The Uneasy Topic of Tax Opinion Standards

by Robert W. Wood[1]

Tax opinions are often a mixture of legal nuances, factual details, discussion of tax authorities, and legal arguments. One portion of the opinion sounds (and is) conclusory. "It is our opinion that. . . ." However, the vast majority of the opinion is likely to analyze the facts and the law in excruciating detail. It may even bounce between alternative arguments. Some clients, indeed perhaps most, will look first and foremost to the conclusion. They may skip over the facts, analysis, arguments, and more. In general, if not in every case, clients want the opinion to be as strong as possible. That may also be true for the discussion of authorities and facts, but it is certainly true for the conclusion.

The Punchline

The tax opinion standards discussed later are consequential and dictated by Treasury. Yet no client is likely to be as happy with an opinion concluding that they have a "reasonable basis" for a tax position as they would be with a "should" opinion. The tax professional writing the opinion treads a tightrope between wanting to make the client happy and wanting to color within the lines that the IRS, Treasury, and the community of tax professionals have laid out.

The standard of the opinion will most commonly be one of these: (1) reasonable basis; (2) substantial authority; (3) more likely than not; or (4) should. There are two other

[1] Robert W. Wood practices law with Wood LLP (www. WoodLLP.com) and is the author of Taxation of Damage Awards and Settlement Payments and other books available at www.TaxInstitute.com. In this article, Wood examines tax opinion standards and the difficult mix of legal and client-relations issues that practitioners should consider as they write them.

standards — “not frivolous” and “will” — that occupy the extreme opposite ends of the spectrum. But each of those extremes is rarely written, and their rarity is appropriate.

How tax practitioners and clients define these opinion standards varies. So do the frequent judgment calls that make up these imprecise standards. Some clients may not be aware that the language indicates any particular standards at all. However, there are some common definitions:

- Not frivolous: There is a 10 to 20 percent chance your tax argument will prevail;
- Reasonable basis: There is approximately a 1 in 3 chance that you will prevail;
- Substantial authority: There may be cases both ways, but there is approximately a 40 percent chance you will win;
- More likely than not: The odds are better than 50 percent that you will win;
- Should: There is approximately a 60 percent or higher probability that you will prevail; and
- Will: Your desired tax treatment is virtually assured — 90 percent or better.

Importantly, all of these standards assume that the tax position will actually be audited. The approximate probabilities don’t take into account the (significant) chance that a tax return will pass unnoticed. Most tax returns are never examined, but an opinion’s conclusion can’t be based on the audit lottery. Of course, the fact that audits occur only in a small percentage of cases is not lost on clients.

Tax opinion standards are meant to convey the likelihood of succeeding on the merits, assuming the pertinent tax issue is examined. Determining the chances of success on the merits involves comparing the relative weight of authorities supporting or not supporting the legal position. This standard is supposed to be measured objectively, by reviewing and applying the pertinent or relevant authorities to the facts.

Of course, no matter how objective one tries to be, there are subjective elements that lead to differing opinions. Could one competent tax professional say it is "more likely than not," while another says "should"? Sure, it can and does happen. However, might one say "reasonable basis" while another says "will"? It is hard to see how, unless one tax professional is mistaken about the facts or the law.

Why the Conclusion Is Critical

It is not surprising that clients want an opinion to be strong. They want the opinion's author to be fully invested in the plan, fully supportive of the arguments, and so on. In some cases, clients have been drinking at the particular fountain in question for so long that they may not be objective. They may feel let down if the tax practitioner gives them a less than ringing endorsement of the tax plan that is the subject of the opinion.

Clients may even be angry. In some cases, one goal of the opinion is to give comfort to third parties, such as investors, bankers, accountants, or others. Such interested parties might not read the entire opinion, but they may be much more likely to have a view on the conclusion. Will it say "more likely than not" or better? If it doesn't, will they proceed? Will they file a tax return, fund a loan, invest money, or close the deal? If they don't like the few words in the conclusion, they may not do any of those things. The stakes in the conclusion of the opinion can thus be high. The stakes can also be high for the firm of tax professionals writing the opinion. Will the client pay the invoice if the opinion's conclusion is not up to snuff?

Even if this particular invoice is not at risk, will the client go to another law firm the next time a deal comes around? For tax professionals, one must be realistic and honest about the chances of success for the tax plan in question. Yet too much negativity and too much pushback can be bad for business.

