

UNITED STATES OF AMERICA  
DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
OFFICE OF PROFESSIONAL RESPONSIBILITY  
WASHINGTON, DC

DIRECTOR, OFFICE OF PROFESSIONAL  
RESPONSIBILITY,

Complainant,

v.

COMPLAINT NO. 2006-1

JOHN M. SYKES, III,

Respondent.

DECISION

This matter arises from a complaint issued on January 19, 2006, by the Director, Office of Professional Responsibility, Department of the Treasury, Internal Revenue Service (OPR), pursuant to 31 C.F.R. 10.60 and 10.91, issued under the authority of 31 U.S.C. 330 (1986), seeking to have Respondent, John M. Sykes, III, an attorney engaged in practice before the Internal Revenue Service, suspended from such practice for a period of one year. The complaint alleges that Respondent failed to exercise due diligence in connection with certain opinions he issued to the investment firm comprised of Large Hedge Fund LP #1, Large Hedge Fund LP #2 and Large Hedge Fund LP #3,<sup>1</sup> on or about Date 1 and Date 2, and that he willfully engaged in disreputable conduct within the meaning of 31 C.F.R. Part 10, when he issued those opinions.

Respondent filed a timely answer denying that he engaged in any misconduct and/or that he has engaged in any disreputable conduct and asserting that this proceeding is time-barred under the statute of limitations provided in 28 U.S.C. 2462 because the alleged misconduct occurred more than five years prior to issuance of the complaint.

A hearing was held in Washington, DC, on September 18 through 20, 2007, at which the parties were given a full opportunity to examine and cross-examine witnesses and to present other evidence and argument. Proposed findings of fact, conclusions of law, and supporting reasons submitted by the parties have been given due consideration. Upon the entire record and my observation of the demeanor of the witnesses, I make the following

Findings of Fact

Respondent is a tax attorney who has been associated with the State #1 office of the law firm of Attorney & Attorney (A&A) since Date 4 and has been a partner in that firm since Date 3. He has an LL.M. degree in tax from NYU Law School and has over 30 years of experience in a practice specializing in the tax aspects of leasing transactions. Partner 1, a retired A&A partner who also specialized in the tax aspects of leasing transactions and who worked with

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<sup>1</sup> These entities were related limited partnerships and will be referred to collectively as Large Hedge Fund.

Respondent for many years, described him as one of the brightest tax attorneys he has ever met. Tax Attorney 1, a tax attorney and financial advisor with extensive experience in private practice, Government, and academia, testified that he regarded Respondent “as one of the best tax lawyers I’ve worked with.” In its post-hearing brief, OPR states that “Respondent is an acknowledged expert in the area of the tax law at issue in the underlying case,” which gave rise to the complaint in this proceeding. Respondent first became involved with what led to the underlying case when he was part of an A&A team that worked on a series of leasing transactions known as Leasing Transactions #1 and Leasing Transactions #2.<sup>2</sup>

The Leasing Transactions #1 were designed by Tax Attorney 1 and the financial advisory firm of Advisory Firm #1 for its client Corporation #1 and involved Corporation #1’s computer leasing business. In Date 5, Corporation #1 sought the assistance of Advisory Firm #1 to improve its competitive position in the computer leasing industry. Previously, Corporation #1 had leased computer equipment it owned to end-users for approximately 36 months. Under the leasing structure devised by Advisory Firm #1 in the Leasing Transactions #1, Corporation #1 entered a master lease, leasing the computer equipment to Offshore Entity #1 for a period of 60 months, subject to the end-user leases. Offshore Entity #1, in turn, subleased the computer equipment, also subject to the end-user leases for a period of approximately 48 months to Limited Partnership #1, a limited partnership comprised of Advisory Firm #1 and the investment firm Investment Company #1. Under the sublease Limited Partnership #1 was to pay rent to Offshore Entity #1 for the term of the sublease. Limited Partnership #1 prepaid a portion of its rent under the sublease in an amount equal to about 92 percent of the rents due it under the end-user leases. To do this Limited Partnership #1 borrowed money from Bank #1, securing the loan with the rents it anticipated receiving under the end-user leases. Offshore Entity #1 used the prepayment to purchase U.S. Treasury securities which served as security for Offshore Entity #1’s rental payments to Corporation #1 under the master lease. In addition to the economic benefits flowing to Corporation #1 and others in these transactions, they were designed to create substantial tax benefits for various investors by shifting otherwise taxable income to Offshore Entity #1, which was not subject to taxation by the United States, and shifting deductions and losses related to that income to entities that were U.S. taxpayers.

