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Transactional Planning and Advice

Linda Galler
Maurice A. Deane School of Law at Hofstra University

Michael B. Lang

Chapter 3

TRANSACTIONAL PLANNING AND ADVICE

I. CLIENT CONFLICTS

Circular 230 §§ 10.20 and 10.29
Tax Court Rule 24(g) (Appendix G)
Model Rules 1.7, 1.8, 1.9 and 1.13(a)
AICPA ET § 102.03 and Interpretation 102-2 (Appendix H)

A. Introduction

The point of conflicts of interest rules is to protect clients' reasonable expectations that legal advisors and representatives will act on their behalf free from compromising loyalties and influences. Thus, the basic principle embodied in the Model Rules' conflict provisions is that a lawyer may not represent anyone where the interests of another person — a current or former client, perhaps, or the lawyer's own interests — could impair the lawyer's ability to zealously and impartially act on a client's behalf. Resolution of a conflict might entail declining to undertake representation, withdrawing from an existing representation, or obtaining a client or clients' written consent to proceed despite a conflict.

The basic rules governing conflicts of interest are contained in Model Rule 1.7. This rule sets out the general conflicts of interest principles on which all other conflicts rules rely. Model Rule 1.7(a) provides that a lawyer may not represent a client if that representation involves a concurrent conflict, meaning that either:

1. the representation of one client will be directly adverse to another client, or
2. there is a significant risk that representation of one or more clients will be materially limited by the lawyer's responsibility to another client, a former client, or a third person, or by the lawyer's own personal interest.

Notwithstanding a concurrent conflict, however, Model Rule 1.7(b) permits a lawyer to represent a client if:

1. the lawyer believes that she will be able to competently and diligently represent each affected client,
2. the representation is not prohibited by law,
3. the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding, and
4. each affected client gives informed consent, confirmed in writing.

AICPA conflicts of interest rules are set forth at AICPA Code of Professional Conduct ET Section 102.03 and Interpretation 102–2, which are reproduced at Appendix H. Conflicts of interest for accountants are defined in terms of

relationships that could be viewed by a client, employer, or another party as impairing a CPA's objectivity. If a CPA believes that a professional service can be performed with objectivity, however, and the relationship is disclosed to and consent is obtained from the client, employer, or other appropriate party, then the CPA is permitted to perform the professional service. Conflicts cannot be waived with respect to engagements that require independence, e.g., audits, reviews and other attest services.

B. Differences Among the Guiding Principles

The conflicts of interest rules in Circular 230 § 10.29 are very similar to those in Model Rule 1.7. Circular 230 § 10.29, however, imposes three additional requirements. First, while both the Model Rules and Circular 230 require that conflict waivers be confirmed in writing, Circular 230 mandates that confirmation be obtained within a reasonable period of time, but in no event later than 30 days after the client has consented to the representation. (The AICPA standards do not require written consent.) Second, unlike Model Rule 1.7, which permits affected clients to provide informed consent verbally if the consent is contemporaneously documented by the practitioner in writing, a verbal consent followed by a confirmatory letter authored by the practitioner will not satisfy Circular 230 § 10.29 unless the confirmatory letter is countersigned by the client. Finally, under Circular 230, practitioners are required to retain copies of written consents for at least 36 months from the date on which representation of the client concludes.

Practitioners must provide copies of written consents to IRS officers or employees, including those from OPR, upon request. Although the requirement to turn over copies of written consents is explicitly stated in Circular 230 § 10.29(c), it is consistent with the practitioner's duty, as a general matter under Circular 230 § 10.20, to provide documents and information to the IRS upon proper and lawful request. Unlike Circular 230 § 10.29(c), however, Circular 230 § 10.20 explicitly provides that information and documents need not be turned over if the practitioner believes in good faith and on reasonable grounds that the records or information are privileged. Perhaps the very fact that Circular 230 § 10.29 requires that written consents be obtained and held for 36 months should the IRS or OPR request them is meant to negate privilege as to such written consents because there could be no realistic expectation of privacy. Of course, this argument presumes that the client understands at the time of signing that the consent must be turned over by the practitioner to the IRS upon request. It is the client's expectation of privacy, and not the attorney or tax adviser's, that matters for privilege purposes.

Alternatively, it is possible that OPR regards written consents as ineligible for protection by the attorney-client or Section 7525 privilege in the first instance. Such a position may often be incorrect, particularly if a written consent document includes or reflects privileged communications. Therefore, where a practitioner chooses to explain the nature of a conflict to her client in writing, it would be prudent to have the client consent, or confirm consent, in a separate document, which could be turned over to the IRS or OPR without worry. It is generally understood that OPR considers failure to retain or turn over a written consent a violation of Circular 230 regardless of the quality of the underlying representation.

Practitioners representing clients in Tax Court proceedings must comply with the Tax Court's own rule on conflicts of interest:[1] Tax Court Rule 24(g) provides that if any counsel of record "represents more than one person with differing interests with respect to any issue in the case," she must secure the clients' informed consent to the representation, withdraw from the case, or take whatever other steps are necessary to obviate the conflict of interest. Tax Court Rule 24(g) imposes the same obligations on any counsel who "was involved in planning or promoting a transaction or operating an entity that is connected to any issue in a case." Counsel who is a potential witness in a case must withdraw or take other steps necessary to obviate a conflict; obtaining the client's informed consent is not an option in this situation.

PROBLEM 3-1

X is the president and chief executive officer of Family-Run Corp., a small, family-run business. Family-Run engages Practitioner to prepare tax returns for the company, its officers and its shareholders (all family members). As Practitioner prepares Family-Run's return, there is a question as to whether a payment the company made to X is a deductible payment of compensation or a nondeductible return of capital. Does Practitioner have a conflict of interest? If so, can it be cured, and how?

PROBLEM 3-2

Q, A and B, all individuals, are partners in LP, a limited partnership. Q is the general partner. Q engages Practitioner to prepare LP's return (Form 1065) and the partners' Schedules K-1. Practitioner is separately engaged by Q, A and B to prepare their individual income tax returns. While preparing LP's return, Practitioner identifies an issue as to the meaning of a provision in the partnership agreement that will affect the allocation of partnership items to the partners. This provision could be interpreted to provide an allocation of certain tax benefits to Q, to the detriment of A and B. Does Practitioner have a conflict of interest? If so, can it be cured, and how?

PROBLEM 3-3

Jon and Kate were married for all of 2009. In June 2009, Kate initiated divorce proceedings. In early 2010, Jon engages Practitioner to prepare the couple's joint tax return for 2009. Not long after, Kate (through her attorney) asks Practitioner to prepare her 2009 tax return as married filing separately. When Practitioner informs Kate's attorney that he was already engaged by Jon to prepare a joint return for the couple, the attorney informs Practitioner that Kate has no intention of signing a joint return. Does Practitioner have a conflict of interest? If so, can it be cured, and how?

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[1] Practitioners representing clients in Tax Court must comply with all of the Model Rules, which have been adopted as rules of practice before the court. Tax Court Rule 201(a). Differences between the Model Rules and the rules adopted by one's own state of admission or practice, therefore, should be carefully monitored.

C. Business Planning

Most Corporate Tax classes begin with a study of the tax consequences of corporate formation, "Section 351 exchanges." Inevitably, students are asked to consider a hypothetical set of facts involving several unrelated persons who, together, desire to incorporate a new entity, with each person transferring previously-owned property, cash and/or services to the newly-formed entity in exchange for stock and, perhaps, other property ("boot"). Students are routinely asked to consider whether each transferor recognizes gain or loss, and what each transferor's basis in her newly acquired stock and boot will be. On the corporate side, students learn that the corporation itself recognizes no gain or loss on the issuance of shares, and master the increasingly complicated rules governing a corporation's basis in property received from transferors. Professors go to great lengths to assist students in divining those situations in which nonrecognition is a benefit and those in which it is not. Students brainstorm solutions to assist the various players in, e.g., recognizing losses but not gains, preserving or protecting unrecognized losses, and maximizing corporate basis in depreciable assets. Corresponding concepts are covered in Partnership Tax classes in connection with formation of partnerships and limited liability companies.

What typically is omitted from such instruction, however, is an examination of the ethical situation in which an attorney hired by all of the transferors finds herself. While individuals entering into a new business venture might view their interests as common, that is not necessarily so. Particularly in the case of small businesses founded by individuals, one attorney is often hired by the entire group to handle the corporate formation.

If a lawyer agrees to accept representation, who is the client, the individual transferors (separately or as a group) or the corporation that results from the representation? Does the answer depend upon whether the attorney will continue to work professionally with the corporation?

State Bar of Arizona Opinion No. 02-06

(Sept. 2002)[2]

Summary

A lawyer may form a business entity for various individuals and be counsel only for the yet-to-be-formed entity, if appropriate disclosures and consents occur. Alternatively, a lawyer may represent all of the incorporators, collectively, with appropriate disclosures.

Facts

Lawyer is a business law practitioner who currently represents several businessmen in various matters. The existing clients ask the lawyer to form a new entity corporation for them and to be counsel only for the entity.

Questions Presented

1. May a lawyer represent a yet-to-be-formed entity during formation?
2. Can a lawyer represent the prospective entity without being deemed to also represent the incorporators?
3. If so, what disclosures must the lawyer make to the constituents to clarify who is the client?

* * *

Opinion

1. Can a lawyer represent an entity that does not yet exist?

Yes, as long as the incorporators understand that they are retaining counsel on behalf of the yet-to-be-formed entity and will need to ratify this corporate action, *nunc pro tunc*, once the entity is formed. According to [Rule] 1.13(a), a lawyer may represent an "organization." The Comments to the Rule explain that an "organizational client is a legal entity, but it cannot act except through its officers, directors, employees, shareholders and other constituents. ... The duties defined in this comment apply equally to unincorporated associations."

An "organizational client" or "entity" can be a separate client. For purposes of the ethical analysis, this Opinion will refer to "corporations" as the entity at issue, but the analysis also is applicable to other legal entities.

To determine whether a lawyer ethically may represent a yet-to-be-formed corporation, the analysis must include a review of Arizona corporate and partnership statutes. A.R.S. § 10-203 provides:

A. Unless a delayed effective date is specified in the articles of incorporation, incorporation occurs and the corporate existence begins when the articles of incorporation and certificate of disclosure are delivered to the commission for filing.

Under this statute, a corporation does not exist as a separate legal entity until its articles of incorporation are filed with the Corporation Commission.[3] Section 10-204 of the Arizona Revised Statutes further cautions that individuals who attempt to transact business as a corporation, knowing that no corporation exists, will be jointly liable for their actions. Presumably, however, a newly formed corporation may ratify pre-incorporation acts of the corporation, *nunc pro tunc*.

A decision from Wisconsin specifically holds that a lawyer hired to form an entity can represent the to-be-formed entity, not the incorporators, and the "entity" rule applies retroactively. Jesse v. Danforth, 485 N.W.2d 63 (Wis. 1992). This view would be consistent with the "entity" theory of representation, under [Rule] 1.13(a). The "entity" theory holds that a lawyer may represent the corporation and does not, necessarily, represent any of the constituents that act on behalf of the entity — even if it is a closely held corporation. See, e.g., Skarbrevik v. Cohen, England & Whitfield, 282 Cal. Rptr. 627 (Cal. App. 1991); Bowen v. Smith, 838 P.2d 186, (Wyo. 1992).

[3] [1] Partnerships, however, are not required to make a filing to establish their existence; a partnership exists once there is an "association of two or more persons to carry on as co-owners [of] a business for profit... whether or not the persons intend to form a partnership." A.R.S. § 29-1012.A.

An alternative view is the "aggregate" theory in which the lawyer is found to represent the incorporators/constituents collectively as joint clients. See Griva v. Davison, 637 A.2d 830 (D.C. 1994). Under the aggregate theory, a lawyer represents multiple co-clients during formation of the corporation and then once the entity is formed, the clients must determine whether the lawyer will continue to represent all of the constituents and the entity, or just the entity. Who a lawyer may represent depends upon whether the lawyer's independent professional judgment would be materially limited because of the lawyer's duties to another client or third person. See [Rule] 1.7(b); Matter of Shannon, 179 Ariz. 52, 876 P.2d 548 (1994). As discussed below in Section 3, there are specific disclosures that a lawyer must make to co-clients, in order for them to consent to a joint representation.

Thus, a lawyer may represent an entity during the formation process, as long as the constituents who are acting on behalf of the yet-to-be-formed entity understand and agree to the entity being the client.

