

What Good Is a Tax Opinion, Anyway?

By Robert W. Wood

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The shorthand justification for getting a tax opinion may simply be penalty protection, but that maxim sells tax opinions short. Tax opinions, especially if prepared early, can help shape the transaction or position, help with information return issues, help direct the return preparer, and help in tax controversies. This article notes attorney-client privilege issues with opinions and also suggests opinion summaries for return preparers.

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As tax practitioners, we generally focus on the trees, particular branches, or even leaves. We rarely stand back and look at the forest. Most lawyers are specialists, and tax lawyers are more specialized than most. A tax opinion is arguably one of the more specialized tasks tax lawyers undertake.

When we write tax opinions, as many of us do frequently, they are generally about technical issues that combine factual details and legal analysis. At least one portion of the opinion may be conclusory: "It is our opinion that . . ." However, nearly all or most of the opinion is likely to analyze the facts and the law in excruciating detail.

It may be surprising, therefore, that tax lawyers often cannot satisfactorily answer the question many clients ask: What good is a tax opinion, anyway? This kind of question, perhaps in varying forms, can come from highly sophisticated clients, highly unsophisticated ones, or anyone in between. We may give different answers in response, and the answers may depend on the type of opinion being rendered and the subject matter.

Even so, there are some broad precepts that I suspect apply across the board with tax opinions. Acknowledging that what one finds significant about a tax opinion

may be highly individualized, I submit that the following six points about tax opinions are the most important.

1. An opinion isn't primarily about the penalties. My first observation may generate considerable ire, but I do not believe most tax opinions are written primarily for purposes of penalty protection. We tax lawyers give lip service to this notion, but it is often an understatement or overstatement. Of course, depending on the standard of the opinion (reasonable basis, substantial authority, more likely than not, or should), there are varying degrees of protection from an assertion of penalties.

Clients want an opinion that is as strong as possible. It is certainly true that one of the reasons for that desire is penalty protection. Yet any discussion of penalties presupposes that the substantive position has failed (or at the very least, has been attacked). In 30 years as a tax lawyer, I have never met a client who would cheerfully pay the assessed taxes and interest and be satisfied that they had achieved the vaunted penalty protection from an opinion.

Instead, clients want to win. They want to have their tax position upheld. At the very least, they want to be able to compromise the matter on an acceptable basis.

In fairness, of course, many tax lawyers may be using the "penalty protection" label as an abbreviation. Perhaps some practitioners use the thumbnail description of penalty protection but mean it in context as much more. They might complete their description with the statement that a tax opinion gives you a measure of penalty protection. Even if it turns out that your tax deduction, capital gains treatment, or other tax position is challenged and defeated by the IRS, the IRS should not be able to add penalties as well. If things go badly, you would thus pay the taxes and interest, but (hopefully) no penalties.

Perhaps I am wrong to offer this more full-blown description, but I think most clients want much more than just penalty protection. In that sense, it is deceptive to say that opinions are about penalty protection. Besides, this diverts attention from what the opinions really mean.

2. An opinion should develop legal theories, authorities, and support. Far more than penalty protection, I believe the primary reason a client should want a tax opinion is to thoroughly document and develop a case and its legal theories. The opinion's bottom line may be that there is substantial authority (or some other level of confidence) for the position, but for the conclusion to have meaning, it should be accompanied by a thorough examination of the relevant authorities. Of course, this is a requirement for any covered opinion under Circular 230.¹

¹See 31 C.F.R. section 10.35(c)(2).

Covered opinions must consider all significant federal tax issues, that is, all issues the IRS has a reasonable basis to challenge. This raises the difficult question of the extent to which an opinion must develop and document the reasons against the tax position as well as the reasons for it.

Some tax lawyers prefer to write opinions in a one-sided, rather than balanced, fashion. Clients may really like an opinion that is one-sided (in their favor) rather than what they perceive as wishy-washy. They may like conclusory or short-form opinions because they are mercifully short. Conversely, some clients may prefer to have all the risks laid out before them.

