Written Federal Tax Advice – Regulation and Risks

Selected Topics

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I. Introduction

A. When you give written tax advice, there’s a lot to think about!

B. Possible consequences to the attorney if the advice is wrong:
   1. Sanction under Circular 230?
   2. Discipline by the Bar?
   3. Penalty under Code section 6700?
   4. Penalty under Code section 6701?
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   6. Malpractice claim?
   7. Securities law exposure?
   8. Criminal penalties under Code section 7602?

C. Possible consequences to the client if the advice is wrong:
   1. Unexpected taxes, interest, and, possibly, penalties.
   2. Query: Will penalty protection be effective?

D. Different settings call for different analyses:
   1. Giving advice to a taxpayer planning a transaction.
   2. Giving advice that the client will use to induce another person to enter into a transaction.
   3. Giving “ordinary” advice to a taxpayer preparing a return.
   4. Giving a “penalty-protection” opinion to a taxpayer preparing a return.
   5. Giving advice to a paid return preparer.
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1. Who is your client?

2. What does your client need?

3. What consequences will giving the advice expose you to?

II. Code sections 6662, 6662A, and 6664: The function of tax opinions in protecting taxpayers from substantial understatement penalties

A. Disclaimer: The focus of this portion of the outline is the effect of written tax advice on the imposition of tax penalties. The outline does not provide comprehensive information about the tax penalties discussed.

B. Logic of the accuracy-related penalty rules under Code section 6662.

1. Code section 6662(a) and (b)(3), imposes on the taxpayer a penalty equal to 20% of any underpayment of income tax attributable to a substantial “understatement.”

2. Under Code section 6662(d)(2)(B), the taxpayer’s understatement generally is reduced by the following amounts:

   a. The portion of the understatement that is attributable to “the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment” (the “substantial authority” rule).

   b. The portion of the understatement that is attributable to “any item if—(I) the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a statement attached to the return, and (II) there is a reasonable basis for the tax treatment of such item by the taxpayer” (the “reasonable basis” rule).

3. Under Code section 6662(d)(2)(C), neither the substantial authority rule nor the reasonable basis rule applies to any “item attributable to a tax shelter.” In general, Code section 6662(d)(2)(C)(ii) provides that a tax shelter is a plan or arrangement a “significant purpose” of which is “the avoidance or evasion of Federal income tax.”

   a. Note: For years ending before October 23, 2004, Code section 6662(d)(2)(C) provided that the substantial authority rule applied in the case of a tax shelter item of a noncorporate taxpayer if the taxpayer “reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.”

   b. The regulations under Code section 6662 still reflect this now-repealed provision. See Reg. § 1.6662-4(b)(4)(ii)(C) and -4(g)(1)(i).
4. “Reasonable cause” exception: Under Code section 6664(c)(1), an accuracy-related penalty may not be imposed under Code section 6662 “with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.”

a. Reliance on advice. Reg. § 1.6664-4(b)(1) provides, in part: “Reliance on . . . the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. . . . Reliance on . . . professional advice . . . however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.”

b. Thus, even if there is not actual substantial authority for an incorrect return position, it may still be possible for the taxpayer to avoid the substantial understatement penalty if the taxpayer relied on professional advice in taking the position. (However, see Reg. § 1.6664-4(f)(2)(i)(A), in connection with “tax shelter” positions.)

c. Standards for advice. Reg. § 1.6664-4(c) provides certain minimum requirements that must be satisfied in order for a taxpayer to establish that it has “reasonably relied in good faith on advice (including the opinion of a professional tax advisor).” Those requirements include the following:

i. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. Reg. § 1.6664-4(c)(1)(i).

ii. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. The regulations emphasize that the advice must not be based on “an inaccurate representation or assumption as to the taxpayer’s purposes for entering into a transaction or for structuring a transaction in a particular manner.” Reg. § 1.6664-4(c)(1)(ii).

d. Reg. § 1.6664-4(c)(2) provides that “advice” includes “any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the Code section 6662 accuracy-related penalty. Advice does not have to be in any particular form.”

i. Thus, advice does not have to be in writing to satisfy the literal requirements of Reg. § 1.6664-4. As a practical matter, however, it may
be difficult for a taxpayer to prove reliance on professional advice that was not reduced to writing.

ii. The meaning of the phrase “on which the taxpayer relies, directly or indirectly, with respect to the imposition of the Code section 6662 accuracy-related penalty” is unclear. However, since the phrase refers to the taxpayer’s reliance “with respect to the imposition of the . . . penalty,” and not to the taxpayer’s reliance with respect to taking the return position, it is reasonable to read the definition as meaning that a taxpayer may rely on advice that the penalty should not apply. For example, where a tax shelter item is not involved, the definition of “advice” suggests that a taxpayer may rely on an opinion concluding that there is substantial authority for the taxpayer’s position.

iii. Query: Does an opinion at a higher-than-minimum comfort level increase the likelihood that the taxpayer will succeed in avoiding the penalty under the “reasonable cause” rule? There is no clear answer to this question.

e. Reg. § 1.6664-4(f) provides additional requirements for application of the reasonable cause exception to understatements attributable to tax shelter items of corporate taxpayers.

i. First, there must be substantial authority for the corporation’s tax treatment of the item. Reg. § 1.6664-4(f)(2)(i)(A).

ii. Second, the corporation must have “reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment.” Reg. § 1.6664-4(f)(2)(i)(B).

iii. A corporation may be treated as satisfying the foregoing “reasonable belief” requirement if “[t]he corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor’s analysis of the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.” Reg. § 1.6664-4(f)(2)(i)(B)(2).

f. Tax shelter items of non-corporate taxpayers.

i. There are no special rules in Reg. § 1.6664-4 relating to tax shelter items of noncorporate taxpayers. However, since Code section 6662(d)(2)(C) has treated corporate and noncorporate taxpayers the same since the enactment of the 2004 Act, there is a distinct possibility that the IRS will impose the Reg. § 1.6664-4(f) requirements on understatements attributable to tax shelter items of noncorporate taxpayers.
ii. This conclusion is somewhat bolstered by Reg. § 1.6662-4(g)(4)(i)(B), which relates to the pre-2004 Code section 6662(d) rules for tax shelter items of non-corporate taxpayers. That arguably obsolete regulation provides that the reasonable belief standard under former Code section 6662(d) may be satisfied where “[t]he taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor’s analysis of the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this Code section and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.”

C. Possible amendment of the Code section 6664 regulations to conform to Circular 230.

1. The Preamble to the December 17, 2004, Circular 230 amendments (discussed in more detail below) includes the following statement: “Written advice will not be treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not written to be used and cannot be used for the purpose of avoiding penalties. Similarly, written advice generally will not be treated as a marketed opinion if it does not concern a listed transaction or a plan or arrangement having the principal purpose of avoidance or evasion of tax and the written advice contains this disclosure. The Treasury Department and the IRS intend to amend 26 CFR 1.6664-4 to clarify that a taxpayer may not rely upon written advice that contains this disclosure to establish the reasonable cause and good faith defense to the accuracy-related penalties.” T.D. 9165, December 17, 2004 (emphasis added).

2. Notwithstanding the foregoing language in T.D. 9165, Reg. § 1.6664-4 has not been “clarified” in the manner described. Unless and until the Code section 6664 regulations are amended, the pertinent question is whether, under the general principles in Reg. § 1.6664-4(b)(1), a taxpayer may rely in good faith on written advice that includes such a statement. As noted above, Reg. § 1.6664-4(b)(1) provides in part: “Reliance on . . . professional advice . . . constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.”

