Reasonable Basis, Underdog of Tax Opinions

by Robert W. Wood

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In this article, Wood examines reasonable basis tax opinions, and he argues that this underdog of tax opinions is underrated.

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Tax advisers specialize in taxes, and many specialize in subsets of the tax law. Tax opinions can be about narrow issues, but some combine many technical tax provisions into what is meant to be a cohesive whole. The client thinks of it as a single tax opinion, but it may cover many tax issues. Many of us write tax opinions, generally about technical issues that combine factual details and legal analysis. The bulk of the opinion is likely to analyze the facts and the law in excruciating detail. But in any opinion, at some point you are supposed to come to a conclusion, to reach and express the author's opinion based on all the facts and analysis.

Reasons and Timing

Some clients directly ask for a tax opinion. Others are nudged by a litigation lawyer, transactional lawyer, banker, accountant, or financial adviser who counsels that they "should really have a tax opinion about this." Some clients ask, "Why do I need one? Can't I get it later if the IRS audits me?" For the opinion to have value in a dispute with the IRS, you need it before you file your tax return so you can be said to be relying on it when you sign your return under penalties of perjury.[1]

The conventional response to why clients need an opinion is that it protects them against penalties. Penalty protection is a worthy goal, but a good tax opinion should provide much more than penalty protection. If the opinion writer is involved in the transaction during its progress, the tax opinion should provide comfort and direction as the transaction is being planned. That interactive process is valuable and can prevent mistakes before they are carved in stone. Also, it can enable the opinion's author to write a stronger opinion.[2]

A tax opinion should aid in handling an audit or tax controversy. Whatever form the controversy takes — an audit, a trip to IRS Appeals, or the proverbial day in court — there will be deadlines. There is rarely enough time to do everything you want to do, so being able to refer to a thorough tax opinion is a luxury. It can mean the difference between a good result and a bad result.

It is inappropriate to simply hand over thorough and balanced tax opinions to the IRS.

[1]It wouldn't be a bad idea for the client to actually *read* the opinion before filing. In a case involving a notorious tax shelter, the IRS successfully argued that a corporate taxpayer couldn't escape the negligence penalty simply by showing that it had *received* a tax opinion before filing its return — the taxpayer had to show that it actually (that is, subjectively) relied on the legal authorities cited in the opinion as the basis for its return position. *Wells Fargo & Co. v. United States*, No. 09-CV-02764 (D. Minn. 2017), *aff'd*, 957 F.3d 840 (8th Cir. 2020).

[2]Still, a mild note of caution may be warranted. Taxpayers seeking penalty relief on the ground that there was reasonable cause for their positions, and they acted in good faith (*see* section 6662(c)(1)), frequently point to their reliance on opinions or other professional tax advice. The courts have not hesitated to reject this defense when the adviser participated in structuring the transaction in question and can fairly be viewed as promoting it to the taxpayer. *See, e.g.*, *Blum v. Commissioner*, 737 F.3d 1303 (10th Cir. 2013); *106 Ltd. v. Commissioner*, 684 F.3d 84 (D.C. Cir. 2012). Although subjective reliance isn't (yet) an established requirement in reasonable basis cases, it is not hard to imagine the IRS pursuing this line of attack in such cases if the tax adviser had a similar "conflict of interest."

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You might give the government arguments it hadn't considered. The only exception is when the taxpayer has already conceded that the tax position failed, and the only thing left on the table is whether penalties will apply. However, opinions 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 asking about the justification for a position taken on a return, that may not be enough time to do a thorough job. Besides, the client may not tell you about a notice until the last minute. Whatever the dynamic, having a thorough tax opinion waiting in the file can prove invaluable.

Confidence Level

Tax opinions are usually written at one of these standard levels of confidence: (1) reasonable basis; (2) substantial authority; (3) more likely than not; or (4) should. There are two other standards, "not frivolous" and "will," at the lowest and highest levels in the opinion firmament, but because they are rarely written, we are left with four main categories. Tax opinion standards are meant to convey the likelihood of succeeding on the merits, assuming the pertinent tax issue is actually examined by the IRS.

