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LONG TERM CAPITAL HOLDINGS V. UNITED STATES:

THE END OF PENALTY PROTECTION?

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Long Term Capital Holdings v. United States: The End of Penalty Protection?

March 2005

by Miriam L. Fisher[1]

"Bad facts make bad law." - Anonymous

The *Long Term Capital Holdings* decision,[2] issued by the U.S. District Court for the District of Connecticut on August 27, 2004, presents a microscopic case study of the heyday of sophisticated and aggressive tax planning. Admittedly, it is not a pretty picture. Assuming its primary holdings are sustained on appeal,[3] it will be remembered as a stunning government victory in its assault on tax shelters. Not only did the court disallow $106 million in tax losses claimed by Long Term's partners, holding that the underlying transactions lacked economic substance other than to create tax benefits, but the court upheld the government's imposition of the 40% accuracy-related penalty. In doing so, Judge Janet Bond Arterton dissected and then rejected Long Term's penalty defense of reasonable reliance on the advice of its professional tax advisors.

The opinion was issued after a yearlong trial; it runs nearly 100 pages with 110 detailed footnotes. It is extraordinarily meticulous in its analysis of the evidence and the law, both with respect to the merits of the tax treatment of the transactions and the application of penalties. The court displays a true depth of understanding of the complex financial dealings at issue and of the tax law; no detail is brushed aside. The court explores alternate theories for each of its primary holdings, and the decision may prove difficult to attack on appeal. The outcome at trial, particularly with respect to the penalty issue, appears to have been strongly influenced by the court's impressions of witness testimony offered at trial.

The particular facts as described in *Long Term Capital Holdings* relating to Long Term's reasonable reliance on advice of counsel on the whole may seem particularly egregious

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[2] 330 F. Supp. 2d 122 (D. Conn. 2004) (hereinafter "Op.").

[3] *Long Term Capital Holdings v. United States*, No. 3:01CV1290 (2d Cir.), filed October 27, 2004.

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and Judge Arterton's view of those facts particularly harsh. Nevertheless, the court's decisive rejection of the reliance on counsel defense undeniably sends a warning shot across the bow of taxpayers who hope to steer clear of penalties when they obtain tax opinions from qualified tax professionals and sends shivers up the spines of heretofore-confident tax practitioners who offer clients their legal expertise.

The Court's Opinion

- *Facts Relevant to the Penalty Holding*

The respective roles played by Long Term's principals and its various advisors, including the two law firms that issued the tax opinions underlying Long Term's claiming of a $106 million capital loss, is exhaustively explored in the court's opinion and lays the groundwork for the court's penalty holding against the taxpayer.

The opinion described from its inception a scenario – originating with, and counseled by, a variety of outside advisors – whereby the hedge fund partnership Long Term Capital Holdings[4] took part in a series of transactions that would ultimately result in the contribution of low-value, high-basis preferred stock to the partnership and the subsequent sale of the stock that would generate enormous tax losses allocable to the partnership in 1997. Highlighted early in the opinion is the immense sophistication of Long Term's principals – including Myron Scholes, the 1997 Nobel Laureate for Economics, and two professors of finance from M.I.T and Harvard Business School – who stood to benefit from the claimed tax losses, as well as the considerable tax expertise of its in-house counsel, Larry Noe, a former partner of Coopers & Lybrand known for his "detailed familiarity with federal partnership law."[5] Scholes had co-authored a book titled *Tax and Business Strategy: A Planning Approach*, which, Judge Arterton pointed out, "covers various tax concepts, such as economic substance, business purpose, and the step transaction doctrine."[6]

The opinion detailed communications about the transactions among Long Term's principals and noted the significant involvement of Scholes and Noe in various aspects of the underlying transactions.[7] Four principals testified at trial, recalling in various degrees

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[4] Long Term had produced impressive returns for its investors from its inception in 1994 until 1997. Op. at 131. The hedge fund collapsed in 1998 when it was taken over by a consortium of Wall Street banks following Russia's default on its sovereign debt, which had been a significant investment of the fund. *See Experts Assess the Influence of Long Term Capital's Loss*, The New York Times, August 30, 2004.

[5] Op. at 128-29 nn.3, 4, 6, 7.

[6] Op. at n.6.