3. Note: If the Circular 230 disclaimer in an opinion makes it unreasonable for a taxpayer to rely on the opinion, it is possible that, in the case of a non-tax shelter item, a substantial authority opinion gives more penalty protection than a more-likely-than-not opinion with a disclaimer.

D. Special rules for reportable transactions under Code section 6662A

1. Imposition of penalty
a. Code section 6662A(a) imposes a penalty equal to 20% of a taxpayer’s reportable transaction understatement (30% if the facts of the transaction are not adequately disclosed).

b. Under Code section 6662A(b), a reportable transaction understatement is generally equal to the highest rate of tax multiplied by the reduction in income attributable to either (a) a listed transaction or (b) a reportable transaction with a significant tax avoidance purpose.

2. Reportable transactions

a. Code section 6662A(d) defines “reportable transaction” and “listed transaction” by cross-reference to Code section 6707A(c).

b. Code section 6707A(c)(1) defines “reportable transaction” to mean “any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under Code section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.”

c. Code section 6707A(c)(2) defines a “listed transaction” to mean “a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of Code section 6011.”

d. Under the Code section 6011 regulations, the following types of transactions are considered to be reportable transactions:

   i. Listed transactions.

   ii. Confidential transactions.

   iii. Transactions with contractual protection.

   iv. Significant loss transactions ($10 million in a single year for corporations; $2 million in a single year for individuals).

   v. Transactions with a significant book-tax difference.

3. Reasonable cause/good faith exception to penalty under Code section 6662A.

a. Code section 6664(d)(1) provides: “No penalty shall be imposed under Code section 6662A *** with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.”
b. Under Code section 6664(d)(2), however, this reasonable cause exception applies only if

i. The facts of the transaction are adequately disclosed,

ii. There is substantial authority for the taxpayer’s position, and

iii. “The taxpayer reasonably believed that such treatment was more likely than not the proper treatment.”

c. Advisors who may not be relied upon.

i. Code section 6664(d)(3)(b)(ii) provides that the taxpayer’s “reasonable belief” may not be based on an opinion provided by a “material advisor” who “participated in the organization, management, promotion, or sale of the transaction” or has a fee arrangement that is contingent on tax benefits from the transaction.

ii. Note that, under Code section 6111(b), an advisor who does not exceed a substantial fee threshold ($50,000 for individual taxpayers and $250,000 for corporate taxpayers) is not a “material advisor.”

d. Opinions that may not be relied upon.

i. Code section 6664(d)(3)(b)(iii) provides that the taxpayer’s “reasonable belief” may not be based on an opinion that fails to meet the following requirements, which are similar to the requirements set forth in Reg. § 1.6664-4(c) for “advice.”

(A) It may not be based on unreasonable factual or legal assumptions.

(B) It may not unreasonably rely on representations or statements of any person.

(C) It must identify and consider all relevant facts.

ii. As noted above, the Preamble to the December 17, 2004, Circular 230 amendments states that the IRS intends to amend the Code section 6664 regulations to “clarify” that a taxpayer may not establish reasonable cause and good faith by relying on written advice that contains a Circular 230 disclaimer stating that the advice cannot be used for the purpose of avoiding penalties. Although the Code section 6664 regulations have not been amended in this manner, it is still possible that reliance on an opinion with a Circular 230 disclaimer is prohibited under the general principles in Reg. § 1.6664-4(b)(1), which provides in part: “Reliance on . . . professional advice . . . constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.”
4. There is no way of avoiding the Code section 6662A penalty on a reportable transaction understatement other than the reasonable cause/good faith exception. Therefore, a client engaging in a reportable transaction will generally need a "more likely than not" opinion.

E. Practical conclusions: What characteristics must written advice have to be useful as penalty protection under the accuracy-related penalty provisions?

1. All items

   a. Written advice does not provide penalty protection unless it satisfies the requirements of the "reasonable cause" rules in Code section 6664 and the regulations thereunder.

   b. Written advice will not qualify as "advice" that can be relied upon unless it satisfies the two requirements in Reg. § 1.6664-4(c).

      i. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. Reg. § 1.6664-4(c)(1)(i).

      ii. The advice must not be based on unreasonable factual or legal assumptions or representations. Reg. § 1.6664-4(c)(1)(ii).

2. Non-tax-shelter items

   a. In the case of a non-tax-shelter item, it appears, although it is not certain, that the advice need conclude only that there is "substantial authority" for the taxpayer’s position (or a "reasonable basis" for the position, if the position is adequately disclosed).

   b. It is not clear whether a taxpayer can reasonably rely on an opinion that concludes that there is substantial authority for the taxpayer’s opinion but does not substantiate that conclusion with the type of analysis set forth in Reg. § 1.6662-4(d)(2). It would be prudent for the advisor to include such analysis in the opinion.

3. Tax shelter items

   a. In the case of a tax shelter item of a corporate taxpayer, the advice must "unambiguously state that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service." Reg. § 1.6664-4(f)(2)(i)(B)(2).

   b. It is possible that the IRS will seek to impose the foregoing requirement on tax shelter items of non-corporate taxpayers as well, although the regulations do not currently impose such a requirement.
c. The opinion must be based on the advisor’s analysis of facts and authorities following the methodology required under Reg. § 1.6662-4(d)(3)(ii) to conclude that there is “substantial authority” for an item.

4. Reportable and listed transactions
   a. In the case of a reportable or listed transaction, the advice must be of a type that enables the taxpayer to reasonably believe that the taxpayer’s treatment of the transaction is “more likely than not the proper treatment.” (Probably, that means following the Reg. § 1.6664-4(f)(2)(i)(B)(2) prescription that the advice “unambiguously state that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.”)
   b. The opinion may not be from a “material advisor.” (Note that an advisor whose fee is less than $50,000 (in the case of an individual taxpayer) or $250,000 (in the case of a corporate taxpayer) is not a material advisor.
   c. The opinion must satisfy the requirements in Code section 6664(d)(3)(B)(iii).

5. Effect of Circular 230 disclaimers
   a. As noted above, the Preamble to the December 17, 2004, Circular 230 amendments (T.D. 9165) states that the IRS intends to amend the Code section 6664 regulations to “clarify” that a taxpayer may not establish reasonable cause and good faith by relying on written advice that contains a Circular 230 disclaimer stating that the advice cannot be used for the purpose of avoiding penalties.
   b. Although the Code section 6664 regulations have not been amended in this manner, it is still possible that reliance on an opinion with a Circular 230 disclaimer is prohibited under the general principles in Reg. § 1.6664-4(b)(1), which provides in part: “Reliance on . . . professional advice . . . constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.”
   c. Note: A great many e-mails, memos, and letters containing written tax advice include Circular 230 “boilerplate” disclaimers even though they are not required to do so under Circular 230 to avoid being treated as “covered opinions” (e.g., because they reach only a “substantial authority” level of comfort). The IRS could argue that the recipient of written tax advice with such a disclaimer cannot rely on the advice in good faith.