Determining the chance of success on the merits involves comparing the relative weight of authorities supporting and opposing the legal position. This standard is supposed to be measured objectively, by reviewing and applying the pertinent authorities to the facts. Of course, no matter how objective one tries to be, subjective elements can lead to differing opinions. One competent tax professional might say a position is "more likely than not" to prevail, while another might say that it "should" be upheld.

It could be relevant if the client puts undue pressure on the law or accounting firm writing the opinion. The author may go back to the cases, rulings, and arguments to reassess whether he can edge it a little higher for the benefit of a demanding client. A client might even say, "We won't pay you unless your opinion says 'should.'" I don't know if or how many of these conversations occur, or how overt they are. I don't know if they directly lead to opinion writers' upping the confidence level without analysis.

But I suspect that some of us are put in difficult positions at times. In some cases, it may be appropriate to narrow an opinion. In others, it may be helpful to ask for a signed representation from the taxpayer about a sticky factual point. Still, any representations must be real and realistic, not something the opinion writer knows or has reason to know isn't true. The opinion writer must be reasonable in relying on it.

Opinions Vary

As an expert witness in tax malpractice cases, I sometimes have wondered what the opinion writer was thinking, especially when deciding on the opinion's confidence level. My intuition is that some awkward conversations might help explain the wild optimism when that "more likely than not," "should," or even "will" (!) appears to jump off the page, seemingly at odds with reality.

All but the simplest opinions involve a melding of facts, law, and legal judgment, so it's understandable that opinions will differ. I regularly see opinions that seem slightly more optimistic or slightly more pessimistic than I am. I am probably more pessimistic or cautious than many tax advisers. There are principled different opinions on some issues that have nothing to do with collecting a fee. But some of us who remember the last tax shelter era can think of examples outside these principled debates.

Some variations seem hard to explain. For example, might one practitioner say "reasonable basis," while another says "will"? Perhaps, but it's hard to see how, unless one tax professional is wildly mistaken about the facts or the law. Not even all tax people agree on exact percentages for many tax opinions. For example, is reasonable basis 20 percent or perhaps 25 percent? We'll come back to that issue.

Exactly what the facts are might be the most ignored part of the opinion in at least some cases. If you send your client a draft of a tax opinion, you want their input on all of it. But the part they are most qualified to vet carefully is the facts. Some clients assume that they gave it all to you, so you should get it right. Some clients may not read much more than the conclusion section that has the critical opinion standard. If they need a more likely than not opinion for their investors, CPA, tax insurance, or any other reason, they are likely

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to turn directly to the conclusion to see what it says.

Some clients may not question the opinion standard and may be happy with reasonable basis. Opinion standard lingo can also be unfamiliar. "More likely than not" might sound like a bare fraction over 50 percent, a teeter-totter. In contrast, "substantial authority" may sound more like a ringing endorsement of the deal.

It isn't surprising that clients want an opinion to be strong. They want the opinion's author to be fully invested and fully supportive of the arguments. In some cases, clients have been drinking at the specific fountain in question for so long that they may not be objective. Examples might include conservation easements, captive insurance, or Maltese pension plans. A client may feel let down if the tax practitioner gives a less-than-ringing endorsement of the tax plan that is the subject of the opinion.

Everyman's Tax Opinion

I want to focus on the lowest of the four common tax opinion standards: the humble reasonable basis opinion. If you are a big, wealthy, sophisticated taxpayer, you might scoff and keep shopping for a law firm that will issue a "more likely than not" or "should." Reasonable basis may be the lowest of the four, but it is not shabby, is nothing to be ashamed of, and is perfectly, well, reasonable. It's kind of the everyman's tax opinion, and its name has a commonsensical ring.

We all want to be reasonable, but just what does that mean? In 2019 I tried to address the uneasy topic of tax opinion standards, what each means, and the sometimes difficult dialogue between tax advisers and clients surrounding just what the tax opinion standard should be in a given case.[3] In that article, I tried to tackle myriad factors that make writing tax opinions, managing client expectations, and arriving at the appropriate tax opinion standard a tough job. I also listed what I understood to be the sometimes loosely defined tax opinion standards in terms of that elusive percentage chance that you are right:

- Not frivolous: There is a 10 to 20 percent chance your tax argument will prevail;
- Reasonable basis: (I will save the percentages of this one for discussion below);
- Substantial authority: There may be cases both ways, but there is about 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 a 60 percent or higher probability that you will prevail; and
- Will: Your desired tax treatment is almost assured — 90 percent or better.

