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Debunking 10 Myths About Tax Opinions

By Robert W. Wood

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In this article, Wood identifies 10 common misconceptions about tax opinions and clarifies how, when, and why tax opinions should be used.

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Tax opinions are widely misunderstood. A tax opinion may be about a financial product or transaction, even as part of the promotional materials. An opinion may be about a transaction or issue peculiar to the taxpayer who commissions it. Some tax lawyers write many opinions; others write none. Some accountants also write them.

A good tax opinion discusses the facts, legal arguments, and pertinent authorities in favor as well as against the tax position in question. One portion of the opinion is conclusory: "It is our opinion that. . . ." Nonetheless, the vast majority of the opinion should analyze the facts and law in detail and present an even-handed assessment.

Surprisingly, many clients and tax advisers have trouble expressing exactly why one should get a tax opinion or how to use it. The answer may depend on the type of opinion rendered and the type of matter at issue. However, these 10 myths about tax opinions may help clear up some common misconceptions.

1. Tax Opinions Bind the IRS

Obviously, they do not. Yet this myth still generates confusion. A tax opinion will usually state that it does not bind the IRS or any other tax agency. If you want a binding commitment from the taxing authority in question, you must get a ruling.

Getting a ruling is a separate subject with its own set of rules and myths. Unfortunately, if the tax issue is plain vanilla in character, it may not be possible to get a ruling. Simple or easy queries are sometimes labeled as "comfort rulings," something the IRS generally will not issue.

Conversely, if the tax issue is unique or difficult, it may be outside the realm of rulings for reasons on the other extreme. Many taxpayers feel that the middle ground — where you *can* get a ruling from the IRS — is the only place you do not really need one.

2. Tax Opinions Are About Penalty Protection

Not in large part. It is true that the most commonly stated reason to get a tax opinion is to avoid penalties. Just about everyone in the tax business says this at one time or another. One reason may be those annoying legends slapped onto everything: "You can't rely on this e-mail for penalty protection."

Fortunately, that legend is no longer required.[1] But I do not believe most tax opinions are written primarily for purposes of penalty protection. Depending on the standard of the opinion (reasonable basis, substantial authority, or more likely than not), there are varying degrees of protection from an assertion of penalties. Clients want an opinion that is as strong as possible.

Also, although penalty protection is a legitimate reason for getting a tax opinion, no client wants or expects the claimed tax position to fail. If all the opinion accomplishes is saving penalties, it does not seem unfair to say that the opinion has mostly failed. Clients want to have their tax position upheld. At the very least, they want to be able to compromise the matter on an acceptable basis.

Many people use the penalty protection label as shorthand for a more comprehensive statement. They might really mean:

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[1]*See* T.D. 9668.

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> A tax opinion gives you a measure of penalty protection, so that even if it turns out that your tax deduction, capital gains position, etc., is attacked by the IRS and defeated, the IRS should not be able to add penalties. If things go badly, you would thus pay the taxes and interest, but (hopefully) no penalties.

Most clients expect far more than just penalty protection. Besides, the focus on penalties diverts attention from what opinions should really be about.

3. Good Tax Opinions Are Strong and Assertive

Yes and no. Clients want their tax lawyer to be an advocate, and they want their case stated as strongly as can be justified. 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). Indeed, an opinion that argues both sides can be perceived by the client as wishy-washy.

Clients may like conclusory or short-form opinions because they are mercifully short. On the other hand, clients may prefer to have all the risks laid out before them. Even if they do not prefer it, I believe clients are better off with a fully informed statement of the facts and the law. In fact, the only argument against this would be disclosure of the opinion, a subject addressed below.

4. Good Tax Opinions Don't Argue Both Sides

Actually, they should. A client should want a tax opinion that thoroughly documents and develops the 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 opinion's bottom-line conclusion to have meaning, it should be accompanied by a thorough examination of the relevant authorities.

An argument can be made that it is safer from a disclosure perspective to refrain from laying out the government's case too well, a subject I turn to under the ''Disclosure'' heading (Myth 8) below. But how can an assertive opinion really be helpful if it is one-sided and just says what the client wants to hear? To me, an opinion must develop and document the reasons against the tax position as well as the reasons for it.

5. Assumptions Can Be About Anything

Not really. For many years, the Treasury regulations contained rules stating that tax opinions could not be based on unreasonable assumptions about the facts or law or unreasonably rely on representations, statements, findings, or agreements. The rules were recently changed, but it remains true that assumptions should be stated and should be reasonable and realistic.

An opinion should not take into account the likelihood of an audit or settlement. Plus, an opinion should consider all relevant legal authorities and relate the law to the facts. When evaluating a practitioner's advice, the IRS applies a reasonableness standard. There is a heightened standard of care if the practitioner knows or should know that the written advice will be used to promote, market, or recommend a course of action that has a significant purpose of avoiding or evading tax.

A practitioner can rely on the advice of another person if, in light of the facts and circumstances, that reliance is reasonable and made in good faith. But reliance is not reasonable if the practitioner knows or reasonably should know that: (1) the opinion of the other person should not be relied on; (2) the other person is not competent or lacks the necessary qualifications to provide the advice; or (3) the other person has a conflict of interest.

6. There Is Time for an Opinion if I Get Audited

No. This remains a common misconception. There is rarely time to get a good and thoughtful opinion at the audit stage. Even if there were, it would hardly be the same as one done before the transaction or before tax return filing.

Besides, if the opinion is to have any value at all for purposes of penalty protection — there it is again — the opinion must be written before the tax return is filed. If the client files a tax return claiming the position in question without a legal opinion, it is possible to do all this work later if and when the tax position is contested. Clients commonly ask why writing the opinion later, if and when the IRS audits, is not a good way of handling it. 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]

It may be risky to file the return before receiving a written opinion. The timing and content of verbal advice can be challenging to prove if not well documented.[4] At a minimum, the ''opinion'' may shift and change until it is nailed down in writing.