[7] "Noe and Scholes were well aware of the tax law requirements of economic substance and business purpose and discussed the need therefore to figure out a reason independent of taxes for Long Term to engage in a transaction with the holders

the series of formal and informal presentations they received concerning the transaction and the concerns raised.[8] Scholes memorialized in a 1996 memorandum to Long Term, shortly after the contribution of the low-value, high-basis preferred stock, his belief that, "If we are careful, most likely we will never have to pay long term capital gains on the 'loan' from the Government."[9] He also asked how Long Term should pay "those who brought the Tax Losses to Fruition."[10] Among Long Term's management, it appears only Scholes and Noe likely ever read the legal opinions on which Long Term relied, and no one seems to have seriously raised questions concerning the legal analysis in the opinions or the representations on which the opinions relied. It was not overlooked that Scholes earned a special partnership allocation of several million dollars for his work in connection with the transaction, and Noe earned a bonus of $50,000 to $100,000 for his part.[11]

Long Term's involvement in the transactions appears to have originated from a conversation between James Babcock of the investment banking firm Babcock & Brown and Long Term's regular outside tax counsel Donald Turlington.[12] According to the court, Babcock & Brown would receive what the court termed a "disguised fee" of $1.2 million[13] for their participation in the two types of cross-border leasing transactions that would produce the low-value, high-basis preferred stock and in the transactions by which Long Term would ultimately obtain and sell that stock, resulting in the claimed tax losses. Turlington, who withdrew from involvement in the transactions early on due to potential conflicts of interest,[14] would end up in a dispute with Babcock & Brown and Long Term over his entitlement to a fee for his role in bringing the transactions to Long Term. The dispute was resolved when Babcock & Brown and Long Term contributed $550,000 and $1.25 million, respectively, to a total $1.8 million settlement with Turlington.[15]

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of the high-basis preferred stock, understanding that Long Term 'would have to have a way … to expect to profit from that interaction.'" Op. at 142, citing trial transcript.

8 Op. at 153-55.

9 Op. at 157, citing Gov't Ex. 320B.

10 *Id.*

11 Op. at 180.

12 Op. at 142.

13 The fees were paid pursuant to a consulting arrangement, which the court characterized as having no performance requirements and pursuant to which Long Term paid Babcock & Brown $100,000 per month for 12 months. The court construed the arrangement as a ruse by Long Term to avoid the appearance that it was paying a cash fee to buy tax benefits. Op. at 144-45, 177-78.

14 Op. at 143.

15 Op. at 159.

The law firm of Shearman & Sterling had advised Babcock & Brown with respect to the seminal leasing transactions (which occurred prior Long Term's involvement), issuing opinions that the leases involved in the transactions were true leases.[16] Shearman & Sterling also opined as to the preservation of the preferred stock's high basis in the hands of Long Term as transferee of such stock following a series of exchange transactions. The firm was originally engaged by Babcock & Brown for this purpose, but this engagement was subsequently assumed directly by Long Term, when the partnership engaged the law firm at Turlington's suggestion.[17] Long Term engaged Shearman & Sterling only after confirming that it could render an opinion at the "should" level.[18] The law firm issued to Long Term five nearly identical opinions that the preferred stock the partnership received in the exchange transactions, which had sold for approximately $1 million, had an adjusted tax basis in Long Term's hands of $107 million.[19] Long Term paid Shearman & Sterling $500,000 for the opinions plus approximately $13,000 in related costs.[20]

The court described Shearman & Sterling's opinions as "contain[ing] no legal reasoning or analysis" but only a recitation of the facts underpinning the legal conclusions, including representations and assumptions on which the firm relied.[21] Although Noe testified that he understood the law firm had prepared a separate memorandum containing its legal reasoning and authority and had the documentation to support the representations and assumptions it relied on, Judge Arterton found the record deficient in this respect. Shearman & Sterling produced a single memorandum containing only part of its reasoning, and produced no written record or recollection in testimony of any analysis of the step transaction doctrine, alter ego or sham transaction theories. Noe, for his part, had never asked to see Shearman & Sterling's legal or factual analysis and did no analysis of his own regarding the representations and assumptions underlying the opinions, the court noted.[22]

Turlington had also suggested that Long Term contact the law firm of King & Spalding for advice on the potential federal partnership tax consequences of the contribution of preferred stock and any possible subsequent sale thereof.[23] King & Spalding tax partners William McKee and Mark Kuller, known for their expertise in partnership law, were retained in May 1996 and had primary responsibility for the engagement, including issuance of a tax opinion as to the transactions' impact on Long Term. An apparently

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[16] Op. at 132.

[17] Op. at 142-43.

[18] Op. at 145.

[19] Op. at 145-46.

[20] Op. at 147.

[21] Op. at 146.

