221 and 222 n.16 (“taxpayers may not reasonably rely on an adviser tainted by an inherent conflict of interest that taxpayer had reason to know of”). There are a number of factors that supported the “Inherent conflict of interest” in the court’s view, but it is unclear whether each would have supported the decision independently, whether the presence of all of these factors in the aggregate was necessary to the court’s opinion, or whether the court would have reached the same conclusion only if at least more than one of the factors, if perhaps not all, had been present. Later in this article, the factors will be explored separately.

\textsuperscript{15} Browne, supra note 12, argues that the case law does not support a per se rule that says it is “unreasonable for a taxpayer to rely on advice from a tax adviser that planned a transaction and has a financial interest in its implementation.” 131 TAX NOTES at 1363. Moldenhauer, supra note 12, argues against a per se rule, preferring a rule that looks to all the facts and circumstances.

\textsuperscript{16} Many of the cases reported in this area involve disqualification motions. For a case involving a tax lawyer, see Para Technologies Trust v. Comm’r, 64 T.C.M. (CCH) 922 (1992). As explained infra, conflicts of interest in a malpractice context often provide the motive explaining why the lawyer might have provided what appears to be incompetent advice.

\textsuperscript{17} See M.R.P.C. 1.7 (general rule on conflicts of interest).

\textsuperscript{18} Circ. 230, § 10.29. Circular 230, including this rule, applies to anyone admitted to practice before the Service.
entering into or continuing the representation despite the conflict, and obtain the client’s informed consent before proceeding. From this perspective, the client is the party to be protected through required competence, diligence and communication by the practitioner in dealing with the client. Because Circular 230 applies to anyone who “practices” before the Service,19 this perspective also applies to CPAs, enrolled agents, registered return preparers and others who practice before the Service.20

The discrepancy between the Canal Corp court’s approach to conflicts of interest in applying the reasonable cause, good faith defense under section 6664(c) and the treatment of conflicts of interest in the law governing lawyers – in areas such as malpractice and disqualification of counsel motions - and the ethical rules governing tax practitioners has significant implications for both malpractice litigation and disciplinary proceedings. In a narrow sense, it raises the question of whether a tax firm (whether a law firm or a CPA firm) such as PWC or the individual practitioners involved in advising Canal are potentially subject to disciplinary action by a State Bar, State accounting regulatory authority or the IRS Office of Professional Responsibility (“OPR”),21 or whether a penalized client like Canal may have grounds for suing its tax advisors in malpractice as a result of the conflict of interest, perhaps in conjunction with other factors. More generally, it calls for an exploration of the relationship between the role of an “inherent” conflict of interest for section 6664(c) purposes and the regulation of tax practitioners under general principles of the law and ethical rules governing lawyers and other tax professionals. Perhaps more significantly, it suggests at least asking whether a conflict of interest on the part of a tax advisor that is sufficiently “inherent and obvious” to preclude the taxpayer’s reliance on the advisor’s opinion to avoid a substantial understatement penalty would also undermine the taxpayer’s malpractice action against the advisor based on the unreasonableness of the advice in the opinion. Or, to put it differently, would and should Canal have had a viable malpractice claim against PWC on the ground that the “should” opinion did not meet the standard of care expected from tax professionals providing such advice? To what extent is the conflict of interest involved relevant in answering this question?

From another perspective, Canal Corp also suggests a failure in the tax advisor/client relationship. PWC and Salomon Smith Barney suggested the leveraged partnership structure ultimately used for the Canal Corp transaction, quite possibly aware that the structure, while never approved by the Service as a technique for deferring tax on the sale of a business, was at

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19 “Practice” before the Service is defined very broadly to include, inter alia, “rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion.” Circ. 230 § 10.2(a)(4).
20 See Circ. 230 § 10.3 Who may practice.
21 Since PWC and the practitioners involved were acting as CPAs, Bar discipline might not be appropriate. However, one of PWC’s practitioners, David Miller was a licensed attorney and might also have been subject to discipline by the Bar in his state of licensure. CPA regulatory authorities also have conflicts of interest rules. See AICPA Code Prof. Cond. § 102-2.
least discussed as an available technique by some practitioners.  However, several changes were made in the basic paradigm for the transaction, most apparently at Canal’s suggestion. Each of these changes undermined the tax viability of the transaction. Yet, there is no indication that PWC ever hesitated in its commitment to provide a “should” opinion, warning Canal in effect that the requested changes might undermine the tax viability of the transaction.

*Canal Corporation* Transaction

The facts of the case can be summarized briefly. Canal Corporation (then known as Chesapeake Corporation, but referred to herein as Canal) wanted to sell its wholly-owned subsidiary WISCO, which was engaged in the tissue business, but its large built-in gain in WISCO made a direct sale undesirable because of the large taxable gain such a sale would produce. Consultation with Salomon Smith Barney (Salomon) and PWC led to the choice of a leveraged partnership structure. The basic plan called for (1) WISCO to transfer all of its tissue business assets to a joint venture, in the form of an LLC, in return for a minority interest in the LLC; (2) Georgia Pacific (GP), the acquiring company, to transfer its tissue business assets to the LLC for a majority interest, (3) the LLC to borrow funds from an unrelated party and immediately distribute the loan proceeds in a special distribution to Canal, with (4) Canal guaranteeing the debt through a subsidiary (presumably WISCO). Canal made it clear “to PWC and Salomon that the asset transfer and special distribution had to be nontaxable for it to approve the transaction,” since the tax deferral allowed it to accept a lower valuation of WISCO’s business for purposes of the transaction. This basic paradigm has been referred to as “well known and accepted within the profession,” although this remark seems to have been

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22 See infra text accompanying note 27.
23 Nonetheless, while the extent of PWC’s explanation, if any, of the confidence level represented by a “should” opinion is not discussed in the court’s opinion, Canal was clearly aware that a “should” opinion did not mean the anticipated tax results of the transaction were a sure thing, since Canal represented to Moody’s and Standard and Poor’s that the only risk in the transaction was the tax risk. See 135 T.C. at 209.
24 The opinion states that Salomon “recommended” the leveraged partnership structure as “the best alternative for maximizing shareholder value.” 135 T.C. at 203. This presumably reflected the deferred tax treatment as to which PWC would have provided input.
25 It is not entirely clear whether Salomon and PWC originally proposed that the debt be guaranteed through a subsidiary and, if so, whether WISCO was envisioned as playing that role.
26 135 T.C. at 204-205.
27 See Moldenhauer, supra note 12, at 22 n. 59 (citing several CLE publications, all of which appeared after the *Canal Corp* transaction); Robert Willens, “Tribune’s Divesture of the Cubs Reprises “Levpar” Structure,” 2009 TNT 212-6 (Nov. 5 2009), indicating the Chicago Tribune intended to use a leveraged partnership structure to sell the Cubs, but noting that it “seems clear that the Service is generally hostile to levpar transactions and might be expected to challenge Tribune’s attempt to exploit this technique. It is instructive to note that there has never been a case that has analyzed the efficacy of this strategy and, therefore, there is no precedent for assessing the merits of the Service’s position on these transactions.” See also Blake D. Rubin, Andrea Macintosh Whiteway &
directed at the general paradigm without the limitations that Canal sought on the indemnity agreement.\textsuperscript{28}