Ultimately, what I believe is most valuable in an opinion is a thorough discussion of the issues, the law, and the facts. An argument can be made, however, that it is safer from a disclosure perspective to refrain from laying out the government's case too well in an opinion — a subject I turn to below.

3. An opinion should be written early. If the client files a tax return claiming the position in question without a legal opinion, it is possible to write the opinion later, if the tax position is contested. Clients commonly ask why this isn't a good idea. Here are several reasons.

First, if the return position precedes the opinion, the reasonable cause defense may not apply. After all, a taxpayer must first receive tax advice to claim good-faith reliance on it.² Of course, tax advice is broadly defined to include any communication containing the adviser's conclusion, and that includes verbal advice.³ However, it may be risky to file the return before a written opinion is issued. The timing and content of verbal advice can be challenging to prove if it is not well documented.⁴ At a minimum, the "opinion" may shift until it is nailed down in writing.

Second, if the tax position has been attacked, it is unlikely that anyone at that point will take a reasoned or balanced view of both sides of the argument. Understandably, at that stage all writing will be geared toward advocacy.

Third, in developing the opinion and assessing the positives and negatives about the position and how it might be attacked, the nuances about reporting and disclosure should be explored. They should be explored then, before the return is filed, not later.

Fourth, there are often adjustments that can be made in the position, the investment, or transaction. This will depend to a large extent on timing. The tax opinion may be prepared pretransaction or it may be prepared post-transaction but before the filing of the return.

Within this timing range, pretransaction (or at least preclosing) is always best. It is easy to see why. Often,

some aspect of the transaction can be profitably tweaked and made better because the spadework of the opinion is being done while it can have maximum benefit. The opinion thus becomes part of the shaping of the transaction itself.

Even when the transaction is closing or already closed at the time the opinion is being written, it is not uncommon for additional documentation to be solicited and provided as part of due diligence. Certificates, declarations, and other such documents may be helpful to the strength and scope of the opinion. They can often shore up documentation and plug perceived holes.

Of course, such documents are likely to be far more compelling if prepared contemporaneously with the deal closing, or at the latest, at tax return time when the transaction is being reported. Certificates, declarations, and the like are rarely effective if prepared several years later during (or in the face of) an audit. Conversely, they can often be quite helpful if prepared contemporaneously with the deal closing or in connection with an opinion written before returns are filed.

Talk of integrating a tax opinion with the transaction advice (and possible modifications to the transaction that may be suggested by the tax lawyers), is clearly an advantage of pretransaction tax opinions. Yet it also inevitably raises the specter of conflicts of interest. These issues too are best addressed early. Recently, the Tax Court in *Canal Corp. et al. v. Commissioner*⁵ admonished that:

Courts have repeatedly held that it is unreasonable for a taxpayer to rely on a tax adviser actively involved in planning the transaction and tainted by an inherent conflict of interest.⁶

It is debatable whether this is an overstatement. But regardless of how one characterizes this recent platitude, it seems beyond doubt that the time for second opinions and questions about independence and thoroughness is pretransaction. Only then is a fully informed taxpayer able to make and act on decisions. Later when the deeds are done and the government is attacking the transaction, an opinion is hardly objective.

4. An opinion should be drafted with potential disclosure in mind. A legal opinion is a sensitive document. It 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 then and later. Certainly the client will receive it.

A lawyer should be careful who is copied, since that simple act may waive the privilege. Also, watch out for the implied waiver doctrine. Lawyers and their clients

²See *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122, 206-207 (D. Conn. 2004), *Doc 2004-17390*, 2004 TNT 169-15, *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005), *Doc 2005-19826*, 2005 TNT 187-16; *Cordes Finance Corp v. Commissioner*, T.C. Memo. 1997-162, *Doc 97-9271*, 97 TNT 63-5, *aff'd without pub. opinion*, 162 F.3d 1172 (10th Cir. 1998), *Doc 98-31618*, 98 TNT 208-9.