[22] *Id.*

[23] Op. at 143.

critical fact seized on by Judge Arterton is that King & Spalding's formal, written "should-level" opinion concerning the 1997 contribution and sale of preferred stock was issued in January 1999, more than nine months after Long Term filed its 1997 tax return claiming the losses in question.[24] This caused the court to delve deeply into the issue of how much analysis underlying the ultimate tax opinion – as well as how much communication with the taxpayer with respect thereto – was actually completed before April 15, 1998, the date the tax return in question was filed. For only information in the taxpayer's hands on the date of filing could be relevant to a determination of whether the taxpayer relied reasonably and in good faith on the advice of counsel for its tax return position.

Asserting that its written opinion was still in the draft stage at the time the losses were claimed by Long Term on its tax return, King & Spalding nonetheless apparently communicated its conclusions (or a part thereof) to Long Term on or before April 14, 1998.[25] At trial, Long Term produced an internal memorandum from that date authored by Noe. Noe's memorandum detailed discussions with Kuller in which Kuller confirmed orally that the allocation of the loss to the partnership should be sustained and that the opinion would be rendered in accordance with applicable regulations governing substantial authority for a return reporting position and reasonable reliance on the advice of professionals. Noe's memo included statements to the effect that all relevant information had been provided and considered and that the opinion was based on then-current federal income tax law and administrative practice.[26]

What the court initially noted about the King & Spalding opinion as ultimately issued – other than its date of issuance – was that, although it was expressly prepared in anticipation of possible future litigation, it contained no citations to the law of the U.S. Court of Appeals for the Second Circuit, the court to which any trial-level decision involving Long Term's tax return would be appealable.[27] Chief among the representations and assumptions relied upon in the opinion, and on which the court focused, were (a) that Long Term entered into the transaction for valid and substantial business purposes, independent of tax considerations, and (b) that Long Term reasonably expected to make a material pre-tax profit, even when taking into account all related fees and transactions costs.[28]

The court's rejection of Kuller's testimony regarding his analysis of Long Term's expectation of pre-tax profit is painful to read, and it appears that Judge Arterton's perception of Kuller's credibility at trial may have colored the whole of her opinion in

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[24] Op. at 147. Long Term paid King & Spalding $400,000 for the opinion, plus $125,650 in hourly fees. Op. at 176.

[25] Op. at 148.

[26] *Id.*, citing Pet. Exh. 346.

[27] Op. at 149.

[28] Op. at 151, citing Pet. Exh. 357.

this case and clearly influenced her ruling on the penalty issue. It should be noted that Kuller's credibility was initially, and perhaps fatally, undermined by Long Term's choice of trial counsel. Kuller and his partner McKee, co-authors of King & Spalding's tax opinion, ultimately left that firm in 1999 to become partners at McKee Nelson, the firm that represented Long Term in the trial. Kuller had represented Long Term in the initial stages of its IRS audit and, while not counsel of record at trial, he participated significantly on Long Term's behalf in trial preparation. The court noted that McKee Nelson's representation of Long Term in the trial, including Kuller's participation as a key witness on behalf of Long Term, was in accordance with local rules of practice and consented to by the government. Nevertheless, Judge Arterton found that Kuller had an "obvious stake" in Long Term prevailing in the litigation, and "[t]he substance and credibility of Kuller's testimony [was] evaluated in this context."[29]

The opinion details the judge's perceptions of Kuller's demeanor as a witness: his testimony is described as having the "distinct quality of advocacy" and his "belligerence" on cross-examination by the government is contrasted with his manner on direct examination by his own counsel.[30] The court found uncorroborated Kuller's very detailed testimony at trial concerning how he had evaluated Long Term's expectation of a material pre-tax profit and had discussed his analysis at length with Noe before the tax return was due.[31] Judge Arterton determined Kuller's testimony concerning how costs and profits were treated in the opinion to be in conflict with the language of the opinion, otherwise unsupported by the record and lacking in credibility.[32] Kuller's testimony regarding his pre-tax profit analysis was not supported by any contemporaneous documentation nor was it strongly corroborated by Noe's testimony, which the court described as "vague" in this regard. In a finding ultimately critical to its penalty determination, the court determined that Long Term failed to prove the "pre-tax profit analysis was ever made and discussed with Noe contemporaneously . . . and prior to Long Term's tax return filing."[33]

Long Term's tax returns for 1997 were prepared by the accounting firm of Price Waterhouse. The losses at issue were reported by Long Term as a net of income and losses using the term "Net Unrealized Gains" on line 6 of Schedule M-1, which is used to report differences between book and tax income and losses. A prior draft of the return had used the term "Net Capital Gains/Losses," but that description was changed after input from Price Waterhouse and Coopers & Lybrand.[34] The court would ultimately

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[29] Op. at 147 and n.35.

