



# Tax talk

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## Canal Corporation's Tax Odyssey

*By Robert R. Pluth Jr.*

*Canal Corporation and Subsidiaries v. Commissioner*<sup>1</sup>, a case recently decided by the U.S. Tax Court, provides some disturbing guidance in connection with the reliance on the opinion of a sophisticated tax advisor in an effort to avoid accuracy-related penalties under the Internal Revenue Code.

### FACTS

Canal Corporation (formerly Chesapeake Corporation) is a Virginia company engaged in various segments of the paper industry, including the manufacturing of tissue through Wisconsin Tissue Mills, Inc. (WISCO), its largest subsidiary. In the mid 90's, Canal decided to change its focus and WISCO no longer was a good fit. Georgia Pacific (GP), which also was in the tissue business, wanted to buy WISCO but Canal was reluctant to sell it. Due to its low tax basis in the WISCO assets, Canal would have incurred a significant tax liability upon a sale.

Instead, with the help of Salomon Smith Barney (Salomon) and Pricewaterhouse Coopers (PWC), Canal decided to form a "leveraged partnership" with GP.<sup>2</sup> Under this structure, both WISCO and GP transferred all of their respective tissue business assets to a new partnership which, in turn, borrowed \$755.2 million from a third party that

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<sup>1</sup> 135 T.C. No. 9 (August 5, 2010).

<sup>2</sup> The participants referred to the venture as "Project Odyssey" after the Odyssey by Homer. Canal was identified as "Calypso" and GP as "Zeus." Calypso was a beautiful sea nymph who used her charms to hold Odysseus captive for seven years on the island of Ogygia. Odysseus' patron goddess, Athena, ultimately prevailed upon Zeus, the king of the gods, to order the release of Odysseus. Zeus complies by sending (who else?) Hermes, the messenger of the gods, to so instruct Calypso.

Coincidentally or not, under Code § 737 a partner (such as Canal) that contributes appreciated property to a partnership on a tax-deferred basis and receives an otherwise tax-deferred distribution from the partnership of other property within seven years of the original contribution is required to recognize gain. See also Code § 704(c)(2)(B) (containing a similar seven year waiting period). The fact that Homer, composing his epic poem sometime between the ninth and seventh centuries B.C., could have anticipated the significance of this seven year "cooling off period" under the Internal Revenue Code is nothing short of astounding!

was immediately distributed to Canal as a "special distribution." The contributions were intended to be tax free. Canal agreed to a lower valuation of its contributed assets in exchange for tax deferral, and ended up with a 5% interest in the partnership. GP guaranteed the partnership's debt that was incurred to fund the special distribution. Although GP did not require it to do so as a condition of doing the deal, Canal was advised by PWC that it needed to indemnify GP so as to make the special distribution a non-taxable distribution as opposed to a disguised sale under Code § 707(a)(2)(B).<sup>3</sup>

Ultimately, in an effort to limit Canal's economic exposure, the indemnity came from WISCO, whose only asset (other than the partnership interest) was a corporate jet valued at \$6.0 million and an inter-company receivable from its parent, Canal, in the amount of \$151 million.<sup>4</sup> The indemnity only covered the repayment of principal, which was not due for 30 years. Further, GP had to first proceed against the partnership's assets before trying to collect on WISCO's indemnity. Prior to incurring the debt to fund the special distribution, the partnership had assets worth \$1.15 billion. The court found that, immediately after the transaction, WISCO had a net worth of \$151 million, or 21% of its maximum exposure under the indemnity.

For a fixed fee of \$800,000, PWC rendered a tax opinion to Canal (using a "should" standard) that, among other things, the transaction would not constitute a disguised sale. In addition to helping structure the transaction and rendering the opinion, PWC was Canal's longstanding auditor and tax preparer. PWC advised Canal that it did not have to guarantee the debt but only to indemnify GP. In this respect, the Canal leveraged partnership transaction differed from the reported structure used when the Tribune Company recently disposed of its interest in the Chicago Cubs, Wrigley Field and related assets. See Willens, *Tribune's Divestiture of the Cubs Reprises 'Levpar' Structure*, *Tax Notes Today* (November 5, 2009). Tribune, which then was in bankruptcy, reportedly agreed to guarantee the repayment of the debt, along with a substantial portion of the related interest, incurred to fund its special distribution from the leveraged partnership it entered into with Ricketts Acquisition LLC.

