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Tax Tips From Tyra Banks

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Wood provides tips to tax lawyers, including how to manage the scope of tax return preparer liability, understand opinion standards, deal with tax shelters, and minimize penalties with disclosures.

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Imagine a dignified television studio (surely an oxymoron) with subtle lighting, a large stage, a dais of judges, and bold signage indicating the set of *America's Next Top Tax Lawyer*. Thirteen steely-eyed and soberly suited contestants stand expectantly before our host, the tax lawyer equivalent of Tyra Banks. (I acknowledge that imagining the tax lawyer equivalent of Tyra Banks might not be so easy.)

Our Tyra-like host then intones gravely:

> I see 13 of you standing before me, and yet I am holding only 12 photos in my hand. And these photos are of those who are still in the running toward becoming America's next top tax lawyer.

She then turns over each tax lawyer headshot to reveal a discovery. The contestants' nervous faces greet each successive photo flip with building anxiety. After many eliminations, only two tax lawyers remain.

We interrupt this scene for a commercial break, perhaps for tax planning software or *Tax Notes*. As this loud and snazzy ad concludes, we return to the studio's silent and sober tension. The contestants gaze expectantly outward, apprehensively watching the cameras and studio audience.

Once again our tax Tyra affects a somber mask, and says:

> I am now holding only one photo, and that photo is of the person who is still in the running toward becoming America's next top tax lawyer. The other must proceed to collect his belongings and immediately leave.

Then it comes, the elimination that means one more budding tax lawyer is no longer in the running toward becoming America's Next Top Tax Lawyer. Of course, so far there is no such show. If there were, the audience would undoubtedly be small.

That's a pity, because the work of tax lawyers is interesting, their job is demanding, and the mix of individuals who do this work is rich and diverse — far more so than most people believe. Taxes are critical to nearly everything, affecting business and personal decisions everywhere. Moreover, tax law is more intellectually stimulating than many lawyers and laypeople imagine.

There may even be some cachet to being a tax lawyer, a kind of reverse panache such as what enveloped nerds following the *Revenge of the Nerds* movies or during (but not necessarily after) the dot-com bubble. Yet being a tax lawyer is not much of a spectator sport. There are many TV shows about lawyers, but none about tax lawyers.

Until we see the debut of *America's Next Top Tax Lawyer*, here are some ruminations on steps that may help budding tax lawyers. Some of these points may apply equally to accountants in our increasingly seamless tax profession.

1. Consider one's dual role. Tax advisers should worry about giving good advice to please their clients and keep them out of trouble. That involves the push/pull of not being too conservative and not being too much of a risk taker. Some of this is about you, and some of it is about your client. Not every client is the same or has the same perspective on risk and certainty. It is terribly important to explore those issues.

If something goes wrong, the client may seek legal recourse against the tax adviser. As with any other personal service business, consider malpractice liability. That militates in favor of good communication, so the client who is taking risks is well aware of those risks and their materiality.

A tax adviser has a unique role, helping clients to comply with their tax obligations. Whether or not you view this role as quasi-governmental, the IRS

and Treasury do. In fact, they have detailed rules, including the increasingly ubiquitous Circular 230,[1] explaining what tax advisers and return preparers can and cannot do.

There are not only dos and don'ts, but also potential penalties on the tax adviser apart from penalties on the taxpayer. One set of potential penalties applies to ''tax return preparers,'' which turns out to be a term of art.

2. Consider yourself a preparer. Many tax lawyers don't actually prepare tax returns or perhaps only prepare specific types of returns. Whether or not you prepare returns, you may be regarded as a return preparer at least regarding some of your tasks.[2] That can cause you to wonder whether you can separate roles. Perhaps you might prefer to be subject to return preparer standards only Mondays and Wednesdays, but not on other days of the week. This is tempting but seems dangerous.

I routinely advise clients about specific line items on their returns (for example, the deductibility of attorney fees or the tax treatment of a settlement payment). This is plainly advice about a return, regardless of whether I sign it. There can be nuances about the liability of signing return preparers and non-signing return preparers.[3]

However, to simplify these rules, get used to assuming you have preparer liability and to abiding by the standards the IRS enunciates. You may not have preparer liability in every case, but you're probably better off assuming that you do.