[30] Op. at 151.

[31] Op. at 149-51. The court concluded that "if [the pre-filing analysis and discussions] even took place, it was not in the embellished form offered by Kuller's testimony." Op. at 150.

[32] Op. at 151-53.

[33] Op. at 143.

[34] Op. at 139.

view the use of the term "Net Unrealized Gains" on the return in this manner as an act of concealment by the taxpayer to avoid detection on audit, which served to undermine Long Term's claim of good-faith reliance as a penalty defense.[35]

The Holding on the Merits

The court upheld the Internal Revenue Service's disallowance of Long Term's claimed capital losses on the grounds that the transaction in which the low-value, high-basis stock was contributed to Long Term lacked economic substance other than the creation of tax benefits.[36] In the alternative, the court applied the step transaction doctrine to recast the series of transactions as a prearranged sale of the preferred stock to Long Term.[37] These holdings, and the underlying facts and law, are discussed more fully in a companion White Paper by Gary B. Wilcox, "Lease Strips and Viral Stock: Are They Dead Yet?"

The Holding on Penalties

The court devotes an unusually substantial portion of its opinion to an exacting analysis of the accuracy-related penalty provisions at issue and its findings in regard thereto. The IRS had asserted that Long Term was liable for the 40% gross valuation misstatement penalty imposed under IRC § 6662(a), (b)(3) and (h)[38] with respect to the inflated basis in the preferred stock. In the alternative, the government argued for imposition of the 20% accuracy-related penalty on a variety of grounds – substantial valuation misstatement under § 6662(a) and (b)(3), negligence or disregard of rules and regulations under § 6662(a) and (b)(1), and substantial understatement of income under tax under § 6662(a) and (b)(2). The court upheld the IRS in imposing the 40% gross valuation misstatement penalty and, in the alternative, the 20% penalty for substantial understatement, and found no need to reach the issue of negligence.[39] In doing so, the court rejected Long Term's primary penalty defense that it reasonably and in good faith relied on the opinions of qualified tax professionals.

The penalty portion of the opinion initially covers several pages in consideration of a disputed issue as to whether the government in this partnership-level proceeding had the burden of going forward with the evidence on the issue of penalties under IRC § 7491. Ultimately, the court determined that it need not reach any determination because the government had met *any* burden of production it may have had with respect to the

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[35] Op. at 211.

[36] Op. at 172. Significantly, the court relied heavily on case law from the Second Circuit in reaching its conclusions concerning the transaction's economic substance and the step transaction doctrine. This case has been appealed to the Second Circuit.

[37] Op. at 136, 196.

[38] All references to "IRC" or the "Code" are to the Internal Revenue Code of 1986, 26 U.S.C., as amended.

[39] Op. at 196.

appropriateness of penalties.[40] The court then made quick work of determining the applicability of the 40% gross valuation misstatement penalty. Under the Code, a gross valuation misstatement exists if the value or adjusted basis of property claimed on a return is 400% or more of the value or adjusted basis determined to be correct.[41] The court concluded that its application of the step transaction doctrine had the effect of imputing to Long Term a cost basis in the preferred stock of approximately $1 million, compared to the adjusted basis claimed of $107 million – well in excess of the 400% threshold for application of the 40% penalty.[42]

The penalty analysis then focused on the alternative imposition of a 20% substantial understatement penalty, which is imposed where the "understatement" of tax, i.e., the difference between the tax shown on the return and the correct tax ultimately determined due, is the greater of 10% of the correct tax due or $5,000.[43] The standards by which a taxpayer may make a showing to reduce or avoid the substantial understatement penalty are particularly Byzantine, which perhaps accounts for the court's meticulous evaluation of each element of Long Term's potential defenses to imposition of the penalty. The applicable penalty statute contains more stringent rules relating to penalty defenses in the case of "tax shelters," defined therein as "any plan or arrangement" a significant purpose of which is "avoidance or evasion of Federal income tax."[44] Not surprisingly, the court determined the preferred stock transaction, already found to lack economic substance, to be a "tax shelter" for purposes of the substantial understatement penalty.[45] Thus, Long Term bore the burden of proof in showing that it was not liable for the substantial understatement penalty because it had "substantial authority" in support of its claimed tax treatment of the transaction and a "reasonable belief" that its claimed tax treatment was more likely than not proper.[46] The court found it had neither.