2. Can a lawyer represent *only* the yet-to-be-formed entity and not the constituents?

Who a lawyer represents depends upon the reasonable perceptions of those who have consulted with the lawyer. In re Petrie, 154 Ariz. 295 (1987). When two or more individuals consult with a lawyer about forming an entity, it is the responsibility of the lawyer at that initial meeting to clarify who the lawyer will represent. [Rule] 1.13 provides that a lawyer may represent an entity and the Rule suggests that the lawyer will not automatically be considered counsel for the constituents because paragraph (e) of the Rule provides:

A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of [Rule] 1.7. If the organization's consent to the dual representation is required by [Rule] 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

In Samaritan v. Goodfarb, 176 Ariz. 497, 508, 862 P.2d 870 (1993), the Arizona Supreme Court confirmed that a lawyer representing an entity does not automatically represent the constituents. Therefore, unless a lawyer wants to be counsel to all of the incorporators and the entity, the lawyer should specify that the lawyer does not represent the constituents collectively — the lawyer only represents the entity. If an engagement letter or oral representation by the lawyer suggests that the constituents are represented as an aggregate, then the lawyer will have ethical obligations to each constituent. Aggregate representation also is ethically proper if the disclosure to each client includes an explanation that the lawyer may have to withdraw from representing each client if a conflict arises among the clients.

3. What disclosures should a lawyer make to the incorporating constituents to obtain their informed consent to the limited representation of the entity?

The underlying premise of the conflict Rules is loyalty to clients. Where a lawyer's independent professional judgment for a client is materially limited due to anything or anyone, a conflict may exist. Thus, in order to avoid inadvertent conflicts caused by misunderstandings of constituents in corporate representations, it is crucial for lawyers to specify exactly who they represent, who they do not represent, and how information conveyed to the lawyer by

constituents of an entity client will be treated, for confidentiality purposes. The Restatement Third, The Law Governing Lawyers, Comment b to § 14 provides in part: "A lawyer may be held to responsibility of representation when the client reasonably relies on the existence of the relationship. ..."

See also Comment f: "[A] lawyer's failure to clarify whom the lawyer represents in circumstances calling for such a result might lead a lawyer to have entered into client-lawyer representations not intended by the lawyer."

Therefore, it is crucial that a lawyer specify in the engagement agreement if the lawyer is not representing the constituents of an entity client.

Even if the engagement letter specifies that the constituents are not clients, lawyers still should regularly caution constituents that they are not clients — particularly when they consult with counsel. Lawyers who represent entities also must be aware of the entity's potential fiduciary duties to the constituents, so that the lawyer does not run afoul of those statutory or common law obligations. For instance, there are cases that have held that lawyers may have fiduciary duties to non-clients, depending upon whether the entity represented had fiduciary duties to the third parties. See Fickett v. Superior Ct. of Pima Cty, 27 Ariz. App. 793, 558 P.2d 988 (1976); Matter of Estate of Shano, 177 Ariz. 550, 869 P.2d 1203 (App. 1993) (lawyer disqualified as counsel to administrator for an estate because of prior representation of one beneficiary and derivative duty of neutrality to all beneficiaries). Accordingly, lawyers for entities should be mindful of this potential responsibility and that a derivative fiduciary duty to constituents may cause a conflict of interest for the lawyer.

The engagement letter also should explain that once the entity is created, the constituents agree to ratify the lawyer's services, *nunc pro tunc* on behalf of the entity.

With respect to confidentiality obligations, lawyers should specify how information conveyed to the lawyer will be treated for confidentiality purposes. If the firm is representing only the entity, constituents must be advised that their communications to the lawyer will be conveyed to the other decision-makers for the entity and are not confidential as to the entity. The information is confidential, however, according to Rule 1.6(a), to the "outside world." Similarly, information shared by one co-client that is necessary for the representation of the other joint clients will be shared with the other co-clients because there is no individual confidentiality when a joint representation exists.

Finally, if the lawyer has chosen to represent multiple clients, including the constituents and the entity, the lawyer should explain, at the beginning of the joint representation, that in the event that a conflict arises among the clients, the lawyer most likely will need to withdraw from representing all of the co-clients. However, some commentators, including the Restatement Third, note that the engagement agreement may provide that in the event of a conflict, the lawyer may withdraw from representing one of the co-clients and continue to represent the remaining clients. The usefulness of such provisions was recently demonstrated in In re Rite Aid Corp. Securities Litigation v. Grass, 139 F. Supp. 2d 649 (E.D. Pa. April 17, 2001), where the court permitted the law firm to withdraw as counsel for one of the executives of Rite Aid and continue as counsel for the entity in a class action suit, primarily because the engagement agreement provided for such action.

In *Jesse v. Danforth*, 485 N.W.2d 63 (Wis. 1992), a case referred to in the State Bar of Arizona opinion, *supra*, the Wisconsin Supreme Court held that the client is the corporation, not the corporation's constituents. This is referred to as "the entity theory." The court stated:

> We thus provide the following guideline: where (1) a person retains a lawyer for the purpose of organizing an entity and (2) the lawyer's involvement with that person is directly related to that incorporation and (3) such entity is eventually incorporated, the entity rule applies retroactively such that the lawyer's pre-incorporation involvement with the person is deemed to be representation of the entity, not the person.
>
> In essence, the retroactive application of the entity rule simply gives the person who retained the lawyer the status of being a corporate constituent during the period before actual incorporation, as long as actual incorporation eventually occurred.

Id, at 67. Under the "entity theory" of representation, a corporate lawyer typically is not disqualified from representing the corporation in litigation between the corporation and one or more of its constituents. It also means that the corporate lawyer generally is not liable to shareholders, officers, or directors for malpractice or breach of fiduciary duty. Moreover, as specifically noted by the court in *Jesse v. Danforth*, the identity of the client has implications with respect to the attorney-client privilege. The corporation, and not the constituents, holds the privilege as to communications pertaining to the organization of the entity. Individual constituents, however, hold the privilege where a communication does not relate directly to the purpose of organizing the entity.

If the lawyer's dealings with constituent individuals become so extensive and personal that the individuals reasonably believe that the lawyer represents them personally, a court or disciplinary authority might conclude that, despite the "entity theory," a lawyer-client relationship has nonetheless been formed between the lawyer and the individual constituent. Attorneys should be familiar with their own states' corporate laws when evaluating possible conflicts of interest questions in the context of business representation.

Samples of conflicts language for engagement letters often are available on the web sites of state bars. For example, the Georgia Bar web site includes a lengthy "Report on Engagement Letters in Transactional Practice." That report is available at http://www.gabar.org/public/pdf/sections/buslaw/eltp.pdf. The Colorado state bar web site also contains an interesting example, at http://www.cobar.org/repository/LPM%20Dept/FeeAgmts/EngageLtr ConflictofInterestASparkman.pdf?ID=260. The American College of Trust and Estate Counsel offers samples, as well, at http://www.actec.org/public/EngagementLettersPublic.asp.

PROBLEM 3-4

Three prospective clients meet with Lawyer to discuss a new business venture. A, who has experience in the business, would contribute his management skills, B would contribute a substantial amount of cash, and C would contribute assets that could be used in the business. Each person would receive one-third of the stock in a newly formed corporation. A, B and C have asked Lawyer

to create the corporation and to advise them with respect to tax and other issues related to forming and operating the business.

a. May Lawyer represent all three individuals seeking to form the business? Whom should Lawyer represent in the case? How would you advise Lawyer to proceed?

b. Would your answer to (a), above, change if A, B and C brought in another "partner," D, who would contribute property with an adjusted basis in excess of value?

c. If a dispute were to arise among the three "partners," and one of them decided to hire her own lawyer, could Lawyer continue to represent the remaining "partners"?

d. Suppose that you accept the representation in full compliance with your ethical obligations and that several years later, A calls you to discuss renegotiating her salary. How should you handle her call?

PROBLEM 3-5

You recently filed a letter ruling request with the IRS on behalf of Smithco, Inc. to the effect that a series of contemplated transactions should, with application of the step transaction doctrine, be treated as a tax-free reorganization. Jonesco, Inc. has asked you to represent it in Tax Court litigation in which its position will be that a similar series of transactions should not to be stepped together, but should instead be treated as separate steps, with the result that there is no reorganization. Can you take the case? Would your answer be different if you are representing Smithco in Tax Court rather than in the ruling process? What is the answer if you are representing Smithco in connection with an audit, after the transaction has already been reported as a reorganization on a filed tax return?

D. When Business or Personal Relationships Fail

Human nature being what it is, disputes often develop between or among business "partners," once business operations have commenced. Whether a lawyer previously worked with all of the co-venturers or merely represented the entity, questions arise as to whether the attorney may continue in the representation and whom the attorney may represent. Among the concerns is the possibility that the attorney received confidential information that may not be used against a former client. While the case below arose out of a personal, not a business, relationship, the ethical considerations are well exemplified.

DEVORE v. COMMISSIONER

United States Court of Appeals, Ninth Circuit
963 F.2d 280 (1992)

PER CURIAM:

Gary Devore appeals from the United States Tax Court's denials of his motions to vacate deficiency judgments for the tax years 1970-1975. Devore contends that dual representation of himself and his ex-wife in the tax proceedings resulted in a conflict of interest that prevented their joint counsel from raising defenses on his behalf. We have jurisdiction under 26 U.S.C. §§ 7482(a), 7483. We reverse the

orders of the tax court and remand for an evidentiary hearing to determine whether Devore was prejudiced by his former counsel's conflict of interest and whether Devore had reasonable grounds for failing to seek independent counsel.

Background

For many years, Maria Cole and her former husband, Nat King Cole, had been represented by attorney Harry Margolis. Margolis continued to represent Maria Cole after Nat King Cole's death. Maria Cole and Gary Devore were married in 1969. For the year 1970, Devore filed an individual return. Joint returns were prepared for all other years during the marriage. Until June 1987, Harry Margolis was the sole counsel of Cole and Devore. Leo Branton, Jr., became co-counsel with Margolis in June 1987. Margolis died on or about July 15, 1987 and Branton became the sole counsel of record on behalf of Cole and Devore in connection with the instant actions. The tax proceedings culminated in the entry of two judgments against Devore.

Cole and Devore were separated in 1976, and were divorced in 1978. The tax court did not render judgments in the instant cases until 1989. Despite their divorce, joint counsel continued to represent Cole and Devore throughout the tax proceedings.

After a four day trial, the tax court determined that Devore was individually liable for a federal tax deficiency of $135,302, and for a negligent return penalty of $6,765. The tax court found that Devore failed to carry his burden of proof in establishing that certain checks totaling $210,000 did not constitute reportable income to him. Two checks had been issued to Devore by a company controlled by Margolis. These checks were received by Devore, but were immediately endorsed over to Margolis. Devore alleges that these funds were then used to purchase a home in the name of Maria Cole. The tax court found that the $210,000 represented by the two checks was income attributable to Devore.

In a second judgment entered pursuant to stipulations of settlement, Devore and Cole were held jointly and severally liable for deficiencies totaling over $300,000 for the years 1971-1975.

Devore states that he entered and left his marriage to Cole with a net worth of less than $10,000 and that he lacks the money to satisfy the judgments. He further states that he was unsophisticated in tax matters and that he was continually excluded from the financial affairs of Maria Cole.

Devore moved, through new counsel, to vacate the tax court's deficiency judgments. He asserted that when counsel represented him and Cole jointly, a conflict of interest resulted. This conflict, argues Devore, prevented joint counsel from bringing innocent spouse and agency defenses which would have diminished his tax liability. The tax court denied these motions.

Discussion

A tax court's decision not to reopen a record for the submission of new evidence "is not subject to review except upon a demonstration of extraordinary circumstances which reveal a clear abuse of discretion." *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359, 363 (9th Cir. 1974).

The facts of Devore's case constitute "extraordinary circumstances." One spouse was in a substantially weaker position with reference to the other. Devore earned a negligible income while his wife controlled a significant sum of money. Devore was unsophisticated in tax matters and was excluded from the financial affairs of his wife.

Our research uncovered only one case that is directly on point. In *Wilson v. Commissioner*, 500 F.2d 645 (2nd Cir.1974), a husband and wife had filed joint tax returns. The husband earned a much larger income than his wife. A deficiency judgment was entered against the couple. Throughout the tax proceedings, they were jointly represented by the same attorney. However, they were also engaged in a simultaneous annulment action. In the annulment action, the husband was represented by the same attorney who represented the couple in the tax proceedings.