3. Be wary of tax shelters. Tax shelters are defined in section 6662(d)(2)(C)(ii) to include any plan or arrangement having a significant purpose of avoiding or evading federal income tax. Also, the reportable transactions to which section 6662A applies include listed and reportable transactions that have a significant purpose of tax avoidance or tax evasion.[4]

You can put to the side tax controversies in which you represent a client engaged in a dispute with the government. There will be many transactions in which you are involved that may have tax ramifications as a significant purpose. Indeed, as a tax adviser, one of your primary jobs is trying to arrange your client's affairs to lawfully minimize taxes.

But are the tax ramifications the reason the client is entering into the transaction? Usually economics and business goals will be more important than tax goals, but the manner of accomplishing the business goal is designed to be tax efficient. That doesn't mean the transaction is a tax shelter.

However, if the tax goals are paramount and the transaction is marketed for tax benefits, it seems fair to call it a tax shelter. The safest policy may be to not help create these transactions, not invest in them, not advise clients to invest, and not write tax shelter opinions. Yet those rules may be overcautious and may keep you from earning a living. In any case, preparing returns for clients who invest in shelters (with proper disclosures) is okay, as is defending the client in a tax controversy.

Moreover, if you shun shelter clients, you may prevent them from having good representation. Of course, distinguishing among the roles of designing shelters, opining on them, advising clients about them, preparing returns, and dealing with the aftermath. One could be willing to undertake some roles but not others because the liabilities and risks are different. However you come out on this personal debate, if you are going to venture into the shelter arena, know the ropes.

With tax shelters and reportable transactions to which section 6662A applies, you incur a penalty under section 6694(a) unless you meet a high standard. The penalty applies unless (1) you had a reasonable belief that the position set forth in the return would more likely than not be sustained on the merits or (2) there is substantial authority for the position and you advise your client of the penalty standards that apply if the transaction is considered a tax shelter. The section 6694(a) standard applies for returns prepared for tax years ending after October 3, 2008.[5]

Even if you try to steer clear of tax shelters, there may be circumstances in which you're uncertain if a transaction is a shelter. You must identify shelter transactions to which the higher level of disclosure and scrutiny applies. The challenge is that the literal statutory definition is broad enough to encompass many ordinary transactions.

To take a common example, what if your client is trying to solicit money via a stock offering with the promise of tax benefits? In the waning months of 2010, many such solicitations were made with the idea that some stock purchased in a qualifying small C corporation before 2011 would give rise to tax-free gain when sold five years later. Did that make the transaction a tax shelter?

Presumably no, because the primary object of the transaction was to raise capital for the business, not

[1]31 C.F.R. part 10.

[2]*See* section 7701(a)(36); reg. section 301.7701-15.

[3]*See* reg. section 1.6694-1(b)(2) and (3).

[4]Section 6662A(b)(2).

[5]*See* Notice 2009-5, 2009-3 IRB 309, *Doc 2008-26376*, *2008 TNT 242-13*.

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to generate tax benefits.[6] This is true even if the primary motivation for an individual investor might have been to obtain tax benefits.[7] There is simply nothing in the typical stock offering that seems to warrant the pejorative title of ''tax shelter.''

In most cases, a tax shelter will be readily recognizable. Keep an eye out for transactions that promise little economic gain other than tax benefits, that use financing techniques that don't conform to business practices, or that rely on strained (or incorrect) interpretations of the code, regulations, or rulings.[8] Watch for transactions in which seemingly disparate transactions and parts are cobbled together in a way that appears to make little economic sense. If the arrangement is a close call and you aren't comfortable that the transaction's tax treatment would satisfy the more likely than not standard, you should consider the consequences of its potential treatment as a tax shelter.

4. Carefully assess how much authority you have. Be thorough and circumspect in assessing how much authority you have. How do you determine whether your tax issue meets the substantial authority or more likely than not standard?