The court parsed the regulations and case law relating to "substantial authority" in painstaking detail. Judge Arterton ultimately held that a taxpayer who has lost on the merits can only escape penalty by citing *legal* sources that would hold for the taxpayer on the merits on closely analogous facts, and a taxpayer may not rely on evidence or facts as

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[40] Op. at 196-99. The burden then shifted to Long Term to introduce evidence of any defenses to the imposition of penalties.

[41] IRC § 6662(e)(1)(A) and (h)(2)(A)(i).

[42] Op. at 199. In a footnote, the court explores an alternate theory that, if the contribution and subsequent sale of the preferred stock are disregarded due to lack of economic substance, Long Term's basis in the stock is zero, and the claimed adjusted basis "infinitely more" than the correct value. *Id.* at n.99.

[43] IRC § 6662(d).

[44] IRC § 6662(d)(2)(C)(iii)(III).

[45] Op. at 200.

[46] IRC §6662(d)(2)(B) and (C).

"substantial authority."[47] Having cast the transaction as one engaged in purely for tax avoidance, the court viewed the existence of substantial legal authority in support of Long Term's tax return position a virtual impossibility. Since the court had found the transaction lacking in economic substance, "Long Term has not and cannot cite authority, much less substantial authority, for the proposition that a taxpayer may claim losses from a transaction in which the taxpayer intentionally expends far more than could reasonably be expected to be recouped through non-tax economic returns in a transaction the sole motivation for which is tax avoidance."[48]

The court similarly rejected Long Term's claim that it reasonably believed that its tax return position was more likely than not proper. The court found first that Long Term *itself* (i.e., its principals) failed to analyze all the pertinent facts and legal authorities and therefore could not have relied on such analysis to conclude that it had a more than 50% chance of success on the merits. Therefore, since Long Term claimed it relied on the opinions of Shearman & Sterling and King & Spalding in this regard, it could only establish its "reasonable belief" in the validity of its return position by demonstrating its reasonable good-faith reliance on those opinions under the reasonable-cause exception to the accuracy-related penalties under IRC § 6664(c).[49] In evaluating Long Term's assertion of the reasonable-cause exception to imposition of penalties, the court reached the crux of its penalty analysis, and that analysis was strongly influenced by the judge's mostly negative impressions of the evidence offered by Long Term concerning the professional advice it received.

Again, the court recited the applicable regulations in detail.[50] The reasonable-cause exception to the imposition of an accuracy-related penalty is set forth in IRC § 6664, which provides that no penalty will be imposed with respect to an underpayment if the taxpayer shows that there was reasonable cause and that the taxpayer acted in good faith.[51] Specifically, reliance on professional advice may constitute reasonable cause and good faith for purposes of the exception, "if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."[52] The determination is made on a

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[47] Op. at 203. Rather, the taxpayer's motives and reliance on facts can be raised in the context of asserting the reasonable-cause and good-faith defense under IRC § 6664(c). Op. at 204.

[48] Op. at 204. The court's reasoning here seems particularly circular and harsh since, rightly or wrongly, Long Term presumably did not initially operate from the premise that the transaction was solely tax motivated. Note that internal IRS memoranda introduced at trial apparently indicated that the IRS National Office may have believed that Long Term had substantial authority for its return position. Op. at 205 n.108.

[49] Op. at 205.

[50] Op. at 205-06.

[51] IRC § 6664(c)(1).

[52] Treas. Reg. § 1.6664-4(b)(1).

case-by-case basis.[53] The court focused specifically on the "threshold requirements" for applying the exception that (a) the advice be based on all pertinent facts and circumstances and the law as it relates thereto, and (b) the advice must not be based on unreasonable factual and legal assumptions and must not unreasonably rely on representations of the taxpayer or others that the taxpayer knows, or has reason to know, may not be true.[54] The court concluded that, in order to establish reasonable cause, Long Term had to have relied on *both* Shearman & Sterling and King & Spalding. Because the court found Long Term did not prove reasonable good-faith reliance on King & Spalding's professional advice, it never reached the question of whether Long Term's reliance on Shearman & Sterling was reasonable.[55]