The disguised sale provisions in the Code allow the IRS to recast a contribution of property to a partnership, followed by a distribution of cash to the contributing partner within two years of the contribution, as a taxable sale in certain circumstances. The success of Canal's tax planning hinged upon its reliance on an exception to the disguised sale rules for certain "debt-financed distributions" to the extent the distributions are traceable to debt allocated to the distribute partner under the Code § 752 regulations.<sup>5</sup> Those regulations generally require recourse debt (such as the loan in question) to be allocated to the partner or partners bearing the ultimate economic risk of repayment, without separately making a determination of whether such partner(s) actually have the economic ability to meet their obligations "... unless the facts and circumstances indicate a plan to circumvent or avoid the obligation."<sup>6</sup>

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<sup>3</sup> The objective was to be able to argue that the special distribution did not exceed WISCO's tax basis for its partnership interest, and that its basis included 100% of the partnership debt incurred to fund the distribution.

<sup>4</sup> WISCO also retained environmental liabilities for the cleanup of a Superfund site as required by the EPA. The environmental issues apparently were created while the business was owned by Phillip Morris, which sold the business to Canal and indemnified it for the loss subject to a \$120 million remaining cap. WISCO, along with other Canal subsidiaries, also remained liable for a \$450 million credit facility that enabled Canal to make a prior acquisition.

<sup>5</sup> See Reg. § 1.707-5(b)(1).

<sup>6</sup> See Reg. § 1.752-1(a)(1); Reg. § 1.752-2(b)(1).

In an unreviewed opinion, Tax Court Judge Kroupa ruled that the transaction was a taxable disguised sale by Canal of its tissue business (yielding a \$524 million gain). She held that WISCO's indemnity created "... no more than a remote possibility ..." that WISCO actually would be called upon to pay the underlying debt. The court relied on an "anti-abuse" rule contained in the disguised sale regulations that previously had not been interpreted by the courts.<sup>7</sup> That rule allows a partner's obligation to be disregarded if it is undertaken to merely give the appearance of subjecting the partner to an economic risk of loss if the substance of the arrangement is otherwise.

Since it is a case of first impression, *Canal* raises a number of interesting issues, including:

- (a) What factors trigger the application of the anti-abuse rule in the first instance, particularly since the regulations generally provide that one does not have to do an economic analysis of the partner's ability to pay?
- (b) What level of net worth must the obligor partner demonstrate in order to be assured of having its obligation respected?
- (c) Would the result clearly have been different if the parent, Chesapeake, had indemnified GP even though the indemnity was not demanded by GP or the lender?

### ACCURACY-RELATED PENALTY

In its amended answer to the taxpayer's petition to the Tax Court, the IRS also asserted a \$36.7 million accuracy-related penalty for substantial understatement of income tax. Given the manner in which the penalty was asserted, under applicable Tax Court rules the government bore the burden of proof.

The penalty does not apply if the taxpayer can show reasonable cause and that it acted in good faith.<sup>8</sup> Relying on a competent tax advisor generally constitutes reasonable cause when the underlying deficiency arises as a result of the proper interpretation of substantive, rather than procedural, matters of tax law. The court noted that this "reliance" exception is not unlimited. The advice cannot be based on unreasonable factual or legal assumptions, for example. The court had the following problems with the tax opinion rendered by PWC:

- The court was offended by the \$800,000 fixed fee charged by PWC for its opinion. Judge Kroupa felt that PWC "... crossed over the line from trusted advisor ... to advocate for a position with no authority..." As a result, she concluded that the taxpayer did not act with reasonable cause or in good faith. Although large in absolute dollars, one might reasonably argue that the fee was not unreasonable given the size of the transaction. As a practical matter, writers of tax opinions often can be characterized as also being "advocates." Further, the applicable regulations do not require a tax advisor to be "independent" in order for a taxpayer's reliance to be reasonable for purposes of avoiding accuracy-related penalties; rather, the advisor must be "professional."
- Since PWC was intimately involved in structuring the transaction, Judge Kroupa concluded that PWC was not objectively able to assess the tax risks raised by the structure. This is disconcerting since it is quite common for the firm giving the tax opinion to also be involved in structuring the underlying transaction.