All those figures assume that the tax position *will* be audited and that the IRS *will* challenge any position with which it disagrees. Yet both the writer and the recipient know perfectly well that is factually not true. The reality is that audits are rare, but the opinion standard percentages assume a 100 percent audit rate. In my 2019 article, for reasonable basis, I expressed my understanding that reasonable basis was about a one-third chance of success, or 33.3 percent. Shortly after that article appeared, my friend and esteemed tax lawyer Dick Lipton pointed out that my 1 in 3 chance for reasonable basis was inflated.[4] In fact, while there appears to be no universal rule, Lipton noted that the American Institute of CPAs settled on 20 percent, a far cry from 33.3 percent.

Do Exact Percentages Matter?

There appears to still be debate, or at least differences of opinion, about precisely what reasonable basis means in percentages. In 2021 Sharon M. Fisk, director of the IRS Office of Professional Responsibility, and Timothy J. McCormally, special counsel to the OPR, held the 27th Annual Tax Practitioner and IRS Fall Seminar. Among other topics, they took on the big job of explaining the IRS and Circular 230. In that

[3] Robert W. Wood, "The Uneasy Topic of Tax Opinion Standards," *Tax Notes Federal*, Dec. 16, 2019, p. 1823.

[4] Richard M. Lipton, "Practitioner Helps Define 'Reasonable Basis' Standard," *Tax Notes Federal*, Jan. 13, 2020, p. 283; *see also* Wood, "Lipton Is Right," *Tax Notes Federal*, Jan. 20, 2020, p. 426.

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OPR presentation, they identified reasonable basis as 25 percent.[5] As OPR put it:

> Reasonable Basis (25%). When a reasonable and well-informed analysis by a person knowledgeable in the tax law concludes there is at least a 25% likelihood a position would be upheld on its merits. MUST be paired with disclosure.

It's unlikely that a taxpayer or practitioner would be penalized or disciplined for setting the bar at 20 percent rather than 25 percent, but a taxpayer who relies on a reasonable basis opinion may fail in an audit. After all, a reasonable basis opinion means that the taxpayer has a 1 in 4 (according to OPR) chance of winning, which means there is a 75 percent chance the IRS will win.

Clients want their tax lawyer to be an advocate, and they want their case stated as strongly as can be justified. For that reason, 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. I have had clients complain about parts of an opinion that discuss the IRS's potential arguments. "Why," they ask, "are you taking the IRS side of this? Please don't talk about the tax cases that are bad for us!"

Clients may like conclusory or short-form opinions because they are mercifully brief. But clients should prefer having all the risks laid out before them. Even if it isn't their preference, I believe clients are better off with a fully informed statement of the facts and the law. The only argument against that would be if the opinion is disclosed, which normally doesn't make sense anyway unless it is disclosed solely in a penalty fight.

The opinion's bottom line may be that there is a reasonable basis 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. How can an assertive opinion really be helpful if it is one-sided and just says what the client wants to hear?

Disclosure? Yes, Please

One unvarnished reason I like reasonable basis opinions is built in. If you have a reasonable basis opinion, you need to disclose the position on your return. People rarely talk about disclosure as a *good* thing. Without knowing exactly why, most people don't want to disclose unless they must. Discretion and privacy sound better. They may not even know what disclosure is, but it sounds like extra work and extra risk of audit.

Extra audit attention is the last thing anyone wants. Ironically, however, I believe that disclosure can *reduce* risk in some cases. One big question about disclosure is what this extra explanation is and how much extra information to offer. How much extra varies considerably, not only in legal requirements but also in practice. Sometimes the IRS says disclosure is "required," although the real requirement is in the IRS penalties you might attract if you fail to disclose and are audited.

There are almost infinite circumstances in which disclosure could be required. The IRS wants disclosure if you don't have at least "substantial authority" for your tax position. If your tax opinion says "reasonable basis," you disclose because your position is weaker than substantial authority. Technically, you don't *have* to disclose. But disclosing is a way to get out of penalties. Besides, a tax return preparer may not be comfortable filing your return without it.