In order for the transactions to have the desired effects, it was essential that the leases be considered “true leases” for U.S. tax purposes. If Corporation #1, as the owner of the computer equipment, did not retain sufficient burdens and benefits of ownership at the end of the lease terms the leases could be considered sales of the property rather than leases. Among the factors to be considered in determining a “true lease” are the value of the equipment at various times during the lease term and the expected remaining useful life of the leased property at the end of the lease.

As the Leasing Transactions #1 were being formulated in early Date 5, A&A was retained by Advisory Firm #1 to advise it on structuring the transactions and to provide opinions on the “true lease” status of the leases. The A&A team was under the direction of firm Partner 1<sup>3</sup> and Respondent, at that time an associate attorney of the firm, was part of that team.<sup>4</sup> The credited testimony of Partner 1 and Respondent and the documentation in the record

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<sup>2</sup> The Leasing Transactions #1 involved leases of Corporation #1 computer equipment and the Leasing Transactions #2 transaction involved truck leases.

<sup>3</sup> Partner 1 estimated that, as of Date 5, he had worked on between 50 and 100 tax opinions involving the subject of “true leases.”

<sup>4</sup> The law firm of Law Firm #3 served as co-counsel and assisted in putting these transactions together.

establishes that the A&A team and its co-counsel sought to identify all of the legal issues likely to be involved and that they conducted extensive legal research and analyses of the tax statutes and common law doctrines reasonably expected to have an impact on the lease transactions before A&A issued any opinions. These included Internal Revenue Code (Code) Sections 269, 446, and 482, and the common law doctrines of business purpose, economic substance, substance-over-form, step transactions and sham transactions.

One of the important factors in the analysis done by A&A was an appraisal of the computer equipment. If the equipment had insufficient value and remaining useful life, it could result in the lease transactions being treated as sales for tax purposes. Partner 1 and Respondent were involved in selecting the appraiser of the computer equipment. After interviewing four appraisal firms, the firm of Appraisal Firm #1 was chosen and Appraiser #1 did the appraisal of the computer equipment. Partner 1 testified that they closely examined all of the appraisal firms and concluded that Appraisal Firm #1 had the needed experience in the computer equipment area. Respondent testified that he reviewed a draft of Appraiser #1's appraisal to assure that it was internally consistent and that it provided the answers needed to evaluate the tax consequences of the lease transactions. He also discussed the appraisal with Appraiser #1 and had him explain any parts that were unclear. Partner 1 testified that because he had not dealt with leases of computer equipment before he wanted someone else with experience in that area to review the Appraisal Firm #1 appraisal to give him "some level of comfort" that the approach used and the value determined by Appraisal Firm #1 were correct and that its conclusions were reasonable. The firm of Accounting Firm #1, with whom Partner 1 had previously dealt, was selected to review the Appraisal Firm #1 appraisal. Accounting Firm #1 concluded that the Appraisal Firm #1 appraisal followed generally accepted appraisal procedures, the conclusions in the appraisal were reasonable, and that the methodology used to determine residual values of the computer equipment was reasonable.<sup>5</sup>

Ultimately, A&A issued five written opinions signed by Partner 1 concerning the federal tax consequences of the subject lease transactions which closed between August Date 5 and July Date 6. Those opinions concluded that the master leases and subleases were "true leases" and that the rent prepayment under the subleases was income to Offshore Entity #1.

These opinions were issued as "short form" opinions, meaning that they contained a detailed recitation of the facts and conclusions relating to the particular transaction but did not contain a written legal analysis. Partner 1 testified that in his experience clients in leasing transactions preferred to have, and A&A always issued, short form opinions. He said that much of the legal analysis in the firm's leasing practice was similar and cumulative and involved a collection of materials in the firm's files which were developed in connection with other leasing transactions, sometimes, dating back several years.

These true lease opinions were issued at the "more likely than not level," which Partner 1 testified means that there is at least a 51 percent chance that the conclusions in a tax opinion given to a client are correct and that if the case went to court, was properly tried, and all of the facts and law were understood by the tribunal, that is what the result would be. This is contrasted with a "reasonable basis" opinion which has a 25 percent chance that it is correct, a "substantial authority" opinion which has about a 40 percent chance, a "should" opinion which has a 75 to 80 percent chance, and a "will" opinion which has about a 95 percent chance.

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<sup>5</sup> Respondent testified that the Leasing Transactions #2 involving trucks was simpler and A&A did not feel a need for a review of that appraisal.

The next steps in these lease transactions were the “exchange transactions” in which during Date 5 and Date 6 Offshore Entity #1 transferred its leasehold interests and the U. S. Treasury securities to a number of U.S. corporate investors in exchange for preferred stock in those corporations.<sup>6</sup> These exchanges were structured to be tax-free exchanges under Section 351 of the Code and were intended to provide tax benefits to the U.S. corporations by separating the income received by Offshore Entity #1, which was not subject to U.S. taxation, from the deductions for the rent paid to Corporation #1 under the leases by the U.S. corporate taxpayers. The process is referred to as “lease stripping.”

