

TaxTrends

THIRD-PARTY TAX OPINION LETTERS HELD BY IRS ARE NOT DISCOVERABLE • RES JUDICATA DOES NOT BAR TAXPAYER FROM CLAIMING NOL CARRYBACKS



PROCEDURE & ADMINISTRATION

Third-Party Tax Opinion Letters Held by IRS Are Not Discoverable

The Tax Court denied a taxpayer's motion to compel the IRS to produce redacted copies of all third-party tax opinions regarding son-of-boss transactions it had collected, as well as a list of the names and addresses of all law firms and accounting firms known to the IRS to have issued tax opinion letters regarding son-of-boss transactions because the

opinion letters and the firm list were not relevant, the request did not appear reasonably calculated to lead to discovery of admissible evidence, and the materials were nondisclosable "return information" per Sec. 6103(b)(2).

Background

James Menighan, through a limited liability company he owned, acquired and contributed offsetting digital options on foreign currency to the 3K Investment Partners partnership (the partnership). On examination, the IRS determined that Menighan formed and used the partnership to engage in a so-called son-of-boss transaction that was designed to artificially inflate Menighan's basis in the partnership. The IRS alleged that the transaction was a prepackaged tax shelter that Menighan purchased from the law firm *Jenkins & Gilchrist, P.C.* (*Jenkins & Gilchrist*). As a result of this determination, the IRS issued a final partnership administrative adjustment that made changes to the items reported on the partnership's tax return for the 2000 tax year.

The partnership challenged the IRS's determination in Tax Court. During the proceedings, the partnership requested that the IRS provide it with redacted copies of all third-party tax opinions collected by the IRS regarding son-of-boss transactions (the opinion letters) and a

list of the names and addresses of all law firms and accounting firms known to the IRS to have issued son-of-boss transaction tax opinion letters. The IRS objected to the request on the grounds that the opinions and the list were irrelevant and that the request was not likely to lead to the discovery of admissible evidence, was unduly burdensome, and impermissibly sought confidential third-party return information. The partnership filed a motion with the Tax Court to compel the IRS to produce the opinion letters and the list.

The Tax Court's Decision

The Tax Court held that the opinion letters and the firm list were not relevant to the subject matter of the case and the discovery request was not reasonably calculated to lead to the consequent discovery of admissible evidence in the case. Therefore, it denied the partnership's motion to compel the IRS to produce the letters and the list.

The partnership argued that the opinion letters and the firm list were relevant to its reasonable cause and good-faith defense (under Sec. 6664(c)) against the IRS's determination of penalties under Sec. 6662. Whether a taxpayer had reasonable cause and acted with good faith depends upon the facts and circumstances of each case. The partnership first

contended that the opinion letters would bolster its reasonable cause and good-faith defense because they would show that national law firms across the country had endorsed the same position the partnership took with respect to son-of-boss transactions. According to the Tax Court, this argument failed because a taxpayer must establish the reasonableness of its position on the basis of the facts and merits of its own case. Therefore, the advice that tax advisers may have given to other taxpayers based on their facts and circumstances were irrelevant to the reasonableness of the position that the partnership took.

The partnership also argued that the opinion letters and the firm list were relevant to its contention that it had reasonably relied on the advice of its tax advisers. The Tax Court flatly rejected the idea that the information had any bearing on whether it was reasonable that the partnership relied on the advice of *Jenkins & Gilchrist*, stating that if the partnership did not have access to this information before it filed its returns, the court did not see how the information could possibly establish that the partnership's reliance was reasonable. The Tax Court found that even if the opinion letters tended to show that *Jenkins & Gilchrist* was competent to provide the advice, the relevance of this evidence was too remote to justify discovery of the opinion letters and the firm list, considering that the information related to confidential third-party information, its production would be burdensome for the IRS, and evidence of *Jenkins & Gilchrist's* competence could be more easily obtained from other sources.

Finally, the partnership contended that the opinion letters were not returns or return information that could not be disclosed under Sec. 6103(a). The Tax Court found that the opinion letters fell under the expansive definition of return information found in Sec. 6103(b)(2)(A) and that the Supreme Court had held that redacting taxpayer identifying information from return information did not change its character (see *Church of Scientology of Cal.*, 484 U.S. 9 (1987)). In addition, the Tax Court found that because the opin-

ion letters were not prepared by the IRS and contained specific taxpayer information that was protected by Sec. 6103, they were not written determinations of the IRS that are required to be made public under Sec. 6110.