Consider the facts and the law; however, you can't consider audit rates, so you must assume the position will be audited and tested on the merits.[9] Evaluate the case law and administrative authority, and use your best legal judgment considering the facts and the law. Law school prepares you well for this kind of evaluation, but not necessarily for the type of percentage determinations that tax opinions require.

There is substantial authority if the weight of the authorities supporting the tax treatment is substantial in relation to the weight of authorities supporting contrary treatment.[10] All authorities pro and con should be considered. The weight of authorities is determined in light of the pertinent facts and circumstances.[11]

In determining whether there is substantial authority, you are not supposed to take into account the applicability of court cases to a taxpayer's situation because of the taxpayer's residence in a particular jurisdiction. However, there is substantial authority for a position if there is controlling precedent from the U.S. court of appeals to which the taxpayer has a right of appeal regarding the position. Thus, if there is a controlling favorable tax case in the Ninth Circuit where the taxpayer lives but unfavorable cases in all the other circuits, there is substantial authority for the position.[12]

Regarding timing, there is substantial authority for a position only if there is substantial authority on the date the return or refund claim is prepared, or if there was substantial authority on the last day of the tax year to which the return relates.[13]

Inevitably, some advisers may come out differently than others on the question of substantial authority. The standards are meant to be objective, but they are necessarily somewhat subjective, too. You may find disagreements, as when one firm says it can only issue a substantial authority opinion while another may feel comfortable opining that a position would more likely than not be sustained on the merits.

This can create palpable tension between your role as client-getter and your duties under Circular 230. If a client has been told by three other law firms that only a reasonable basis opinion is possible, but you can land a huge piece of business if you're willing to issue a more likely than not opinion, should you?

However tempting those opportunities may be, you should issue a more likely than not opinion only if you truly believe, based on your independent assessment of the law and the facts, that it is more likely than not the position will prevail. If you're unsure whether you have enough favorable (and factually similar) authority to tip the balance in favor of your reported treatment (more likely than not means a more than 50 percent chance your position will prevail[14]), you should consider disclosing the position. It may help to debate the authorities with a colleague and compare your assessments of the position's chances of success.

5. When in doubt, disclose. It may sound trite, but one of best ways to avoid penalties as a preparer (and therefore also as an adviser who is assuming he is a preparer) is to ensure that the client discloses any tax position that is less than clear. Of course, it is tough to decide not only whether to disclose, but also how much to disclose and the form of the disclosure.

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[6]*See Lore v. Commissioner*, T.C. Memo. 1990-56 (''The definition of a tax shelter thus directs our analysis to the purpose of the 'partnership, entity, plan, or arrangement,' rather than to the subjective motivation of the individual investors. Although the principal purpose of a plan may be difficult to discern, it is clear that when profit is not one of a plan's possible outcomes and the tax benefits sought are substantial, the plan's principal purpose is tax avoidance or evasion.''); *accord Davis v. Commissioner*, T.C. Memo. 1989-607.

[7]*Id.*

[8]*See* reg. section 1.6662-4(g)(2)(i).

[9]*See* Circular 230 sections 10.34(d)(1), 10.35(c)(3)(iii), and 10.37(a).

[10]Reg. section 1.6662-4(d)(3)(i).

[11]*Id.*

[12]*See* reg. section 1.6662-4(d)(3)(iv)(B).

[13]Reg. section 1.6662-4(d)(3)(iv)(C).

[14]*See* Circular 230 section 10.35(b)(4)(i).

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In general, however, when in doubt, opt for disclosure. Disclosure isn't a cure-all, but it is close. If you don't have the requisite level of authority to avoid preparer penalties without disclosure, you may avoid penalties by disclosure.