6. Scope of opinion
   a. Since the reasonable cause exception applies to the extent there is reasonable cause and good faith with respect to a “portion of an underpayment,” it can be argued that an opinion may be relied upon to avoid the penalty with
respect to a portion of an underpayment if the opinion concludes only that the required degree of authority exists for the specific position that ultimately is not sustained and thus gives rise to that portion of the underpayment.

b. In the case of a non-tax shelter item, it should not be necessary for the opinion to address issues that ultimately are resolved in the taxpayer’s favor. However, there is no authority establishing that a taxpayer may rely in good faith on an opinion that narrowly addresses only the issue that is resolved against the taxpayer and ignores all other issues.

c. In the case of a tax shelter item of a corporate taxpayer (and, possibly, a non-corporate taxpayer), an opinion may not be relied upon unless it “unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.” The “tax treatment of the item” may include the resolution of multiple issues. Therefore, it is possible that an opinion that is intended to be relied on to protect against penalties in connection with a tax shelter item must cover multiple issues. In some cases, this may prevent a taxpayer from relying on an opinion that satisfies the Circular 230 requirements for a “limited scope opinion.”

III. FIN 48

A. Background


2. The general rule of recognition under FIN 48 is that, in order to report the benefit of a tax position on a company’s financial statement, the company must determine that it is more likely than not that the position will be sustained, based on the technical merits of the position, if the taxing authority examine the position. (FIN 48, ¶6, ¶7, and ¶A2.)

3. If it is determined that a tax position satisfies the more likely than not recognition standard, the company then must determine the largest amount of the tax benefit from the position that has more than a 50-percent likelihood of being realized after examination and, if dispute and compromise are likely, settlement with the taxing authority. (FIN 48, ¶8.)

B. Function of opinions of counsel

1. FIN 48 does not require that a company obtain a tax opinion from outside counsel in order to establish that the more-likely-than-not recognition standard has been satisfied. When a tax position involves technical complexity or significant
uncertainty, however, a tax opinion may be the best evidence supporting the company’s decision to recognize a tax benefit. In this regard, FIN 48 states:

“The Board believes that a tax opinion can be external evidence supporting a management assertion and that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law. Other evidence, in addition to or instead of a tax opinion, supporting the assertion also could be obtained; the level of evidence that is necessary and appropriate is a matter of judgment that depends on all available information.”

2. Thus, companies may ask counsel for more-likely-than-not opinions supporting tax positions.

C. General non-application of Circular 230 “covered opinion” rules to FIN 48 opinions

1. Under Reg. § 10.35(b)(2)(ii)(C), the term “covered opinion” generally does not include “[w]ritten advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the Internal Revenue Service reflecting the tax benefits of the transaction.”

2. Moreover, under Reg. § 10.35(b)(4)(ii), an opinion that is not a “marketed opinion” and does not relate to a “listed” transaction or a “principal purpose” transaction, can avoid being treated as a “covered opinion” if it contains a disclaimer stating that “it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.”

3. Thus, the full panoply of procedures required by Circular 230 for covered opinions will not be necessary for many opinions requested by companies for FIN purposes. However, auditors may question the value of an opinion supporting GAAP recognition of a tax position if the covered opinion procedures are not followed. Accordingly, when asked by a company for an opinion for FIN 48 purposes, counsel should discuss with the company the procedures to be followed in preparing the opinion.

D. Nature of a FIN 48 opinion

1. The purpose of a FIN 48 opinion is to enable a company’s management to make an informed judgment about the proper recognition and measurement of the benefits from a tax position. Counsel should make no assumptions about the scope of the guidance needed by the client and should discuss scope at the outset of an engagement.
2. Because measurement of a tax benefit under FIN 48 may require a prediction of the likely outcome of settlement negotiations with a taxing authority, counsel may be asked to give written advice that goes beyond mere legal analysis.

E. Avoiding risks

1. If a company requesting tax advice in connection with a FIN 48 determination has not yet filed its tax return with respect to the position in question, or if the position may lead to a refund claim, counsel should clarify that the advice will not be used in connection with the preparation of the return or refund claim, so as to avoid being treated as a return preparer. See Reg. 301.7701-15(a)(2)(ii).

2. In such a situation, it also is advisable to insert Circular 230 disclaimer language in a FIN 48 opinion to ensure that counsel will not be subject to sanction by the IRS if the opinion does not satisfy all of the “covered opinion” requirements.

IV. Circular 230

A. Introduction

1. Circular 230, contained in Reg. §§ 10.0 through 10.93, generally provides “rules governing the recognition of attorneys, certified public accountants, enrolled agents, and other persons representing taxpayers before the Internal Revenue Service,” including “rules relating to the authority to practice before the Internal Revenue Service; . . . the duties and restrictions relating to such practice; . . . the sanctions for violating the regulations; . . . the rules applicable to disciplinary proceedings; and . . . general provisions including provisions relating to the availability of official records.” Reg. § 10.0.

2. Following is a brief summary of the sanctions that may be imposed for violations of Circular 230, followed by a discussion of the Circular 230 rules relating to written tax advice.

B. Sanctions (see Reg. §§ 10.50 and 10.52)

1. Under Reg. § 10.52, a practitioner may be sanctioned for violating Reg. § 10.35 “recklessly or through gross incompetence.”

2. Under Reg. § 10.50, the possible sanctions for such behavior (after notice and an opportunity for a hearing) are:

   a. Censure, suspension, or disbarment from practice before the IRS. Reg. § 10.50(a).

   b. Imposition of a monetary penalty, not exceeding “the gross income derived (or to be derived) from the conduct giving rise to the penalty.” Reg. § 10.50(c)
C. Standards for all written advice

1. Under Reg. § 10.37(a), all “written advice” concerning one or more Federal tax issues is subject to the following requirements:

   a. The advisor may not base the advice on unreasonable factual or legal assumptions.

   b. The advisor may not unreasonably rely on representations, statements, findings, or agreements of the taxpayer or any other person.

   c. The advisor must consider all relevant facts that the advisor knows or should know.

   d. The advisor may not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through compromise if it is raised on audit.

2. The scope of the engagement and the type and specificity of the advice sought by the client are considered in determining whether an advisor has complied with these requirements. Reg. § 10.37(a).

D. Definition of “written advice”


E. Additional standards for “covered opinions” (see Reg. § 10.35(c))

1. The advisor must use reasonable efforts to identify and ascertain all relevant facts, including facts relating to future events. Reg. § 10.35(c)(1)(i).

2. The advisor may not base the opinion on any factual assumption that the practitioner knows or should know is incorrect or incomplete, such as a projection, financial forecast, or appraisal if the practitioner knows or should know that it is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare it. Reg. § 10.35(c)(1)(ii).

3. The advisor may not base the opinion on any factual representation that the practitioner knows or should know is incorrect or incomplete. Reg. § 10.35(c)(1)(iii).

4. The advisor may not assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. Reg. § 10.35(c)(1)(ii). The advisor may not rely on a factual representation that a transaction has a business purpose if (1) the representation does not include a specific description of the business purpose or (2) the practitioner knows or should know that the representation is incorrect or incomplete. Reg. § 10.35(c)(1)(iii).
5. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner. Reg. § 10.35(c)(1)(ii).

6. The opinion must identify in a separate section all factual representations relied upon by the practitioner. Reg. § 10.35(c)(1)(iii).

7. The opinion must relate the law to the facts. Reg. § 10.35(c)(2)(i)

8. The opinion must consider all “significant federal tax issues” and must state (with significant explanatory detail) the advisor’s opinion as to the likelihood of prevailing on the merits with respect to each such issue.

   a. A Federal tax issue is “significant” if the IRS “has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.”