On October 13, 1995, the IRS had issued Notice 95-53 in which it announced its intention to challenge losses claimed as a result of lease stripping transactions. The notice indicated that new regulations might be issued and also stated that the IRS may apply various specified sections of the Code and corresponding regulations to such transactions, as well as, common law principles, including, the business-purpose doctrine, the substance-over-form doctrine, and the step and sham transaction doctrines, to existing transactions.

A&A had acted as counsel to Advisory Firm #1 on the five Leasing Transactions #1 exchange transactions which closed between October Date 5 and August Date 6. It provided the corporate investors with the true lease opinions signed by Partner 1 which were based on the work done in connection with the lease transactions. Other counsel for the corporate investors used these true lease opinions in issuing their own opinions advising the clients concerning the deductibility of their rental payments under the master leases and whether the exchange transactions met the requirements of Section 351 of the Code.<sup>7</sup>

The tax opinions authored by the Respondent which led to the complaint in this matter concern the basis for tax purposes of the preferred stock held by Offshore Entity #1 as a result of the exchange transactions. Some of that stock was acquired by Large Hedge Fund which in Date 3 requested that A&A provide it with opinions as to the basis of the stock in order to claim substantial losses on its partnership tax returns when the stock was sold and to insulate it from penalties that might be asserted by the IRS. Respondent authored and signed those tax basis opinions and OPR alleges that in doing so he failed to exercise due diligence and engaged in disreputable conduct.

The basis opinions authored by Respondent were short form opinions. They opined that (a) the exchange transactions met the requirements for a tax-free exchange under Section 351 of the Code, (b) the stock received by Offshore Entity #1 would have a basis equal to the amount specified therein, and (c) if Offshore Entity #1 were to sell that stock for cash in a bona fide arms-length transaction with economic substance, its gain or loss from that sale would be determined by reference to the basis specified in the opinion.

In Date 7, Large Hedge Fund sold some of the stock it had received from Offshore Entity #1 for approximately one million dollars. On its Federal partnership tax returns, relying a tax opinion from the firm of Law Firm #2 as to the tax consequences of the acquisition and sale of the stock and on the basis opinion provided by Respondent as to the tax basis of that stock, Large Hedge Fund claimed a basis which purportedly gave it net capital losses of over \$100 million. After an examination of those returns, the IRS disallowed the losses claimed by Large Hedge Fund on the grounds that the transactions between Offshore Entity #1 and Large Hedge

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<sup>6</sup> Those corporations were Corporation #3, Corporation #4, Corporation #5, Corporation #6, and Corporation #7.

<sup>7</sup> The firms were Law Firm #5, Law Firm #4, and Accounting Firm #2.

Fund were sham transactions which lacked a non-tax business purpose and did not have reasonable expectations of profit apart from the benefits accruing to Large Hedge Fund from the purported losses for tax purposes. Substantial penalties were also imposed on Large Hedge Fund for understatement of income.

Large Hedge Fund challenged the IRS's determinations in the U.S. District Court for the District of State #2 and lost. The court held that the sale of the high basis preferred stock lacked economic substance beyond the creation of tax benefits, that the transfer of the stock to Large Hedge Fund in exchange for a partnership interest and the subsequent sale of that interest back to Large Hedge Fund constituted a single sham transaction not having a reasonable expectation of profit and lacking in any business purpose other than tax avoidance. The court also held that Large Hedge Fund was subject to the understatement of income penalties asserted against it because it did not establish that it could reasonably rely on the Law Firm #2 opinion regarding tax treatment of the partnership transactions. Because of that, the court did not reach the question of whether Large Hedge Fund could have reasonably relied on the A&A opinions concerning the basis of the stock. (Redacted opinions concerning third party.) Following the trial and decision in the district court in the Large Hedge Fund tax case, the Department of Justice, which had represented the IRS in that proceeding, referred this matter to OPR which subsequently issued the complaint against Respondent.

#### Analysis and Conclusions

While the Respondent admits to having engaged in "limited practice" before the IRS, he does not concede that the matters involved here constitute practice before the IRS or make him subject to the federal statute, 31 C.F.R. U.S.C. 330, and the regulations at 31 C.F.R. Part 10 governing such practice.<sup>8</sup> However, he has not pursued this contention in his post-trial brief. Section 10.2(d) of 31 C.F.R. broadly defines practice before the IRS to include all matters connected to a presentation to the IRS or any of its officers and employees relating to a taxpayer's rights, privileges, or liabilities under the federal tax laws. The ultimate purpose of the basis opinions prepared by Respondent which are the subject matter of this proceeding was to convince the IRS that the basis of the stock in question for tax purposes was what the opinions said it was and to shield the taxpayer from penalties that might be asserted if the IRS disagreed with the basis being claimed. I find that the opinions were intended and were reasonably expected to be a part of the taxpayer's presentation to the IRS in support of its position with respect to the basis of the stock and that Respondent's preparation of those opinions constituted practice before the IRS. Consequently, I find that Respondent is subject to the law and regulations governing such practice.