The Second Circuit held that it could "reverse a discretionary denial by the Tax Court of post-opinion motions only if there are shown to be 'extraordinary circumstances.'" *Wilson*[,] 500 F.2d at 648, quoting *Pepi, Inc. v. C.I.R.*, 448 F.2d 141, 148 (2nd Cir. 1971). The court held that the facts in Wilson were sufficiently compelling to constitute "extraordinary circumstances." The attorney could not competently advance the interests of the wife in the tax proceedings while representing the husband in a separate annulment action. It thus reversed the tax court's denial of Mrs. Wilson's post-opinion motions. It remanded the case to the tax court, allowing Mrs. Wilson to present evidence explaining her failure to seek the advice of independent counsel and to raise the annulment issue.

The facts supporting Devore's claim of "extraordinary circumstances" are at least as compelling as those of Wilson. In Wilson, the attorney represented both the husband and wife in tax proceedings while representing the husband in a simultaneous annulment litigation. However, the couple was still married at the time of the tax proceedings. In the instant case, the parties were separated in 1976 and divorced in 1978. The trial did not take place until 1989. By this time, the marriage was clearly over. Arguably, Devore's interests were compromised by counsel's simultaneous representation of Devore and Cole.

Accordingly, we remand to the tax court for an evidentiary hearing to determine if Devore was prejudiced by his former counsel's conflict of interest and to establish the reasonableness of his failure to retain independent counsel. If Devore satisfies these burdens, he should be granted a new trial at which innocent spouse and agency defenses may be asserted.

The *Devore* case is somewhat unique in that the aggrieved spouse was the ex-husband. Most often, innocent spouse claims are made by an ex-wife. Why? What special responsibilities does this impose on a lawyer who perhaps has a preexisting professional relationship with the ex-husband?

Many law firms are loathe to provide legal services at the same time to individuals (e.g., estate planning) and businesses entities in which those individuals own interests because disagreements often arise between or among the individuals, creating painful conflicts of interest problems for lawyers. For an example of such a conflict, see *Pascale v. Pascale*, 549 A.2d 782 (NJ 1988), *infra*, Section I.F.

PROBLEM 3-6

You have represented Mr. and Mrs. Mildew in connection with an audit of their joint federal income tax return. Following the audit, the IRS issues them a joint notice of deficiency. You prepare a petition, which they both sign, and which is then filed in the Tax Court. Two weeks before the case is scheduled to go to trial, Mrs. Mildew calls, says they are getting divorced and tells you that her divorce lawyer has discovered that her husband was skimming cash receipts out of their jointly owned restaurant without reporting them on the couple's tax returns. What are your ethical and other obligations to each of the Mildews, IRS counsel, and the Tax Court?

PROBLEM 3-7

Practitioner prepared a joint return filed by a married couple. The couple later divorced. May Practitioner represent both spouses in connection with an IRS challenge to expenses that were claimed on the joint return? Note that Section 6013(e) (innocent spouse relief provision that applied at the time *Devore* was decided) has been replaced by Section 6015. Does your analysis change because of the statutory change? What must Practitioner do if she decides to accept representation?

PROBLEM 3-8

Several years ago, before Husband married Wife, Lawyer represented Husband in connection with the formation of a business venture. Recently, Wife approached Lawyer to request representation in divorce proceedings against Husband. Can Lawyer accept the representation? What are Lawyer's ethical obligations?

E. Tax Shelters

During the last several years, taxpayers and the IRS have been actively engaged in litigating over the tax consequences of transactions that the IRS has labeled "tax shelters." For tax benefits generated from a purported tax shelter transaction to be upheld, courts have consistently held that the transaction or series of transactions at issue must have economic substance. In an often-quoted articulation of the economic substance doctrine, the Court of Appeals for the Fourth Circuit stated:

> To treat a transaction as a sham, the court must find [1] that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and [2] that the transaction has no economic substance because no reasonable possibility of a profit exists.

Rice's Toyota World v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985).

The Circuit Courts of Appeals that have considered the economic substance doctrine agree generally on the articulation of its two parts as set forth in *Rice's Toyota*, but differ on how to apply the test. Some circuits have required that a transaction satisfy both the business purpose and economic profit standards to validate a transaction (conjunctive test). Other circuits require satisfaction of only one of the standards to validate a transaction (disjunctive test). Some

courts give more weight to one prong than the other, in some cases disregarding one or the other of the two prongs altogether. In some cases, courts will consider both prongs as merely factors, among others, in determining whether a transaction has any practical economic effects other than the creation of tax benefits.

The following problems exemplify conflicts of interest issues arising in the context of the economic substance doctrine.

PROBLEM 3-9

Your law firm represents eighteen different clients who invested in a transaction sold by the same accounting firm. For each client, you must prove that the client had a profit motive for investing in the transaction, which the IRS has called a tax shelter. Can you offer the same profit motive for each client (e.g., expectation of a specific return on a series of hedging transactions)?

PROBLEM 3-10

If profit motive or business purpose is an essential element of proof to obtain a deduction from a tax shelter investment, does representation of multiple clients who invested in essentially the same transaction (1) dilute any single client's chances of obtaining a favorable settlement or (2) impose ethical constraints on the lawyer when additional clients are added to the representation roster?

PROBLEM 3-11

With the informed consent of the parties, your law firm has undertaken representation of investors in a tax shelter in proceedings before the Tax Court in which the tax benefits of the shelter are being challenged. During the pendency of the proceeding, a separate class action is brought against the shelter promoters on behalf of a putative class consisting of the investors in the shelter, including some of your firm's clients. Your firm does not anticipate participating as counsel in the class action on behalf of either side. Can your firm continue in the Tax Court representation? *See* D.C. Opinion No. 165 (Jan. 21, 1986). Would it matter whether the promoters have agreed to pay all of your professional fees incurred by the investors in the Tax Court proceeding?

PROBLEM 3-12

An accounting firm developed and promoted a tax shelter in which your firm's client invested. Can your firm represent that client at the same time that it represents the accounting firm in malpractice cases that do not involve tax shelters? Can your firm represent that client at the same time that it represents the accounting firm in malpractice cases that do involve tax shelters?

PROBLEM 3-13

Your law firm's banking department does loan documentation work for a bank that provided financing for a tax shelter transaction. A tax department client invested in one such tax shelter transaction. Can the firm represent both the bank and the investor?

PROBLEM 3-14

Your law firm represents a large insurance company on general corporate and regulatory matters. The insurance company sold a transaction, which the IRS alleges is substantially similar to a listed transaction but which the insurance company claims was substantially different than the listed transaction, to Investor. Can you represent Investor in connection with an IRS audit?

F. Estate Planning

Conflicts of interest generally arise in estate planning in one of four situations.

Spouses. First, and most commonly thought of, are conflicts involving concurrent representation of spouses. (Many, but not all, of the same issues arise, as well, when representing unmarried cohabitants.) Children from prior marriages or large disparities in wealth between spouses might be a reason to suggest separate representation. Spouses of substantially different ages may have conflicts in their planning goals. In addition, when one spouse dies, the surviving spouse and the estate could have differing interests. For example, the surviving spouse may wish to make an election against the estate or the executor may wish to make an election that increases the surviving spouse's share of the estate while decreasing the interests of other beneficiaries.

Nonetheless, and despite all of the possible conflicts, spouses frequently visit attorneys together for the purpose of preparing their wills. Often, these are reciprocal wills — wills that are essentially mirror images of each other, in which each spouse leaves his or her residuary estate to the other. Under Model Rule 1.7, a lawyer should, in most cases, be able to represent and plan for both spouses jointly. However, the lawyer should require each spouse to sign a written waiver of confidentiality as to the other so that any information provided to the lawyer by either spouse must be revealed to the other spouse. All information provided to the lawyer, of course, would still be protected against disclosure to third parties. The reluctance of a spouse to sign a waiver should alert the lawyer to the possible existence of a non-waivable conflict of interest.

The lawyer must explain to both spouses that their interests could conflict, particularly where they do not agree on the identity of beneficiaries or fiduciaries. Under Model Rule 1.7, each spouse must sign this statement, agreeing to allow the lawyer to use his or her best efforts and judgment to represent each of them, despite these possible conflicts. It would be wise for the lawyer and spouses to agree that both spouses must be present whenever either wishes to change any of his or her estate planning documents.

The American College of Trust and Estate Counsel offers samples of conflicts language for engagement letters in estate planning, at http://www.actec.org/public/EngagementLettersPublic.asp. The Colorado state bar web site also contains a good example, at http://www.cobar.org/repository/Inside_Bar/Trust Estate/OrangeBook_Dec2007_EngagementLetter.pdf?ID=2841.

Families. Second, conflicts may arise where parents and children seek representation or advice. A parent and child might have different ideas about the use or disposition of a trust fund benefitting the child, or an adult child and an infirm parent might disagree about transfers of the parent's property. Conflicts

also often arise when adult children are involved in a family-owned business, which forms a substantial portion of a parent's estate.

Particularly where the lawyer is approached by an adult child or children in connection with estate planning for a parent, care should be given to the question of who is the client — the adult child(ren) or the parent? Surprisingly, intentions in this regard are often unclear: is the purpose of the representation to plan for the disposition of the parent's assets as he or she intends or to protect the interests of a particular beneficiary? If the attorney previously represented either the parent or the child, the attorney might possess confidential information, gained through the course of that representation that would be inconsistent with representing the other.[4]

Once it is determined who the client is, it is important to make sure that everyone understands and agrees. Even where such an understanding is reached, however, maintaining confidentiality between lawyer and client often presents challenges. For example, elderly clients may feel more comfortable meeting with the lawyer in the company of their children. Significant decisions are made at these meetings and it is the attorney's responsibility to establish a clear and confidential line of communication without the presence or undue influence of family members. Attorneys are strongly advised to talk to the client alone to make sure that problems of conflicts of interest and undue influence do not exist, and to explain confidentiality concerns.

<u>Businesses and their Constituents.</u> Third, a conflict may arise when a lawyer represents a business entity and a majority or controlling owner, as was discussed earlier in this chapter. Additional issues arise where business and estate planning overlap. For example, an estate plan of a majority shareholder of a closely-held corporation could affect the business plans or ownership of the corporation as well as the relationship between the corporation and other shareholders.

PASCALE v. PASCALE

New Jersey Supreme Court
549 A.2d 782 (1988)

POLLOCK, J.

Plaintiff, John J. Pascale (Pascale), seeks to set aside a transfer of stock and real estate to his son David P. Pascale (David). Pascale contends that a confidential relationship existed between him and David and that the same attorney advised both of them in connection with the transfer. The issue is whether the transfers are invalid because David exercised undue influence over Pascale.

* * *

Nearly fifty years ago, in 1939, Pascale founded a machine tool and die business, which was later incorporated under the name Quality Tool & Die Company Inc. (Quality). In 1952, plaintiff established a second, smaller machine tool company, Majoda Tool and Die Company (Majoda), which operated out of

[4] Moreover, if the parent is incapacitated or appears to suffer from a diminished capacity, particular issues pertaining to such a representation must be considered. Discussion of such matters is beyond the scope of this book.

Quality's premises in Hoboken. By 1960, both businesses had become quite profitable.

In the 1960s, Pascale introduced his older son, John, Jr., into the businesses, and six years later, Pascale gave all the stock in Majoda to John, Jr. David began full-time employment with Quality in 1971. Sometime before 1972, John, Jr. left Majoda and assigned all of his stock to Pascale and David.

In March 1972, Pascale's wife instituted a divorce action, and the two sons chose sides: John, Jr. sided with his mother, and David with Pascale. Consequently, Pascale did not see John, Jr. again until their apparent reconciliation in 1978. In 1973, to minimize his net worth and thereby to reduce his wife's share in an equitable distribution of his assets, Pascale signed a stock certificate, which purported to transfer ownership of his Quality shares to David. The certificate, however, was backdated to 1968, four years before the institution of the divorce action.

Initially, the fraud worked. An accounting firm, which was appointed by the matrimonial court to investigate Pascale's assets, reported on June 7, 1973, that Pascale was "essentially responsible" for the operations of Quality and Majoda, but that he had transferred his stock in both corporations to David on October 16, 1968. The matrimonial court approved the property settlement based on this false information. Although Pascale claims that the stock certificate and corporate books are lost, David produced at the trial of the within matter a photocopy of a signed copy of the backdated October 16, 1968, stock certificate.