9. The opinion must (a) provide the advisor’s “overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment” and the reasons for that conclusion, or (b) explain why it is not possible to reach an overall conclusion. Reg. § 10.35(c)(4)(i).

   a. Presumably, the phrase “the Federal tax treatment of the transaction” is intended to refer to a treatment that is specified in the opinion as the treatment sought by the taxpayer or the treatment intended to be reflected on a return.

10. The opinion must include certain disclosures

   a. Every covered opinion must disclose the nature of any compensation arrangement or referral arrangement between the advisor and any person other than the client with respect to promoting, marketing, or recommending any arrangement that is the subject of the opinion. Reg. § 10.35(e)(1).

   b. If the opinion is a “marketed opinion,” it must disclose that it is a marketed opinion and must recommend that the taxpayer obtain independent advice. Reg. § 10.35(e)(2).

   c. If the opinion considers less than all of the significant Federal tax issues relating to the subject matter of the opinion (a “limited scope opinion”), the opinion must disclose that (i) it is limited to certain issues, (ii) there may be additional issues that could affect the tax treatment of the transaction that is the subject of the opinion, and (iii) the opinion cannot be relied on to avoid penalties with respect to issues that are not considered in the opinion. Reg. § 10.35(e)(3).
d. If the opinion does not reach a “more likely than not” conclusion with respect to one or more significant Federal tax issue, it must disclose that fact and must further disclose that the opinion cannot be relied on to avoid penalties with respect to those issues. Reg. § 10.35(e)(4).

F. Definition of “covered opinion” (see Reg. § 10.35(b)(2))

1. Subject to certain exclusions (see Reg. § 10.35(b)(2)(ii)), a “covered opinion” is “written advice” (including an electronic communication) that concerns one or more federal tax issues arising from one of the following three types of transactions:

   a. A “listed” transaction.

   b. A “partnership or other entity, any investment plan or arrangement, or any other plan or arrangement” (herein, an “arrangement”) with a “principal purpose” of tax avoidance or evasion.

   c. In some cases, an arrangement with a “significant purpose” of tax avoidance or evasion.

2. In the case of a “significant purpose” arrangement, an opinion “concerning one or more Federal tax issues arising from” the plan or arrangement is a covered opinion only if it falls within one of the following categories:

   a. Reliance opinion.

   b. Marketed opinion.

   c. Confidential opinion.

   d. An opinion with “contractual protection” (i.e., an opinion for which the fee is contingent on the taxpayer’s realization of tax benefits or on the tax consequences supported by the opinion being sustained).

3. Definition of “reliance opinion” (see Reg. § 10.35(b)(4))

   a. An opinion is a “reliance opinion” if it “concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer’s favor.”

   b. Written advice with respect to a “significant purpose” arrangement is not treated as a reliance opinion “if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.”
4. Definition of “marketed opinion” (see Reg. § 10.35(b)(5))

   a. Written advice is a “marketed opinion” if “the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner’s firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).”

   b. Written advice with respect to a “significant purpose” arrangement is not treated as a “marketed opinion” if the opinion prominently discloses that (i) it cannot be relied on for penalty avoidance, (ii) it was written to support the marketing or promotion of the arrangement, and (iii) the taxpayer should obtain independent tax advice.

5. Meaning of “significant purpose”

   a. The term “significant purpose” is not defined in Circular 230. It also is not defined in any guidance under Code section 6662(d)(2)(C)(ii), in which the term is used in the definition of “tax shelter”.

   b. The only guidance concerning the meaning of “significant purpose” is provided in regulations under the now-repealed tax-shelter registration rules. (See former Code section 6111, as in effect before the enactment of P.L. 108-357.) Reg. § 301.6111-2(b) states, in part:

   “(1) In general. The avoidance or evasion of Federal income tax will be considered a significant purpose of the structure of a transaction if the transaction is described in paragraph . . . (3) of this section. . . . ***

   “(3) Other tax-structured transactions. A transaction is described in this paragraph (b)(3) if it has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction and the tax shelter promoter (or other person who would be responsible for registration under this section) reasonably expects the transaction to be presented in the same or substantially similar form to more than one potential participant, unless the promoter reasonably determines that—

   “(i) The potential participant is expected to participate in the transaction in the ordinary course of its business in a form consistent with customary commercial practice (a transaction involving the acquisition, disposition, or restructuring of a business, including the acquisition, disposition, or other change in the ownership or control of an entity that is engaged in a business, or a transaction involving a recapitalization or an acquisition of capital for use in the taxpayer's business, shall be considered a transaction carried out in the ordinary course of a taxpayer's business); and
“(ii) There is a generally accepted understanding that the expected Federal income tax benefits from the transaction (taking into account any combination of intended tax consequences) are properly allowable under the Internal Revenue Code for substantially similar transactions. There is no minimum period of time for which such a generally accepted understanding must exist. In general, however, a tax shelter promoter (or other person who would be responsible for registration under this section) cannot reasonably determine whether the intended tax treatment of a transaction has become generally accepted unless information relating to the tax treatment and tax structure of such transactions has been in the public domain (e.g., rulings, published articles, etc.) and widely known for a sufficient period of time (ordinarily a period of years) to provide knowledgeable tax practitioners and the IRS reasonable opportunity to evaluate the intended tax treatment. The mere fact that one or more knowledgeable tax practitioners have provided an opinion or advice to the effect that the intended tax treatment of the transaction should or will be sustained, if challenged by the IRS, is not sufficient to satisfy the requirements of this paragraph (b)(3)(ii).”

The foregoing guidance under former Code section 6111 may be valuable as a defensive weapon where a practitioner has provided informal written advice at a high level of comfort regarding a tax-motivated but common transaction, such as multi-party like-kind exchange. However, it must be recognized that there is no authority for applying the Code section 6111 regulations in this context.

G. Limited scope opinions (see Reg. §§ 10.35(c)(3)(v) and 10.35(e)(3))

1. In some circumstances, a “covered opinion” is not required to consider all significant Federal tax issues relating to the transaction that is the subject of the opinion (i.e., it may be a “limited scope opinion”).

2. Under Reg. § 10.35(c)(3)(v), a limited scope opinion is permissible if (a) the opinion does not involve a listed transaction or a “principal purpose” transaction, (b) the opinion is not a marketed opinion, and (c) the opinion contains the disclosures required for limited scope opinions by Reg. § 10.35(e)(3).

3. Since a marketed opinion may not be limited in scope, a marketed opinion that relates to a “significant purpose” transaction and does not cover all significant Federal tax issues relating to the transaction must state that it cannot be used for penalty protection in any respect at all. If it does not contain such a disclaimer, it will be a defective “covered opinion.”
V. American Bar Association (“ABA”) opinions regarding tax advice

A. Relevance of ABA opinions

1. Opinions issued by the ABA are interpretations of the ABA’s Model Rules of Professional Conduct. Neither the Model Rules themselves nor the ABA’s interpretive opinions have any independent legal effect.

2. Nonetheless, to the extent the Model Rules have been adopted in a state in which an attorney practices, ABA opinions are likely to be taken into account by the Bar and the courts in the state.

3. Both Oregon and Washington have adopted Rules of Professional Responsibility that are based on the ABA’s Model Rules. Accordingly, the ABA opinions discussed below are relevant to Oregon and Washington attorneys.