The disclosure should include a description of the relevant facts affecting the tax treatment of the item.[15] It must be sufficient to adequately apprise the IRS of the reason for the disclosure.[16] Just as there can be differences of opinion about the chances of success of a particular tax position, there can be differences of opinion about what to say in a disclosure and how to say it.[17]

There is a vast difference between disclosures in the style of Hemingway and those emulating Faulkner. Some disclosures in the return itself will be enough. I favor those white paper disclosures whenever possible.[18] Yet the IRS prefers for disclosures to be on Form 8275, a form designed for this purpose.[19]

In the past some courts approved white paper disclosures in lieu of Form 8275.[20] However, the current regulations indicate that Form 8275 is necessary unless otherwise expressly permitted by revenue procedure.[21] Sometimes disclosure must be on Form 8275-R, as when the taxpayer is taking a position that conflicts with a regulation.[22]

6. Disclose to your client. When you talk about disclosure, most tax professionals assume you're talking about disclosure *to the IRS*. But there's also disclosure to the client. Believe it or not, disclosing tax issues and risks to your client is sometimes overlooked.

It is simply good client relations to keep them informed so they know the good, the bad, and the ugly. If the tax treatment is uncertain, make sure your client knows! While this is common sense (and common courtesy), you might be surprised to learn that the IRS also talks about disclosure to clients.

You can avoid the section 6694 preparer penalty for tax shelter items if there is substantial authority for the position and you advise the taxpayer of the penalty standards applicable to him if the transaction is deemed to have a significant purpose of federal tax avoidance or evasion.[23] This tell-your-client standard is detailed and unforgiving.

The advice to the taxpayer must explain that (1) if the position has a significant purpose of tax avoidance or evasion, there must be, at a minimum, substantial authority for the position; (2) the taxpayer must possess a reasonable belief that the tax treatment was more likely than not the proper treatment in order to avoid a penalty under section 6662(d) as applicable; and (3) disclosure in accordance with reg. section 1.6662-4(f) won't protect the taxpayer from the assessment of an accuracy-related penalty if section 6662(d)(2)(C) applies to the position.[24]

7. Keep good and contemporaneous records. Not only must you disclose to your client, but you must also be able to prove that you did.[25] That doesn't mean relying on your memory or your client's memory. Make a written record that you gave all the required disclosures and did so in a timely manner. The preparer must contemporaneously document the advice in his files.

It is best to give advice in writing. Some advisers even ask clients to sign an acknowledgement that they received the disclosure, although this will annoy some clients.

8. If you advise another preparer, document that, too. One preparer may advise another. If a nonsigning preparer provides advice to another preparer regarding a position for a tax shelter, the

[15]Section 6662(d)(2)(B)(ii)(I).

[16]*See, e.g.*, *Goeden v. Commissioner*, T.C. Memo. 1998-18, *Doc 98-2474*, *98 TNT 10-3* (taxpayer's disclosure, even though not "full and detailed," was considered adequate because the IRS was "alerted to the fact that petitioner had received settlement payments from the credit union, some taxable and some nontaxable"); *Elliott v. Commissioner*, T.C. Memo. 1997-294, *Doc 97-18884*, *97 TNT 124-8*, *aff'd*, 149 F.3d 1187 (8th Cir. 1998), *Doc 98-13984*, *98 TNT 85-83* ("The test of adequate disclosure does not rest solely on whether a taxpayer has identified the correct section of the Code to support a reported deduction. What is critical is whether the taxpayer adequately disclosed enough relevant data concerning the treatment of the item to alert the Commissioner to a potential controversy.").

[17]*See* George R. Goodman, "Tax Return Compliance," *Tax Notes*, Sept. 1, 1997, p. 1201, *Doc 97-24796*, or *97 TNT 169-68* (contending that usually taxpayers should make "the least disclosure necessary, though in some cases it might be possible to write a persuasive disclosure statement that has a strong chance of forestalling a challenge").

[18]For items for which disclosure on the return is sufficient, see Rev. Proc. 2010-15, 2010-7 IRB 404, *Doc 2010-1993*, *2010 TNT 18-8*.

[19]*See* reg. section 1.6662-4(f)(1).