The first obstacle to Long Term's claim of reliance on King & Spalding was its lack of proof with respect to the content of any advice it may have received from the law firm prior to the filing date of its 1997 tax return. Judge Arterton determined that the oral opinion memorialized in an e-mail by in-house counsel Noe on April 14, 1998 constituted only the last of the three opinions ultimately rendered by King & Spalding, i.e., one regarding allocation of the built-in loss on the sale of stock. Thus, Long Term was unable to show that it even received timely advice in connection with those issues most relevant to the court's holding on the merits: the tax basis of the preferred stock and the recognition of the loss on the ultimate sale.[56] Moreover, the testimony regarding the content of any such advice received by Long Term was found to be too vague (in the case of Noe), or was disbelieved by the court (in the case of Kuller).[57] The court was also critical of Noe for conceding that he had not read all the authorities ultimately cited in the written opinion and for failing to ask Kuller whether Second Circuit authority should have been included.[58]

Because of these deficiencies in proof as to the timeliness and content of King & Spalding's advice to Long Term, the content of the law firm's final written opinion did not govern the court's analysis of Long Term's reasonable reliance on King & Spalding. Nevertheless, the court evaluated King & Spalding's written opinion in light of Long Term's reasonable-cause claim, assuming *arguendo* it had been timely received.[59] Predictably, the court found the opinion did not meet the threshold requirements for reasonable good-faith reliance. Thus, Long Term failed to prove (a) that the opinion was

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[53] *Id.*

[54] E.g., such as an inaccurate assumption as to the taxpayer's purpose for entering into the transaction. Op. at 206, citing Treas. Reg. § 1.6664-4(c)(1).

[55] *Id.* and n.109.

[56] Op. at 207.

[57] Op. at 207-08. The court's skepticism in this regard was directed at Kuller's testimony concerning the detailed discussions he claimed to have had with Noe concerning material pre-tax profit potential.

[58] Op. at 208.

[59] Op. at 208-11.

based on all the pertinent facts and circumstances and law related thereto and (b) that unreasonable factual and legal assertions were not relied on in rendering the opinion. The court's analysis of the record in this regard is nothing short of blistering.

First, the court found that use of the standard preface to the opinion, stating that it was prepared in anticipation of possible future litigation, coupled with the opinion's untimeliness, "casts doubt on its contents as . . . a reasoned opinion" on the application of the tax law to the transactions.[60] Such prefatory language is not unusual and is ordinarily used to preserve the attorney work-product privilege. The court's reaction to it suggests a perhaps unrealistic expectation that opinion writing would be utterly devoid of any hint of advocacy or, for that matter, any expectation of confidentiality. The court next faults the opinion for failing to demonstrate, "factually or analytically," why it was reasonable to rely on Long Term's factual representations. Here the court points to the lack of supporting evidence, such as internal King & Spalding memoranda, that would have revealed the results of the firm's due diligence with respect to, e.g., Long Term's expectation of profit and business purpose.[61] Based on its evaluation of all the facts at trial, the court held that "a reasonably diligent analysis of facts and circumstances would have revealed at least some of those assumptions to be unreasonable and unsupportable."[62]

The court then attacked the King & Spalding opinion's legal analysis as deficient. Since the court relied heavily on Second Circuit case law in reaching its holdings on the merits, it deemed glaring the absence of Second Circuit citations in the opinion. It found "little, if any" legal analysis of the economic substance of the transaction and "minimal" legal analysis as to the application of the "end result test" it employed to apply the step transaction doctrine.[63] Again, the court pointed to the absence of research memoranda in King & Spalding's files addressing these issues. "Such background research," the court fairly sniped, "does not involve obscure or inaccessible caselaw references, [and] is basic to a sound legal product, especially for [a] 'should' level opinion and a premium of $400,000. With hourly billing totals exceeding $100,000 there could not have been research time constraints."[64]

Ultimately, the court rejected the evidence offered by Long Term concerning the advice it received from King & Spalding as amounting to no more than "general superficial pronouncements" as to the underlying diligence and reasonableness. In addition, the court was critical of the failure of Long Term's principals to read the opinion and discuss

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[60] Op. at 209.

[61] *Id.*

[62] Op. at 209.

[63] Op. at 210.