B. Opinion 314

1. ABA formal Opinion 314, issued in 1965, sets forth the ABA’s basic position regarding the role of an attorney in advising clients regarding tax matters. The principal focus of Opinion 314 is the advocacy of a taxpayer’s position to the IRS.

2. The most basic principle set forth in Opinion 314 is that the IRS should be considered the taxpayer’s adversary, rather than a quasi-judicial tribunal, and an attorney advocating a taxpayer’s position before the IRS “is under no duty to disclose its weaknesses, any more than he would be to make such a disclosure to a brother lawyer.”

3. Opinion 314 extends this principle to an attorney advising a taxpayer regarding a position to be taken on a tax return. Opinion 314 includes the following statement:

   “[A] lawyer who is asked to advise his client in the course of the preparation of the client’s tax returns may freely urge the statement of positions most favorable to the client just as long as there is reasonable basis for those positions. Thus where the lawyer believes there is a reasonable basis for a position that a particular transaction does not result in taxable income, or that certain expenditures are properly deductible as expenses, the lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures.”

4. Opinion 314 is silent on the degree of “due diligence” an attorney is obligated to perform before advising a taxpayer regarding a tax return position.
5. Apparently, many attorneys interpreted the phrase “a reasonable basis” to permit an attorney to advise taking a return position that was supported by any authority whatsoever, regardless of the weight of contrary authority. Accordingly, in 1985, the ABA issued Opinion 85-352, replacing the “reasonable basis” standard with a “realistic possibility of success” standard.

C. Opinion 85-352

1. ABA formal Opinion 85-352 sets forth the ABA’s current position regarding the standard for advising a taxpayer that it may take a position on a tax return. Following is the salient language of Opinion 85-352:

“[A] lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no ‘substantial authority’ in support of the position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated. In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.” (Emphasis added.)

2. Opinion 85-352 does not quantify the “realistic possibility of success” standard.

3. Opinion 85-352 is silent on the degree of “due diligence” an attorney is obligated to perform before advising a taxpayer regarding a tax return position.

D. Opinion 346

1. Opinion 346, issued in 1982, deals solely with opinions issued to promoters of tax shelters to be used in connection with the marketing effort. Opinion 346 expressly limits its scope to “advice by a lawyer concerning the federal tax law applicable to a tax shelter if the advice is referred to either in offering materials or in connection with sales promotion efforts directed to persons other than the client who engages the lawyer to give the advice.”

2. The guidelines in Opinion 346 for the preparation of tax shelter opinions are similar to the guidelines adopted by the IRS in Circular 230 for “covered opinions.” Following is a summary of the requirements set forth in Opinion 346 (largely taken verbatim from the Opinion):

a. The lawyer should establish the terms of the relationship with the offeror-client at the time the lawyer is engaged to work on the tax shelter offering, making clear that, in order to issue the opinion, the lawyer requires from that
client a full disclosure of the structure and intended operations of the venture and complete access to all relevant information.

b. The lawyer should make inquiry of the client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect, or are suspect, or are inconsistent, or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry.

c. The lawyer should relate the law to the actual facts to the extent the facts are ascertainable when the offering materials are being circulated. A lawyer should not issue a tax shelter opinion that disclaims responsibility for inquiring as to the accuracy of the facts, fails to analyze the critical facts, or discusses purely hypothetical facts.

d. The lawyer should make reasonable inquiries to ascertain that a good faith effort has been expended to comply with laws other than tax laws.

e. The lawyer should take reasonable steps to assure that all material federal income and excise tax issues have been considered and that all of those issues which involve the reasonable possibility of a challenge by the Internal Revenue Service have been fully and fairly addressed in the offering materials.

f. The lawyer should provide an opinion as to the likely outcome on the merits of the material tax issues addressed in the offering materials.

g. The lawyer should provide an overall evaluation of the extent to which the tax benefits in the aggregate are likely to be realized.

h. The lawyer should assure that the offering materials correctly represent the nature and extent of the tax shelter opinion.

VI. Return preparer penalty under Code section 6694(a)

A. Background

1. Imposition of penalty. Code section 6694(a) imposes a penalty on a tax return preparer who prepares a return or refund claim that understates the taxpayer’s tax liability due to a position that falls short of specified standards.

2. Advisor as return preparer. Under Reg. § 301.7701-15, “[a] person who renders advice which is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund” may be treated as a return preparer if the entry is considered to be a “substantial portion” of the return or refund claim.
3. **2007 amendment.** Until the passage of P.L. 110-28 in May 2007, Code section 6694(a) did not receive a significant amount of attention, because the amount of the penalty was only $250, and the penalty was imposed only if a portion of the taxpayer’s understatement was due to (a) an undisclosed position “for which there was not a realistic possibility of being sustained on its merits” or (b) a disclosed position that was “frivolous.” Regulations under this provision provided: “A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.” Reg. § 1.6694-2(b)(1).

The 2007 tax act dramatically changed Code section 6694(a). First, the amount of the penalty was increased to the larger of (a) $1,000 and (b) 50% of the income derived by the preparer with respect to the return. Second, the act raised the standards of conduct for tax return preparers. For undisclosed positions, the act replaced the “realistic possibility” standard with a requirement that there be a “reasonable belief” that the tax treatment of the position would “more likely than not be sustained on its merits.” For disclosed positions, the act replaced the “nonfrivolous” standard with the requirement that there be a “reasonable basis” for the tax treatment of the position. See Code section 6694(a)(2).

4. **Advisor-taxpayer conflict.** The foregoing changes to Code section 6694 have been vexing to all tax advisors, in part because the preparer’s penalty risk for a return position that is supported by “substantial authority” but is not “more likely than not” to be sustained can be avoided only through disclosure by the taxpayer, whereas disclosure of such a position does not benefit the taxpayer under Code section 6662 and may increase the taxpayer’s chance of audit.

5. **IRS Notice 2008-13.** In January 2008, the IRS issued Notice 2008-13, which, for the time being, reduces the risk that tax advisors will be subject to penalty under Code section 6694(a).

6. **Possible legislative relief.** On April 15, 2008, the House of Representatives passed H.R. 5719, which would generally conform the preparer penalty under Code section 6694(a) to the taxpayer’s substantial understatement penalty under Code section 6662.

**B. Basic rules for imposition of penalty**

1. Under Code section 6694(a)(1), if any part of an understatement of tax liability with respect to a tax return or a claim for refund is due to a position described in Code section 6694(a)(2), a “tax return preparer” who prepared the return or refund claim may be liable for a penalty equal to the greater of (a) $1,000 and
(b) 50% of the preparer’s income derived with respect to the return or refund claim.

2. (Code section 6694(a)(2) is confusingly written with double negatives. The following paragraphs in this outline restate the rules in section 6694(a)(2) without the negatives.)

3. A position is described in Code section 6694(a)(2) if (a) the preparer knew or reasonably should have known of the position and (b) the position is an unreasonable position. (The term “unreasonable” is actually used only in the heading of section 6694(a)(2). It is, however, easier to refer to an “unreasonable” position than a position that is “described in section 6694(a)(2)(B) and (C).”)

4. A position is unreasonable unless one of the two following conditions exist:
   a. There was a reasonable belief (presumably, the preparer’s belief) that the position would “more likely than not” be sustained on its merits; or
   b. The position was disclosed by the taxpayer as provided in Code section 6662(d)(2)(B)(ii) and there was a “reasonable basis” for the position.