Inasmuch as OPR seeks to suspend Respondent from practice before the IRS for a period of one year, 31 C.F.R. 10.76(a) requires that "an allegation of fact that is necessary for a finding against the practitioner must be proven by clear and convincing evidence in the record." While not defined in Circular No. 230, a generally accepted definition of clear and convincing evidence is that it requires a degree of proof which will produce in the mind of the trier of fact a firm belief as to the allegations sought to be established. It is more than a mere preponderance but less than proof beyond a reasonable doubt. *Jove Engineering, Inc., v. IRS*. 92 F.3d 1539, 1545 (11th Cir. 1996); *Hobson v. Eaton*, 399 F.2d 781, 784 fn. 2 (6th Cir.1968). The allegations

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<sup>8</sup> The regulations are contained in what is known as Treasury Department Circular No. 230. The current version of Circular No. 230 was last revised in 2005 and contains the procedural rules applicable to this proceeding. The 1996 version was in effect when Respondent's basis opinions were issued and govern this proceeding.

must be proven to a “high probability.” *Waits v. Frito-Lay, Inc.*, 978 F.2d 1093, 1105 (9th Cir. 1992).

The complaint alleges that Respondent failed to exercise due diligence in violation of 31 C.F.R. 10.22(a) and (c) when he authored the five basis opinions addressed to Large Hedge Fund in which he failed to analyze, and advise his clients of, relevant facts, law, and regulations that could have had an effect on the basis of the stock. Specifically, it alleges that (1) the opinions contained no analysis of the possible effect of IRS Notice 95-93 which advised that the IRS would challenge lease stripping transactions under current law and regulations and by applying the “business purpose” doctrine and the “substance-over-form” doctrine, including the “sham transaction and “step transaction” doctrines; (2) the opinions contained no analysis of the substance-over-form doctrine, including the sham transaction and step transaction doctrines; (3) the opinions contained no analysis of the economic substance of the lease stripping transactions; (4) Respondent did not make sufficient inquiries to determine whether the assumptions contained in the opinions were correct; and (5) Respondent did not make sufficient inquiries to determine whether the lease stripping transactions had a valid and reasonable expectation of a pre-tax profit and whether the parties to the transactions had complied with the contractual terms of the transactions. The complaint also alleges that when Respondent authored the basis opinions without performing due diligence he willfully engaged in disreputable conduct within the meaning of 31 C.F.R. 51.

Section 10.22 of 31 C.F.R., Diligence as to accuracy, provides:

Each attorney, certified public accountant, enrolled agent, or enrolled actuary shall exercise due diligence

(a) In preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

....

(c) In determining the correctness of oral or written representations made by him to clients with reference to any matter administered by the Internal Revenue Service.

Section 10.52 of 31 C.F.R., Violation of regulations, provides:

A practitioner may be disbarred or suspended from practice before the Internal Revenue Service for any of the following:

(a) Willfully violating any part of the regulations contained in this part.

While the term “willful” is not defined in the regulations, its use in the Treasury laws has consistently been held to mean, in both civil and criminal contexts, the “voluntary, intentional violation of a known legal duty.” E.g., *United States v. Pomponio*, 429 U.S. 10, 12 (1976); *Thibodeau v. United States*, 828 F. 2d 1499, 1505 (11th Cir. 1987). Consequently, OPR does not have to show that Respondent acted with malicious intent or bad purpose, only that he purposefully disregarded or was indifferent to his obligations.

OPR has established that Respondent was aware of his client’s purpose in seeking the basis opinions, i.e., to establish a tax basis for use in claiming substantial deductions, that he

was aware of Notice 95-53, which gave notice that the IRS intended to challenge lease stripping transactions when he authored those opinions, and that he was familiar with the requirements of Treasury Regulation 1-6664-4, which provide standards as to when a taxpayer may rely on the advice of tax advisors as evidence of reasonable cause and good faith for purposes of avoiding substantial understatement of income penalties with respect to tax shelter items. The regulation requires that the advice take into account all relevant facts and circumstances, including the taxpayer's purpose in entering into and structuring the transaction, and must not be based on any unreasonable factual or legal assumptions or representations. OPR asserts that in preparing and issuing the basis opinions Respondent willfully failed to meet the duty of due diligence owed to its client Large Hedge Fund and to the Internal Revenue Service and by so doing he engaged in disreputable conduct.