[64] Op. at 211.

among themselves in any depth the reasonableness of its factual and legal assumptions.[65]

One final nail was hammered into the coffin of Long Term's claim of reasonable good-faith reliance. The tax return reporting – netting the losses against other capital gains and reporting the net as "Net Unrealized Gains" on Schedule M-1 – was deemed by Judge Arterton "a transparent attempt to conceal Long Term's efforts to keep the huge tax losses claimed from raising the red audit flag." The claimed capital losses were neither "unrealized" nor "gain," and the court found no justification for reporting the losses using "misleading titles and labels." This, in the court's view, negated any claim of good faith, and the court found it "of little moment" that these "disingenuous choices were counseled and encouraged by consultants."[66]

The Decision's Impact

Every litigator knows that litigation is hazardous and unpredictable. Reading the court's opinion in *Long Term Capital Holdings*, one cannot help but conclude that the evidence offered by the taxpayer in this case certainly failed to carry the day in virtually every respect. The court seemed ultimately to take offense at the conduct of these extraordinarily sophisticated taxpayers and their highly qualified, and highly paid, professional tax advisors, and that tone permeates every aspect of the court's opinion. In hindsight, Long Term's decision to be represented in the litigation by Kuller's law firm, McKee Nelson, seriously undermined Kuller's credibility as a key witness for Long Term by giving him what the court termed a "clear stake" in the case's outcome. This was not the sole instance of the court's focus on the potential bias of Long Term's witnesses. The substantial compensation earned by the principals and advisors, respectively, in connection with the transaction is waved around by the court like so much dirty laundry, implying that everyone had a greedy hand in the till and a reason to turn a blind eye to an overly-aggressive tax position and then to defend it zealously in court.

Each case turns on its own facts, and this case was chockfull of unfavorable facts that ultimately presented insurmountable obstacles for Long Term. Long Term's high-caliber, Nobel Prize-winning management was, of course, bound to be held to an unmercifully high standard in terms of how well it understood the underlying tax implications of the transactions and the applicable legal principles. The transactions were unusual for Long Term, which also had no previous relationship with the majority of the outside advisors who consulted on the transactions. As already noted, a key witness for the taxpayer was a partner in the law firm representing Long Term in the litigation, and the court doubted his credibility and dismissed significant portions of his testimony. King & Spalding's written tax opinion was not issued in time to provide a basis for Long Term's reasonable reliance thereon. Significantly, both Shearman & Sterling's and King & Spalding's internal documentation in support of the due diligence and factual and legal analysis behind their opinion letters was surprisingly sparse. That fact gave rise to the

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[65] *Id.*

[66] Op. at 212.

implication that the taxpayers and their advisors gave insufficient consideration to the factual representations and law relied upon. The opinion letters themselves, at least as described by the court, appear to have taken a more superficial approach to the legal analysis than was warranted. Long Term's tax return reporting of the loss was in a non-standard format the court read as designed to mislead the IRS. And, it cannot be discounted that the losses claimed were enormous, particularly relative to the value of the preferred stock – a bad "visual," regardless of the merits of the tax position.

The cumulative effect of these "bad facts" led to some particularly harsh judgments on the law. And, once the court had decided to invalidate the transactions for tax purposes, it cut Long Term off at every conceivable turn as the taxpayer tried to show the efforts to which it went – with the help of reputable legal and accounting firms with considerable depth of relevant expertise – to obtain qualified professional advice concerning its tax position. This is exemplified by the court's reasoning that there could essentially never have been "substantial authority" for a transaction ultimately found to lack economic substance. Also, in dismissing Long Term's claims of "reasonable belief" and "reasonable cause," the court had unusually high expectations about the taxpayer reading not only the opinions *but the underlying authorities* and raising questions about the legal analysis that was there *and that was not there.* Admittedly, some of Long Term's principals may have had the tax expertise to have done so, but the average taxpayer – even the truly financially sophisticated taxpayer – should not be expected to duplicate the efforts of the outside experts on which it relies and provide a highly critical and informed analysis of the tax professionals' work product in order to demonstrate reasonable belief and reasonable reliance.

Another intangible factor that no doubt weighed against Long Term is the current enforcement-heavy environment in tax administration and elsewhere. There is a pervasive and not-entirely-unjustified perception that aggressive tax strategies blossomed out of control in the late 1990s. Frankly, no one in 1997 would have predicted just how far back the tax compliance pendulum has now swung, such that today, "promoter" audits, summons enforcement for client lists, injunctions, penalties, civil lawsuits against professionals and even criminal investigations of tax practitioners are the subject of weekly headlines.

One of the casualties of these tax shelter battles is clearly the attorney-client privilege. In recent cases arising mainly in "promoter" audits – because of the courts' distaste for tax shelters and the strong governmental interest in disclosure in that context – the attorney-client privilege has been substantially narrowed for purposes of rendering tax advice.[67] An early ruling in *Long Term* suggested that the law firms' opinion letters, absent waiver, were likely privileged.[68] As the law stood in 1997, Long Term and its counsel probably expected that their communications and internal work product were privileged, at least

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[67] *See, e.g., United States v. KPMG*, No. 03-C-9355 (D.D.C. May 4, 2004).