PWC had a long history as Canal’s return preparer and auditor.\textsuperscript{29} Through one David Miller (Miller), a licensed attorney (who was with Jenkins & Gilchrist) before moving to PWC’s predecessor firm,\textsuperscript{30} PWC advised that Canal only needed to indemnify the guarantor of the debt to defer the tax, not actually guarantee the debt, and structured the indemnity agreement on this basis. The requirement is that the “seller” actually be liable for repayment of the indebtedness; agreeing to indemnify the guarantor could satisfy this requirement if the indemnity agreement had substance.\textsuperscript{31} From a non-tax standpoint, however, the indemnity was unnecessary because GP agreed to guarantee the debt and did not require an indemnity agreement from Canal. (Furthermore, GP later refinanced the debt through its own finance subsidiary.) This fact weakened the viability of the plan, perhaps not enough to matter in itself, but more followed. At Canal’s request, the indemnity was made an obligation of WISCO, not Canal; was limited to the principal amount of the LLC’s debt, due in 30 years;\textsuperscript{32} required that GP proceed against the LLC’s assets before demanding indemnification, and provided for an increased interest in the LLC for WISCO if it had to make an indemnity payment. Miller does not appear to have questioned the impact of these variations on the leveraged partnership paradigm on the viability of the transaction, although he did advise that WISCO had to maintain a net worth of $151 million (that is, more than 20 percent of the amount of the debt) to avoid immediate taxation of the gain.

PWC was engaged to issue an opinion on the transaction, which was conditioned on PWC’s issuance of a “should” opinion. In addition to addressing the current taxability of the transaction, the opinion also concluded that the LLC was a partnership for tax purposes and that WISCO was partner in the partnership. The viability of the transaction depended on the opinions conclusions being correct on all three issues. Although the court did not really address the

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\textsuperscript{28} For example, the Tribune in the Cubs transaction was said to have guaranteed both the principal and interest on the indebtedness involved, unlike the situation with the indemnity in the Canal Corp transaction. See Willens, supra note 27.

\textsuperscript{29} Although the court does not refer to this fact, this is clearly a conflict of interest.

\textsuperscript{30} See 135 T.C. at 204 n.6, adding that Miller was not a practicing attorney when he gave the opinion.

\textsuperscript{31} Treas. Reg. § 1.752-2(b)(3)(i).

\textsuperscript{32} Assuming a discount rate of 6 percent, the present value of this principal amount at the date of the transaction would have been 17.41 percent of the stated principal amount. See Michael B. Lang, Elliott Manning & Mona L. Hymel, \textit{FEDERAL TAX ACCOUNTING} 393 (2\textsuperscript{nd} ed. 2011). At a discount rate of 8 percent, it would have been less than 10 percent of the stated principal amount.
question of whether the LLC was a partnership for tax purposes, this aspect of the transaction may also have been susceptible to challenge.33

A “should “opinion, according to the court, is “the highest level of comfort PWC offers to a client” about the strength of a tax position.34 The term “should,” however, is not defined in the Internal Revenue Code or the regulations. It is instead a term of art in tax parlance. “Should” is generally considered to mean a position’s likelihood of being upheld on the merits is more than 70%.35 This is not virtual certainty, but instead implies an element of uncertainty. As a result, the better view is that such an opinion should be “a reasoned opinion so that the reader can assess the degree of uncertainty.”36 It is unclear whether the opinion was a reasoned opinion that would have allowed Canal to assess the degree of uncertainty, although the court did indicate that Canal had reported to financial rating services that the only risk in the transaction was the tax risk.37

According to the court, Canal “agreed to pay an $800,000 fixed fee for issuing the opinion,” the amount not depending on the time spent or expenses incurred in the process.38 Some commentators have suggested that this fee was for more than just issuing the opinion, that is, that it also covered work on structuring and implementing the transaction.39 However, for purposes of discussing the implications of the decision, the fee will be assumed to have been paid for the opinion alone since the focus here is on doctrine as opposed to whether the judge got the facts correct in the particular case. PWC sent Canal a letter saying it would bill Canal this amount “at the closing of the joint venture financing.”40 The court later states that the “fee was

34 135 T.C. at 206.
35 Linda Galler & Michal B. Lang, REGULATION OF TAX PRACTICE (2010) at 100.
37 135 T.C. at 209. Evaluating this aspect of the tax opinion was probably further aggravated by the fact that the court apparently thought only a draft of the opinion was submitted in evidence. Commentators who reviewed the record found that the final tax opinion was also submitted into evidence and that the draft referred to by the court was actually a draft of a supporting memorandum. Rubin et al, supra note 12, 130 TAX NOTES at n.27. The author more recently attempted to obtain a copy of the tax opinion. When the request was first made, the transcript of the trial was on line, but it was necessary to have a clerk locate several Exhibits noted on the transcript, if possible, to determine which was the final tax opinion before requesting a copy of the opinion. When a follow up phone call was made on behalf of the author, the transcript was no longer on line, making a review of the final tax opinion impossible before submission of this article for publication.
38 135 T.C. at 206.
39 See, e.g., Lipton & Golub, supra note 12; Rubin et al, supra note 12, 130 TAX NOTES at text preceding n.73. These commentators are probably correct. The transaction was highly complex and involved much more work for PWC than just issuing the opinion. Indeed, the court mentions other work that PWC did on the transaction. See 135 T.C. at 204. Nonetheless, the court seems to clearly find that the fee was for issuing the opinion.
40 135 T.C. at 206.
payable and contingent on the closing of the transaction,” and that “PWC would receive payment only if it issued [Canal] a ‘should’ opinion on the joint venture transaction.”

The transaction took place according to the plan. On the same day that the “should” opinion was issued, reflecting Miller’s advice, GP and WISCO formed Georgia-Pacific Tissue, LLC (LLC), treated as a partnership for tax purposes. GP contributed its tissue business assets, valued at $376.4 million, in exchange for a 95 percent interest in LLC, while WISCO transferred to LLC its tissue business assets, valued at $775 million, in exchange for a 5 percent interest. LLC immediately borrowed $755.2 million from Bank of America and transferred the loan proceeds to Canal’s bank account that it maintained for WISCO. GP guaranteed the loan, which was later refinanced in two steps by a GP subsidiary. WISCO agreed to indemnify GP for any principal payments made under its guaranty. WISCO used some of the funds received to repay an intercompany loan, some to pay a dividend to Canal, some to repay debts to Canal, and then lent Canal $151.05 million in exchange for a 5-year 8-percent note. This note, together with a corporate jet worth $6 million, which was retained by WISCO, represented WISCO’s “maximum exposure on the indemnity.”