C. Advisor as “return preparer”

1. Code section 6694(f) refers to Code section 7701(a)(36) for the definition of “tax return preparer.”

2. Under section 7701(a)(36), any person who prepares “a substantial portion of a return or claim for refund” is treated as the preparer of the return or claim.

3. Reg. § 301.7701-15(a)(1) provides: “A person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund.”
   a. Under this rule, subject to exceptions, an advisor to a taxpayer or to a taxpayer’s return preparer also may be considered a tax return preparer.
   b. Reg. § 301.7701-15(a)(2) clarifies that pre-transaction planning advice does not cause the advisor to be treated as a return preparer, and that tax advice will cause the advisor to be treated as a preparer only if the advice is “directly relevant” to the determination of some aspect of an entry on a return or refund claim. Thus, the regulations state, advice regarding tax reserves on a corporate taxpayer’s financial statement does not cause the advisor to be treated as a return preparer.

4. Reg. § 301.7701-15(b)(1) provides: “Only a person (or persons acting in concert) who prepares all or a substantial portion of a return or claim for refund shall be
considered to be a preparer (or preparers) of the return or claim for refund. A person who renders advice which is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund, will be regarded as having prepared that entry. Whether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined by comparing the length and complexity of, and the tax liability or refund involved in, that portion to the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole.”

a. Under this rule, a person giving tax advice may not know whether the advice will cause him or her to be treated as a return preparer because that treatment will depend on possibly unknown facts about the totality of the taxpayer’s return.

5. Notice 2008-13, sec. B, provides that, until further guidance issued, Reg. § 301.7701-15 is modified, solely for purposes of Code section 6694, by—

“*** Interpreting the term substantial portion in § 301.7701-15(b)(1) to mean a schedule, entry, or other portion of a tax return or claim for refund that, if adjusted or disallowed, could result in a deficiency determination (or disallowance of refund claim) that the preparer knows or reasonably should know is a significant portion of the tax liability reported on the tax return (or, in the case of a claim for refund, a significant portion of the tax originally reported or previously adjusted). This clarifies that any determination as to whether a person has prepared a substantial portion of a tax return and thus is considered a tax return preparer will depend on the relative size of the deficiency attributable to the schedule, entry, or other portion.” (Emphasis added.)

a. This modification apparently is intended to prevent an advisor from being treated as a return preparer if the advisor has no reason to know that the item upon which advice is being given is significant in light of the return as a whole.

b. Note: Since the term “significant” is expressly used in relation to the “tax liability reported on the tax return,” any item arguably could be treated as a “substantial portion” of a return that is expected to report little or no tax.

D. “Reasonable belief” requirement (“more likely than not” standard)

1. The “reasonable belief” requirement in Code section 6694(a)(2)(B) clearly has both a subjective component and objective component. That is, the preparer need not demonstrate that, on a fully objective basis, the position was more likely than not to be sustained on the merits. However, the preparer must have believed that such was the case, and the belief must have been reasonable.
2. Since the “reasonable belief” requirement is a new addition to the Code, the regulations under section 6694 provide no guidance on how reasonable belief is established.

3. Notice 2008-13, which, until the IRS issues further guidance, is generally effective for returns filed after 2007 and for advice provided after 2007, provides the following guidance on the “reasonable belief” requirement (see Notice 2008-13, sec. D):

   a. “[A] tax return preparer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment (without taking into account the possibility that the tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) if the tax return preparer analyzes the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii) and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than fifty percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS.” (Emphasis added.)

   b. “For purposes of determining whether the tax return preparer has a reasonable belief that the position would more likely than not to be sustained on the merits, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer, as provided in §1.6694-1(e).”

   i. Reg. §1.6694-1(e) provides: “[T]he preparer is not required to audit, examine or review books and records, business operations, or documents or other evidence in order to verify independently the taxpayer's information. However, the preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer. The preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist — for example, that the taxpayer maintain specific documents, before a deduction may be claimed. The preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition to the claiming of a deduction.”

   c. “[A] tax return preparer may rely in good faith and without verification upon information furnished by another advisor, tax return preparer or other third party.”

   d. “The tax return preparer . . . may not ignore the implications of information furnished to the tax return preparer or actually known to the tax return preparer. The tax return preparer also must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete.”
E. “Reasonable basis” requirement

1. The term “reasonable basis” is used in Code section 6662(d)(2)(B)(ii). Section 6694 does not incorporate section 6662(d)(2)(B)(ii) by reference, but there is no reason to think the term will be interpreted differently under section 6694.

2. Notice 2008-13, sec. E, expressly provides: “Until further guidance is issued, solely for purposes of section 6694, reasonable basis will be interpreted in accordance with § 1.6662-3(b)(3).”

3. Reg. § 1.6662-3(b)(3) provides: “Reasonable basis. Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662-4(d)(2). (See §1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.)”

F. Required disclosure under the “reasonable basis” exception

1. Under Code section 6694(a)(2)(C)(i), a preparer can avoid the section 6694(a) penalty under the “reasonable basis” exception only if the return position in question is “disclosed as provided in section 6662(d)(2)(B)(ii).”

2. Code section 6662(d)(2)(B)(ii) describes the required disclosure as follows: “[T]he relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.”

3. Important note: If there is “substantial authority” for a position, and the position does not relate to a “reportable position” for which the taxpayer may be penalized under Code section 6662A if disclosure is not made, the taxpayer generally will not wish to disclose the position in the manner described in Code section 6662(d)(2)(B)(ii).

4. The foregoing tension between the preparer and the taxpayer is eliminated (at least for the time being) by guidance in Notice 2008-13 that is discussed under “Additional relief in Notice 2208-13,” below.

G. “Reasonable cause” exception

1. Code section 6694(a)(3) provides: “No penalty shall be imposed under [section 6694(a)] if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.”
2. Reg. § 1.6694-2(d) provides rules relating to the reasonable cause exception. Under those rules, the determination of whether a return preparer acted in good faith takes into account several factors, including the following:

a. “Whether the error resulted from a provision that was so complex, uncommon, or highly technical that a competent preparer of returns or claims of the type at issue reasonably could have made the error.” Reg. § 1.6694-2(d)(1).

b. “Whether the understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors.” Reg. § 1.6694-2(d)(2).

c. “Whether the understatement was material in relation to the correct tax liability.” Reg. § 1.6694-2(d)(3).

d. “Whether the preparer's normal office practice, when considered together with other facts and circumstances such as the knowledge of the preparer, indicates that the error in question would rarely occur and the normal office practice was followed in preparing the return or claim in question.” Reg. § 1.6694-2(d)(4).

3. The foregoing rules probably have little relevance to a tax advisor rendering written advice to a taxpayer or to a signing return preparer in connection with technical matters.

4. The regulations also include rules governing the extent to which a signing return preparer may rely on advice from another professional. Those rules, contained in Reg. § 1.6694-2(d)(5), are modified on an interim basis by Notice 2008-13, sec. F. The modified rules read as follows:

“[A] tax return preparer will be found to have acted in good faith when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice. The advice may be written or oral, but in either case the burden of establishing that the advice was received is on the tax return preparer. A tax return preparer is not considered to have relied in good faith if—

“(i) The advice is unreasonable on its face;

“(ii) The tax return preparer knew or should have known that the third party advisor was not aware of all relevant facts, or

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“(iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the tax return or claim for refund was prepared, that the advice was no longer reliable due to developments in the law since the time the advice was given.”