³Reg. section 1.6664-4(b), (c).

⁴See, e.g., *Long Term Capital Holdings*, 330 F. Supp.2d at 207.

⁵135 T.C. No. 9 (Aug. 5, 2010), *Doc 2010-17535*, 2010 TNT 151-9.

⁶Citing to *Mortensen v. Commissioner*, 440 F.3d 375, 387 (6th Cir. 2006), *aff'g* T.C. Memo. 2004-279; *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993), *aff'g Donahue v. Commissioner*, T.C. Memo. 1991-181; *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43 (2000), *aff'd*, 299 F.2d 221 (3d Cir. 2002).

should bear in mind that invoking reliance on counsel as a defense to penalties can constitute an implied waiver of attorney-client privilege.⁷

If the proponents of the “it’s all about the penalties” mantra are to be believed, wouldn’t they be willing to hand over the legal opinion to the IRS to achieve penalty protection? I suspect this practice is rare. (I, for one, have never done it.) I return to one of my important principles, which is that clients don’t merely want penalty protection, they want to win.

Putting that aside, would one ever want to hand the IRS a veritable roadmap of all of the authorities and all of the arguments, both good and bad? If the opinion is thorough, it may well make arguments the IRS might not discover, might not choose to make, or might not make with the skill or thoroughness of the opinion. In short, a thorough and balanced opinion could be quite damning.

If penalty protection is the real goal, however, the prudent course is to assume that the opinion will ultimately wind up in the hands of the IRS. But keep in mind that unless the “I want penalty protection” white flag is raised, the courts have not proven to be liberal in granting the Service access to tax opinions.

The most famous instances of disclosure have occurred in tax shelter cases, where it often seems that the rules are different. Given the nature of tax shelters and the way in which opinions are intended to thwart penalties, special considerations seem to apply. 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.

Yet even in those cases, privilege doctrines may be upheld. For example, in *Long Term Capital*, the taxpayer was not required to disclose the opinion to the IRS (at least initially), even though the attorney-client privilege was waived as to 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.⁸ This result is all the more surprising when one notes that the case was a shelter case, and a pretty bad one at that. Of course, once the penalty protection issue was front and center, the taxpayer eventually had to hand the opinion to the IRS.⁹

5. An opinion should help the return preparer. The accountants who will prepare the return are not protected by the attorney-client privilege unless the lawyer uses a *Kovell* letter¹⁰ to engage the accountants directly. Unless there is privilege, I usually do not recommend providing

the full opinion letter to the accountants. Doing so might itself vitiate the privilege and allow the IRS to obtain the opinion. Furthermore, it is possible that the accountants might turn over their files to the IRS, thus disclosing the opinion (intentionally or not).¹¹ If the accountants do not have the opinion, they cannot disclose it.

Since opinions are often commissioned because the accountants are concerned about a return position and need outside advice, it may seem self-defeating not to provide the accountant with the full opinion. I respond by suggesting that the accountant can be provided with a short summary letter that:

1. notes that the lawyer was engaged by the client to render a tax opinion on a particular issue;
2. says that the opinion is protected by attorney-client privilege, which is not waived by the short summary¹²;
3. notes that the accountant is the return preparer for the client and that the opinion concludes there is substantial authority (or another standard) for the return position;
4. instructs the return preparer to rely on the lawyer for this return position;
5. instructs the return preparer to disclose the item (if appropriate) and suggests exactly how to do it; and
6. if desired, requests the accountant to send the lawyer a draft of the return so the lawyer can verify these points before the return is filed.

In my experience, return preparers generally prefer such clarity to the kind of voluminous arguments and authorities generally presented in the full opinion letter. The summary letter is conclusory and directive by nature, not discursive.