The Partnership Tax Issue

The underlying partnership tax issue in the transaction is fairly straightforward. The transaction was a classic taxable disguised sale of WISCO’s tissue assets under section 707(a)(2)(B) unless it qualified for the debt-financed transfer of consideration exception under the regulations. However, in order for this exception to apply, as a practical matter virtually the entire bank loan liability would have to be allocable to WISCO, so that WISCO would have sufficient basis in the LLC to render the distribution a nontaxable distribution that simply reduced WISCO’s basis in the LLC pro tanto. Although the loan was nonrecourse, GP’s guarantee made it recourse for purposes of the regulations. Under section 752, a partner’s share

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41 135 T.C. at 221. Commentators have criticized the latter conclusion, suggesting that the evidence did not support the finding that the payment was contingent on the closing of the transaction. See, e.g., Lipton & Golub, supra note 12, 113 J. Tax’n at 352; Rubin et al, supra note 12, text accompanying n.8. By the time the fee agreement for the opinion was entered into, PWC’s commitment to issue the opinion was probably already firm. In fact, this probably aggravated the conflict of interest Miller and PWC faced as Canal sought to limit the risk posed by the indemnity agreement. See discussion infra, text accompanying note 81. Regardless of whether the fee only covered the opinion or covered other work as well, given the long history of the parties’ relationship, if the deal fell apart, some sort of compromise fee would probably have been agreed upon.

42 This refinancing does not seem to have played a part in the court’s conclusion, although PWC issued two other opinions in connection with the refinancing. 135 T.C. at 208.

43 135 T.C. at 208.

44 Treas. Reg § 1.707-5(b).

45 See IRC §§ 731 & 733.
of a recourse partnership liability is the portion of the liability for which the partner bears the risk of loss. The regulations provide mechanical rules for determining which partner is at risk for which portion of the liability. These rules basically ask what would occur upon a so-called constructive liquidation, assuming that all partners or related parties with an obligation and an economic risk of loss will actually perform such obligations regardless of their net worth, “unless facts and circumstances indicate a plan to circumvent or avoid the obligation.”

Canal’s position, reflecting the opinion of Miller and PWC, was that the indemnity agreement was sufficient to support an allocation of the entire LLC indebtedness to WISCO. It seems unlikely that such a conclusion would be viewed as reflecting the real economics of the transaction, but this is certainly a plausible literal reading of the regulations as applied to the transaction up to this point.

However, a so-called anti-abuse rule in Treas. Reg. § 1.752-2(j)(1) provides:

An obligation of a partner or related person to make a payment may be disregarded … for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.

The court had no trouble finding this anti-abuse rule applicable, holding, after taking into account all the facts and circumstances, that the indemnity agreement had no economic substance and provided GP no real protection. The court noted that WISCO’s principal asset was an intercompany note, but that it was not required to retain the note or any other assets. Furthermore, the court noted that the indemnity agreement only applied to the principal amount of the indebtedness and required GP to first exhaust remedies against the LLC’s assets before pursuing WISCO. In fact, GP did not request the indemnity agreement and never requested or received any assurances that WISCO would retain any particular amount of net assets and, in fact, later refinanced the loan with its own finance subsidiary, suggesting the loan to the LLC was not even necessary. Furthermore, the court noted that the fact that Canal represented to Moody’s and Standard & Poor’s that the only risk associated with the transaction was the tax risk

46 Treas. Reg. § 1.752-2(a).
47 Treas. Reg. § 1.752-2(b).
48 Treas. Reg. § 1.752-2(b)(6).
49 Only a tax lawyer could even think this would be plausible.
50 However, WISCO did represent to PWC that it would retain assets with a fair market value at least equal to $151 million as long as the indemnity agreement was in effect. See Rubin et al, supra note 12, 130 TAX NOTES at n.53 and accompanying text. The court did not seem to regard this as important.
51 The court did not determine what the actual present value of this possible payment would be, a determination that would have supported the court’s conclusion. At the 8 percent discount rate reflected in the 5-year intercompany note from Canal that WISCO retained after the transaction, the present value of the principal payment due in 30 years was less than 10 percent of its face amount. See note 32 supra.
indicated that the indemnity agreement was designed to limit any potential liability to WISCO’s assets, at most. As a result, the court concluded that the indemnity agreement should be disregarded and the entire liability should be allocated to GP.

It has been suggested that a more reasonable result would have been to allocate an amount of the liability equal to the value of WISCO’s retained assets to WISCO. Aside from the fact that Canal never seems to have made this argument, it is undermined by the fact that there was no requirement that WISCO continue to hold any particular amount of assets. Also, the present value of the possible indemnity payment was probably substantially less than the amount of WISCO’s retained assets. Furthermore, the argument seems to be at odds with applying the anti-abuse rule on the theory that the indemnity agreement lacked substance.

The Penalty

There was no question that the court’s holding that the transactions resulted in a disguised sale of WISCO’s assets resulted in a substantial understatement of income tax, triggering a penalty unless Canal had a viable defense. It has been suggested that the penalty should not have been applied because Canal had substantial authority for its position. This suggestion is understandable, but probably mistaken. At the time of the transaction, section 6662(d)(2)(C)(ii) clearly stated that the provision exempting a substantial understatement from imposition of a penalty if the understatement was supported by “substantial authority” (section 6662(d)(2)(B)) did not apply to “any item of a corporation which is attributable to a tax shelter.” “Tax shelter,” for this purpose, was defined to mean any partnership, entity, plan or arrangement “if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.” Although some practitioners argued for a narrow construction of this

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52 135 T.C. at 213. If PWC played a role in this representation, the clear conflict between this representation and PWC’s tax opinion would further undermine the viability of the tax opinion.
53 Lipton & Golub, supra note 12, 113 J. Tax’n at 350.
54 See note 32 supra.
55 The deficiency of more than $183 million was more than both 10 percent of the correct tax of $217,576,519 or $21,757,651, and $10,000. See Canal Corp., supra, 135 T.C. at 217, applying section 6662(d)(1).
56 Rubin et al, supra note 12, 130 Tax Notes at Part III, 7th paragraph.
57 IRC § 6662(d)(2)(C)(iii). In fairness to the commentators referred to above, the original definition of “tax shelter” required that “the principal” purpose be tax avoidance, which might well have meant that it did not apply to Canal’s transaction. The statute was amended to replace the words “the principal” with “a significant” in 1997. P.L. 105-34, §1028(c)(2). To add to the confusion, the Treasury Department has never revised the regulations to reflect this change, although the amended definition (renumbered) was the subject of litigation in Valero Energy Corp. v. United States, 569 F.3d 626 (7th Cir. 2009), where the existence of a “tax shelter” undermined the availability of the federally authorized tax practitioner privilege of IRC § 7525, as discussed infra.
definition, the Seventh Circuit’s decision in *Valero Energy Corp. v. United States*,59 involving transactions for this purpose apparently very much analogous to the *Canal Corp* transaction, rejected such a narrow construction.60