5. The foregoing guidance does not make it clear whether, for purposes of the reasonable cause exception, a return preparer may rely on advice from another return preparer that specifically concludes that the tax return position in question achieves a specified level of comfort, as opposed to analytical advice that demonstrates why the position should be, or can be, considered correct. That is, e.g., if a position will be disclosed on the taxpayer’s return, can the return preparer rely in good faith on an opinion from counsel that concludes only that there is a reasonable basis for the position? If the position is not disclosed on the return, must counsel opine that the position would more likely than not be sustained in order the preparer to be entitled to rely on the opinion in good faith? There is no authority on this point, but the better answer to both questions appears to be “yes.”

H. Additional relief in Notice 2008-13

1. Under general authority granted to the IRS by Code section 7805(a), and under the authority of the “reasonable cause exception” in Code section 6694(a)(3), Notice 2008-13 provides relief from the specific disclosure requirement in Code section 6694(a)(2)(C)(i).


3. Notice 2008-13, sec. G, provides the following relief for nonsigning tax return preparers (other relief is granted to signing preparers):

   a. “Until further guidance is issued, solely for purposes of section 6694, a nonsigning tax return preparer shall be deemed to meet the requirements of section 6694 with respect to a position for which there is a reasonable basis but for which the nonsigning tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position as a result of disclosure, if relevant, and of the requirements for disclosure.” (Emphasis added.)

   b. “If a nonsigning tax return preparer provides advice to another tax return preparer, a nonsigning tax return preparer shall be deemed to meet the requirements of section 6694 with respect to a position for which there is a
reasonable basis but for which the nonsigning tax return preparer does not have a reasonable belief that the position would more likely than not be sustained on the merits, if the advice to the tax return preparer includes a statement that disclosure under section 6694(a) may be required.” (Emphasis added.)

c. “If the advice with respect to a position is in writing, the statement must be in writing. If the advice with respect to a position is oral, the statement also may be oral. Contemporaneously prepared documentation in the nonsigning tax return preparer’s files is sufficient to establish that the statement was given to the taxpayer or other tax return preparer.”

4. Thus, until further guidance is issued, a tax advisor giving advice on a position for which the advisor is unable to reach a “more likely than not” level of comfort may avoid risk of a section 6694(a) penalty, as long as there is a “reasonable basis” for the position, simply by informing the recipient of the advice about the disclosure rules that apply to the latter person.

I. Implications for written advice

1. Advice needed by a signing preparer to avoid the signing preparer’s penalty under Code section 6694(a)

a. A signing preparer may seek written advice from counsel for either of two purposes: (i) to obtain a “reasonable belief that the position would more likely than not be sustained on its merits,” or (ii) in the hope of obtaining penalty protection under the reasonable cause exception

b. If a signing preparer’s purpose for obtaining written advice from counsel about a tax return position is to obtain a “reasonable belief that the position would more likely than not be sustained on its merits,” the opinion will need to support such a belief. The guidance in Notice 2008-13, sec. F, on the nature of advice that may be relied on under the reasonable cause exception does not literally apply, but it is difficult to see how a return preparer can form a “reasonable belief” on the basis of an opinion from counsel if, e.g., the preparer knows that counsel is not aware of all relevant facts. Accordingly, counsel should advise the preparer that the advice may not be effective as protection from a section 6694(a) penalty if the preparer knows of relevant facts that have not been shared with counsel.

c. If a signing preparer’s purpose for obtaining written advice from counsel about a tax return position is to obtain penalty protection under the reasonable cause exception, counsel needs to know whether or not the return position will be disclosed (or the signing preparer intends to inform the taxpayer about the disclosure rules). If disclosure will not be made by the taxpayer, and the signing preparer does not intend to discuss disclosure with the taxpayer, an effective penalty protection opinion will have to be at the
more-likely-than-not level. On the other hand, if disclosure will be made by the taxpayer, or the signing preparer intends to discuss disclosure with the taxpayer, the signing preparer may be satisfied with a reasonable basis opinion.

d. An opinion given to a signing preparer to provide penalty protection under Code section 6694 should not lose its effectiveness simply because it does not satisfy the detailed requirements of a “covered opinion” under Circular 230 and, instead, contains a disclaimer that exempts it from such requirements. Under Reg. § 10.35(b)(4)(ii), such a disclaimer will state that the opinion “was not intended or written by the practitioner to be used, and . . . it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.” Such a disclaimer should not prevent the return preparer from relying on the opinion to form a reasonable belief that the position in question is more likely than not to be sustained, if that is what the opinion concludes.

i. In many cases, a signing return preparer will ask counsel for technical guidance only on a single issue relating to the tax treatment of an item. The preparer’s ability to rely on the opinion under either the “reasonable belief” rule in Code section 6694(a)(2)(B) or the “reasonable cause” exception in Code section 6694(a)(3) should not depend on whether the opinion includes all of the “limited scope opinion” disclosures described in Reg. § 10.35(e)(3).

ii. Counsel, however, should seek to avoid treatment of the opinion as a “covered opinion.”

iii. Counsel also should recognize that if the position on which the return preparer seeks advice is a “listed” transaction described in Reg. § 10.35(b)(2)(i)(A) or a “principal purpose” transaction described in Reg. § 10.35(b)(2)(i)(B), a disclaimer will not prevent the opinion from being a covered opinion, and it will not be possible for counsel to honor the signing return preparer’s request for a limited scope opinion. See Reg. § 10.35(c)(3)(v)(A)(ii).

2. Penalty exposure for advisor under Code section 6694(a)

a. As noted above, under Reg. 301.7701-15(b)(1), “[a] person who renders advice which is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund, will be regarded as having prepared that entry.” If the entry constitutes a “substantial portion” of the return, the advisor will be considered a return preparer and may be liable for the penalty under Code section 6694(a) if an understatement of tax results from the entry.
i. This will be so whether the advice is rendered directly to the taxpayer or to the taxpayer’s signing return preparer.

b. Under Notice 2008-13, the advisor’s penalty exposure may be avoided with respect to a return position under the “reasonable basis” exception as long as the following requirements are satisfied:

i. There is, as an objective matter, a reasonable basis for the position.

ii. “[T]he advice to the taxpayer includes a statement informing the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position as a result of disclosure, if relevant, and of the requirements for disclosure,” or, if the advice is given to another tax return preparer, “the advice . . . includes a statement that disclosure under section 6694(a) may be required.”

c. Note: Even if counsel is giving advice at a “more likely than not” level, counsel can avoid penalty under Code section 6694(a) without having a “reasonable belief” that the “more likely than not” conclusion is appropriate, as long as there is a “reasonable basis” for the position as an objective matter and the advice includes a statement of the type described in the preceding paragraph.

J. Possible amendment – H.R. 5719

1. On April 15, 2008, the House of Representatives passed H.R. 5719, sponsored by Ways & Means Committee chair Rangel (the “Rangel Bill”). The White House has threatened to veto the bill if it is passed by the Senate, because it includes a ban on private collection of tax debts, but the bill may be indicative of future Congressional action with respect to Code section 6694(a).

