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Court 'Misguided' in Accuracy-Related Penalty Decision, Practitioners Say

by Sam Young

Summary by taxanalysts

Practitioners contacted by Tax Analysts say they are troubled by the Tax Court's application of the section 6662(b)(2) accuracy-related penalty in its August 4 Canal Corp. v. Commissioner ruling and disagreed on the impact the case will have on leveraged partnerships.

Full Text Published by taxanalysts

Practitioners contacted by Tax Analysts say they are troubled by the Tax Court's application of the section 6662(b)(2) accuracy-related penalty in its August 4 *Canal Corp. v. Commissioner* ruling and disagreed on the impact the case will have on leveraged partnerships. The Tax Court ruled that the taxpayer unreasonably relied on an accounting firm's legal opinion regarding the transaction and that the leveraged partnership was a disguised sale.

In an e-mail to Tax Analysts, Blake D. Rubin, Andrea M. Whiteway, and Jon Finkelstein of McDermott Will & Emery LLP argued that the court misconstrued section 6662 in upholding the accuracy-related penalty against the taxpayer. "The taxpayer should definitely appeal," they wrote. (For *Canal Corporation and Subsidiaries v. Commissioner*, 135 T.C. No. 9 (2010), see *Doc 2010-17535* or *2010 TNT 151-9*.)

Robert Willens of Robert Willens LLC said the court's section 6662 findings will "have untold impact on the opinion business."

Background

Georgia Pacific transferred the assets of its tissue business, worth $376 million, into a new limited liability company in exchange for a 95 percent share in the LLC. Wisconsin Tissue Mills Inc. (Wisco), a wholly owned subsidiary of Chesapeake Corp., transferred its tissue business assets, worth $775 million, to the LLC in exchange for the remaining 5 percent interest. Chesapeake later became Canal Corp.

The LLC borrowed $755 million from a third party and gave it to Wisco as a special cash distribution. The loan was secured by Georgia Pacific, but Wisco agreed to indemnify any payments of principal required of Georgia Pacific.

Wisco used the $755 million to pay dividends to Chesapeake, to make a loan to Chesapeake, and to repay an intercompany loan from another Chesapeake subsidiary. Wisco's assets at the end of the transaction were a note from Chesapeake for $151 million and a $6 million corporate jet.

The indemnification agreement did not require Wisco to retain the note or prevent Chesapeake from canceling it.

Tax Court Judge Diane Kroupa noted that Wisco's assets represented only 21 percent of its maximum potential liability from the loan indemnification and that it was unlikely ever to be required to pay, and found that the transaction did not fit within the debt-financed transfer exception.

PricewaterhouseCoopers had provided Chesapeake with an advisory opinion on the transaction for an $800,000 fixed fee. PWC attorney David Miller determined that if Wisco maintained a net worth of $151 million, or 20 percent of the maximum indemnity amount, the transaction should qualify as a reg. section 1.707-5(b) debt-financed distribution and not be treated as a sale.

Judge Kroupa called Miller's work "haphazard" and said it relied on "dubious assumptions." She found that by both planning the transaction and preparing the advisory opinion, PWC had a conflict of interest such that Chesapeake could not have reasonably relied on the opinion.

Reaction

"It seems to me that when taxpayers get such high level opinions from reputable firms, the courts should give deference to the opinion when penalties are involved," said Todd D. Golub of Baker & McKenzie LLP. He suggested that the flat fee may have unduly influenced Judge Kroupa.

Willens echoed that view, saying, "I couldn't help but think that the judge wanted to make an example of someone who would charge that large a fee for something like this." Under the court's logic, a contingent fee arrangement would be difficult to distinguish from the flat fee, "and that's obviously troubling, too," he added.

In a telephone conversation with Tax Analysts, Rubin said the court skipped necessary inquiries in upholding the accuracy-related penalty. "Regardless of the taxpayer's state of mind, reasonable cause, good faith, etcetera, if there were substantial authority for the position, then the penalty should be inapplicable unless the court determines it's a tax shelter," he said. But without determining whether there was substantial authority for the taxpayer's position or whether the transaction was a tax shelter, the court "just went directly to the [section] 6664 reasonable cause good-faith exception," he said.

The court is also "misguided" in its criticism of Miller's role in the transaction, according to Rubin. Although Judge Kroupa found it inappropriate for Miller to be involved in drafting the joint venture and other agreements, that kind of involvement is commonplace and perfectly appropriate, Rubin said.

Willens agreed that the decision may place additional burdens on leveraged partnerships. Mandating that a third party render an opinion after the transaction has been developed would be an unreasonable requirement, he said.

The IRS has asserted that leveraged partnerships fail economic substance and substance-over-form tests, but the Tax Court applied the section 752 antiabuse rule. Although the court ruled against the taxpayer, the McDermott attorneys wrote that they were pleased with that approach. (For an example of the Service's views on leveraged partnerships, ILM 200246014, see *Doc 2002-25564* or *2002 TNT 222-46*.)

"While the regulations clearly sanction certain leveraged partnership transactions, the transaction before the court was structured in a way that left it susceptible to attack under the section 752 antiabuse rule," they wrote.

Judge Kroupa harshly criticized Miller's handling of the advisory opinion, but Willens argued that the remote possibility that the indemnity would be paid off was more critical to the decision. "I think the court would have applied the antiabuse rule even if more care had been exercised in structuring the agreement," he said.

In fact, most leveraged partnership agreements are structured to make payment improbable, Willens said. "There are enough safeguards to make it a remote possibility that the indemnitor would have to perform. I'm hard-pressed to think of a leveraged partnership situation where there wasn't a remote possibility," he said.

Willens argued that the opinion has implications for all leveraged partnerships, and drew a parallel between the Chesapeake transaction and the leveraged partnership Tribune Co. used to divest itself of the Chicago Cubs and related properties. (For Willens's analysis of the Cubs deal, see *Doc 2009-21603* or *2009 TNT 212-6*.)

The court refused to develop a bright-line test for what level of funding is required to legitimize a leveraged partnership, but "if I were recommending one of these transactions and net worth was a factor, I'd probably be looking for something close to 50 percent of the maximum exposure," Willens said.

The quality of those assets may matter, however. "The higher the quality of the asset, probably the smaller the percentage you'd need," Willens said.

The case "doesn't mean that all leveraged partnership transactions fail," Rubin agreed. With better capitalization and a nonsubsidiary guarantor, "we'd expect that the court might come out differently," he said**.**

The decision "does not change my view that when properly structured, leveraged partnerships are legitimate tax planning transactions that are in compliance with both the letter and the spirit of the law," Golub agreed.

Tax Analysts Information

Code Sections: Section 6662 -- Accuracy-Related Penalty
Section 707 -- Related Interest Transactions
Section 6664 -- Penalty Definitions and Special Rules
Section 752 -- Partnership Liabilities
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