Valero acquired Ultramar Diamond Shamrock Corporation (UDS), an oil company with Canadian subsidiaries. In connection with the acquisition, Valero consulted with Arthur Anderson (AA), both to review a plan Ernst & Young had provided UDS about restructuring and refinancing the Canadian operations and for further tax advice. Soon after the acquisition, Valero was able to realize $105 million in currency losses through transactions implemented with AA’s help. The dispute in the case concerned the application of the IRC § 7525 federally authorized tax practitioner privilege61 to documents the IRS sought from AA in connection with an audit of the transactions. At the relevant time, the privilege was not available with respect to written communications with a representative or agent of a corporation “in connection with the promotion of the direct or indirect participation” of the corporation in “any tax shelter” as defined in section 6662(d).62 Although the meaning of “promotion” in this context is debatable,63 it is the definition of “tax shelter” that matters for present purposes. The Court of Appeals had no trouble concluding that the Service had met its burden of showing that various documents requested concerning Valero’s transactions, albeit not clearly known, fell within the “tax shelter” exception and were not protected from disclosure. The court noted:

This definition of tax shelter is broad and could, as Valero points out, include some legitimate attempts by a company to reduce its tax burden. But it is not our place to tinker with the unambiguous definition provided by Congress. And even under this definition, tax shelters are not boundless. Only plans and arrangements with a significant – as opposed to an ancillary – goal of avoiding or evading taxes count.64

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59 569 F.3d 626 (7th Cir. 2009).
60 The exact nature of Valero’s transactions is not explained since the case involved an effort by the Service to gain access to documents that would allow it to figure out what Valero actually planned and implemented.
61 Section 7525 provides a limited privilege analogous to the attorney-client privilege to written communications between a taxpayer and a federally authorized tax practitioner in connection with obtaining tax advice.
62 The exception now applies to written communications with respect to the promotion of the participation of any person, as opposed to a corporation, in a defined tax shelter. See IRC § 7525(b).
Under this view, it seems fairly clear that since “a significant purpose” of the Canal Corp transaction was the avoidance of Federal income tax, despite the fact that an actual transfer of real business assets was involved, as was also the case in Valero’s acquisition of UDS, the Canal Corp transaction was probably a “tax shelter.” As a result, the “substantial authority” defense to the substantial understatement penalty was unlikely to have been available.

Even if availability of the substantial authority defense was not precluded by the tax shelter exception, it would have been difficult to argue that the Canal position was supported by substantial authority given the evidence in the case. The court’s description of how Miller and PWC concluded that the entire liability could be allocated to WISCO states that Miller “found no legal authority for” his test that, in effect, concluded that either all or none of the liability for the debt should be allocated to WISCO, and that his advice that WISCO hold assets worth at least 20 percent of its maximum exposure under the indemnity was based on an “irrelevant,” “obsolete” revenue procedure. While commentators have explained the technical argument that allocation of the entire liability to WISCO is possible under the regulations, more or less along the lines explained above, the bottom line is that the court found based on the largely undisputed facts that the transaction clearly implicated the anti-abuse rule of Treas. Reg. § 1.752-2(j). The court also noted that PWC’s opinion assumed that the indemnity would be effective, assumed that WISCO hold assets sufficient to avoid the anti-abuse rule, and failed to consider that the indemnity lacked substance, all of which suggest that substantial authority would have been hard to establish on the evidence offered.

Reasonable Cause and Good Faith

Canal argued that the substantial understatement penalty imposed by section 6662 did not apply because the taxpayer had a reasonable cause for the understatement and had acted in good faith. The court followed the regulatory directive that this requires consideration of all

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65 135 T.C. at 206.
66 135 T.C. at 206, 219.
67 See, e.g., Lipton & Golub, supra note 12, 113 J. Tax’n at 344 ff.
68 Supra text accompanying notes 46 ff.
69 135 T.C. at 220.
70 IRC § 6664(c)(1). The burden of proof on the penalty issue was supposedly borne by the Commissioner because it was only asserted in an amended answer. See Canal Corp., supra, 135 T.C. at 217. In most cases, the burden of proof probably doesn’t matter. However, in Canal Corp the fact that a “draft opinion” (for which see note 37 supra) submitted to the court was not only full of errors, but in part not recognized by Miller, the principal author of the tax opinion, clearly irritated the court. 135 T.C. at 219. This may have made it easier for the Commissioner to carry his burden, although the court does not address this question. It is unclear why the court did not discuss the final opinion.
pertinent facts and circumstances, “including the taxpayer’s efforts to assess his or her own proper tax liability, the taxpayer’s knowledge and experience and the reliance on the advice of a professional,” but most importantly, ascertaining “the extent of the taxpayer’s effort to assess the proper tax liability.”\(^7\)

WISCO’s claim to have acted in good faith and to have had a reasonable cause for the understatement boiled down to the fact that it had relied on PWC’s opinion. The court’s evaluation of and rejection of this argument is somewhat confused by its failure to clearly distinguish criticism of the opinion itself from criticism of Canal’s reliance on the opinion. For present purposes, it is worth separately considering the different possible grounds for the court’s conclusion and which grounds would independently support the court’s holding. In this connection, it is also useful to refer to part of the regulatory elaboration on when a taxpayer may properly rely on the advice of a tax professional:

All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith.

(i) **All facts and circumstances considered.** The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

(ii) **No unreasonable assumptions.** The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for

\(^7\) 135 T.C. at 217, referring to Treas. Reg. § 1.6664-4(b).
entering into a transaction or for structuring a transaction in a particular manner.  

It is noteworthy that a reading of the language of the regulation as a whole indicates that the overriding standard is whether the taxpayer reasonably relied on the advice of the tax professional. Thus, the taxpayer’s “education, sophistication and business experience” are relevant, and the advice must take into account the taxpayer’s purposes for the transaction and their relative weights. While the regulation does state categorically that the “advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person,” this is followed by a sentence that suggests that the standard applied is one based on what the taxpayer knew or should have known, not whether the opinion is based on what would have been an unreasonable assumption to a knowledgeable tax lawyer. Earlier cases are arguably consistent with this approach, but it is unclear whether the court in Canal in part, at least, applied a more rigorous rule and, if so, if the more rigorous rule was appropriate. It is more likely that the court concluded that Canal’s executives should have know better than to rely on the PWC opinion, although the court does not say this in so many words.