Specifically, OPR asserts that using the short form opinions, which contained "facts, assumptions and conclusions without setting forth any analysis," put Large Hedge Fund at risk because they did not show that all relevant information had been taken into account and they did not provide adequate documentation to justify Large Hedge Fund's tax position or provide it with penalty protection. It asserts that Respondent failed to exercise due diligence because he knew that the IRS had issued Notice 95-53 and that the tax losses Large Hedge Fund sought to take advantage of had been generated by lease stripping transactions before he issued the basis opinions, but the opinions he issued did not indicate that the high basis of the stock was the result of lease stripping transactions. The opinions failed to mention Notice 95-53 and did not discuss the various statutes and common law doctrines mentioned therein or their applicability to these lease stripping transactions or how they might affect the basis of the stock. They did not show the due diligence performed in arriving at the conclusions as to basis or provide Large Hedge Fund with protection from penalties that might be asserted if the claimed losses were disallowed. This deprived Large Hedge Fund of the opportunity to make an informed decision whether or not to acquire the stock from Offshore Entity #1 and to evaluate its chances for success should the IRS question the asserted basis of the stock and disallow the claimed losses.

Respondent credibly testified as to the due diligence he performed in connection with the basis opinions he issued to Large Hedge Fund and introduced numerous documents on which he relied in arriving at his opinions, which were not included a part of those "short form" opinions. These opinions dealt with the basis of the preferred stock in the hands of Offshore Entity #1 after the exchange transactions with the U.S. companies. He said that prior to the issuance of those opinions he needed to consider several things to reach his conclusions as to basis, i.e., whether the leases were true leases, whether the prepayment of rent by Limited Partnership #1 to Offshore Entity #1 constituted taxable income for federal tax purposes, and whether the exchange of assets by Offshore Entity #1 for the preferred stock constituted tax-free exchanges under Section 351 of the Code.

OPR asserts that Respondent failed to exercise due diligence because he failed to make sufficient inquiries concerning the correctness of certain of the assumptions contained in the opinions. In addressing the issue of whether the transactions between Offshore Entity #1 and the corporations whose stock it acquired constituted valid tax-free exchanges under Section 351 of the Code, he included two assumptions that had not been contained in the earlier "true lease" opinions issued by A&A, i.e., "Assumption (S)" which stated that the U.S. corporate investor had a reasonable expectation of realizing a significant profit from the exchange transaction and "Assumption (V)" which stated that "the exchange transaction was entered into for substantial bona fide non-tax business purposes." However, he did not explain why these assumptions were reasonable and he did not secure such representations from the corporate investors but relied on representations from Advisory Firm #1 which was not a disinterested party but one

with a considerable interest in the outcome of the transactions. It asserts that Respondent failed to reconsider and update the legal analysis underlying the “true lease” opinions he relied on and that he failed to resolve questions about the reliability of the appraisals done by Appraisal Firm #1 in connection with those opinions.

OPR did not present any witnesses with any direct knowledge of the lease stripping transactions involved here, the interaction between Respondent and his client Large Hedge Fund, or the preparation of the basis opinions it alleges constitute disreputable conduct. Rather, it chose to rely on the opinions, which it apparently contends speak for themselves and establish misconduct on Respondent’s part. First, OPR asserts that Respondent’s use of “short form” opinions with respect to the basis of the stock Large Hedge Fund acquired was inappropriate and shows a lack of due diligence on his part, or at least constitutes evidence of a lack of due diligence. The evidence in the record does not support that view. On the contrary, it establishes that use of the short form opinion at that time was the accepted norm.

Respondent testified that prior to making partner at A&A and issuing the opinions in question in Date 3; he had assisted other firm partners in the preparation of dozens of tax opinions, the vast majority of which were short form. No client had ever rejected the use of the short form and he was aware that other members of the tax bar used short form opinions. He knew of no IRS guidelines prohibiting the use of short form opinions until Circular 230 was amended some years after 2000 to require that “covered” opinions be in writing and set forth the reasoning underlying the opinion. Since the amendment, he has not used the short form for the opinions he has issued in order to comply with those requirements.

Respondent also presented the testimony of Larry Langdon, whom I find was qualified as an expert witness. Langdon has extensive tax law experience with the IRS, corporations, private practice, and professional associations. This experience included 22 years as the chief tax officer of Hewlett-Packard Corporation where he had the opportunity and responsibility to review tax opinions prepared by a number of the leading U.S. and international law firms. His IRS experience included serving as its Commissioner of the Large and Midsized Business Division dealing with corporate tax shelter activity. In that position, he was involved in drafting guidelines for practitioners which were issued by the IRS. He established his familiarity with the use of opinions provided to taxpayers by outside counsel and with the published requirements of the IRS with respect to such opinions, including those in Circular 230.