[20]*See, e.g.*, *Corrigan v. Commissioner*, T.C. Memo. 2005-119, *Doc 2005-11355*, *2005 TNT 99-22* (applying former reg. section 1.6661-4(b)) and *Goeden*, T.C. Memo. 1998-18 (applying former section 6661); *see also Schirmer v. Commissioner*, 89 T.C. 277 (1987).

[21]*See* reg. section 1.6662-4(f)(2) ("If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return") (applicable to returns due after Dec. 31, 1991); Rev. Proc. 2010-15; *see also, e.g.*, *Campbell v. Commissioner*, 134 T.C. 20 (2010), *Doc 2010-1561*, *2010 TNT 14-10*; *Zdun v. Commissioner*, T.C. Memo. 1998-296, *Doc 98-25925*, *98 TNT 159-5*, *aff'd*, 229 F.3d 1161 (9th Cir. 2000), *Doc 2000-19305*, *2000 TNT 138-15*.

(Footnote continued in next column.)

[22]*See* reg. section 1.6662-4(f)(1).

[23]Notice 2009-5.

[24]*Id.*

[25]*Id.*

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position will not be considered unreasonable if there is substantial authority for the position and the non-signing preparer provides a statement to the other preparer about the penalty standards applicable to the preparer under section 6694.[26] Again, keep contemporaneous documentation in your file showing that you gave the statement to the other preparer.

9. Don't be afraid to second-guess clients or their advisers. Several tax advisers have gotten into trouble by giving advice on suspect transactions. They may have thought they were protected by reliance on factual assumptions and representations from their clients and other experts. Their advice was later viewed as addressing hypothetical situations, not reality.

A tax practitioner must exercise due diligence in preparing all documents relating to IRS matters, including tax returns.[27] A preparer advising a client to take a position on a return can't ignore the implications of information known to the preparer. He must make further inquiries if information furnished by the client appears to be incorrect, inconsistent, or incomplete.[28]

In short, if you see something that seems odd, ask for more information. Don't give in to pressure to compromise your judgment if clarifying details aren't forthcoming. It's very hard to do, but there is a time to say that you can't continue with a representation, that you can't get beyond an opinion of a specific standard, or that you can't participate unless the position is disclosed to your satisfaction.

10. Be reasonable. This may sound vacuous, but it's not. Given perceived abuses by tax professionals in the past, the IRS now expects tax advisers to take a bigger role in policing the tax system. Still, dialogues with clients can be difficult.

[26]*Id.*
[27]Circular 230 section 10.22(a)(1).
[28]Circular 230 section 10.34(c).

A taxpayer may be reluctant to attach Form 8275 to a return, believing that his position is strong and that Form 8275 will flag his return for examination. This fear is usually unjustified or at least overblown. Because the basic form of disclosure is Form 8275, there is reason to believe many of them are being filed. Of course, a white paper disclosure can also be discussed and can be appropriate in some circumstances.

Whatever the vehicle for the disclosure, carefully consider the words and figures to be used. Although taxpayers may shy away from disclosure, preparers may want to disclose virtually every significant position they believe may be questioned. This can make clients angry, and there is at least a potential for a conflict of interest.

The preparer may recommend disclosure of an uncertain return position to avoid the accuracy-related penalty (on the taxpayer), the preparer penalty, or both. Preparers and their clients have to work through these issues. Usually it's not too difficult, but there will occasionally be hurt feelings or even terminations of engagements when the client and preparer disagree.

As this tip of the iceberg suggests, the waters can be treacherous. Although Circular 230 is complex and can be daunting, read it yourself, and when appropriate, consult with colleagues. Sometimes it is invaluable to get some independent advice from others not as close to the situation or to the client as you are.

Conclusion

Tax lawyers may not have their own reality TV show anytime soon. If we did, a tax lawyer show might be more like a *Top Chef* program than *America's Next Top Model*. Like becoming a chef, becoming a tax lawyer requires one to learn by doing. Far more challenging than merely perfecting a runway walk, tax lawyers must experiment with ingredients and preparations, julienning deductions, broiling credits, and trying depreciation flambé. There is no stock formula, and each tax lawyer may have his own recipe for success.

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