The cases cited by the court in support of its conclusion that Canal could not rely on the opinion because of the inherent and obvious conflict of interest, as well as other cases, generally involve situations where the tax advisor’s stake in the outcome of the representation went far beyond merely receiving a reasonable fee, whether based on time spent or a fixed fee, for work performed. In those cases, the “tax advisors” were promoters and/or received referral fees or commissions from the tax shelter sellers or they received fees based on the magnitude of the tax savings. These cases have been collected and analyzed at length elsewhere, but they are generally very different from the facts in Canal Corp.

The Canal court’s response to the PWC opinion is scattershot to be sure. Numerous articles have been written addressing the standards that opinions should satisfy, both in terms of what the tax professional’s obligations are and in terms of the requirements that opinions should satisfy in order to provide taxpayers penalty protection. But most of this discussion has little to do with evaluating the implications of Canal Corp, which basically focuses on the role of

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72 Treas. Reg. § 1.6664-4(c)(1).
73 Ibid.
74 Treas. Reg. § 1.6664-4(c)(1)(i).
75 Treas. Reg. § 1.6664-4(c)(1)(ii).
76 See, e.g., Pasternak v. Comm’r, 990 F.2d 893 (6th Cir. 1993) (promoter); New Phoenix Sunrise Corp. & Subs v. Comm’r, 132 T.C. 161 (2009) (Jenkins & Gilchrist law firm was promoter); CMA Consol., Inc. v. Comm’r, T.C. Memo. 2005-16 (tax opinion from firm involved in marketing the lease strip deal involved).
77 See articles cited supra, note 12. Browne focuses on the cases that were actually cited in the Canal Corp decision, while Moldenhauer provides a more comprehensive review of the case law. See Moldenhauer, supra note 12, at 4 n.12 (citations), 10 ff. (discussion).
78 See Moldenhauer, supra note 12, at 3 n.11 (collecting cites).
79 Under current Circular 230, the PWC opinion would have been required to satisfy the § 10.35 covered opinion rules. However, that would still not have assured that Canal could have relied upon it to avoid a penalty. See Circ. 230 § 10.35(f)(1).
a conflict of interest on the part of the Miller and PWC. The problem with Canal Corp is that it offers many possible indicia of a conflict of interest in addition to at least the suggestion that the taxpayer should have been aware of other defects in the opinion, but does not indicate which indicia or facts are most significant or would be controlling even in the absence of other indicia or facts. So the discussion that follows will first attempt to sort the indicia and facts out to determine what matters or should matter and what can perhaps be ignored.

The court suggested six somewhat overlapping possible areas of conflicts of interest, some of which would seem to be of more concern than others. First, there is the generalized notion that is unreasonable to rely on a tax advisor with a stake in the outcome of the transaction to which the advice pertains. At a general level, this is undoubtedly correct, but the question is how this applies to the Canal facts. Some of the suggested conflicts seem little more than observations about the transaction that do not rise to the level of conflicts in themselves. These include the fact that the fee was a fixed fee not based on time spent or expense incurred and the fact that Miller relied on his own work or other PWC work to support some of his assumptions, including his review of State law and audits of WISCO and of the LLC’s assets. It is difficult to see why these rise to the level of serious conflicts of interest, assuming in the case of the audits and the examination of State law that these activities were conducted properly.80

Most problematic is the court’s focus on the fee being contingent both on the issuance of a “should” opinion and on the closing of the transaction, which was also contingent on the issuance of a “should” opinion. These provided a strong incentive for Miller and PWC to issue a “should” opinion regardless of efforts throughout the structuring of the transaction by Canal to limit the risk of any real liability under the indemnity agreement. And, indeed this appears to be why Canal ended up with a transaction as to which the hoped for tax consequences were rejected by the Service and the Tax Court. The court’s concern about the magnitude of the fee is also relevant. The client agrees to pay a very substantial fee if the transaction is successfully implemented, thus providing an incentive for PWC to “make sure” the opinion is a “should” opinion and offsetting the risk that the transaction will not be completed, with the possible loss of the fee, or perhaps more likely, a much reduced fee.81

At this point, then the court finds a conflict that provided a motive for an opinion that is in the court’s view unreasonable. The court then notes unreasonable assumptions: that the indemnity agreement would be effective under the partnership tax regulations, that maintaining assets in WISCO worth at least 20 percent of the amount of the stated principal amount of the liability was the appropriate standard to apply and that WISCO would continue to hold enough assets to satisfy this standard. In regard to the latter point, the court ignores WISCO’s representation to PWC that it would retain assets satisfying this standard,82 but the court’s failure to attach any significance to this representation seems appropriate since there is no way for either GP or the IRS to enforce the representation. In any event, initially at least, it is not at all clear why the taxpayer should be treated as knowing or being presumed to know that these

80 There is no suggestion in the court’s opinion that they were not. However, it is unclear if it was appropriate for Miller to examine State law for Canal if he was not acting as a practicing attorney at the time.
81 However, as explained in note 41 supra, if the deal fell through, given the relationship between the parties, a reduced fee might very well have been negotiated.
82 See note 50 supra.
assumptions are unreasonable to the extent they reflect legal judgments, but the taxpayer clearly knew the indemnity agreement had little substance. Canal was aware that it sought to limit the indemnity agreement as much as possible to render the possibility that it might be triggered as sufficiently “remote” to ignore for accounting purposes.83 Yet it did not seem to notice that the opinion (at least in the draft form presented to the court) failed to consider that the indemnity lacked economic substance.

At one level, expecting a taxpayer to see what the court perceives as an “inherent and obvious” conflict of interest is at odds with the way conflicts of interest between lawyers and clients are addressed elsewhere, both ethically and legally. Perhaps what the court is suggesting, although not explicitly, is that the conflict of interest and one or more of the unreasonable assumptions do not require legal or tax expertise to understand. Reliance on the advice of a tax professional, under this view, is only a defense to a substantial understatement penalty where the tax professional’s tax advice is the cause triggering the penalty. Canal, however, should have realized through the ordinary business judgment of its executives that there were problems with the transaction and the PWC opinion, both conflicts of interest resulting from Canal’s behavior and unreasonable assumptions clearly at odds with Canal’s own internal treatment of the indemnity agreement. At some point, from this perspective, such problems are the responsibility of the taxpayer, not the tax advisor, for purposes of the reasonable cause, good faith defense. This conclusion is supported by the court’s citation of United State v. Boyle,84 discussed below, which rejected a similar defense to filing an estate tax return late because of reliance on an attorney, explaining that tax expertise is not required to ascertain the date for filing a return and filing it by such date.