Langdon testified that while, ideally, a taxpayer might prefer to receive a long form opinion detailing all of the facts, all of the possible contingencies, and all of the legal issues, as a practical matter, when A&A provided the basis opinions to Large Hedge Fund it was typical and an accepted practice for outside counsel to use the short form. He described the short form opinion as the “gold standard of opinion writing at that point in time.” He said that several factors drove tax practitioners to favor the short form, including, the time and expense involved in preparing a long form opinion and the need for reasonably quick guidance as whether to go ahead with a transaction or not. This led the opinion authors to concentrate on the key issues of strategic importance, “rather than in effect writing a law review article about issues that might arise at some later point. He testified that a short form opinion did not fail to meet the requirements in Circular 230 which did not require an opinion to set forth a law firm’s legal analysis underlying the opinion. He also testified that he reviewed opinions issued by the law firms of Law Firm #3, Law Firm #4, and Law Firm #5 concerning aspects of the lease stripping transactions in issue here and that those opinions were short form opinions. There is no evidence that any of those opinions were alleged to be inappropriate or inadequate.

Langdon testified that, in addition to the opinions of the above-mentioned law firms, he

reviewed the basis opinions Respondent prepared, background memos and files, draft memos and notes, and valuation reports relating to the transactions. He said that, in his opinion, the quality of the work underlying the basis opinions issued by Respondent to Large Hedge Fund was very thoughtfully done, it did a good job of analyzing the underlying facts, and it met an acceptable standard of legal efficacy for the positions that the basis opinions were supporting, at either the “should” or “more likely than not” level. He said that the basis opinions were “clearly within the top tier, clearly within the top 15, 20 percent of all the opinions” he saw while serving as counsel at Corporation #2.

Partner 1, another experienced tax attorney, testified that he had authored between 50 and 100 short form opinions in his practice before the basis opinions were issued. He said that, in his experience, clients preferred short form opinions which contained a description of the facts, any assumptions that were made, and the conclusions. The detailed legal analysis of a transaction contained in the issuing firm’s files was not made a part of the short form opinion; consequently, such an analysis, discussing not only the pros but also the cons of a transaction, would not be accessible by a taxing authority examining the transaction. Technical Advisor #1, an IRS technical advisor for tax shelters, called as a witness by OPR, testified that she was aware that prior to the year 2002, short form opinions were commonly issued by law firms on tax issues and she was not aware of any rules prohibiting their use. The regulations in Circular 230 were revised, effective December 20, 2004, to require that opinions “relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.” 31 C.F.R. 10.35(c)(2). As Respondent’s brief points out, such a revision would have been unnecessary if this were already required by the due diligence standard in Circular 230. Moreover, Treasury Reg. 1-6664-4(c), concerning the standards for reliance by a taxpayer on professional advice for penalty protection, states that such advice “does not have to be in any particular form.” I find that OPR has failed to establish that Respondent’s use of short form opinions was inappropriate or is evidence of a lack of due diligence.<sup>9</sup>

It is with this in mind that OPR’s other contentions must be considered. OPR contends that Respondent failed to exercise due diligence because he failed to mention in his basis opinions that the purported high basis in the stock acquired by Large Hedge Fund came from lease stripping transactions and because he was aware of but did not discuss in those opinions Notice 95-53, in which the IRS announced its intent to challenge lease stripping transactions. This, it asserts, deprived Large Hedge Fund of the opportunity to make an informed decision regarding whether to enter the transactions with Offshore Entity #1 and make a reasonable evaluation of its potential for success if it subsequently attempted to rely on the basis of the stocks set forth in Respondent’s opinions. I find there is no factual basis for this assertion in this record. As noted, OPR did not call any representative of Large Hedge Fund as a witness or present any other evidence tending to establish that Large Hedge Fund was not aware that the stock it was to acquire in these transactions involved lease stripping, that it did not have knowledge of Notice 95-53, or that the information available to it was not sufficient to make an informed decision about whether to acquire it. Respondent’s credible and uncontradicted testimony was that during his first meeting with representatives of Large Hedge Fund to discuss the possibility of representation, he discussed Notice 95-53 with Accountant #1, an accountant and tax attorney who served as Large Hedge Fund’s Tax Director. Aside from this, it is simply unreasonable to assume that Large Hedge Fund, which was investing millions of dollars in these transactions, did not know that lease stripping was involved. That knowledge was no

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<sup>9</sup> I find that the comments of the judge in the Large Hedge Fund case about Respondent’s opinions to be of little persuasive value since there is no indication that she was aware of the due diligence undertaken by Respondent but not a part of the short form opinions.

doubt one of the reasons why Large Hedge Fund sought the basis opinions in the first place. Further evidence that Large Hedge Fund was made aware of Notice 95-53 is contained in a memo Respondent caused to be sent to Accountant #1, dated October 30, Date 3, which had an attached copy of a portion of an opinion letter A&A had issued to another taxpayer in November Date 6, "which discusses the potential impact of the IRS notice on so-called 'lease stripping' transactions."