Nevertheless, here again one must consider the waiver question. In short summary letters I write, I give the encapsulated opinion, noting that the large opinion is protected by attorney-client privilege, and that the privilege is not waived. There is little risk that the accountant receiving the short letter will assert that such waives the privilege and that he is entitled to the full opinion. However, could the IRS assert that the short letter operates to waive the privilege on the full opinion?

While this assertion could be made, it seems unlikely it would be successful. If cases such as *Long Term Capital* are any 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

⁷See, e.g., *Evergreen Trading, LLC v. United States*, 80 Fed. Cl. 122 (2007), *Doc 2007-6930*, 2007 TNT 55-10 (requiring production of tax opinion unless taxpayer disavowed reliance on counsel as a defense to accuracy-related penalties); *Johnston v. Commissioner*, 119 T.C. 27 (2002), *Doc 2002-18452*, 2002 TNT 154-12.

⁸*Long Term Capital Holdings v. United States*, 91 AFTR 2d 1139, 2003 U.S. Dist. LEXIS 7826 at *32-34 (D. Conn. 2003), *Doc 2003-13211*, 2003 TNT 104-10.

⁹See *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122, 206-207 (D. Conn. 2004), *aff’d*, 150 Fed. Appx. 40 (2d Cir. 2005).

¹⁰See *Kovell v. United States*, 296 F.2d 918, 919 (2d Cir. 1961).

¹¹See, e.g., *Bradley v. Commissioner*, 209 Fed. Appx. 40 (2d Cir. 2006), *Doc 2006-25332*, 2006 TNT 245-7 (attorney-client privilege waived when taxpayer “had disclosed those documents to his accountant, who subsequently disclosed the documents to the IRS during an audit”).

¹²But see *Long Term Capital Holdings v. United States*, 91 AFTR 2d 1139, 2003 U.S. Dist. LEXIS 7826 at *31 (D. Conn. 2003), in which the court held that disclosure to an accountant of the opinion’s conclusion waived the attorney-client privilege to the limited portion of the opinion that reflected what was disclosed.

letter.¹³ Of course, that is the express purpose of the short letter. Indeed, it is written, if not with the knowledge that it will be disclosed, then at least with the awareness that the accountant recipient might (wittingly or not) end up disclosing it.

Of course, it is the client's privilege, not the lawyer's. If the client wants the accountant to have the full opinion, I provide it.

6. An opinion should aid in handling a controversy. For the small percentage of tax cases that ultimately end up in controversy, the opinion has another benefit. It is related to the first advantage of fully exploring the legal theories, but it is distinct. Whatever form the controversy takes, and whether the lawyer becomes involved at the audit stage, in the IRS Appeals division, or in court, there will be deadlines.

As there is rarely enough time to do everything you want to do, the ability to open the file and withdraw a thorough legal opinion is a luxury. It can often spell the difference between a good and a bad result, or at least

¹³See 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").

between an outstanding and a middling one. It is not appropriate to simply hand over legal opinions (if thorough and balanced) to the IRS.

However, they can be excellent documents from which to cut and paste when writing as an advocate. If a client has 30 days to respond to an information document request or a notice about why a position was claimed, that may be enough to do a thorough job. With busy schedules, however, it may not.

Moreover, the client may not tell you about a notice (or may not hire you) until there is only a week left to respond. Whatever the dynamics, having a thorough and thoughtful legal opinion can prove invaluable, even if one never provides its full text to anyone but the client.

Conclusion

Despite my comments, tax opinions may well remain painted with a penalty protection brush. Although I am loath to suggest it, tax opinions may even be divided into two different kinds of tax opinions — shelter opinions and all others. The Service certainly suggests that division in Circular 230. If any tax opinion is all about the penalties, it is surely of the shelter variety. Those opinions that fall into the latter (and I hope larger) category can be viewed quite differently.

In any case, even for those of us who may occasionally use shorthand to describe the benefits of a tax opinion, I suggest that the tax opinion deserves a more complete job description than it often receives.