Consistent with the certificate, David claimed in his deposition that Pascale transferred all the Quality stock to him in 1968. David denied that any transfer of stock from his father to him occurred between 1970 and 1976. When asked at trial who owned the Quality stock in 1976, however, David testified, "my father did." The foregoing facts led the trial court to find that Pascale signed the backdated certificate in 1973 as part of "a scheme to defraud [Pascale's] wife and the matrimonial court."

Following the transfer, Pascale and David continued in their respective roles at Quality. Until 1979, Pascale remained in control, with David managing accounts and performing other office work. From 1971 until late 1981, Pascale and David enjoyed a close personal relationship. Pascale lavished expensive gifts on David and his wife, including cars, real estate, a sable coat, jewelry, and large amounts of cash. David handled Pascale's personal financial affairs, such as check writing, personal bills, safe deposit boxes, and securities.

Late in 1975, however, the Internal Revenue Service asserted a tax deficiency claim against Pascale personally and also against Quality. On the advice of his personal and business accountant, J. Bennett Schwartz, Pascale retained a tax attorney, Bernard Berkowitz, who resolved the IRS matter in January 1979. In the interim, Pascale asked Berkowitz to prepare an estate plan for him.

Early in his representation on both matters, Berkowitz communicated exclusively with Pascale. Pascale, however, directed Berkowitz to "deal directly with David Pascale or Ben Schwartz, but primarily David." According to Berkowitz, Pascale instructed him to develop an estate plan that left "everything to David" while incurring as little tax liability as possible. David confirmed Berkowitz's testimony by acknowledging that he served as an agent for Pascale in dealing with Berkowitz.

As early as 1977, Berkowitz and his associate, Stephen C. Levitt, discussed with David and Schwartz an estate plan that would have left Pascale in control of Quality. For tax purposes, Berkowitz recommended that Pascale transfer to Quality land he owned in Hoboken and that Pascale convert his common stock in Quality into three classes: preferred stock, voting common stock, and nonvoting common stock. The then-existing value of Quality would be ascribed to the preferred stock, which Pascale would retain along with all the voting common stock. David would receive the nonvoting common stock to which all future growth would be attributed.

In May 1978, Berkowitz worked out the details of the recapitalization with David and Schwartz, who in turn informed Pascale of the plan. Although Pascale approved the recapitalization, the plan was never executed.

A year later, on May 9, 1979, Berkowitz, Levitt, and Schwartz met with David. At this meeting, while reading the 1973 accountant's report from the matrimonial action, Berkowitz first learned that Pascale apparently had transferred the Quality shares to David in 1968. It became apparent to Berkowitz that there was a conflict between David and Pascale about the ownership of the Quality stock. As Berkowitz testified, "David Pascale thought he owned the stock; John Pascale thought that he owned the stock." Because the recapitalization plan was premised on Pascale's ownership of the Quality stock, the confusion about stock ownership caused Berkowitz to abandon this plan.

Berkowitz also ascertained that no gift tax had been paid on the backdated transaction. Confronted with this information, Berkowitz devised an alternate plan to fulfill Pascale's intention of leaving, with a minimal tax impact, all of his business assets to David. The plan was for Pascale to give the Hoboken properties and the Quality stock to David, with David paying the gift taxes of $ 54,947. That proposal was consistent with the will prepared by a different attorney and executed by Pascale on December 10, 1975, in which Pascale left his entire estate to David. Berkowitz further believed that the gift to David would reduce the problems inherent in the fraudulent matrimonial scheme, which was evidenced by the backdated stock certificate.

The trial court found that Berkowitz discussed the alternate plan with David and Schwartz, and that each of them in turn discussed it with Pascale. Both David and Schwartz claimed that Pascale understood that by agreeing with this plan, he would be yielding control of Quality to David. Indeed, Schwartz testified that he spoke with Pascale on May 24, 1979, the day Pascale executed the alternate plan, and specifically admonished him that by executing the plan, "he was giving the company away, he could be thrown out in a week."

On that date, Berkowitz, David, and Pascale met at Pascale's office in Hoboken to execute the plan. According to Levitt, with the exception of several letters that his law firm had mailed to Pascale, this meeting was the first time since January 11, 1978, that the firm "had any contact or has any records that reflect any contact with John Pascale." At the meeting, Pascale signed various documents, including two stock certificates of Quality: one that described Pascale as the owner of 310 shares, and the other that described David as the owner of 310 shares. Pascale also signed an assignment transferring his 310 shares of Quality to David, a deed from Pascale and Quality conveying the Quality premises in Hoboken to David, and an affidavit of consideration.

The main dispute in this case is whether Pascale understood that these documents effected an outright transfer of the Quality stock and real estate to David. On this point, as on others, the testimony at trial was in sharp conflict.

According to Pascale, before the May 24, 1979, meeting, he had not received any of the documents. He contends that he had no opportunity to read the documents before signing them, that neither Berkowitz nor David explained the documents to him, and that he relied on them in signing the documents. Pascale testified that he thought he "was to have control [of Quality] to the day I died or was incapable of handling the business."

David and Berkowitz testified, however, that Berkowitz reviewed the documents in detail with Pascale before he signed them. Berkowitz did not remember whether he discussed with Pascale the implications of transferring the Quality stock and the Hoboken properties to David, but he believed that the implications were so obvious that such a discussion was unnecessary. David, however, testified that Berkowitz explained to Pascale that the effect of signing the documents would be to relinquish control of Quality to David. Pascale signed the documents.

On the same day, David executed a will prepared by Berkowitz, in which David bequeathed all his Quality stock to a testamentary stock trust, of which Pascale was the trustee. The beneficiaries of the trust were Pascale and David's wife, and all income was payable to Pascale during his lifetime. In the following year, on October 7, 1980, however, David executed another will, which eliminated the trust and provided that the Quality stock and land would pass to his wife, if she survived, and if she predeceased him, to his mother-in-law.

After the May 24, 1979, meeting, David assumed greater responsibility in managing Quality. Pascale remained active in the business, and continued to receive his $ 3,500 weekly salary, plus approximately $ 700 in travel and entertainment expenses. In January 1980, however, David attempted to reduce Pascale's salary to $ 3,000 per week, but Pascale responded by retroactively reinstating his salary to $ 3,500.

Relations between David and Pascale cooled when David learned that Pascale was helping John, Jr. in a competing machine and tool business. According to Pascale, he first learned that he was no longer in control of Quality in October 1981 following a dispute with David over Pascale's assistance to John, Jr. David ordered Pascale to leave the Quality premises and to consult with a lawyer to confirm that David now controlled Quality and had the right to terminate Pascale's employment. Notwithstanding their dispute, Pascale remained on Quality's payroll until October 1982, two months after he filed the within action. In the interim, during the spring of 1982, Pascale consulted with Levitt, who told him that the effect of the May 24, 1979, transfers was to place David in control of Quality.

* * *

[T]he trial court found that Pascale's attorney, Berkowitz, was not in a position of conflict when he prepared Pascale's estate plan and advised him to execute it, stating, "[a]t all times Berkowitz was Pascale's rather than David's attorney."

The Appellate Division reversed. 216 N.J. Super. 133. It found that a confidential relationship existed between Pascale and David, and that Berkowitz was in a position of conflict when he advised Pascale to execute the transfers.

* * *

We now turn to the question of the conflict of interest on the part of the attorney, Berkowitz, in representing both David and Pascale at the time of the challenged transfer. Here, we also agree with the Appellate Division's assessment that Berkowitz was in a position of conflict in representing both parties. Berkowitz and his associate, Levitt, admitted that there was a conflict in the positions of David and Pascale concerning the ownership of the Quality stock prior to May 24, 1979. Moreover, David admitted Pascale was never informed of the services rendered by Berkowitz in preparing David's estate plan. Despite the fact that David told Berkowitz that he, not Pascale, owned the Quality stock on May 9, 1979, Berkowitz simultaneously represented David and Pascale. Neither Berkowitz nor David ever informed Pascale, however, of David's claim to the stock or that Berkowitz was now representing David. Nonetheless, the trial court found that "[a]t all times Berkowitz was Pascale's rather than David's attorney." The Appellate Division rejected that finding and found that Berkowitz was in a position of conflict because of his simultaneous representation of the parties. 216 N.J. Super. at 142. We agree.

As we have previously stated, "[a] lawyer cannot serve two masters in the same subject matter if their interests are or may became *[sic]* actually or potentially in conflict." *In re Chase*, 68 N.J. 392, 396 (1975). Disciplinary Rule 5-105(A), which was in effect at the time of the transaction, like present Rule of Professional Conduct 1.7, prohibited a lawyer from accepting or continuing employment "if the exercise of his professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of" or continuance of the employment.

A conflict arises when an attorney represents in separate matters multiple clients who have adverse interests in at least one of those matters. "Developments in the Law — Conflicts of Interest in the Legal Profession," 94 Harv. L. Rev. 1244, 1296-1306 (1981). The attorney has divided loyalties that can prevent faithful representation of both clients in the matter in which the conflict arises. *Ibid.* For example, an attorney may not, without making appropriate disclosure, simultaneously represent the testator and the beneficiaries of a will. *Haynes, supra*, 87 N.J. at 181-85. Similarly, here, Berkowitz should not have represented Pascale on the transfer of real estate and stock to David without disclosing that he was simultaneously representing David on an independent matter. Even if Berkowitz believed he could adequately represent the interests of both Pascale and David, he failed to comply with the requirement of Disciplinary Rule 5-105(C) that he fully disclose the conflict.

Consequently, we agree with the Appellate Division that the conflicting claims to ownership of the Quality stock placed Berkowitz in a position of conflict arising from his dual representation of David and Pascale. On the same day, Berkowitz represented Pascale in the transfer of substantial assets to David and also represented David in the drafting and execution of his will. The conflicting claims of stock ownership, as the Appellate Division found, "raised an immediate conflict having the clear potential to raise in the mind of legal counsel the question as to which of the two masters was to be served and protected." 216 N.J. Super. at 142.

Referrals. Finally, an attorney is often asked to recommend a particular bank, trust company or person to serve as a trustee or executor knowing that the company or person will hire the attorney who drafted the will as attorney for the estate. Because this situation potentially creates a conflict between the client and the lawyer's own interest, it should be analyzed under Model Rule 1.7(a)(2) and Circular 230 § 10.29(a)(2).

Illinois State Bar Association Advisory Opinion 99-06
(Nov. 1999)[5]

Facts

An Illinois trust company has developed a lawyer/trust administrator program in which licensed Illinois lawyers, who practice substantially in the area of estate planning, enter into an agency relationship with the trust company. The agency agreement provides that the lawyers will furnish trust administrator services for trusts in which the trust company has been named trustee. The lawyers perform the administrative services for the trust from their law offices and may continue to render legal services to the clients in matters related to the trust or otherwise, for which they bill separately. Once accepted as a trust administrator, the lawyers may refer clients and other persons as potential customers for the trust company's services. The lawyer will bill his clients for legal services in preparing trust instruments and other documents. The trust company does not prepare the trust documents or otherwise practice law.

Assets of the trusts are deposited with the trust company and administered by the trust company's investment advisors or, at the option of the client, in self-directed accounts. Services of the trust company personnel are paid from the trust assets pursuant to an established fee schedule, and the lawyer/trust administrator is paid a fee by the trust company, again under a published fee schedule, from the fee paid to the trust company from the client's trust.

The lawyer/trust administrator acts as a conduit of information between the trust company and its customers, directs payments from the trust, forwards customer investment directives, and responds on behalf of the trust company to customer inquiries. The lawyer/trust administrator offers no investment advice with respect to the trusts. The lawyer's relationship with the trust company, his compensation as trust administrator, and other relevant information are set out in an extensive written disclosure and consent form which the client must sign as a part of the trust agreement.

Inquiry is made as to whether the arrangement described violates any provision of the Rules of Professional Conduct.

Opinion

A variety of issues created by relationships involving lawyers, their clients and fiduciary institutions have been considered by this Committee.

We have stated, for example, that a lawyer who is both a director and lawyer for a bank may not insist that his client designate the bank as a fiduciary, even where the relationship is disclosed to the client. See Opinion No. 90-02 (1990).

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We have also opined that it is professionally improper for a lawyer employed by an institution marketing revocable living trusts to prepare or review such documents for possible use by his clients. Such an arrangement, we felt, posed significant conflict of interest problems that would prevent the lawyer from fairly representing the consumer/client and acting in his best interests. In addition, the lawyer violated Rule 5.5(b) by aiding the unauthorized practice of law by the institution in connection with its preparation of the trust documents. See Opinion No. 90-20 (1991).