Standards Governing Tax Professionals

Both the ethical rules of the legal profession85 and Circular 23086 address conflicts of interest between a tax professional’s personal interest and the interest of her client. Generally speaking, these rules require that the lawyer “1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with clients affected … and obtain their informed consent….”87 The procedural nature of the informed consent requirement varies, with the Model Rule only requiring that it be “confirmed in writing,”88 while Circular 230 § 10.29 requires that it be “confirmed in writing by each affected

83 135 T.C. at 209.
85 See, e.g., MRPC 1.7 (Conflicts of Interest: Current Clients) & 1.8 (Conflicts of Interest: Current Clients: Specific Rules).
86 Section § 10.29 Conflicting interests.
87 MRPC 1.7, Comment [2]
88 MRPC 1.7(b)(4). “Such a writing may consist of a document executed by the client or one that the lawyer promptly records and transmits to the client following an oral consent [by the client].” Comment [20]. See also
client.”89 Most jurisdictions require informed consent and the wise lawyer will get the informed consent in a writing signed by the client. However, California’s Bar for some unexplained reason only requires that a lawyer with a personal interest conflict with the client provide “written disclosure” of this fact to the client90 unless the interest involves a business transaction with the client or a property interest adverse to the client.91 Apparently, the California Bar is satisfied to put the burden on the client to fire the lawyer if the disclosure is sufficiently unsettling. In any event, even tax practitioners in California (whether lawyers, CPAs or enrolled agents) are subject to the Circular 230 rule with respect to any practice before the Service.92

The bottom line is that the applicable rules generally place the burden on the lawyer (or other tax professional) of determining when there is “a significant risk” that the representation of a client “will be materially limited” “by a personal interest of a lawyer.”93 If a conflict of interest is of the kind that would make it impossible for a client to rely on a tax opinion provided by the lawyer or other tax professional for one of the reasons suggested by the Canal Corp opinion, such a “significant risk” would seem to clearly be present, thus triggering the application of both the typical State Bar conflicts ethics rule and Circular 230’s ethics rule. In particular, if a tax professional is involved in implementing a transaction for a client that is contingent on the issuance of a “should” level opinion by the professional regarding the tax consequences of the transaction and the client seeks changes in the original structure of the transaction that may weaken the viability of the transaction for tax purposes, the advisor needs to consider whether this triggers the conflict of interest rules.

Thus, the tax advisor has a duty to determine if she reasonably believes that she can provide “competent and diligent representation” to the client.94 If so, before continuing with the engagement the advisor must obtain the client’s informed consent in accordance with the applicable procedure. The Model Rule definition of “informed consent” states:

Informed consent denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.95

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89 Circ. 10.29(b)(3), which adds that the “confirmation” may be made after the informed consent, but “in no event later than 30 days.” The grammar is awkward, but apparently this means the written confirmation must be made within 30 days after the informed consent.

90 Calif. Rules Prof. Conduct 3-310(B). “Disclosure” for this purpose means informing the client “of the relevant circumstances and of the actual and reasonably foreseeable adverse consequences to the client.” Id. 3-310(A)(1).

91 See Calif. Rules Prof. Conduct 3-300.

92 Practice before the Internal Revenue Service is very broadly defined in Circular 230 § 10.2(a)(4) to include “rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion.”

93 MRPC 1.7(a)(2); Circ. 230 § 10.29(a)(2).

94 See MRPC 1.7(b); Circ. 230 § 10.29(b).

95 MRPC 1.0(e).
Comment 6 to Model Rule 1.0 notes that sometimes it may be appropriate to advise the client to seek the advice of other counsel. The Comment also adds that while a “lawyer need not inform the client … of facts and implications already known to the client,” “a lawyer who does not personally inform the client … assumes the risk that the client … is inadequately informed and the consent is invalid.” This is a rigorous standard and the requirement of having the consent confirmed in a writing, whether under the lax rules of Model Rule 1.7 or under the more rigorous rule of Circular 230 § 10.29, is designed to reinforce “the seriousness of the decision the client is being asked to make and to avoid disputes or ambiguities that might later occur in the absence of a writing.”96 That is, the ethics rules firmly place the risk on the lawyer or tax advisor of proceeding without identifying the conflict of interest, determining if it consentable and obtaining the client’s informed consent.

Placing this risk on the practitioner is the opposite of what Canal Corp did. However, the clear message of the ethics rules is that conflicts that are so significant as to undermine reliance on a tax opinion need to be handled by the practitioner in accordance with applicable legal ethics rules and/or Circular 230, as appropriate. In the Canal Corp transaction, for example, at some point Miller should have realized that Canal’s desire to assure that its prospect of liability under indemnity agreement was remote coupled with its need to receive a “should” level opinion for the transaction created a conflict of interest that needed to be addressed with Canal. When the client takes advantage of the terms of a fee agreement to persuade a tax advisor to provide an opinion at an unjustified level of confidence, the advisor needs to back off and address the conflict of interest before proceeding. The failure to take action when such a conflict is presented may result in discipline.

In the first instance, disciplinary action by a State bar seems unlikely. The State bars are not proactive in disciplining members of the bar, particularly in the tax practice field. However, they will act on the basis of complaints from unhappy clients. Of more moment is the possibility of action by the IRS Office of Professional Responsibility (OPR). OPR receives referrals from clients, but more significantly, from Service personnel at every level, from Justice Department lawyers (generally from the Tax Division) and from the judiciary. OPR is proactive and will pursue cases to a final resolution. Furthermore, once OPR has completed action in a disciplinary action, it will report any discipline imposed to the practitioner’s State bar or accounting regulatory body, which will generally impose sanctions of its own.

Malpractice or Other Liability

The role of conflicts of interest in actions based on malpractice or other liability theories by clients against tax practitioners is often indirect. The Model Rules of Professional Conduct state that “a violation of an ethical rule should not itself give rise to a cause of action nor should

96 Comment [20] to MRPC 1.7, which also states that the writing requirement does not supplant the need in most cases for the lawyer to talk with clients to explain the risks and advantages, if any, of representation burdened with a conflict of interest, as well as reasonably available alternatives....”
it create any presumption … that a legal duty has been breached.”

Nonetheless, the Rules do state that “since the Rules do establish standards of conduct by lawyers, a lawyer’s violation of a Rule may be evidence of breach of the applicable standard of conduct.”