This mix of factors can cloud the tax professional's judgment. It isn't only the client who may be drinking the Kool-Aid. Besides, when faced with an angry client, the tax professional's natural reaction is to want to help. If he believes on reflection that a higher standard can somehow be justified, the tax professional might change a few words in the opinion's conclusion.

But in some cases, just changing standards without a new court decision or a different fact may not look so good. Sometimes, when the opinion standard becomes a problem, the tax professional might tweak the assumptions or facts on which the opinion relies as a way to get to a higher standard of opinion. The tax professional might ask questions or even present an ultimatum.

It might even be a big issue. Can I assume that these two companies are unrelated? If they are, the opinion standard will go up, but do I have reason to believe this assumption might not be correct? Can I assume that you are investing to hold for the long term, not with a view to disposition?

In one of our tax shelter eras, certificates espousing the client's deep-seated profit motives were common, even though everyone may have known the odds of that being true were probably slim. A revised Circular 230 tried to address that. Section 10.34(d) of Circular 230 requires tax practitioners to make reasonable inquiries if information furnished by a taxpayer appears to be incorrect or inconsistent with an important fact or another factual assumption. No longer can tax professionals refuse to look a gift horse in the mouth when clients make representations that seem too good to be true.

Moreover, Treasury regulations[2] provide that a tax opinion can't be relied on for penalty avoidance if the tax opinion is based on unreasonable factual or legal assumptions, including assumptions about future events. The regulations also provide that a tax professional can't render advice if the advice unreasonably relies on the representations, statements, findings, or agreement of the taxpayer, including any representation or assumption that the tax professional knows or has reason to know is unlikely to be true. The regulations specify that a tax professional can't rely on assumptions about the taxpayer's purpose for entering into a transaction or for structuring a transaction that the tax practitioner knows or has reason to know are unlikely to be true.

As a consequence, tax practitioners should be wary of assuming away bad facts to strengthen their conclusions. Although tax practitioners and their clients may find it easier to assume the best motives and outcomes, it is clear that the IRS is not bound to do likewise. A conclusion that relies on unreasonable assumptions may not help clients

[2] Reg. section 1.6664-4(c)(1)(ii)

assess the strength of their reporting positions. It might not even protect the clients from penalties if the IRS successfully challenges the position.

Stronger, Please

Even if there are not bankers, investors, or other third parties waiting in the wings to act based on the conclusion of the opinion, clients naturally want an opinion that is as strong as possible. The most commonly stated reason is that they want penalty protection. However, clients often push far beyond this.

For example, a "substantial authority" opinion should provide the same penalty protection as a "more likely than not" or "should" opinion. Yet many clients want more. Some transactions will not close without one of the higher standards. Some clients also view the tax opinion standard as a vindication that they are right, that their argument or transaction is strong.

The dynamic between lawyer and client can be awkward. Saying to a client that they should get the same penalty protection from a "substantial authority" opinion might suggest that the value of the opinion is penalty protection. But the opinion means much more than that. And rightly or wrongly, the client with a "should" opinion often feels much more protected than one with an opinion whose conclusion is weaker.

Of course, any discussion of penalties presupposes that the substantive position has failed (or at the very least, has been attacked). No client will cheerfully pay the assessed taxes and interest and be satisfied that they achieved the vaunted penalty protection from an opinion. Clients want to win, to have their tax position upheld.

Some clients assume that one major purpose of the opinion is to hand it to the IRS in the event of audit. That can be one reason clients push for a high standard. In reality, of course, most tax professionals will think long and hard about providing an opinion to the IRS. Advocacy letters or briefs based on the opinion are another matter, and are one huge benefit an opinion can provide. Having the facts and the law laid out in advance is worth a lot.

Cutting and pasting portions of the opinion into advocacy letters or briefs can be invaluable. However, in my view, handing an opinion to the IRS is usually a mistake. An exception would be if you have lost the tax case and the only remaining topic is penalties. But if I am right that in most cases it is unlikely that the IRS will see the opinion, the precise standard of the opinion may not be as critical.

Legal Theories, Authorities, and Support

The opinion's bottom line may be that there is substantial authority (or some other level of confidence) for the position. But for the opinion's conclusion to have meaning, it should be accompanied by a thorough examination of the relevant authorities. This raises the difficult question of the extent to which an opinion should develop and document the reasons against the tax position, as well as the reasons for it.