Finally, we have held that the referral of clients to an investment advisor or securities broker, whereby the referring lawyer is paid a fee from the funds being managed for the client, may be permissible provided that appropriate disclosures are made. See Opinion No. 97-04 (1998).

The Committee considers the arrangement outlined above sufficient to satisfy the concerns expressed in our prior opinions, provided that appropriate safeguards are employed to satisfy the rules regarding conflicts of interest.

Where a lawyer's representation of a client may be limited by the lawyer's responsibilities to a third person or by the lawyer's own interests, the lawyer may undertake or continue the representation only if he reasonably believes that the representation will not be adversely affected and the client consents after disclosure. Rule 1.7(b) states the general rule:

> A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest, unless:
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) the client consents after disclosure.

Here, the lawyer as an agent of the trust company is expected to develop business for the trust company by recommending the trust company's services to the lawyer's clients and others. Where the trust company is selected by the client, the lawyer is paid a fee for his services as trust administrator by the trust company based upon the fee for trust services paid by the client/customer. The lawyer accordingly has an incentive to recommend the trust company's services over those of a competing fiduciary. The relationship between the lawyer and the trust company, and the compensation generated by that relationship, involve "responsibilities to a third person" and "the lawyer's own interests," as described in the rule.

Nonetheless, the lawyer may, in the Committee's judgment, reasonably believe that his representation of the client may not be adversely affected by his relationship with the trust company. Since the client may disagree, however, it is incumbent upon the lawyer, pursuant to Rule 1.7(b) of the Rules of Professional Conduct, to disclose his relationship with the trust company, the fee arrangement, and method of calculation (including the source of payment to him), and all other aspects of the relationship. Although the rule does not by its terms require that the disclosure be in writing, the Committee has noted that that is the more prudent practice.

In our Opinion No. 97-04, supra, the Committee had occasion to consider two slightly different referral arrangements involving lawyers, their clients,

and an investment adviser and securities broker. In each case, the referring lawyer was paid a portion of the management fee generated by the investment of the client's funds. We pointed out that such an arrangement constituted a business transaction with a client, governed by Rule 1.8 of the Rules of Professional Conduct, which provides:

> Unless the client has consented after disclosure, a lawyer shall not enter into a transaction with the client if:
>
> (1) the lawyer knows or reasonably should know that the lawyer and client have or may have conflicting interests therein; or
>
> (2) the client expects the lawyer to exercise the lawyer's professional judgment therein for the protection of the client.

We stated that, under pertinent Illinois case law, a presumption of undue influence arises where a lawyer benefits from a business transaction with a client. The presumption may be rebutted only by clear and convincing evidence. Generally, this requires a showing of full disclosure of all relevant information, a transaction that was fair and reasonable, and that the client had the advice of independent counsel, or the opportunity for such advice, before entering into the transaction. In re Anderson, 52 Ill. 2d 202, 287 N.E.2d 682, 682 (1972); In re Schuyler, 91 Ill. 2d 6, 61 Ill. Dec. 540, 424 N.E.2d 1137 (1982); Franciscan Sisters Health Care v. Dean, 95 Ill. 2d 452, 69 Ill. Dec. 960, 448 N.E.2d 872 (1982).

As in Opinion No. 97-04, the investment of the client's trust assets in the case at hand is clearly a business transaction. The profits realized from the investment program are the basis for the trust company's fees from which, in turn, the lawyer/trust administrator's fees are paid. As in Opinion No. 97-04, these fees are not for legal services performed; they emanate from a business transaction in which the lawyer and the client are jointly interested.

Since the amount of the lawyer/trust administrator's fee is affected by the performance of the trust being administered, there is at least the potential for a conflict of interest between the lawyer and his client. The client's objectives with respect to the trust program may dictate a relatively conservative investment approach, which may generate lesser fees to the trust administrator (and the trust company) than would a more aggressive approach. Disclosure must therefore be made and the client's consent obtained in the same manner as prescribed with respect to Rule 1.7(b). It should also be remembered that a conflict of interest problem, although initially addressed by appropriate disclosure and consent, imposes a continuing duty on the part of the lawyer to make supplemental disclosures as developing circumstances warrant.

For the reasons given, the Committee believes that the arrangement described is not professionally improper.

Illinois' version of Rule 1.8(a) is based on the Model Code DR 5-104 rather than the Model Rule. The case law relied on in the Opinion, however, is more or less consistent with Model Rule 1.8(a): the transaction must be fair and reasonable to the client, the lawyer must fully disclose all relevant information, and the client must obtain the advice of independent counsel or have opportunity to obtain such advice before entering into the transaction. Moreover, the Opinion notes that prudent practice entails obtaining the client's written

consent to the essential terms of, and the lawyer's role in, the transaction, as is required by Model Rule 1.8(a).

PROBLEM 3-15

You are asked to do estate planning and will drafting for Bill, the majority shareholder and CEO of Widgets, Inc. (a regular firm client), and Bill's wife, Mary.

a. What must you initially advise Bill and Mary before agreeing to take on their estate planning?

b. Assume that after having heard your initial advice, Bill and Mary still prefer to have you handle all of their estate planning. They provide you with the appropriate informed consent. What would that be?

c. You do the planning and draft the wills, which Bill and Mary execute, but you notice that Bill does not have a buy-sell agreement with Fred, the CFO of Widgets, who is also the minority shareholder. What should you do now?

d. The buy-sell agreement is drafted to provide that on the occurrence of certain events (death, divorce, or bankruptcy of a shareholder), the company will buy back the shareholder's shares in the company, with the valuation determined on a formula basis. When the agreement is ready, Bill offers to set up a meeting for the two of you and Fred in order to get the agreement signed. At that meeting, you ask how Widgets will fund the share repurchase, particularly in the case of Bill's death. Bill says, "Don't worry. It won't be a problem." Fred is concerned, but doesn't pursue the issue. Are you ready to let Bill and Fred sign the agreement?

e. The buy-sell agreement is signed. As you sit at your son's soccer game two years later, you hear from another parent (who works for Widgets) that Bill has been having an affair with Widgets' sales manager, Melody, for "months." What should you do?

f. Mary calls you later that fall, notes that she and Bill are getting a divorce, and asks you to draft a new will for her. Can you do this? Can your firm continue to represent Widgets?

PROBLEM 3-16

Lawyer has represented Husband and Wife for many years in a range of personal matters, including estate planning. Husband and Wife have substantial individual assets, and they also own substantial jointly-held property. Recently, Lawyer prepared new updated wills that Husband and Wife signed. Like their previous wills, the new wills primarily benefit the surviving spouse for his or her life, with beneficial disposition at the death of the survivor being made equally to their children (none of whom were from a prior marriage).

Husband, Wife, and Lawyer have always shared all relevant asset and financial information. Consistent with previous practice, Lawyer met with Husband and Wife together to confer regarding the changes to be made in updating their wills.

Several months after the execution of the new wills, Husband confers separately with Lawyer. Husband reveals to Lawyer that he has just executed a

codicil (prepared by another law firm) that makes a substantial beneficial disposition to a woman with whom Husband has been having an extra-marital relationship. Husband tells Lawyer that Wife does not know about the relationship or the new codicil, as to which Husband asks Lawyer to advise him regarding Wife's rights of election in the event she were to survive Husband. What are Lawyer's ethical obligations?

Suppose that Lawyer tells Husband that Lawyer cannot advise him regarding Wife's rights and that Lawyer is withdrawing from representation of both Husband and Wife. What are Lawyer's obligations with respect to informing or not informing Wife of the substance of Husband's revelation if Husband does not do so himself? *See* Florida Bar Opinion 95-4 (May 30, 1997, *revised,* June 23, 2009).

PROBLEM 3-17

Your law firm regularly engages an appraisal firm to prepare appraisal reports for use in family limited partnership transactions and as litigation support for valuation issues. The appraisal firm did a valuation of corporate stock that was an integral part of a tax shelter. Can you represent an investor in the tax shelter in connection with an IRS audit or Tax Court litigation?

II. CONFLICTS BETWEEN LAWYERS AND CLIENTS

Circular 230 §§ 10.27 and 10.29
Internal Revenue Manual ¶ 4.11.55.4.2 (Appendix I)
Model Rules 1.5, 1.7 and 1.8
AICPA ET § 302 and Interpretation 302-1 (Appendix J)

Among the circumstances described in the general rule governing conflicts of interest, Model Rule 1.7, is one that bans a lawyer from representing a client if there is a significant risk that the representation will be materially limited by a personal interest of the lawyer. Circular 230 § 10.29(a)(2) contains a similar rule. Model Rule 1.8 identifies specific instances of such conflicts and prescribes rules and procedures for dealing with them; in some instances, the client may waive a conflict while, in others, representation is strictly prohibited. (Situations that are not specifically addressed in Model Rule 1.8. remain subject to the more general strictures of Model Rule 1.7.)

PROBLEM 3-18

A brokerage house performed all of the option trades at issue in tax shelter transactions entered into by your Client. The same firm manages all of the 401(k) accounts of your law firm. Do you have a conflict of interest?

PROBLEM 3-19

Lawyer has a number of estate planning clients who could benefit from financial planning advice. She is considering establishing a relationship with Financial Planner, who would pay her a referral fee for each client she refers to him. Can Lawyer accept the referral fee?

Suppose that Lawyer and Financial Planner wish to enter into a reciprocal arrangement under which Lawyer would refer clients to Financial Planner for

financial planning services and Financial Planner would refer clients to Lawyer for legal services. *See* Model Rule 7.2(b)(4); Philadelphia and Pennsylvania Bar Associations Joint Opinion 2000-100 (May 2000); Supreme Court of Ohio Opinion 2000-1 (Feb. 11, 2000).

PROBLEM 3-20

Lawyer holds a patent on an estate planning strategy that might be useful to Client. Can Lawyer ethically recommend the strategy to Client? If so, can Lawyer charge Client a license fee (for use of the patent) in addition to her customary fee for estate planning services?

PROBLEM 3-21

Lawyer has provided tax and other legal advice to a limited liability company (LLC) in a traditional fee-for-service relationship. LLC's business has grown over time and its members believe that it should have a general counsel. They have asked Lawyer to take on this responsibility, on a part-time basis. In lieu of fees for this work, the LLC members have proposed to give Lawyer a 20 percent ownership interest in LLC and a percentage of the company's profits, if any. If Lawyer accepts this position, she would continue her private practice representing other clients. Under what circumstances is Lawyer ethically permitted to enter into the proposed arrangement?

A. Contingent Fees

Circular 230 § 10.27[6] contains a general rule barring unconscionable fees in matters before the IRS. No guidance is provided on what unconscionability means in this context; presumably, the principles in Model Rule 1.5 would govern. Under Model Rule 1.5, factors considered in determining the reasonableness of a fee include:

1. the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
2. the likelihood, if apparent to the client, that acceptance of the particular employment will preclude other employment by the lawyer;
3. the fee customarily charged in the locality for similar legal services;
4. the amount involved and the results obtained;
5. the time limitations imposed by the client or by the circumstances;
6. the nature and length of the professional relationship with the client;
7. the experience, reputation, and ability of the lawyer or lawyers performing the services; and
8. whether the fee is fixed or contingent.

[6] Circular 230 § 10.27(b) permits practitioners to collect contingent fees in three specific situations (which are discussed in the text). On March 26, 2008, the IRS issued Notice 2008-43, 2008-15 I.R.B. 748, adding a fourth situation in which contingent fees are permitted and announcing its intention to amend certain language in Section 10.27(b). The text assumes that the changes announced in Notice 2008-43 have been incorporated into Circular 230. Students should make sure to refer to Notice 2008-43 until such time as Circular 230 is formally amended.

Model Rule 1.5(c) permits contingent fee arrangements — except in domestic relations and criminal matters — so long as they are documented in a writing signed by the client and stating the method by which the fee will be calculated.

The AICPA prohibits contingent fee arrangements in connection with the preparation of an original or amended tax return, or a claim for refund. AICPA ET Section 302 (together with AICPA Interpretation 302-1, reproduced at Appendix J). AICPA Interpretation 302-1 provides several examples of circumstances in which contingent fees are permitted in connection with tax matters:

1. representing a client in an examination by a revenue agent of the client's federal or state income tax return,
2. filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position,
3. filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Internal Revenue Taxation ($2 million) or state taxing authority,
4. requesting a refund of either overpayments of interest or penalties charged to a client's account or deposits of taxes improperly accounted for by the federal or state taxing authority in circumstances where the taxing authority has established procedures for the substantive review of such refund requests,
5. requesting, by means of "protest" or similar document, consideration by the state or local taxing authority of a reduction in the "assessed value" of property under an established taxing authority review process for hearing all taxpayer arguments relating to assessed value., and
6. representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute.