Disclosure could also prevent the IRS from extending the usual three-year statute of limitations on audit. If a taxpayer omits more than 25 percent of gross income on a return, the IRS doesn't just get the usual three years to audit — it gets up to six long years. However, in determining the amount of gross income omitted from a return, it is arguable that the IRS must count what you disclosed — even if you say it isn't taxable.

Of course, a big reason to disclose is penalties. There is a penalty for a substantial understatement of income tax, and the IRS threshold for what is "substantial" is low. Individuals who understate their tax by more than 10 percent or $5,000, whichever is greater,

[5] *See also* Kip Dellinger, "Hand-Wringing Over 'Authority'," *Tax Notes Federal*, Apr. 13, 2020, p. 277 ("most commentaries" indicate that reasonable basis requires "about a 25 percent chance" of prevailing on the merits).

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can end up with this penalty. One way to avoid or reduce it is to adequately disclose the relevant facts.

If you need to or want to disclose, how do you do it? The classic way, which the IRS clearly prefers, is by form. There are two disclosure forms, Form 8275 and Form 8275-R. The latter is for positions that contradict the tax regulations. If you need to file a Form 8275-R, get some professional advice, possibly from more than one source. Form 8275 (without the R) is another matter. These are common forms that are commonly filed.

Vast numbers of tax returns attaching Form 8275 aren't audited. Plainly, that form doesn't automatically trigger an audit, but how much detail to provide is another matter. In the large volume of these forms that I am asked to review, rarely have I not trimmed down the information that the taxpayer or tax return preparer has offered. Some people go on for pages and even send attachments. I have seen many proposed Forms 8275 that are long-winded arguments about the law, all in capital letters and citing many cases.

That isn't appropriate material for a disclosure, nor are attachments. I have seen proposed Forms 8275 that attach full legal agreements or excerpts. If the IRS wants your legal settlement agreement or purchase contracts, it will ask. In short, going overboard in a disclosure is usually unwise. You must disclose enough detail to tell the IRS what you are doing, but keep it short and succinct.

White Paper

Can you omit Form 8275 and instead disclose in a footnote to your return? According to the IRS, Form 8275 is required to avoid the substantial understatement penalty, unless the item is listed as an exception in Rev. Proc. 2016-13, 2016-4 IRB 290, which lists some things the IRS says must be disclosed on Form 8275. Some items can be disclosed on the tax return itself or on a statement. Those include medical, dental, and some trade or business expenses. If your item isn't listed in Rev. Proc. 2016-13, it and the regulations indicate that under section 6662(d)(2), you must file Form 8275.

Notably, however, the courts don't always agree, and sometimes paper disclosures have been seen as enough. Even in an audit setting, the IRS sometimes agrees that a white paper disclosure was okay. However, the IRS's preference for Form 8275 appears to be supported by recent cases that relied on reg. section 1.66624(f)(2) in holding that disclosure inadequate if the taxpayer didn't submit the form.[6]

Conclusion

Not every client wants a formal tax opinion. Yet it can be a helpful checklist item to bring up with clients, noting that the advice you are giving is *less* than a formal tax opinion. If they want more concrete and comprehensive tax advice, you can prepare one. Many clients will say no, but it probably can't hurt to have a record that you pointed out that your discussion or email was *not* a tax opinion. For clients who *do* want an opinion, the humble reasonable basis opinion might be better than you think.

You do all the same work as the loftier opinions, and it has the same benefits, provided that you disclose. And discussions about disclosure can *themselves* be helpful. A sophisticated opinion-shopping client likely won't be interested in a mere reasonable basis opinion. Some clients will ask about the confidence level before you start work and at every point along the way. However, you might be surprised at how many clients are pleased with reasonable basis.

Finally, remember that an opinion is really a statement that the client has *at least* that good a position, in the opinion writer's view. If you opine at reasonable basis, you are saying that the client has a 20 percent or 25 percent *or better* chance of prevailing. It is a floor, not a ceiling. You might be conservative, toggling between reasonable basis and substantial authority before you hit Send. Perhaps you might conclude that because there are so few cases addressing the issue, you are uncomfortable saying that the authority is "substantial." So when it comes to reasonable basis, try it; you'll like it. ■

[6]For discussion of cases, see Wood and Milan N. Ball, "Tax Return Disclosures: What Is 'Adequate' and Why It Matters," *Tax Notes*, Jan. 2, 2017, p. 163.

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