How can one be truly objective without addressing both sides? Some clients, and perhaps some tax lawyers, prefer an opinion that is either entirely or somewhat one-sided, rather than balanced. Discussion of these issues can be vexing. Clients may really like an opinion that is one-sided (in their favor) rather than one they perceive as wishy-washy.

Clients sometimes cross out sections of a draft opinion they find especially worrisome. Whose side are you on, anyway? Clients may like conclusory or short-form opinions because they are mercifully brief. Unfortunately, some client efforts to make opinions “stronger” might conceivably make them less effective for penalty abatement.

Treasury regulations[3] provide that for taxpayers to obtain relief from penalties based on the argument that they relied in good faith on the advice of their tax counsel, the tax counsel’s advice must be based on “all pertinent facts and circumstances.” This includes the taxpayer’s purpose for entering into the underlying transactions. Therefore, paradoxically, the stronger tax opinion for penalty-avoidance purposes may be a tax opinion that addresses both good and bad facts, and good and bad legal authorities, at least relatively evenhandedly. If taxpayers and their counsel go too far in cultivating the tax opinion to address only the good facts and good arguments, they might conceivably create an unintended situation in which an opinion is too strong (or too favorable) to be reasonably relied on. The benefit of (or need for) addressing bad facts and bad authorities in tax opinions is another compelling reason that tax opinions generally should not be provided to the IRS during an examination (or, at least, not before the penalty phase of the examination, if the taxpayer has already lost on the merits). A taxpayer would not want to provide the IRS with a potentially thorough roadmap to the

[3] *See*, e.g., reg. section 1.6664-4(c)(1)(i).

taxpayer's bad facts, bad authorities, and other potential counterarguments against the taxpayer's position.

Once a tax return has been filed, tax opinions are excellent reference material for drafting targeted and advocacy-minded responses to IRS questions and notices. In any case, a balanced opinion may help clients to decide whether they want to take a tax position in the first place. Arguably, clients should feel more informed and protected if they have all the risks laid out before them. That brings up timing.

Timing

An opinion should generally be written before the tax return is filed, before the transaction is closed, and so on. Opinions written after the fact can be valuable, but they are rarely as valuable as an opinion written earlier. Clients commonly ask why the opinion can't be written later, just if the IRS audits.

However, a taxpayer must first receive tax advice in order to claim good-faith reliance on it.[4] Perhaps the tax advice was oral,[5] but the timing and content of oral advice can be challenging to prove if not well documented.[6] At a minimum, the opinion may shift and change until it is nailed down in writing. Absent extenuating circumstances, neglecting to write the opinion before the tax return is filed seems unwise for both client and lawyer. Moreover, if the tax position has been attacked, it is unlikely that anyone will take a reasoned or balanced view of both sides of the equation. At that stage, all writing

---

[4] *See Long Term Capital Holdings v. United States,* 330 F. Supp. 2d 122, 206-207 (D. Conn. 2004), *aff'd,* 50 F. App'x 40 (2d Cir. 2005); and *Cordes Finance Corp. v. Commissioner,* T.C. Memo. 1997-162, *aff'd without pub. opinion*, 162 F.3d 1172 (10th Cir. 1998).
[5] Reg. section 1.6664-4(b), (c).

[6] *See*, *e.g., Long Term Capital*, 330 F. Supp. 2d at 207.

will be geared toward advocacy. The facts will be concrete. If the opinion is drafted early on, adjustments in the documents or position may be possible. Perhaps some aspect of the transaction can profitably be tweaked or improved, because the spadework of the opinion is being done while it can have maximum benefit. The opinion can become part of the shaping of the transaction itself.

Who Sees It?

The professional judgment that goes into the short conclusion is important. Yet what should arguably be most valuable in an opinion is a thorough discussion of the issues, the law, and the facts. Even so, it is arguably safer from a disclosure perspective to refrain from laying out the government's case too well. A legal opinion is a sensitive document.