Circular 230's guidance on the use of contingent fees in tax matters is similar, but not identical, to the AICPA rules. A contingent fee is defined for Circular 230 purposes as:

> any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

Circular 230 § 10.27(c)(1). Contingent fees are prohibited generally for services rendered in connection with any matter before the IRS. Thus, practitioners may not charge contingent fees in connection with preparing or filing of an

original tax return, amended tax return, or claim for refund. Restricting contingent fees in this context is thought to discourage return positions that exploit the "audit lottery." Circular 230 does permit contingent fee arrangements, however, in four specific situations.

First, a practitioner may charge a contingent fee for services rendered in connection with an IRS examination of, or challenge to, an original tax return, amended return, or claim for refund where the amended return or claim for refund is filed (1) before the taxpayer receives a written notice of examination of, or a written challenge to, the original tax return or (2) no later than 120 days after receipt of such written notice or challenge. Contingent fees are permitted in this situation because unlike, e.g., an original return, substantive review by the IRS of the taxpayer's position here is a certainty. Therefore, the rule does not encourage practitioners to encourage frivolous positions that exploit the audit lottery. The 120-day limit addresses governmental concerns over the use of contingent fee arrangements in connection with claims for refund or amended returns that are filed very late in the process of an examination (audit) in the hope that an IRS officer or employee will not look closely at the claims.

Second, a practitioner is permitted to charge a contingent fee for services rendered in connection with a claim for refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS. This exception is meant to address services provided by "account review practitioners" who retroactively evaluate corporate taxpayers' IRS accounts to determine whether they have overpaid interest or penalties. Typically, account review practitioners' fees are based on a percentage of the savings uncovered. Because the interest or penalties have already been paid, a claim for refund is necessary, assuring substantive review by an IRS employee or officer.

Third, a practitioner may charge a contingent fee for services rendered in connection with a whistleblower claim under Section 7623. That section establishes a program under which the IRS may pay rewards to persons who report underpayments of tax by others. Such persons ("whistleblowers") may be entitled to receive a percentage of the taxes recovered by the IRS.

Fourth, a practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Code.

PROBLEM 3-22

Lawyer has been asked by Client for advice in connection with Client's investment in a series of financial transactions, which Client hopes will result in substantial tax savings to Client. Among the services to be provided by Lawyer, Lawyer will issue an opinion letter describing the tax consequences of the investment. May Lawyer's fee reflect a portion of the projected tax savings? Would it matter if Lawyer agreed to (perhaps retroactively) reduce her fee if the tax savings did not hold up under audit or litigation?

B. Tax Return Accuracy Standards

Differences between the income tax return accuracy standards for taxpayers and for the professionals who advise them could result in conflicts of interest. Specifically, with respect to the same position on a taxpayer's return, a tax

adviser might face the imposition of a penalty if such position is not disclosed (i.e., flagged) on the return while, at the same time, the taxpayer faces no penalty risk for nondisclosure. In other words, it could be in the adviser's interest, but not in the taxpayer/client's interest, to disclose a position. Thankfully, Congress significantly reduced the potential for such conflicts by amending Section 6694 (the preparer penalty rules) in 2008 to conform the preparer and taxpayer standards. As is discussed in Chapter 2, *supra*, the basic standard is now "substantial authority" for both groups: return positions that are supported by substantial authority generally will not subject anyone to penalties; positions that lack substantial authority could subject both the taxpayer and her professional adviser to penalties unless the positions are disclosed on the return. *See* Sections 6694(a)(2), 6662(d)(2)(B).

The professional standard articulated in ABA Formal Op. 85-352 differs from the taxpayer standard. That difference creates the potential for conflicts of interest. *See* ABA Section of Taxation Committee on Standards of Tax Practice, Standards of Tax Practice Statement 2000-1 (Dec. 4, 2000), http://www.abanet.org/tax/groups/stp/stmt00-1.html. ABA Formal Op. 85-352 concludes that "[a] lawyer may advise reporting a position on a tax return so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated" (the "realistic possibility of success" standard). A "realistic possibility of success" has been quantified as a likelihood of success approximating one-third. The realistic possibility of success standard also applies to CPAs, but only where the applicable taxing authority has no written standards or if its standards are lower than the AICPA standards. *See* AICPA SSTS No. 1 & Interpretation No. 1-1, "Realistic Possibility Standard" (in Appendix C). The realistic possibility of success standard is inconsistent with Section 6694, as amended, and should be revised or withdrawn.[7] Until revision, however, attorneys are strongly advised to follow the higher standard in Section 6694.

C. Referrals to OPR

The Internal Revenue Manual lists circumstances in which a Revenue Agent *must* or *may* refer a practitioner to OPR. Referral is mandatory in the following situations:

1. when cases in which understatements due to unrealistic positions (Section 6694(a)) are closed (should be "unreasonable positions" in light of 2008 amendments);[8]
2. when cases in which understatements due to willful or reckless conduct (Section 6694(b)) are closed;

[7] No efforts to revise ABA Formal Op. 85-352 are underway as of the date of publication of this text. The AICPA recently revised its SSTSs effective January 1, 2010. The new standard retains the realistic possibility of success standard but requires CPAs to follow a higher standard if one is adopted by the relevant taxing authority. Therefore, CPAs are subject to the higher substantial authority standard in preparing federal returns.

[8] Although Directors of OPR from time to time have indicated that referrals to OPR by Revenue Agents would not be automatic in the case of Section 6694(a) penalties, the Internal Revenue Manual is clear in mandating referrals in these situations.

3. when a penalty for negotiation of a refund check (Section 6694(f)) is assessed;
4. when a penalty for aiding and abetting (Section 6701) is assessed (Revenue Agents should consider referrals to OPR where the Section 6701 penalty was considered but not imposed);.
5. when a penalty for promoting abusive tax shelters (Section 6700) is assessed against an attorney, CPA or enrolled agent;
6. when an injunctive action (Section 7407 or Section 7408) is taken against promoters of abusive tax shelters; and
7. when injunctive action (Section 7408) is taken against an attorney, CPA or enrolled agent.

IRM ¶ 4.11.55.4.2.2.1 (2005).

The following situations *may* warrant a referral to OPR:

1. when return preparer referrals are made to the IRS Criminal Investigation Division (Section 7206);
2. when an appraiser who aids or assists in the preparation or presentation of an appraisal in connection with the tax laws will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person;
3. when a by-pass of representative letter was issued to a tax practitioner;
4. when a practitioner engages in disreputable conduct or incompetence as described in Circular 230 § 10.51;
5. when a tax practitioner is implicated in a frivolous tax return matter (Section 6702);
6. when an accuracy-related penalty (Section 6662(d)) for a substantial understatement is asserted and the facts of the case suggest the practitioner did not exercise due diligence in the preparation of the return;
7. when a practitioner fails to comply with the tax shelter registration requirement (Section 6111) or characterizes such registration as an IRS endorsement of the shelter and takes a position on a tax return that reflects the purported endorsement;
8. when opinions rendered by tax practitioners are used or referred to in the marketing of tax shelters (abusive or otherwise); and
9. when an examination report is written with respect to any tax return of an attorney, CPA, or enrolled agent, or a return prepared by an attorney, CPA or enrolled agent where a Pre-filing Notification Letter was issued in connection with a tax shelter and the loss and/or credit from the promotion was nevertheless claimed on the tax return.

IRM ¶ 4.11.55.4.2.2.2 (2005).

PROBLEM 3-23

Several years ago, Lawyer gave tax advice to a long-time client (Client) with respect to an investment that Client was then considering. Client made the investment. Client's income tax return for the year in which the investment was made is now under audit by the IRS. Because Lawyer is Client's regular tax counsel, Lawyer is representing Client in the proceeding. From comments

made by the IRS Revenue Agent during the course of discussions, Lawyer has the impression that the Revenue Agent believes that Lawyer gave Client bad advice at the time of the investment. What, if anything, should Lawyer do? What, if anything, must Lawyer do?

PROBLEM 3-24

Lawyer represents Client during what Lawyer originally thought was a routine audit. During the course of the proceeding, Lawyer realizes that the Revenue Agent may have grounds for referring her to OPR. Is there automatically a conflict of interest? How should Lawyer decide whether or not to withdraw from the representation?

III. OPINION LETTERS AND WRITTEN ADVICE

Circular 230 §§ 10.22, 10.35, 10.36 and 10.37
Model Rule 2.3
AICPA SSTS No. 1 and Interpretation No. 1-2 (Appendix C and Appendix D)

A. Opinion Letters

Clients frequently ask their tax advisers for written opinion letters stating the lawyers' or accountants' views on the tax treatment or consequences of transactions or investments described in the letters. The letters typically begin with a detailed description of the transaction or investment with respect to which opinions are rendered (these are the facts on which the opinions are based), continue with a statement of the relevant legal principles and authorities and an analysis of how those principles and authorities apply to the facts at issue, and conclude by stating opinions on the tax treatment or consequences. For a variety of reasons, many of which are discussed in this section, opinion letters usually contain a variety of embellishments, as well, e.g., the identity of the person or persons from whom the facts were obtained, the extent to which an opinion relies on representations of others, etc.

Tax opinion letters can be useful in a variety of circumstances. Sometimes, a client merely seeks written comfort that her advisors have thought carefully through the relevant issues and have confidence in their advice. With the adoption and implementation of FASB FIN 48,[9] tax lawyers anticipate being asked

[9] Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes." For tax years beginning after December 15, 2006 (with some exceptions), FIN 48 governs the evaluation by CPAs of material positions taken in any income tax return, for purposes of financial accounting. According to the FASB:

> [FIN 48] clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818746949&blobheader=application%2Fpdf. The full text of FIN 48 is available through links on the FASB and AICPA websites.

for written opinions to influence auditors in creating tax accruals. Clients seek opinion letters as a means of defending against the possible imposition of tax penalties by the IRS; such opinion letters are casually referred to as "penalty protection." Some clients seek tax opinions in order to influence others to participate or invest in a transaction. Finally, sometimes opinions are required by law. For example, federal securities laws may require that transactions involving issuance of securities to the public include an opinion to support discussions of tax consequences included in the offering materials.

Tax opinion letters predict the likelihood of a position being sustained on its merits if challenged by the IRS. In other words, they predict how a court would rule if called upon to decide the issue or issues opined upon, assuming that the court were familiar with all of the relevant facts. In reality, the likelihood of any particular outcome is difficult to quantify; nonetheless, clients ask for, and receive, greater or lesser degrees of assurance depending on the purpose or context of the letter. Although there are neither formal definitions of relevant terminology nor any real agreement on the strength of the various levels, tax opinion letters typically give assurance at one of five levels.[10]

1. Reasonable basis has been quantified by some to be as low as 5% and by others as high as the 20 to 25% range. According to Treas. Reg. § 1.6662-3(b)(3):

> The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in the [substantial authority regulations,] the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.

A position having a reasonable basis avoids a negligence penalty. Treas. Reg. § 1.6662-3(b)(1). Moreover, a return position must have at least a reasonable basis in order to avoid, through disclosure,[11] a penalty for substantial understatement of income tax or a preparer penalty under Section 6694(a). Sections 6662(d)(2)(B)(ii), 6694(a)(2)(B).

2. Substantial authority is difficult to quantify numerically but it certainly may be less than 50%. "Substantial authority" is more stringent than the reasonable basis standard but less stringent than the more likely than not (i.e., greater than 50%) standard. Treas. Reg. § 1.6662-4(d)(2).

> There is substantial authority for the tax treatment of any item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

[10] There could be other standards for opinions, e.g., "not frivolous." The text addresses only the standards that are most commonly utilized. For a tongue-in-cheek breakdown of tax opinion standards, see *A Detailed Guide to Tax Opinion Standards*, 106 TAX NOTES 1469-71 (2005).

[11] Form 8275 is attached to a return whenever a taxpayer or tax return preparer wishes to disclose items or positions in order to avoid certain penalties. Form 8275 is filed, for example, to avoid the portions of the accuracy-related penalty due to disregard of rules or to a substantial understatement of income tax for nontax shelter items if the return position has a reasonable basis. It can also be used for disclosures relating to preparer penalties for understatements due to unreasonable positions or disregard of rules. (Where disclosure is made of return positions that are contrary to a regulation, Form 8275-R is used.)

