Senior Tax Executives (STE) should seriously consider obtaining two independent and distinct professional tax advisers’ opinions, one before a transaction is consummated and one before filing the return, regarding the tax treatment of any potentially controversial transactions they are contemplating. The two opinions satisfy differing needs of the STE and Senior Management.

Divergent motivations exist for the STE and Senior Corporate Management as they complete the due diligence necessary to make the decision to enter into a potentially controversial transaction. Information must be gathered to make a sound business decision; steps must be taken affirmatively to avoid penalty exposure; and financial reporting concerns must be addressed.

First, the STE gathers information and evidence to assist Senior Management in making the business decision regarding the transaction, including the risks (such as potential litigation costs and reputation effects) and the potential outcomes of a tax controversy. While the STE may have become very comfortable with the transaction, both the STE and Senior Management are protected from second-guessing by obtaining contemporaneous evidence before entering the transaction, in which independent tax experts examined all facts and relevant law and reached a conclusion about the most likely ultimate outcome of a potential controversy. A conclusion about the probability of an ultimate outcome will often state all “bad facts” and evaluate them, as well as any technical weakness of arguments, to weigh the risks and hazards of litigation necessary for Senior Management’s decision-making. Opinions are often sought from tax counsel and are referred to hereinafter as Tax Legal Opinions (TLO). TLO that are prepared in anticipation of litigation are protected by the attorney work product privilege against disclosure. TLO may also be privileged if considered confidential by the taxpayer and confidentiality is maintained. TLO that discuss the risks and hazards of litigation contain information that should be protected from waiver by the taxpayer and its advisers.

Second, the STE is motivated to preclude the assessment of penalties. One avenue of defense against the accuracy related penalty of section 6662(b) is disclosure of the transaction in detail (by filing Form 8275 or Form 8275-R or utilizing the provisions of Rev. Proc. 94-69). If the transaction is determined to have a significant purpose of tax avoidance, however — and many controversial transactions may be held to have such a significant purpose — then disclosure is not available as a means to avoid the section 6662(b)(2) penalty. Absent disclosure as a means of penalty protection, the best defense is to rely in good faith on the opinion of a professional tax adviser who is competent, has sufficient expertise, and to whom all necessary and accurate information has been given. In Perrah, the Tax Court stated:

A taxpayer may avoid the application of the accuracy-related penalty by proving that he or she acted with reasonable cause and in good faith. Section 6664(c). Whether a taxpayer acted with reasonable cause and good faith is measured by examining the relevant facts and circumstances, and most importantly, the extent to which he attempted to assess his proper tax liability.

A fully informed third-party opinion, received after a transaction but before a return filing, is an excellent basis for an argument that a taxpayer has gone to great effort to assess the proper tax liability. The TLO received by the STE from competent tax counsel could possibly serve the purpose of providing protection from the section 6662 penalty. (Compare, however, Long Term Capital Holdings, where both the timing and the stated purpose of the TLO were questioned in the context of penalty avoidance.) Even where the TLO clearly was obtained in a timely manner and for the taxpayer’s guidance, it is not possible to maintain privilege for the legal opinion and at the same time use it as a defense against penalties. To be an effective penalty shield, the opinion must be reviewed by the Internal Revenue Service (IRS) and possibly the courts for an evaluation of whether the facts tests, competency tests, and the test that the taxpayer acted on the advice were all met (all components of the “reasonable belief” requirements of Treas. Reg. §1.6662-4).

It is impossible to assert that the tests were met without waiving privilege for the legal opinion, either directly or indirectly. For example, the taxpayer, Evergreen Trading, provided their TLO to the IRS exam team as a penalty defense. Later, when the controversy over the tax treatment of the transaction reached litigation, Evergreen Trading tried to use privilege to prevent disclosing the TLO in discovery. The court in Evergreen Trading commented that “…the release of those documents to their adversary waived any privileges that otherwise might be associated with those documents.” Similarly, Thomas E. Johnston was assessed penalties under sections 6662 and 6663 for 1989, 1991, and 1992. He attempted to overcome the penalties, stating in a court petition that he had “relied upon advice of qualified experts…” Johnston later attempted to assert privilege to protect the attorney-client communications. The Tax Court held that Johnston’s statement of reliance on the communication was an implied waiver of privilege.

Therefore, a separate, distinct opinion that is obtained solely for the purpose of section 6662(b) protection should be considered. Such an opinion will hereinafter be referred to as a “section 6664(c) opinion.” The STE should seek an independent tax adviser not involved in tax planning or marketing, who is not affiliated in any way with the transaction, and who is independent in all ways from the authors of the legal opinion. The TLO should not be reviewed by, commented
on, or discussed with the section 6664(c) opinion writer in order to preserve the confidentiality of the legal opinion.\(^1\) The section 6664(c) opinion should carefully consider all the facts and circumstances, including the taxpayer’s purposes for entering the transaction and should reach a conclusion about the proper tax treatment of the transaction. The section 6664(c) opinion should be obtained by the taxpayer before filing a return that includes the transaction.