In the case of a conflict of interest, one common remedy in litigation and at times in other contexts is a motion to disqualify the lawyer from representation. However, in many contexts that sort of remedy is not relevant. For example, in the kind of situation presented by the Canal Corp transaction had Miller or PWC sought to represent Canal in the examination of the return for the year at issue or in the Tax Court, the Service or the counsel for the government, noting that PWC had planned and advised about of the tax consequences of the transaction, would have been likely to ask to have PWC disqualified from the representation.

This kind of remedy would have been of no avail to the taxpayer, Canal.

In malpractice contexts, however, the lawyer’s breach of the duty of loyalty to a client paralleling the ethical duty of loyalty to the client will invariably also implicate a breach of the duty of care or some other duty to the client. This is so because an action to recover damages requires proof of more than just a breach of a duty to the client. For example, a malpractice action based on negligence require that the plaintiff prove (1) negligence (that is, a breach of the duty of care) on the part of the lawyer, (2) that the lawyer’s negligence was the proximate cause of the loss sustained by the client, and (3) that the client sustained actual damages as a result.

Mere disloyalty to a client is not generally actionable simply by itself.

The relationship of a conflict of interest, however, to malpractice or other grounds for a client to sue a lawyer, such as breach of contract, is both more complex and more insidious if the lawyer or tax practitioner is the defendant. Not only will the conflict co-exist with a breach of a duty of care or a breach of contract. It may in fact also be the cause of (or incentive for) the breach. In Canal Corp, the desire on the part of Miller and PWC to provide the “should” opinion on which the transaction was conditioned, despite the changes in the original paradigm on which the transaction’s structure was based, most likely played a role in the issuance of the opinion on which the court found that Canal could not rely. In a malpractice context, the argument, however, would be that PWC and Miller breached their duty of care to Canal.

A malpractice defendant in a tax malpractice case may a have difficult time explaining to the trier of fact what the appropriate standard of care is, both because of the multiple levels of confidence that may be used in providing a tax opinion to a client and because of the complexity of the applicable substantive law. In Canal Corp, for example, commentators have suggested

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97 See MRPC Scope [20].
98 Id., last sentence.
99 See Para Technologies Trust v. Comm’r, 64 T.C.M. (CCH) 922 (1992) (taxpayer’s counsel of record disqualified under Tax Court Rule 24(f) [now 24(g)] because of multiple conflicts in litigation over “contractual trust company” tax shelter scheme which counsel had been involved in planning and promoting). Cf. Circular 230 § 1029(c), requiring written consents to waiving conflict of interest under Circular 230 to be provided to any officer or employee of the Service on request.
100 See Linda Galler & Michael B. Lang, REGULATION OF TAX PRACTICE 237 (2010). There are other theories under which clients may sue their lawyers, such as for breach of fiduciary duty, fraud, breach of contract, negligent or intentional misrepresentation, and false or deceptive trade practices, but regardless of the theory it is necessary to determine if there is a duty to the client that was breached and if the breach was the cause of actual damages. Id. at 234-235.
that the transaction’s tax characterization was supported by substantial authority.\footnote{101} Had this standard been applicable,\footnote{102} it is not entirely clear how the Tax Court would have handled the case. Had that been the relevant standard of care, however, in a malpractice case, the difficulty for a trier of fact would have been far greater.

A conflict of interest, on the other hand, even if not obvious, is much easier to explain to a trier of fact. And, once explained, the conflict of interest shows the trier of fact a motive for the tax advisor to have provided the taxpayer incorrect advice, making it easier for the trier of fact to be persuaded that the provision of the advice itself breached the duty of care and constituted malpractice. The *Canal Corp* opinion certainly suggests that Canal had a potential malpractice claim against PWC and Miller. Any of the conflicts of interest mentioned by the court, if spelled out in more detail, would clearly facilitate persuading the trier of fact that the opinion breached PWC’s and Miller’s duty of care to Canal.

Once such a case results in a malpractice claim, the risks to the tax advisor are substantial and difficult to accurately assess. Of course, the fee may have to be returned. In fact, the wise advisor may offer to return the fee voluntarily in the hope of forestalling a malpractice filing.

The other possible damages fall into two categories, those that are direct costs of filing an incorrect tax return (direct damages) and those that may be viewed as the costs of being persuaded to engage in a transaction that the taxpayer would not have engaged in absent the incorrect advice (consequential damages). In the first category, the most obvious, and perhaps largest, item of damages is the penalty imposed by the Service. In a case such as *Canal Corp*, the tax advisor would clearly be liable for the amount of the penalty.\footnote{103} In addition, any reasonable legal and/or accounting fees incurred in contesting or settling the underlying tax liability should also be recoverable damages.\footnote{104}

Another possible item of damages is the interest paid because of the late payment of taxes. There is little law on this subject and what there is in conflict.\footnote{105} The better view, adopted by the New York courts, seems to be that recovery of such interest should not be permitted because it is paid to the Service for the use of the money and does not represent damages suffered by the taxpayer plaintiff.\footnote{106} This, however, seems to be the minority view.\footnote{107} Other states either allow a recovery of interest paid to the Service as damages or limit the recovery of interest “to the extent it exceeds interest actually earned by the plaintiff on the underpaid taxes.”\footnote{108}

\begin{itemize}
  \item \footnote{101} See note 56 supra.
  \item \footnote{102} For why this standard was probably not applicable, see text accompanying notes 56ff. supra.
  \item \footnote{105} See generally Jacob L. Todres, supra note 103, at 722-731 (2008).
  \item \footnote{107} See Todres, supra note 103, at 724 text accompanying n.111.
  \item \footnote{108} Todres, supra note 103, at 724. See also Caroline Rule, “What and When Can a Taxpayer Recover from a Negligent Tax Advisor”, 92 J. TAX’N 176 (Mar. 2000).
\end{itemize}
Consequential damages in this context may be difficult to prove, but can be substantial. In the Canal Corp transaction, Canal would presumably argue that the deal would not have been done but for the tax opinion that was provided, but what does this mean in terms of damages? Would it have been modified and done on a taxfree basis? If so, when? Would Canal have waited for awhile to obtain a higher price in a taxable transaction? If so, for how long and for what price? Furthermore, if Canal would have pursued any of these alternatives, assessing damages means determining how much tax would have been paid and when, estimating what an appropriate discount rate would be to value a later tax payment. It also means figuring out how any proceeds, whether taxable or taxfree, would have been invested – again coming up with an appropriate discount rate. If WISCO had been retained for any period, it would be necessary to establish an estimated rate of return on WISCO. Those who have been involved on either side of tax shelter malpractice litigation know how many variables there are in these questions. While the proof problem is a difficult obstacle for the plaintiff seeking consequential damages, the potential risk to the defendant is sufficient to counsel settlement. In fact, major tax shelter malpractice cases to date have generally been settled, whether by arbitration, mediation or by the parties directly through their counsel, sometimes for very large amounts.109

Does This Make Sense?