> All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed in [Treas. Reg. § 1.6662-4(d)(3)(ii)].

Treas. Reg. § 1.6662-4(d)(3)(i). (Students should be quite comfortable with the meaning of "substantial authority" after having studied Chapter 2 of this text.)

Because this standard can be satisfied at less than 50% certainty, it is possible that there could be substantial authority for more than one position. Moreover, unlike any of the other levels of assurance, substantial authority is not stated in the regulations in terms of how likely a particular outcome will be but focuses instead on the strength, or relative strength, of the authority or authorities supporting a position.

A position must have substantial authority in order to avoid the penalty for substantial understatement of income tax without disclosure or a preparer penalty under Sections 6694(a).[12] Sections 6662(d)(2)(B)(i), 6694(a)(2)(A).

3. <u>More likely than not</u> means having a greater than 50% likelihood of being sustained on the merits. Treas. Reg. §§ 1.6662-4(g)(4)(i)(B), 1.6694-2(b)(1).[13] For tax years beginning after December 15, 2006 (with some exceptions), "more likely than not" is the standard or threshold that must be used by CPAs in assessing all material positions taken in any income tax return.[14] FIN 48 requires a company to undertake and retain a detailed analysis of tax positions that may be uncertain and to document whether each such position can be recognized as more likely than not. While tax opinions are not required to meet the FIN 48 threshold, companies routinely engage outside tax counsel or advisers to prepare tax opinions on significant positions to determine whether such positions meet the "more likely than not" standard.

4. <u>Should</u> is not quantified or defined in either the Code or the regulations, but is generally considered to mean a likelihood of success of more than 70%. Thus, a "should" opinion opines at a level greater than "more likely than not" but less than "will." Although some attorneys use the phrases "weak should" and "strong should" to describe the strength of their opinions, such terminology rarely is reflected in the opinion letters themselves. Because the level of "should" is uncertain, these letters typically include reasoning or analysis so that the reader can assess the degree of certainty or uncertainty for herself. (Not surprisingly, an opinion letter that includes a lengthy analysis is referred to as a "reasoned opinion.").

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[12] In addition, substantial authority is required in order to qualify for the reasonable cause exception to the penalty for reportable transaction understatements. Section 6664(d)(2)(B).

[13] A position must meet the more likely that not standard to avoid certain penalties related to tax shelters and reportable transactions. Sections 6664(d)(3)(C), 6694(a)(2)(C).

[14] The "more likely than not" threshold, for FIN 48 purposes, means that: (1) a benefit related to an uncertain tax position may not be recognized in financial statements unless it is "more likely than not" that the position will be sustained based on its technical merits; and (2) there must be more than a 50 percent likelihood that the position would be sustained if challenged and considered by the highest court in the relevant jurisdiction.

5. Will means 95 to 100%. A "will" opinion is considered a "clean" or "unqualified" opinion of near certainty. "Will" opinions may be subject to exceptions, limitations, and/or assumptions, so long as they are customary and are stated in the letter.

B. Ethical Considerations

1. Ethical Rules

In drafting an opinion, lawyers must be mindful of traditional ethical standards. For example, under ABA Formal Op. 85-352, a lawyer is prohibited from lvising tax return positions that fall short of a "realistic possibility of success" andard. The same standard is generally thought to govern any tax advice ven to a client to the extent that tax return positions are or will be involved (e.g., advice in the course of structuring transactions that will involve tax return positions), including tax advice in the course of preparing legal documen

> [A] lawyer, in representing a client in the course of the preparation of the client's tax return, may advise the statement of positions most favorable to the client if the lawyer has a good faith belief that those positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. A lawyer can have a good faith belief in this context even if the lawyer believes the client's position probably will not prevail. However, good faith requires that there be some realistic possibility of success if the matter is litigated.
>
> * * *
>
> Thus, where a lawyer has a good faith belief in the validity of a position in accordance with the standard stated above that a particular transaction does not result in taxable income or that certain expenditures are properly deductible as expenses, the lawyer has no duty to require as a condition of his or her continued representation that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures.
>
> In the role of advisor, the lawyer should counsel the client as to whether the position is likely to be sustained by a court if challenged by the IRS, as well as of the potential penalty consequences to the client if the position is taken on the tax return without disclosure. Section 6661 [now Section 6662] of the Internal Revenue Code imposes a penalty for substantial understatement of tax liability which can be avoided if the facts are adequately disclosed or if there is or was substantial authority for the position taken by the taxpayer. Competent representation of the client would require the lawyer to advise the client fully as to whether there is or was substantial authority for the position taken in the tax return. If the lawyer is unable to conclude that the position is supported by substantial authority, the lawyer should advise the client of the penalty the client may suffer and of the opportunity to avoid such penalty by adequately disclosing the facts in the return or in a statement attached to the return. If after receiving such advice the client decides to risk the penalty by making no disclosure and to take

> the position initially advised by the lawyer in accordance with the standard stated above, the lawyer has met his or her ethical responsibility with respect to the advice.
>
> In all cases, however, with regard both to the preparation of returns and negotiating administrative settlements, the lawyer is under a duty not to mislead the Internal Revenue Service deliberately, either by misstatements or by silence or by permitting the client to mislead.
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> In summary, a lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no 'substantial authority' in support of the position, and there will
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> an extension, modification or reversal of existing law. *This requires that there is some realistic possibility of success if the matter is litigated.* In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.

The realistic possibility of success standard has been quantified as a one in three, or greater, likelihood of being sustained on the merits. Treas. Reg. § 1.6694-2(b)(1) (as in effect prior to Dec. 15, 2008); Circular 230 § 10.34(d)(1) (as in effect prior to Apr. 4, 2008). Prior to 2008, Circular 230 mandated the same realistic possibility of success standard with respect to tax return positions, and the preparer penalty rule under Section 6694(a) incorporated that standard, as well. The AICPA rule was the same. Thus, all tax professionals were governed by the same reporting standards in all contexts. (The tax professional was governed by a different reporting standard than her client, however — realistic possibility of success versus substantial authority.[15])

In 2008, Section 6694(a) was amended to require that, with respect to tax advice, a return preparer must meet the substantial authority standard (as described in Chapter 2). The realistic possibility of success standard was removed from Circular 230 § 10.34(a) because it was inconsistent with the statutory amendments.[16] Therefore, while the tax practitioner's statutory reporting (i.e., penalty) standard now conforms to her client's (i.e., both are now substantial authority), the attorney's ethical standard is now inconsistent with both, and Circular 230 is silent on the matter. As of this writing, ABA Formal Op. 85-352 has not been revised to reflect the incongruities and no efforts to make the appropriate revisions are underway. The ethical standard set forth in Opinion 85-352, therefore, must be revised to conform the ethical standard to Section 6694(a), or withdrawn.

[15] Ethical issues arising out of this conflict were addressed by the ABA Section of Taxation Committee on Standards of Tax Practice in its Standards of Tax Practice Statement 2001-1 (Dec. 4, 2000), http://www.abanet.org/tax/groups/stp/stmt00-1.html. Specifically, this Statement explores whether the benefits of adequately disclosing return positions, which might have affected taxpayers and advisers differently, generated conflicts of interest.

[16] As of the date of publication of this text, the substantial authority standard has not been added to Circular 230. While the Director of OPR has indicated that an amendment to Circular 230 § 10.34(a) will be proposed shortly, it is not clear that the forthcoming standard will mirror Section 6694(a).

Opinion letters that may be used or relied upon by third parties (other than the client), e.g., prospective investors in a transaction organized and promoted by a client, must comport with Model Rule 2.3, under which (1) the rendering lawyer must reasonably believe that making an evaluation for the benefit of third parties is compatible with other aspects of the lawyer's relationship with the client and (2) if the lawyer knows or reasonably should know that the evaluation is likely to affect the client's interests materially and adversely, the lawyer may not provide the evaluation unless the client gives informed consent. According to the Comments to Model Rule 2.3, when a question about the legal situation of a client arises at the instance of the client's financial auditor, the lawyer's response may be made in accordance with procedures recognized in the legal profession, such as the so-called "treaty" entered into between the ABA and AICPA. *See* ABA Comm. on Audit Inquiry Responses, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information,* 31 BUS. LAW. 1709 (1975).[17]

2. AICPA Standards

According to the AICPA SSTSs and interpretations (Appendix C), the same standard that applies to tax return preparation applies to professional services involving tax planning. Interpretation No. 1-2 to SSTS No. 1 (Appendix D). Tax planning, for this purpose, includes any oral or written recommendation or expression of an opinion in a prospective or completed transaction on either a return position or on a specific tax plan by the member, the taxpayer or a third party. Interpretation No. 1-2 provides guidelines for issuing opinions and for reviewing opinions given to the client by other tax professionals.

Under the AICPA standard, "[a] member should not recommend that a tax return [or tax planning] position be taken with respect to any item unless the member has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged." The AICPA recently revised this standard, which was at odds with both Circular 230 and Section 6694(a). The new standard retains the realistic possibility of success standard in situations where the applicable taxing authority has no written standards or where such written standards are lower than the AICPA's standards; otherwise, members would be required to comply with standards imposed by such an authority. Thus, in the case of a federal tax return, the preparer penalty standard in Section 6694 (i.e., substantial authority) would govern.

C. Circular 230

In 2004, Treasury issued final regulations prescribing opinion standards and rules that were aimed primarily at opinions rendered in tax shelter transactions. The regulations, however, cover other written opinions, as well. Please review Circular 230 §§ 10.35, 10.36, and 10.37. Circular 230 § 10.35 provides standards and rules applicable when rendering a "covered opinion." Circular 230 § 10.37 provides standards and rules that apply when Circular 230 § 10.35

[17] The treaty is currently under revision in light of statutory and other changes, including FIN

does not. Thus, the first hurdle to overcome is whether any particular written advice is or will be considered a "covered opinion." Although the definition of a "covered opinion" is elaborate, the standards and rules that apply to "covered opinions" are straightforward.

As a preliminary matter, Circular 230 § 10.35 applies only to "written advice," including electronic communications. Oral advice is not affected. The inclusion of electronic communications means that relatively innocuous e-mails covering tax topics may constitute "written advice" within the regulations. If they do, then the requirements of Circular 230 § 10.35 apply unless the e-mail explicitly disclaims that its contents may be relied upon by the recipient for certain purposes. *See, e.g.*, Circular 230 § 10.35(b)(5)(iii). This explains the ubiquitous Circular 230 disclaimers that are now prominent at the end of e-mails sent from many law and accounting firms.[18]

1. Covered Opinions

A "covered opinion" is written advice (including electronic communications) that concerns one or more federal tax issues arising from of the following:

1. A transaction that is the same as or substantially similar to a "listed transaction." These are transactions that the IRS identifies as tax avoidance transactions, typically in a Notice. (The IRS web site contains a listing of listed transactions, e.g., "Recognized Abusive and Listed Transactions — LMSB Tier I Issues in Alphabetical Order," http://www.irs.gov/businesses/corporations/article/0,,id=204155,00.html.) Listed transactions are a type of reportable transaction, participation in which must be disclosed in an investor's tax return. Treas. Reg. § 1.6011-4.
2. An entity, plan or arrangement, the principal purpose of which is federal tax avoidance or evasion. The fact that "principal purpose" is not defined is a source of frustration to practitioners. But see Treas. Reg. § 1.6662-4(g)(ii), which defines "principal purpose" in the context of the substantial understatement penalty as it applies to tax shelters.
3. An entity, plan or arrangement, a significant purpose of which is federal tax avoidance or evasion, but only if the written advice is:
   a. a reliance opinion,
   b. a marketed opinion,
   c. subject to conditions of confidentiality, or
   d. subject to contractual protection.

These four subcategories, (a)-(d), are expounded upon in Circular 230 § 10.35. In practice, it may be difficult to conclude that a transaction *does not* have a significant purpose where tax consequences were considered in making structuring decisions. Therefore, many tax practitioners rely on falling outside of the four subcategories to avoid having to comply with the Circular 230 § 10.35(c) rules, or include in their written advice or opinion letters the disclaimer language discussed below.

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ederal tax law contained herein are not intended or
purposes of avoiding penalties that may be imposed
investment plan or arrangement."