An opinion is usually prepared by a lawyer for a client and thus subject to attorney-client privilege — so it is worth asking who should receive it, and to whom it should be disclosed, both at the time of preparation and later. The client will receive it, but be careful whom you copy, because that simple act may waive the privilege. Also, watch out for the implied waiver doctrine. Invoking reliance on counsel as a defense to penalties can constitute an implied waiver of attorney-client privilege.[7]

Would one ever want to hand the IRS a veritable roadmap of all the authorities and all the arguments, both good and bad? If the opinion is thorough, it may make arguments the IRS might not discover, might choose not to make, or might not make with the skill

[7] *See, e.g., Evergreen Trading LLC v. United States*, 80 Fed. Cl. 122 (2007) (requiring production of tax opinion unless taxpayer disavowed reliance on counsel as a defense to accuracy penalties); and *Johnston v. Commissioner*, 119 T.C. 27 (2002).

or thoroughness of the opinion. A thorough and balanced opinion could be quite damning if it is provided to the IRS.

Fortunately, unless the “I just want penalty protection” white flag is raised, the courts have not been liberal in granting the IRS access to tax opinions. The most famous instances of disclosure have occurred in tax shelter cases, in which it often seems that the rules are different. The more egregious the shelter, the more a court may be willing to bend the concept of privilege to give the IRS access to the opinion.

However, in Long Term Capital,[8] the taxpayer was not required to disclose the opinion to the IRS (at least initially), even though the attorney-client privilege was waived for portions of it. After reviewing the opinion in camera, the court concluded that it was prepared in anticipation of litigation. Accordingly, the entire opinion was protected by the work product doctrine. This result is all the more surprising when one notes that the case was a shelter case, and a pretty bad one at that. Once the penalty protection issue was front and center, the taxpayer eventually had to hand the opinion to the IRS.[9]

The accountants who will prepare the return could be brought within attorney-client privilege by a Kovel[10] letter. Without that precaution, I don’t recommend providing the full opinion letter to the accountant, unless the client understands the risk and makes that decision. Providing the opinion to the accountant may vitiate the privilege and allow the IRS to obtain the opinion.

---

[8] *Long Term Capital Holdings v. United States,* No. 3:01-cv-1290 (D. Conn. 2003).
[9] *See Long Term Capital*, 330 F. Supp. 2d at 206-207.
[10] *See Kovel v. United States*, 296 F.2d 918, 919 (2d Cir. 1961).

Further, it is possible that the accountant might turn over files to the IRS, thus disclosing the opinion (intentionally or not).[11] If the accountant doesn't have the opinion, he can't disclose it. If the accountant needs a summary, he can be provided with a short summary letter stating that:

1. the lawyer was engaged by the client to render a tax opinion on a particular issue;
2. the opinion is protected by attorney-client privilege, which is not waived by the short summary;[12]
3. the opinion concludes that there is substantial authority (or other standard) for the return position;
4. the return preparer can rely on the lawyer for this return position;
5. the return preparer should disclose the item (if appropriate) in a manner described in detail in the short letter; and
6. the accountant should send the lawyer a draft of the return so the lawyer can review it and comment or approve the return before it is filed.

The summary letter is conclusory and directive by nature, not discursive. However, could the IRS successfully assert that the short letter waives the privilege on the full opinion? I don't know, but it seems unlikely. If cases such as Long Term Capital are any

---

[11] *See, e.g., Bradley v. Commissioner*, 209 F. App'x 40 (2d Cir. 2006) (attorney-client privilege waived where taxpayer "had disclosed those documents to his accountant, who subsequently disclosed the documents to the IRS during an audit").
[12] *But see Long Term Capital*, No. 3:01-cv-1290, in which the district court held that disclosure to an accountant of the opinion's conclusion waived the attorney-client privilege for the limited portion of the opinion that reflected what was disclosed.

indication, the worst that could happen is that the IRS could succeed in getting the particular portions of the full opinion that are summarized or quoted in the short letter.[13]

Conclusion

There is no easy formula for the professional judgment and client relations dance involved in arriving at a tax opinion standard. Independent and dispassionate professional judgments can also vary materially. One tax professional may weigh the facts and authorities and say “more likely than not.” Another might say “should.”

Some clients will walk up and down the street, shopping tax opinion standards until they get the answer they want. When the tax professional knows that is happening or has happened, that tricky dynamic should cause a redoubling of the tax professional’s caution.

[13] *See also In re von Bulow*, 828 F.2d 94, 102 (2d Cir. 1987) (holding that “extrajudicial disclosure of an attorney-client communication — one not subsequently used by the client in a judicial proceeding to his adversary’s prejudice — does not waive the privilege as to the undisclosed portions of the communication”).