Reflections

This case highlights a key point of a reasonable cause and good-faith defense: The taxpayer must establish the defense directly, not by analogy. The Tax Court characterized the partnership's argument as "everyone's doing it," but the fact that other taxpayers are doing the same thing should not have a bearing on whether it is reasonable in a specific taxpayer's case.

As the Tax Court noted, any advice provided in the undisclosed opinion letters was not provided to the partnership or for its benefit—and could not have been relied on by the partnership, since it did not know the contents of the undisclosed opinion letters. The fact that other tax advisers may have been giving similar advice to other taxpayers about transactions that were in some way similar to the transactions the partnership was engaged in was too tenuous to establish reasonable cause or good faith.

3K Investment Partners, 133 T.C. No. 6 (2009)

Res Judicata Does Not Bar Taxpayer from Claiming NOL Carrybacks

The Tax Court ruled that the doctrine of res judicata did not bar a taxpayer from claiming net operating loss (NOL) carrybacks to 1999 and 2000, despite a prior deficiency case involving those years, because the statutory scheme for NOL carrybacks includes Sec. 6511(d)(2)(B)(i), which allows a refund attributable to an NOL carryback notwithstanding "the operation of any . . . rule of law," which includes res judicata.

The Doctrine of Res Judicata

Under the judicial doctrine of res judicata, when a court has entered final judgment on a cause of action, the parties to the suit are bound by this judgment with

respect to every matter that was offered and received in support of or in opposition to the claim or demand and any other admissible matter that might have been offered for that purpose. In the context of income taxes, the tax liability for each tax year is a separate cause of action, and if the taxpayer and the IRS have previously litigated a liability for a tax year, neither party can relitigate the liability for any reason unless an exception to the doctrine applies.

The First Tax Court Case

The taxpayer, *Ron Lykins, Inc. (RLI)*, reported an NOL on its 2001 income tax return filed in June 2002. In November 2002, it filed an application for a tentative refund to carry back the 2001 NOL to 1999 and 2000. The IRS refunded the requested amounts in December 2002.

In February 2003, the IRS sent RLI a statutory notice of deficiency covering both 1999 and 2000, which stated that RLI owed more tax than it had reported for both tax years. The notice did not refer to the NOL carrybacks from 2001 or the refunds RLI had received. RLI filed a petition with the Tax Court to challenge the IRS's determination.

RLI believed that the 2001 NOL was involved in the deficiency determination for 1999 and 2000 and referred to the NOL in its petition. In the litigation, the IRS also took the position that the 2001 NOL was at issue in the case. However, RLI later changed its mind with respect to the 2001 NOL and in 2005 filed an amended petition that did not refer to the NOL. The IRS still believed that the 2001 NOL was at issue in the case, but it did not file an answer to RLI's amended petition, did not amend its original answer to take the NOL or the refunds into account, and never asked for a holding that the NOL carryback was excepted from the decision in the case.

At trial, neither side presented evidence regarding the 2001 NOL or the carrybacks to 1999 or 2000. In March 2006, the Tax Court entered a decision in favor of RLI, holding that RLI did not owe any additional tax for 1999 and 2000. The IRS did not appeal the case, and it became final in June 2006.

The Collection Due Process Hearing

In March 2005, the IRS issued summary assessments against RLI for the amounts of the refunds for 1999 and 2000. RLI did not pay the assessments, and the IRS issued a final notice of intent to levy. In response, RLI requested a collection due process (CDP) hearing. The IRS Appeals Office granted the hearing, but it determined that the IRS could proceed with levy. RLI attempted to raise the issue of the validity of its NOL carryback from 2001, but the Appeals Office refused to consider the issue, stating that RLI had already had the opportunity to dispute the NOL carryback claim in the first Tax Court case. RLI also argued unsuccessfully that the IRS should not be allowed to proceed with the levy; it claimed that the IRS was barred from asserting any liabilities for those years because the Tax Court held in the first case (after RLI had requested its CDP hearing) that there was no deficiency for RLI's 1999 or 2000 tax years.