In *Long Term Capital Holdings*, the court stated: “The King & Spalding written opinion was not issued until January 27, 1999, over nine months after Long Term claimed the losses, and, while Noe testifies he received the drafts of it prior to its issuance, he did not testify he ever received any drafts before Long Term’s tax return was filed. There was no corroborative evidence offered regarding the existence or timing of his receipt of such drafts.”\(^1\)

The section 6664(c) opinion should also be obtained before disclosures required by the Securities and Exchange Commission (SEC), including conclusions under FASB Interpretation No. 48 (FIN 48). For example, FIN 48 requires consideration and possible accrual of interest and penalty on uncertain tax benefits not recognized, to the extent interest and penalty apply.\(^2\) The section 6664(c) opinion is evidence that there is no applicable penalty and that no accrual of penalty is appropriate. An ultimate disposition (whether in exam, appeals, or litigation) of the transaction that results in a penalty, without adequate documentation of why the penalty was not accrued, may lead to an assertion that the financial statements should be restated back to the quarter that the company first reported the transaction on its tax return. Restatement assertions are best avoided by adequate contemporaneous documentation of the taxpayer’s belief that no penalty was applicable.

The section 6664(c) opinion can and should be made available to the IRS exam team during the examination; it exists for the taxpayer to use as an affirmative defense of reasonable cause based on reliance on professional advice. The section 6664(c) opinion can also be made a part of the financial accounting workpapers, referred to in the FIN 48 documentation, copied, and referred to by independent certified public accountants as part of their attest function, all without concern of waiver of privilege. The entire question of *Textron*\(^3\) becomes moot through use of a section 6664(c) opinion. If Textron had obtained a section 6664(c) opinion, it could have relied on that, in whole or in part,\(^4\) for its FIN 48 work, and the attorney work-product would have remained secure.

Utilization of a two-opinion strategy achieves the objectives of protecting the STE and Senior Management from second-guessing, provides Senior Management with the proper and necessary advice concerning risks and hazards of litigation in business decision making, obtains litigation strategy advice, yet also protects the taxpayer from penalties while meeting all of the transparency and documentation requirements necessary for companies that issue financial statements.

The section 6664(c) opinion supports the tax return, provides the conclusions necessary for FIN 48 documentation, and assists both the taxpayer and the IRS in the audit process. After two years of FIN 48 compliance, all public companies now have an inventory of tax positions that are “uncertain.” In an age of increasing calls for transparency combined with a real and growing need for IRS audit efficiency, taxpayers should also consider disclosing their uncertain tax positions and associated section 6664(c) opinions as a matter of course at the beginning of an IRS exam. To the extent STEs fear opening “Pandora’s Box” on their potentially controversial tax positions, perhaps utilization of section 6664(c) opinions, in tandem with TLO, would help move taxpayers toward more transparency.

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1. The phrase “potentially controversial” is intended to exclude abusive tax shelters, listed transactions, and other reportable transactions, all of which generally go beyond being “potentially” controversial. Additional requirements not addressed here must be met in the case of listed transactions. See I.R.C. § 6662A and Notice 2005-12, 2005-7 I.R.B. 494 (February 17, 2005).
4. Treas. Reg. §1.6662-4(g)(4) contains two alternatives for assertion of ‘reasonable belief.’ One is reliance on a third-party opinion. The other is an in-house analysis by the taxpayer. While neither is stated as preferred by the regulations, there are advantages to using a third-party opinion. In the event that a penalty threat appears to be used in a stated or implied manner as settlement leverage during an examination or at appeals, a third-party memo provides a buffer against that threat. The presence of a third-party opinion that is fully in-line with the regulations’ requirements and received prior to filing a return substantially strengthens the STE position during negotiations; the STE can ignore the penalty threat and negotiate from a stronger position. An internal analysis may not be treated, from a negotiating perspective, with the same weight due to its self-serving nature.
5. I.R.C. §§6664(c) and Treas. Reg. § 1.6662-4.
6. Perrah v. Commissioner, 84 T.C.M. (CCH) 547.
7. *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004): “The first page of the King and Spalding opinion states that it was prepared as part of Long Term’s litigation strategy in anticipation of possible future litigation over the claimed losses, language sounding like a predicate for assertion of an attorney work product privilege against disclosure, which Kuller testified was its purpose. The opinion’s timing and stated purpose casts doubt on its contents as serving the purpose of providing a reasoned opinion on the application of tax law to the facts of the OTC transaction for client guidance in future actions.”
10. To the extent the TLO is also work product, different standards of waiver apply.
12. FASB Interpretation No. 48, ¶ 16: “If a tax position does not meet the
minimum statutory threshold to avoid payment of penalties..., an enterprise shall recognize an expense for the amount of the statutory penalty in the period in which the enterprise claims or expects to claim the position in the tax return.” FASB Interpretation No. 48, ¶ B51: “The Board also considered recognition in the financial statements of a provision for the anticipated payment of interest or penalties or both. The tax law for many jurisdictions requires the payment of penalties when a specified confidence level is not met for a tax position... Therefore, for completeness of the financial statements the Board decided that a liability should be recognized when it was deemed to be incurred based on the provisions of the relevant tax law. That is, consistent with accrual accounting, the financial statements should reflect... penalties in the first period the tax position was taken in a tax return that would give rise to the penalty, based on the provisions of the relevant tax law.”


14. To the extent the section 6664(c) opinion reached a more-likely-than-not conclusion, the benefit of the tax position could be recognized in the financial statements; whether additional analysis beyond the scope of the section 6664(c) opinion is necessary under FIN 48 for purposes of the amount to be recognized is based on facts and circumstances. Taxpayers may consider requesting that a section 6664(c) opinion be expanded to fulfill both penalty protection and complete documentation for purposes of FIN 48.