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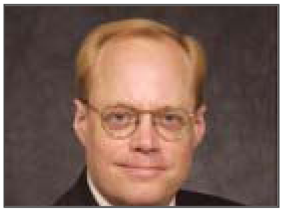

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THE TAX LAWYER

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Why Tax Opinions Are Valuable

I write a significant number of tax opinions, so I admit I'm biased about their value. Even so, it surprises me how many people pay for a tax opinion without thinking about what they are getting. Conversely, many don't obtain a tax opinion despite a crying need.

It's even puzzling what people mean when they talk about a "tax opinion," since there are different varieties. At a minimum, you should distinguish tax opinions about your own situation from ones attached to an investment program. The latter are quite different from more customized opinions. I'll try to avoid the term "tax shelter," since (perhaps appropriately) it has become a dirty word. Tax opinions that are marketed in connection with investment offerings are subject to different standards with the IRS and raise different issues.

Example: Your broker pitches you to buy an interest in an LLC owning railroad cars that will carry special food products. You get a prospectus showing you'll get depreciation and tax credit benefits worth five times your investment in the first 12 months. You can't sell for three years, but who needs sales proceeds when you're getting tax benefits like that! A tax opinion included with the prospectus says it is "more likely than not" you'll get your tax benefits.

You may have had no contact with the law or accounting firm rendering the opinion. You probably don't think of them as looking out for your interests, as they are representing the promoter or sponsor of the investment program. Still, it's clear you're supposed to be impressed by the opinion. You may get your own tax adviser to formally or informally opine on it too. Considering the role of the "marketed" tax opinion in such an offering, it is surprising that more investors do not commission their own tax opinion.

Sometimes these investments go bad. That may be because something goes wrong, they were bad to begin with, they were not based on economics, they were really just tax shelters, etc. Investors who originally cared only about tax benefits may now also want investment returns. Alternatively, the IRS may deny the tax benefits despite the tax opinion that promised them. This is a recipe for litigation, and there's been lots of it.

There has been much tax shelter activity and litigation over the years. One type of litigation is with the IRS. Another is between investors and promoters if the investment goes under or tax benefits are denied.

Opinion Standards. Tax opinion standards vary, but generally conform to one of the following choices:

- ***Not frivolous*** = There's a 10% to 20% chance your argument will prevail.
- ***Reasonable Basis*** = There's a roughly one in three chance you'll win.
- ***Substantial Authority*** = There are cases both ways, but there's probably about a 40% chance you'll win.
- ***More Likely Than Not*** = The odds are better than 50% that you'll win.
- ***Should*** = It's about 60% likely that you'll win.
- ***Will*** = Your tax treatment is nearly assured.

Under IRS standards, the tax practitioner must ***assume*** an audit so the opinion conclusion is not based on audit lottery. In reality, audits occur only rarely.

Penalty Protection? One question is the extent to which an opinion will get you out of penalties if the IRS disagrees with your treatment. If an opinion is marketed (like tax shelter opinions), it must say the tax benefits are "more likely than not" or that they "should" be upheld to get penalty relief. Moreover, the author of the opinion can't blindly rely on representations (for example, "the investor has a motive to make a profit") if they are unreasonable.

If an opinion is not of the marketed variety, it can help eliminate penalties even if it only sets forth a "reasonable basis" for your tax position (provided your position is disclosed on your return). But the highest level of penalty protection would come with an opinion that your position is "more likely than not" correct or higher.

These standards may all seem confusing. What isn't confusing is what most taxpayers want. After all, most taxpayers don't want to end up paying all of the tax and all of the interest associated with a failed tax position, even if they can get the penalties waived! Thus, much of the "it's all about the penalties" mantra is a red herring.

Best Protection? What taxpayers ***really*** want is to have their tax position upheld. That makes the best reason to get a tax opinion to help secure your position. An opinion—especially one prepared not at tax return time but while you are still effecting the purchase or transaction involved—can help put you in the best possible light on both the facts and the law.

For more, see [What Good is a Tax Opinion Anyway].

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