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<sup>7</sup> See Reg. § 1.752-2(b)(6).

<sup>8</sup> IRC § 6664(c)(1); Reg. § 1.6664-4(a).

- Since GP did not bargain for the indemnity, the normal "give and take" one would expect to find in the structuring of a complex, tax-sensitive transaction was lacking. In fairness, this was not PWC's fault. Further, the court does not suggest that WISCO's indemnification lacked consideration or otherwise was not a binding legal obligation, apart from the issues of (a) whether WISCO was likely to be called upon to perform and (b) whether it had the meaningful ability to do so.
- The court found it "unreasonable" that PWC could give a "should" opinion, the second highest opinion standard given in tax opinions,<sup>9</sup> given that there was not much precedent other than the Treasury's own longstanding regulations which, as noted above, generally do not require that one look to the economic wherewithal of the partner that ultimately is obligated to repay a partnership liability. Judge Kroupa is likely to take some heat regarding this analysis. It is not uncommon for "should" opinions to be given based upon an analysis of the applicable sections of the Internal Revenue Code, applicable Treasury regulations and analogous authorities in cases in which no direct guidance exists.<sup>10</sup> Further, more often than not, taxpayers seek formal tax opinions in connection with the "tough cases," those presenting issues that have not been directly addressed by the IRS or the courts. Given the cost of preparing tax opinion in accordance with Treasury Circular 230, clients generally do not request tax opinions for the everyday, "easy" issues.
- PWC's opinion apparently assumed that the indemnity was effective as a matter of law and that WISCO would hold assets sufficient to avoid the application of the anti-abuse rules noted above. This irked the judge, who thought it assumed away the "very crux" of the issues presented. In this regard, WISCO was not formally required to maintain any specific level of net worth. Assuming that the court's description accurately reflects the substance of the PWC opinion, this reaction is not surprising. This type of opinion writing was common prior to Circular 230 being modified in December of 2004 to require that the opinion writer do its own diligence regarding the facts and not base the opinion on critical assumptions.
- Inexplicably, only a draft, rather than the original, of PWC's opinion was submitted into evidence. The draft was described by the court as being "... littered with typographical errors, disorganized and incomplete." Further, the PWC partner who quarterbacked the opinion process, while testifying in its support, apparently "... failed to recognize several parts ..." of it. It is difficult to imagine what set of circumstances led to this result. Was the opinion never finalized? Certainly, these factors must have reinforced the court's views regarding the size of the fee charged for the opinion and its impact on PWC's ability to remain objective.

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<sup>9</sup> This standard is higher than "more likely than not" (i.e., more than a 50% chance of being sustained if challenged by the IRS) but not as high as a "will" opinion (i.e., virtual certainty of being sustained if challenged, a standard often reserved for bond deals).

<sup>10</sup> In this regard, another way to avoid accuracy-related penalties in certain circumstances is to show that "substantial authority" existed for the taxpayer's position. The applicable regulations state as follows: "There may be substantial authority for the tax treatment of an item despite absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision." Reg. § 1.6662-4(d)(3)(ii).

Given the dollars involved, *Canal* undoubtedly will be appealed. In the meantime, what lessons can we glean from it? Do not enter into fixed-price tax opinion arrangements? Seek an opinion from an "independent" tax specialist not "tainted" by his or her involvement in structuring the transaction? It is difficult to assess how much harm to the taxpayer's position was caused by its inability to produce a final tax opinion. One cannot help but think that this controversy could have been avoided by having Canal, rather than WISCO, give the indemnification to GP. This apparently was PWC's initial advice but Canal's management wanted to insulate the parent from liability. As noted above, the Tribune Company reportedly structured the leveraged partnership involving the Chicago Cubs by placing the parent's assets at risk. Sometimes you just have to step up to the plate....

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