More importantly, the evidence shows that Respondent was aware of Notice 95-53 and had analyzed the statutes and legal doctrines referenced therein before he issued the basis opinions. The documentation in the record and testimony of Respondent and Partner 1 establishes that they and other members of A&A had worked together closely in doing the extensive research and analysis leading to the true lease opinions that Partner 1 issued to Advisory Firm #1 in Date 5 and Date 6, which concluded that the master leases and subleases were "true leases" and that the rent prepayment under the subleases was income to Offshore Entity #1. Neither the extent nor the quality of the due diligence underlying these opinions is questioned here. The evidence shows that in the course of their research and analysis they recognized the possible applicability and considered each of the following statutes and common law doctrines which were delineated in Notice 95-53 when it was subsequently issued in October Date 6: Code Sections 269, 446(b), and 482; business purpose doctrine; economic substance doctrine; and substance-over-form doctrine, including the step and sham transaction doctrines.

Although obviously pertinent to the some of the issues Respondent would later address in his basis opinions, OPR dismisses this work as not relevant to whether Respondent engaged in due diligence in preparing those opinions and says that, even if it was relevant, that due diligence "needed to reconsidered and updated to ensure that the legal analysis was still valid at the time of the exchanges between Long Term and Offshore Entity #1." It does not say why. Notice 95-53 did not change the law applicable to lease stripping transactions, it merely said that the IRS might be issuing new regulations which would apply to future transactions lease stripping transactions and that it would be examining past transactions using various statutes and legal doctrines. The evidence shows that A&A had already considered those statutes and legal doctrines and concluded that they did not apply or, as in the case of the step transaction theory, specifically structured the transactions so that it did not apply. Respondent has also established that the basis of the stock in question was established as of the date of the exchange transactions and that subsequent events had no effect on it or required further consideration before he reached the conclusions set forth in the basis opinions. Respondent testified that this was the case, as did an expert witness Expert Witness #1, a tax attorney with over 30 years of experience primarily in the area of finance and leasing, who said that "the things that defined basis were done upon the completion of the exchange." OPR's witness Technical Advisor #1 also agreed with that proposition. OPR asserts that this argument is "unpersuasive," but it presented no evidence or authority to the contrary.

As a part of its argument that Respondent needed to reconsider the due diligence performed in connection with the true lease opinions, OPR asserts that Respondent failed to make sufficient inquiries to determine the correctness of two of the assumptions contained in his basis opinions which were not part of the previous opinions. It contends that these assumptions concerning the parties' expectations of profits were not reasonable. It asserts that he failed to contact the appropriate parties to confirm that they expected a profit from the transactions, but accepted, without question, the representations of Advisory Firm #1, which had a financial interest in the transactions which it had promoted, as to their profit motives. It also asserts that the appraisal of the computer equipment on which the computations of potential profits were based was deficient and that it was unreasonable to rely on it.

I find that the evidence fails to establish that Respondent's reliance on representations of Advisory Firm #1 was unreasonable as matter of law because it had a financial interest in these transactions. On the contrary, the credible and uncontradicted evidence was that Advisory Firm #1 was a leading firm in the leasing field with a reputation for professionalism and integrity. Expert Witness #1 testified that he was familiar with the firm and its personnel and described it as "absolutely first rate," and having an excellent reputation as a firm that would get a job done right and would have more knowledge about the transactions involved than most of the participating parties. He was asked if he would rely on a representation from Advisory Firm #1 in a leasing transaction in which he represented one of the parties and said that he "would rely on their representation regarding financial matters." Partner 1 testified that Advisory Firm #1 was the pre-eminent firm in its field and that he "felt very comfortable relying on any representation they made." He said that Advisory Firm #1's position in the leasing field was "so exalted" that it could not afford to provide anything but "an accurate and thorough representation." Respondent, likewise, testified that he was aware of Advisory Firm #1's standing in the industry. He said that when he was given the representation that Advisory Firm #1 had provided one of the corporations involved in the exchange transactions he felt that he could reasonably rely on it in reaching his opinion because it would not make a statement as to a fact or a financial analysis it did not believe it could stand behind. The evidence here indicates that a representation made by Advisory Firm #1 would be at least as reliable as a representation by a party who stood to gain by establishing that it had an expectation of a non-tax benefit from the transaction. The cases cited by OPR as purportedly establishing the unreasonableness of reliance on representations by the promoters of a transaction or their agents are all factually distinguishable from the situation presented here. But in any event, Respondent has shown that he did not than uncritically accept representations from Advisory Firm #1.