[68] *Long Term Capital Holdings v. United States*, Ruling on Respondent's Motion to Compel (D. Conn. Oct. 30, 2002).

unless or until Long Term would have to assert that it reasonably relied on counsel's opinions. Given the perceived lack of file documentation put in evidence at trial, it is doubtful the law firms anticipated the kind of intense scrutiny that a court would ultimately give to the services they rendered. This is one of the characteristics of the *Long Term* decision that will and should have the most significant impact. No tax advisor in today's environment should presume that his or her opinions or files will not be subject to this type of scrutiny – as to timeliness, content, factual due diligence, and depth and relevance of background legal analysis – and should act accordingly. As if the *Long Term* decision did not constitute sufficient warning in this regard, newly enacted legislation and amendments to the professional practice regulations governing the issuance of tax opinions make it crystal clear that the rules have forever changed.[69]

Not surprisingly, the IRS is treating *Long Term* as a decisive and precedent-setting win in the tax shelter enforcement arena. And who can blame them? Their recent enforcement rhetoric is fueled by the court victory, and they have been quick to suggest that the case's reasoning and outcome will apply in other contexts. This is the greatest danger posed by the decision in *Long Term*, and the peril of over-extending the reasoning of *Long Term* was demonstrated by recent events.

On October 20, 2004, the IRS announced with fanfare its tightening of Appeals settlement guidelines in cases involving lease strips, including full concession of the tax benefits and a mandatory penalty at 50% of whichever penalty the IRS has proposed (either the 40% or 20% accuracy-related penalty). Implicitly, the IRS was also denying any benefit of a case-by-case review of the facts by Appeals. The change was hailed in IRS press releases as a quick adjustment in reaction to the Service's victory in *Long Term*, and a "ratchet[ing] up of pressure on those entering into abusive transactions."[70] The very next day, October 21, 2004, the U.S. District Court in Maryland handed the government a decisive loss on summary judgment in another closely-watched piece of tax shelter litigation, *Black & Decker Corp. v. U.S.*[71] In a startlingly brief opinion, the court held, in spite of Black & Decker's concession of a tax avoidance motive in entering into a *listed* contingent liability transaction (i.e., one subsequently designated by the IRS as abusive), that the transaction was not a sham because it had bona fide and real economic implications for the parties. The decision, if upheld on appeal, would entitle Black & Decker to a $57 million refund, and the government's counterclaim for penalties would necessarily fail. Two more government losses on economic substance followed closely

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[69] The American Jobs Creation Act of 2004, enacted October 22, 2004, created new disclosure and reporting requirements as well as heightened professional conduct standards, penalties and sanctions for tax practitioners. In addition, final regulations (T.D. 9165) issued on December 17, 2004 under Treasury Department Circular 230 further tighten practitioner standards for issuing tax opinions.

[70] *Appeals Tightens Screws on Shelter Investors*, 2004 TNT 204-H (Oct. 21, 2004), quoting IRS Commissioner Mark W. Everson.

[71] No. WDQ-02-2070 (D. Md. Oct. 20, 2004).

on *Black & Decker*'s heels.[72]

The lesson here is that not all tax shelter cases can or should be treated alike. The government is faced with the difficult job of sorting out the differences among them, or the courts will do it for them. The particular alphabet soup of *Long Term*'s facts is unlikely to be duplicated in *any* other case – even a case that involves lease strips. Moreover, as the statute says,[73] the facts and circumstances underlying an analysis of reasonable cause in the penalty context must be evaluated on a *case-by-case* basis. Thus, there should be no cookie-cutter test for penalties in listed transaction cases, and the government's victory in *Long Term* does not justify such an approach.

Does *Long Term* signal the end of the penalty protection taxpayers expect to enjoy when they obtain opinions from tax professionals? Hopefully not. However, to quote a memorable *Monty Python* skit, taxpayers with opinions already in hand can, indeed, expect "the Spanish Inquisition" with respect to the facts surrounding their reliance on those opinions. And a practitioner's approach to writing tax opinions will necessarily be, from here on out, a much tighter process or the consequences could be severe for both the taxpayer and the professional.

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[72] *Coltec Industries Inc. v. United States*, No. 01-072T (Fed. Cl. Oct. 29, 2004); *TIFD III-E Inc. v. United States*, No. 3:01CV1839 (SRU) (D. Conn. Nov. 1, 2004).

[73] *See* Treas. Reg. § 1.6664-4(b)(1).