A "covered opinion" does not include preliminary written advice if a practitioner reasonably expects to provide the client with more extensive written advice later in the representation. Moreover, written advice that would be a "covered opinion" under the significant purpose category is not considered a "covered opinion" if the advice (1) concerns the qualification of a qualified plan, (2) is a state or local bond opinion,[19] or (3) is included in documents required to be filed with the SEC. (Query whether documents that are typically filed with the SEC, but which are not explicitly required to be filed, are "covered opinions.")

a. Significant Purpose Transactions

Of the three categories of written advice that can be covered opinions, the third, the significant purpose transaction, poses the most issues for practitioners because these transactions are not necessarily overtly tax-motivated and because practitioners must determine which of the four subcategories, if any, within the significant purpose category the written advice falls into. The most significant and potentially troubling of the four is the "reliance opinion," which is the type of opinion that clients use or attempt to use to defend against imposition of penalties; hence, reliance opinions conclude at a confidence level of at least more likely than not that one or more significant federal tax issues would be resolved in favor of the taxpayer. The regulation permits clients and tax advisers to opt out of Circular 230 § 10.35 by prominently disclosing in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used, for the purpose of avoiding penalties. Thus, the taxpayer cannot use the opinion letter to establish the reasonable cause and good faith defense to the accuracy-related penalty. *See* Section 6664(c); Treas. Reg. § 1.6664-4.

Written advice constitutes a marketed opinion if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner or her firm in promoting, marketing, or recommending an entity, investment plan, or arrangement. A disclaimer can take the written advice out of the category. While the drafters of the regulation probably had in mind marketed tax shelter opinions, the regulatory language is broad enough to apply to private offerings in the capital markets (in which filing with the SEC is not required). Such transactions probably meet the "significant purpose" test where the investments themselves offer tax advantages. For example, preferred stock bears a lower tax cost than straight debt because dividends are taxed at capital gains rates. *See* Section 1(h). For foreigners, straight debt often offers tax advantages because, e.g., the interest might be exempt under the portfolio interest rules. *See* Section 871(h).

The remaining two categories pose fewer issues for practitioners.

b. Requirements for Covered Opinions

Circular 230 § 10.35(c) sets forth specific requirements that must be met in giving a covered opinion. While most good practitioners have, in the past,

[19] State and local bond opinions are addressed separately in Circular 230.

followed similar practices to those in the regulation in rendering tax opinions, the regulation exceeds prior practice in several significant ways. First, the requirements apply to what practitioners might otherwise think of as casual advice, e.g., e-mails. Under Circular 230 § 10.35, if an e-mail constitutes a covered opinion, then all of the requirements must be followed. Second, the regulations require that the practitioner's analysis be set forth in the opinion itself. In the past, opinions might have contained a detailed analysis (a "long-form opinion") or might have simply stated the practitioner's opinions and conclusions (a "short-form opinion"). In some cases, analysis underlying short-form opinions was provided separately to clients and/or maintained [illegible] ner's file. (A short-form opinion was the basis for OPR's unsuc- [illegible] nary proceeding in the *Sykes* case discussed in Chapter 1.) [illegible] lation requires that certain information be set forth in sepa- [illegible] prescribed, rather than in a format selected by the rendering [illegible]

The regulation requires that conclusions be stated with respect to each significant federal tax issue considered in the opinion. In the past, practitioners might have rendered opinions on some, but not all, tax issues. Perhaps clients' motives were nefarious but, in many cases, clients asked for opinions only on issues which they anticipated the IRS would be likely to examine. Under the current rules, practitioners may provide an opinion that considers less than all of the significant federal tax issues only if (1) the practitioner and client agree that the client may rely on the opinion for penalty protection only with respect to issues addressed in the opinion, (2) the opinion does not pertain to a listed transaction or a principal purpose transaction, and (3) the opinion includes certain required disclosures.

Students should review the requirements of Circular 230 § 10.35(c) at this time. An opinion that meets the requirements of Circular 230 § 10.35 satisfies the practitioner's responsibilities under that section. However, the persuasiveness of the opinion and the taxpayer's good faith reliance on the opinion will be determined separately should the need arise (e.g., if the taxpayer uses the opinion to satisfy the reasonable cause and good faith exception to the accuracy-related penalty). In broad stroke, Circular 230 § 10.35(c) mandates that practitioners consider all relevant facts, relate the law to the facts, evaluate the significant federal tax issues, and provide a conclusion.

1. <u>Factual matters.</u> The practitioner must make reasonable efforts to identify and ascertain the facts and is prohibited from basing her opinion on unreasonable factual assumptions or representations. The opinion must contain a section identifying all relevant facts, all factual assumptions, and all representations, statements, or findings of the taxpayer relied on in the opinion.

2. <u>Relate law to facts.</u> The opinion must relate the applicable law to the relevant facts. The practitioner may not assume a favorable conclusion with respect to any significant federal tax issue or otherwise base an opinion on unreasonable assumptions or representations. The opinion may not contain any internally inconsistent legal analyses or conclusions.

3. <u>Evaluation of significant federal tax issues.</u> The opinion must consider all significant federal tax issues and provide conclusions as to the likelihood that the taxpayer will prevail on the merits of each. The opinion must provide a

conclusion, and indicate the confidence level of the conclusion, as to each of the issues and explain and describe the reasons for all conclusions. A covered opinion that fails to conclude at a confidence level of at least more likely than not that a significant federal tax issue would be sustained on its merits if challenged must prominently disclose that the opinion does not reach that confidence level and that the taxpayer may not use the opinion to avoid penalties. Moreover, none of the following possibilities may be taken into account in evaluating the taxpayer's chances of success on the merits: that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

4. <u>Overall conclusion.</u> A covered opinion must state an overall conclusion or explain why an overall conclusion could not be reached.

In rendering an opinion, a practitioner is permitted to rely on the opinion or opinions of another practitioner with respect to one or more significant federal tax issues unless the practitioner knows or should know that the opinion or opinions of the other practitioner should not be relied upon. If a practitioner relies on the opinion of another practitioner, however, the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in that other opinion.

2. Best Practices

Circular 230 § 10.36 requires that individuals rendering written advice and their firms take reasonable steps to ensure that the firm has adequate procedures for complying with Circular 230 § 10.35. Failure to maintain adequate procedures could result in discipline under Circular 230 as to both the firm and the individual. While the IRS has not ruled on the matter, it would seem that the traditional practice of requiring approval by at least two partners before rendering a formal tax opinion (the so-called "two partner rule") would constitute a reasonable practice.

3. Other Written Advice

Written advice that does not constitute a "covered opinion" must be rendered in accordance with the rules in Circular 230 § 10.37, which are less detailed than those in Circular 230 § 10.35. The rules in Circular 230 § 10.37 are essentially procedural; practitioners are permitted to give written advice regardless of whether the practitioner concludes that any particular issue will be resolved in favor of the taxpayer and regardless of the confidence level the practitioner has with respect to any particular issue's resolution. It seems clear under general ethical principles, however, that a practitioner's reservations about the strength her advice should be communicated to the client.

Under Circular 230 § 10.37, a practitioner is prohibited from giving written advice only under four circumstances:

1. the practitioner bases the written advice on unreasonable factual or legal assumptions, including assumptions as to future events;

atements, find-

he practitioner

4. in evaluating a federal tax issue, the tax practitioner takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

In evaluating whether a practitioner has failed to comply with Circular 230 § 10.37, all facts and circumstances will be considered. A heightened standard of care is expected of a practitioner who gives written advice that she knows or has reason to know will be used or referred to by a person other than the prac-

Are the following "covered opinions"? If so, what advice would you give to the practitioners about the preparation and content of the advice? In the alternative, how can the practitioners in each case alter the advice to avoid the "covered opinion" rules? If the "covered opinion" rules do not apply, what standards should the advice meet?

a. A corporate lawyer receives the following question by e-mail from a long-time client: "I'm buying a machine for $10,000. I'm paying $1,000 cash and financing the rest. I'll get to take depreciation deductions from a $10,000 basis, right?" The corporate lawyer responds: "Yes."

b. In discussing with her client whether to accept a settlement in a tort suit involving personal physical injury, a trial lawyer reminds her client (in writing) that "the settlement won't be taxable to you."

c. In (a) and (b) above, would it matter if the advice were given orally? Why or why not?

PROBLEM 3-26

a. Practitioner advised client prior to the commencement of negotiations for a transaction. Alternative structures were discussed and different assumptions were made regarding future circumstances as a means of determining the strategy for negotiations. After the transaction is completed, the taxpayer checks with the practitioner, by e-mail, to confirm the tax treatment of a particular item associated with the transaction. Is the practitioner's reply, if in writing, subject to the covered opinion rules?

b. Suppose that several years later, the client is notified that the IRS intends to examine its return for the year in which the transaction occurred. The practitioner advises the client in writing about the possible likelihood or grounds for an IRS challenge, and discusses the possible range of settlement outcomes under various dispute resolution alternatives, speculating or opining on the likely outcomes under each alternative. Does the discussion constitute a "covered opinion" or "other written advice"? How can the practitioner answer if the client asks whether she had a reasonable basis for any of the positions?

PROBLEM 3-27

Do the following e-mail communications constitute covered opinions? Why or why not?

a. Lawyer has advised Client, a group of investors, regarding an acquisition of Target, an S corporation organized in Delaware. Client has formed Purchaser, a Delaware corporation, to make the purchase. The purchase is intended to be a "qualified stock purchase" with respect to which a Section 338 election will be made. Client sends an e-mail to Lawyer: "Lawyer — The largest shareholder in Target would like the opportunity (but not the obligation) to invest in Purchaser at some point after Purchaser acquires Target. Will that have any effect on the basis step-up that we are expecting?" Lawyer responds: "As long as he isn't obligated to reinvest, I believe that should be ok, although the answer isn't entirely clear-cut."

b. Client, a U.S. citizen, is an employee of an Italian corporation the stock of which is traded on the New York Stock Exchange. Client e-mails Lawyer: "My employer is offering me the opportunity to purchase stock. However, they are requiring that I contractually agree not to sell the stock for three years. Will I still be entitled to a 15 percent rate on the dividends if I agree to that?" Lawyer: "Yes, I believe that you will still be entitled to the 15 percent rate. To get that rate, the stock must be 'readily tradable' on a U.S. exchange. But, I believe that that requirement applies based on the class of stock that you own, such that individual contractual arrangements with respect to the stock don't matter."

c. Lawyer has been advising Client regarding a divisive tax-free reorganization of one of its businesses. Client's in-house tax counsel sends Lawyer the following e-mail: "Lawyer — I know you said that Parent needs to use 100% of the cash it receives from Subsidiary in the reorganization to pay down third-party debt of Parent under Section 361(b)(3). Parent plans to invest the $1 million it receives from Subsidiary in certificates of deposit, then six months later, pay $1 million to third-party creditors of Parent, but Parent will keep the interest it earns on the $1 million through the certificate of deposit. Ok?" Lawyer responds: "Your proposal probably works. We should talk."

d. Lawyer has been advising Acquiror regarding the negotiation of Acquiror's merger with Target throughout the past three months. The merger is intended to qualify as a reorganization of Target into Acquiror under Section 368(a)(1)(A). Shortly before the merger agreement is to be signed, Acquiror sends an e-mail to Lawyer that states: "Lawyer — Target is skeptical when we say that our proposed consideration of 60% stock/40% cash will satisfy the continuity of interest requirement. Could you confirm that this consideration mix will not pose a continuity problem? I would like to forward your e-mail to Target's CEO." Lawyer quickly responds by email: "As we have discussed many times, the consideration mix will satisfy the continuity of interest requirement."

e. Lawyer has advised Client, a Delaware corporation, for years regarding corporate transactions. Client sends Lawyer the following e-mail: "Lawyer — Quick question, if we own stock in a corporation and a large number of options to purchase stock in that corporation, and the corporation redeems all of our stock (but we still hold the options), is it possible that

we would receive dividend treatment on the redemption (qualifying for the dividends received deduction)?" Lawyer responds by e-mail: "Obviously I need more facts to reach a firm conclusion, but generally, when a person owns an option to purchase stock, the tax law treats the person as owning the stock for purposes of testing a redemption. So, in a situation where you owned enough options, you would qualify for dividend treatment (and the dividends received deduction) when the corporation redeems your stock. However, there would be collateral consequences, including possible gain recognition under the extraordinary dividend rules of Section 1059, which we need to discuss."

PROBLEM 3-28

Taxpayer intends to issue a debt instrument that has a variety of equity characteristics. Taxpayer requests that Lawyer provide a formal written opinion that Section 163(l) should not prevent deductibility of interest on the instrument. Lawyer is willing to deliver such opinion. Can she?