Respondent testified that he had reviewed the written representations from Offshore Entity #1 in the record that it had entered into the transactions with the expectation of making a meaningful pre-tax profit from its interest in the transactions. For each transaction, he had examined and analyzed a detailed spreadsheet showing Offshore Entity #1's expected pre-tax return from the transaction and, in turn, that of the U.S. corporation issuing the exchanged stock which took over Offshore Entity #1's position in the leasing transaction and determined that it also had a substantial non-tax economic benefit from the transaction. The transaction he discussed in detail in his testimony involving Subsidiary #1, a subsidiary of Corporation #3, projected a 21 percent rate of return. He said he was also aware of due diligence Subsidiary #1 had done before entering the exchange transaction which included an opinion obtained from the law firm of Law Firm #5 concerning the exchange transaction and he drew on his own knowledge of the transactions.

Key to the question of whether the parties had an expectation of a non-tax profit from these transactions was the residual value of the subject computer equipment. According to Partner 1, the appraisal of that value was "the fundamental factual reference point" from which the tax opinions issued by A&A flowed. OPR contends that A&A did not investigate the appraiser's qualifications and had "reservations" about the appraisal obtained from Appraisal Firm #1. Therefore, Respondent should have done something more to assure that the appraised values were accurate before he issued his basis opinions. The evidence does not support that contention. In fact, there is no evidence that any of the numerous parties or attorneys involved in these transactions ever questioned the accuracy of the appraisals. Respondent and Partner 1 credibly testified that they interviewed four appraisal firms and according to Partner 1 made an "extensive" examination of their qualifications before selecting Appraisal Firm #1. OPR's contention is apparently based on the fact that after A&A received

and analyzed the Appraisal Firm #1 appraisal it engaged Accounting Firm #1 to review it as well. Partner 1 credibly testified that he did this because he had not used Appraisal Firm #1 before, he had not done lease financing involving computer hardware before, and he wanted assurance that the approach used and the value determined by Appraisal Firm #1 was reasonable. There is no evidence that A&A believed that the Appraisal Firm #1 appraisal was not accurate or that its methodology was flawed in any way. Contrary to the assertion by OPR, it does not appear that A&A placed significant restrictions on Accounting Firm #1's review of the appraisal. It was not seeking a second appraisal, only confirmation that the methodology employed and the conclusions reached were reasonable. That is what it got. It appears that OPR now faults Respondent for not doing the same kind of due diligence that A&A had already done. I find that OPR has failed to prove by clear and convincing evidence that Respondent's use of the assumptions it questions in his basis opinions was unreasonable or amounted to a lack of due diligence on his part.

### Conclusions of Law

I find that OPR initiated this disciplinary proceeding based on the fact that Respondent used short form opinions in advising Large Hedge Fund concerning the basis of the stock it obtained in the exchange transactions with Offshore Entity #1. It has provided little more than that fact as the evidence in support of its complaint allegations and has failed to prove any of those allegations by clear and convincing evidence, as required by Circular No. 230.<sup>10</sup> Respondent's evidence establishes that use of the short form opinions was an accepted practice at the time they were issued, and more important, that he had done the due diligence necessary to support the conclusions contained in those opinions. Accordingly, I find that OPR has not proved that Respondent failed to meet the requirements of the regulations or that he willfully engaged in disreputable conduct when he issued those the basis opinions to Large Hedge Fund. I find that the complaint should be dismissed.<sup>11</sup>

On these findings of fact and conclusions of law and on the entire record, I issue the following

### ORDER<sup>12</sup>

The complaint is dismissed in its entirety.

Dated, Washington, D.C. January 29, 2009

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Richard A. Scully  
Administrative Law Judge

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<sup>10</sup> Respondent has repeatedly questioned OPR's good faith in bringing this proceeding. However, it appears that if he had been more forthcoming during OPR's investigation of his conduct in preparing the basis opinions, this complaint might not have been issued.

<sup>11</sup> Having found that Respondent did not engage in any misconduct, I find it unnecessary to reach the question of whether or not the statute of limitations in 28 U.S.C. 2462 is applicable to this proceeding.

<sup>12</sup> Pursuant to 31 C.F.R. 10.77, either party may appeal this Decision to the Secretary of the Treasury within thirty (30) days of its date of issuance.