It is tempting to think that the Tax Court’s refusal to allow Canal Corp to rely on the PWC opinion provided to it in connection with the WISCO transaction places an unfair burden on Canal as taxpayer to be aware of conflicts of interest on the part of its tax advisor and unreasonable assumptions underlying the opinion that few taxpayers are prepared to understand. Perhaps, however, these matters should be explained to the taxpayer, with particular references to the regulations. The assumptions in the opinion could be flagged for the taxpayer. Conflicts of interest, in particular, are at times difficult even for lawyers to see, but they are really not matters requiring substantive tax law expertise. In any event, perhaps more attention to such issues in the context of aggressive tax planning would be appropriate. If Canal Corp had been permitted to rely on the PWC opinion to establish a reasonable cause, good faith defense to the substantial understatement penalty, PWC and Miller would be likely to suffer no more than relatively modest penalties under IRC § 6694, although OPR might pursue disciplinary proceedings. This is hardly a sound policy result.

It is notable that the Tax Court cited United States v. Boyle,110 a case involving a taxpayer penalized for late filing of an estate tax return. The taxpayer was executor of the estate and had retained an attorney to handle the estate. The taxpayer and his wife asked the attorney from time

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109 Less than three years ago, Professor Jay Soled of Rutgers, in writing about tax shelter malpractice litigation reported that “there is not a single reported decision determining whether a particular defendant committed malpractice,” although there have been reports of very substantial settlements. Jay A. Soled, “Tax Shelter Malpractice Cases and Their Implications for Tax Compliance,” 58 AM. U. L. REV. 267, 271 n.11, and 274-275 and 276 n.33 (2008).
to time about the progress of the estate and the preparation of the return and were “assured that they would be notified when the return was due and that the return would be filed ‘in plenty of time.’” The attorney overlooked the matter because of a clerical error in his office. The taxpayers resisted a statutory penalty for late filing of the return on the ground that the late filing was due to “reasonable cause.” In rejecting the taxpayer’s argument, the court stated:

To say that it was “reasonable” for the executor to assume that the attorney would comply with the statute may resolve the matters as between them, but not with respect to the executor’s obligation under the statute. The court distinguished reliance on a tax advisor’s advice as to a matter of tax law, explaining that tax expertise is not required to know that returns have fixed filing dates.

In effect, the Tax Court seemed to be saying the same thing about conflicts of interest and unreasonable assumptions, that these are matters for purposes of the reasonable cause, good faith defense for which no special tax law expertise is required. In fact, it is probably true that these are more readily discernable by taxpayers than the filing requirements for estate tax returns, for which at least some sources of information about the arbitrary filing dates must be consulted. In any event, in both situations the burden of selecting a tax advisor who did not perform adequately is under the court decisions to be borne by the taxpayer. One might say that since the client chose the advisor, the client should bear the cost of the advisor’s bad advice in the first instance, at least where the matter is not one as to which tax law expertise is required. The government imposes the penalty on the taxpayer, but the taxpayer may then seek redress from the advisor, PWC and Miller. Arguably this is a better overall result as a matter of policy than allowing Canal to rely on the advice to avoid the substantial understatement penalty. The malpractice risk seems much more significant to tax professionals than the risk of a modest penalty or even discipline by OPR.

This view of Canal Corp finds further support in the Tax Court’s 2011 decision in Stephen G. Woodsum v. Comm’r. Woodsum was the managing director of a private equity investment firm. In 2006, he and his wife received more than 160 information returns including a Form1099 showing a $3.4 million capital gain on termination of a swap transaction. These information returns were turned over to a specialized tax firm which had one of its preparers prepare the couple’s 115-page Federal income tax return, but did not include the $3.4 million dollar item, apparently due to an oversight. Petitioners reviewed the return for signing and filing at a meeting at 11 A.M. on the due date for the return (with extension), apparently with their tax advisor flipping through the pages commenting on certain items, but neither they nor their tax

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111 Id. at 243
112 Id. at 250
113 Id. at 251.
114 See Soled, supra note 109, who argues that “tax malpractice cases have had an important chilling effect on abusive tax shelter formation,” with “anecdotal evidence” indicating that tax professionals “are reluctant to promote abusive tax shelters for fear of malpractice exposure.” 58 AM. U.L. REV. at 330.
116 This item would have been the third largest long-term capital gain on the return.
advisor noticed that the actual preparer had left the $3.4 million item off the return. The IRS determined a deficiency and assessed an accuracy penalty under IRC § 6662(a).

Woodsum and his wife disputed the penalty, claiming that they acted in good faith, with reasonable cause, in relying on their return preparation firm. The court rejected this defense, noting that “the duty of filing accurate returns cannot be avoided by placing responsibility on a tax return preparer,” that the taxpayers did not fulfill their duty to review the return, and that in signing the erroneous return the taxpayers were not relying on “substantive professional advice” [emphasis added], but were just perpetuating a clerical mistake.117 Their reliance on the return preparer or tax advisor was not reasonable cause for omission of the $3.4 million item from the return because, in effect, there was no “advice” from the preparer or advisor to exclude the item from income. Again, good faith reliance on a tax advisor to support a reasonable cause, good faith defense to a taxpayer accuracy penalty requires that the reliance be based on professional advice regarding the application of the substantive tax law. If the advice of the preparer or advisor does not reflect matters involving tax expertise, reliance on the advisor’s advice will not support a reasonable cause, good faith defense.

Lessons for the Tax Professional

1. Be wary about potential conflicts of interest. If a client proposes changes in a transaction that may weaken the transaction’s tax viability, say so and explain that your original advice may no longer apply. Put this in writing. If the client’s proposals place you in a conflict of interest situation, be sure to follow the applicable conflicts rules. See below.

2. Follow the proper process for obtaining informed consent whenever a conflict is involved. Part of this process may involve advising the client about the risk that the client may not be able to rely on your opinion for penalty protection and/or suggesting that the client consult with independent counsel.

3. Explain to the client that penalty protection may not be available to the extent your advice reflects matters which do not involve tax law expertise.

4. For covered opinions, read and explain to clients in writing Circular 230 § 10.35(f)(1):

   An opinion that meets the requirements of this section satisfies the practitioner’s responsibilities under this section, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer’s good faith reliance on the opinion will be determined separately under the applicable provisions of the law and regulations. [Emphasis added.]

117 136 T.C. No. 29 at 19 and 24.
5. Better yet, maybe the gist of the statement above should be explained in writing for all opinions, with a brief explanation of the regulations describing the application of the reasonable cause, good faith defense against a penalty for a substantial understatement where the defense is based on reliance on the advice of a tax advisor.\textsuperscript{118}

\textsuperscript{118} See Treas. Reg. § 1.6641-4(c)(1).