Second, if the tax position has been attacked, it is unlikely that anyone at that point will consider both

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[2]*See Long Term Capital Holdings LP v. United States*, 330 F. Supp.2d 122, 206-207 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005); *Cordes Financial Corp. v. Commissioner*, T.C. Memo. 1997-162, *aff'd without pub. opinion*, 162 F.3d 1172 (10th Cir. 1998).

[3]Reg. section 1.6664-4(b) and (c).

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

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sides of the equation with a reasoned or balanced view. Understandably, at that stage, all writing will be geared toward advocacy.

Third, the nuances about reporting and disclosure should be explored when developing the opinion and assessing both the positive and negative of the position and how it might be attacked, not later. The nuances of whether and how to disclose the tax position must be considered *before* the return is filed.

7. Opinions Should be Post-Transaction

No, this one could not be further from the truth. Not only should an opinion be written before the tax return is filed, it should be written in parallel with the event or transaction. That is the best way to help shape the transaction or issue.

Adjustments can often be made to positions, investments, or transactions. The tax opinion may be prepared pre-transaction, or it may be prepared post-transaction but before the filing of the return. Pre-transaction (or at least pre-closing) is always best.

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 shaping the transaction itself. Even when the transaction is closing or closed while the opinion is being written, it is not uncommon for additional documentation to be solicited and provided as part of the opinion's due diligence.

Certificates, declarations, and other related documents may help the strength and scope of the opinion. They can often shore up documentation and plug perceived holes. Of course, these documents are likely far more compelling if prepared simultaneously with the 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 simultaneously with the closing or in connection with an opinion written before returns are filed.

8. Opinions Don't Discuss Disclosure

A legal opinion is a sensitive document. Usually prepared by a lawyer for a client and thus subject to attorney-client privilege, 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.

But be careful to whom you provide a copy, because that simple act may waive the privilege. Also, watch out for the implied waiver doctrine. Lawyers and their clients should bear in mind that invoking reliance on counsel as a defense to penalties can constitute an implied waiver of attorney-client privilege.[5]

If the proponents of the "it's all about the penalties" mantra are to be believed, would there be any reason not 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 arguments, both good and bad? If the opinion is thorough, it may well make arguments the IRS might not have discovered, might not have chosen to make, or might not have made 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 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. 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 that context, privilege doctrines may be upheld. For example, in *Long Term Capital Holdings LP v. United States*,[6] 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.[7] 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

[5]*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); *Johnston v. Commissioner*, 119 T.C. 27 (2002).

[6]91 A.F.T.R. 2d 1139, 2003 U.S. Dist. LEXIS 7826 at *32-34 (D. Conn. 2003).

[7]*Long Term Capital Holdings*, 91 A.F.T.R. 2d 1139 (D. Conn. 2003).

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protection issue was front and center, the taxpayer eventually had to hand the opinion to the IRS.[8]

9. Opinions Should Be Given to Return Preparers

Actually, I believe you should rarely do this. In cases when the accountants who will prepare the return have not been brought within attorney-client privilege (as by a lawyer using a *Kovel*[9] letter to engage the accountants directly), 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).[10] 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 sound self-defeating not to provide the accountant with the full opinion.

But I answer by suggesting that the accountant can be provided with a short summary letter that:

- notes that the lawyer was engaged by the client to render a tax opinion on a particular issue;
- recites that the opinion is protected by attorney-client privilege, which is not waived by the short summary;[11]
- notes that the accountant is the return preparer for the client and that the opinion concludes that there is substantial authority (or other standard) for the return position;
- instructs the return preparer to rely upon the lawyer for this return position;
- instructs the return preparer to disclose the item (if appropriate) and suggests exactly how to do it; and
- 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 it waives the privilege and that he is entitled to the full opinion. But could the IRS assert that the short letter operates to waive the privilege?

While this assertion could be made, it seems unlikely to be successful. If cases such as *Long Term Capital Holdings* 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 letter.[12] 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.

10. Opinions Are Not Helpful in Controversies

Wrong again. Actually, opinions are *really* helpful, usually not as a whole but as a resource for cutting and pasting. For the small percentage of tax cases that ultimately end up in controversy, whatever form the controversy takes and whether the lawyer becomes involved at the audit stage, in appeals, or in court, there will be deadlines to meet.

As there is rarely enough time to do everything you want to do, it is a luxury to be able to open the file and withdraw a thorough legal opinion. This can often spell the difference between a good and a bad result, or at least between an outstanding and a middling one.

Legal opinions (if thorough and balanced) are not appropriate to simply hand over 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 particular position was claimed, that may be enough time to do a thorough job. But with busy schedules, 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.

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[8] *Supra* note 4, at 206-207.

[9] *See Kovel v. United States*, 296 F.2d 918, 919 (2d Cir. 1961).

[10] *See, e.g.*, *Bradley v. Commissioner*, 209 Fed. Appx. 40 (2d Cir. 2006) (attorney-client privilege waived when taxpayer "had disclosed those documents to his accountant, who subsequently disclosed the documents to the IRS during an audit").

[11] *But see Long Term Capital Holdings*, 91 A.F.T.R. 2d 1139, 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.

[12] *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").

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Conclusion

Despite these comments, tax opinions may still be viewed as being all about penalty protection. If any tax opinion is all about the penalties, then it is surely one of the shelter variety. The more sanguine variety of tax opinion (which I hope and believe is a far larger category) can be viewed quite differently.

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.

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