The Second Tax Court Case

In May 2007, RLI petitioned the Tax Court to review the IRS's determination. RLI's principal argument was that because the Tax Court had decided that RLI did not have a deficiency for 1999 and 2000, the judicial doctrine of res judicata applied, closing the 1999 and 2000 tax years to further IRS challenges. In its turn, the IRS argued that res judicata applied to RLI, so it could not dispute the deficiency. The Tax Court rejected both sides' arguments and held that res judicata did not bar RLI or the IRS from disputing the 2001 NOL carryback and its tax effect upon RLI's 1999 and 2000 liabilities.

In its decision, the Tax Court first examined whether the parties could have litigated the NOL carryback claims in the first case. The court found that under Sec. 6213(a), the Tax Court's deficiency jurisdiction extends to the entire subject matter of the correct tax, including both the IRS's claim to a greater deficiency than is stated in the notice of deficiency and the taxpayer's claim to an overpayment of tax. It also found that Sec. 6214(b) explicitly gave the Tax Court authority to ad-

dress NOL carrybacks from other years in determining the correct deficiency for the years at issue. Because the Tax Court had the authority to address the NOL carryback claims, and the facts showed that both the IRS and RLI knew about the issue and could have presented evidence about it, the Tax Court concluded that for purposes of res judicata, the parties had not litigated the NOL carryback claims in the first case.

The Tax Court then analyzed whether res judicata applied to both RLI and the IRS in the case. The IRS contended that res judicata precluded RLI from raising the NOL carryback claims in the CDP hearing review because RLI permitted the Tax Court to enter a decision in the first case without considering the NOL claim. The Tax Court disagreed, stating that while RLI could have litigated the issue, it did not have to raise it to avoid the application of res judicata. According to the Tax Court, RLI was not required to raise the issue in the first case because Sec. 6511(d)(2)(B)(i) allows a refund claim attributable to an NOL carryback claim to be considered even if it would otherwise be prevented by any law or rule of law. The Tax Court held that res judicata was such a rule of law.

RLI argued that under res judicata the Tax Court's decision in the first case precluded the IRS from assessing additional taxes for 1999 and 2000. The Tax Court again held that the doctrine did not apply. It noted that while Sec. 6212(c)(1) generally bars the IRS from issuing a second notice of deficiency after a taxpayer has filed a petition in the Tax Court in response to a first notice of deficiency, the statute explicitly allows the IRS to determine an additional deficiency that results from a tentative carryback refund—even if the IRS has previously issued a notice of deficiency for the carryback year and the taxpayer has filed a petition in the Tax Court. The Tax Court explained that this was allowed because Sec. 6213(b)(1) provides an exception to Sec. 6212(c)(1) for mathematical and clerical errors, and Sec. 6213(b)(3) provides that a tentative carryback refund may be assessed “as if it were due to a mathematical or clerical error.”

According to the Tax Court, Secs. 6212(c)(1), 6213(b), 6411 (the section that provides for a tentative refund claim), and 6511(d)(2)(B) create a unique statutory regime for the IRS's allowance and recapture of tentative carryback refunds that allows the IRS or a taxpayer to split a deficiency caused by an erroneous refund of taxes due to the recapture of a tentative NOL carryback to a tax year from a deficiency related to the tax liability for that year. Accordingly, res judicata does not preclude litigation of a deficiency assessment based on a tentative NOL carryback refund even if the liability for the year to which the NOL was carried back had already been litigated. However, the Tax Court made it clear that this exception to res judicata afforded by the four code sections applied only to the recapture of tentative refunds and that it did not apply to other situations (e.g., in a case of fraud) in which Sec. 6212(c)(1) alone allowed for the issuance of a second notice of deficiency.

Although the Tax Court held that res judicata did not apply to RLI and that RLI was not precluded from challenging the merits of the IRS's deficiency claim, RLI had not raised the substantive merits of its claim to the 2001 loss that it carried back in its petition. Because RLI had not made a claim in its petition that the Appeals Office had abused its discretion by not ruling on the merits of the NOL carryback, the Tax Court held that it had conceded the issue and would not address it. Therefore, it upheld the IRS's proposed levy against RLI.

Reflections

In rejecting the res judicata claims of both sides, the Tax Court properly let the decision rest on whether RLI was actually entitled to the NOL carryback refund based on substantive tax law. While RLI may not have prevailed on the merits of its refund claim, it ensured this result by not raising the issue.

Ron Lykins, Inc., 133 T.C. No. 5 (2009)