2. The Rangel Bill would amend Code section 6694(a) to provide three different penalty-avoidance standards, depending on the nature of the return position in issue.

a. In the case of any position with respect to a “tax shelter” (as defined in Code section 6662(d)(2)(C)(ii)) or a “reportable transaction” to which Code section 6662A applies, the return preparer would be subject to penalty unless “it is reasonable to believe that the position would more likely than not be sustained on its merits.”

b. In the case of any position disclosed as provided in Code section 6662(d)(2)(B)(ii)(I) and not related to a tax shelter or a reportable transaction, the return preparer would be subject to penalty (subject to a reasonable cause/good faith exception) unless “there is a reasonable basis for the position.”
c. In the case of any other position, the return preparer would be subject to
penalty (subject to a reasonable cause/good faith exception) unless “there is
or was substantial authority for the position.”

3. In all cases, a reasonable cause/good faith exception would be available.

4. Under the Rangel Bill, the comfort levels needed to avoid return preparer
penalties under Code section 6694(a) generally would be the same as the comfort
levels needed to avoid taxpayer penalties for substantial understatements under
Code section 6662.

VII. Negligence/malpractice

A. Disclaimer: This section of this outline is intended only to identify issues, not to
examine them in depth.

B. Elements of a legal malpractice claim

1. The elements of a legal malpractice claim are the same as the elements of any
negligence claims, namely: (1) a duty to the claimant, (2) breach of the duty,
(3) causation, and (4) damages.

C. To whom is a duty owed?

1. The traditional rule has been that a lawyer can be liable for negligence in the
conduct of professional duties only to the client, and not to third parties. Ethical
Oregon Lawyer, § 15.3.

2. However, under Section 552 of the Restatement (Second) of Torts, an attorney
who negligently provides false information knowing that certain third parties will
rely on it may be liable to those parties.

D. Breach of duty of care

1. Note that an attorney purporting to be a tax specialist will be held to a standard of
care appropriate for attorneys practicing in that specialty. If a tax matter involves
particular issues with which an attorney is not conversant, it may be necessary for
the attorney to consult a specialist.

2. Note that it may be difficult to determine whether the duty of care is breached in a
case involving uncertain law.

E. Causation and damages

1. Damages that may be sought by a taxpayer/client as a result of erroneous tax
advice include the following:
a. An amount of tax liability that the client did not expect to incur by reason of the attorney’s advice.

b. Interest on such a tax liability.

c. Penalties that the client did not expect to incur by reason of the attorney’s advice.

d. Loss from an investment that the client allegedly would not have made but for the client’s advice.

2. Special circumstances to be taken into account

a. Would the client have incurred the tax liability even if correct advice had been rendered?

b. What decisions did the client actually make based on the erroneous advice?

c. Were the client’s own actions a contributing factor resulting in the tax liability or penalty?

d. Were the client’s damages reasonably foreseeable?

VIII. Tax shelter promoter penalties

A. Federal

1. Code section 6700 imposes a monetary penalty on any person who (a) assists in organizing or selling any entity, plan, or arrangement, and (b) in connection with that entity, plan, or arrangement, makes or furnishes “a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter.” (Code section 6700(a).)

2. The amount of the penalty is “50 percent of the gross income derived (or to be derived) from such activity by the person on which the penalty is imposed.” (Code section 6700(a), last sentence.)

3. The term “tax shelter” is used only in the heading of section 6700. The penalty applies to any materially false or fraudulent statement about tax matters in connection with any “entity” or “plan or arrangement.”

4. The section 6700 penalty can be imposed on an attorney rendering a tax opinion that contains material statements of law that the attorney knows to be false. For example, in Autry, Jr. v. United States, 899 F.2d 973 (11th Cir. 1989), the 11th Circuit held that “as a matter of law, [the promoter’s] statements as to the allowability of the ACRS and ITC with respect to the intangible aspects of the
cattle breeding program were false” and that the penalty should be imposed if the promoter knew that the statements were false. In *Autrey*, the person subject to the penalty was a “lawyer and tax specialist” who was also the organizer and principal promoter of the tax shelters in question. Nothing in section 6700, however, would prevent application of the penalty to a tax attorney knowingly furnishing a false tax opinion to or on behalf of an independent promoter of a “plan or arrangement.”

5. Presumably, the penalty imposed under Code section 6700 on an attorney who provides a materially false tax opinion for a fee is equal to 50 percent of the fee. It could be argued, however, that a person who merely receives a fee for providing an opinion on the tax consequences of an activity is not deriving gross income from the activity and therefore is not subject to penalty under section 6700. I have found no authority on this point.

B. Oregon

1. ORS 314.406, enacted in 2007, imposes a monetary on any person who promotes an Oregon-related tax shelter. Following is the entire text of this new provision:

   **314.406 Penalty for promotion of abusive tax shelter.**

   (1) A penalty shall be imposed on a person who promotes a tax shelter if:

   (a) The person is or would be subject to a penalty for promoting an abusive tax shelter under section 6700 of the Internal Revenue Code; and

   (b) The tax shelter satisfies any of the following conditions:

   (A) The tax shelter is organized in this state.

   (B) The tax shelter is doing business in this state.

   (C) The tax shelter derives income from sources in this state.

   (D) At least one investor in the tax shelter is an Oregon personal income taxpayer or an Oregon corporate excise or income taxpayer.

   (2) The amount of the penalty shall equal 100 percent of the amount of gross income derived by the person in promoting the tax shelter.

   (3) A penalty imposed under this section shall be in addition to and not in lieu of any other penalty.

2. Points of note

   a. The Oregon penalty applies only to “a person who promotes a tax shelter.” It is not clear whether a person who knowingly furnishes a materially false tax opinion to a person actively promoting a tax shelter is intended to be considered to be “a person who promotes a tax shelter.” The language of ORS 314.406(1)(a), however, can be read to imply that any person subject to a penalty under Code section 6700 is considered to be such a person.”
b. While the penalty imposed under Code section 6700 is based on the penalized person’s gross income “derived from” the arrangement in question, the penalty imposed under ORS 314.406 is based on the “gross income derived by the person in promoting the tax shelter.” This can be read to exclude a fee for providing a tax opinion.

IX. Criminal exposure under Code section 7206(2)

A. Under Code section 7206(2), “Any person who ... willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document” is guilty of a felony and may be imprisoned for up to three years.

1. Following is the language of section 7602(2) as it may pertain to an attorney providing written tax advice: “Any person who . . . willfully aids or assists in . . . or advises the preparation . . . under . . . the internal revenue laws, of [any] document, which is fraudulent or is false as to any material matter . . . .”

B. Justice Department view of how Code section 7206(2) applies to tax opinions based on false representations

1. In a letter submitted to the U.S. District Court for the Southern District of New York in United States v. Jeffrey Stein, et al., the Justice Department explained the basis for asserting that the defendants – accountants who provided tax opinions in connection with the promotion of tax shelters – had violated Code section 7206. The government asserted that the criminally fraudulent act was the reliance in the opinions on material facts that the defendants knew to be false. Following is an instructive excerpt from the government’s letter to the court:

“As an initial matter, various defendants’ motion papers appear to take the position that the template opinion letters relating to the transactions described in the Indictment as FLIP/OPIS, BLIPS, and SOS constitute a description of the transactions “as designed.” The Government disagrees and intends to prove at trial that these transactions “as designed” are as set forth below, not as set forth in the template opinion letters. The Government alleges that these opinion letters do not reflect the transactions “as designed,” but instead contain misleading information, false statements, and material omissions designed to disguise the transaction and mislead the IRS. Moreover, the Government alleges that the conspirators drafted these opinion letters so that they misrepresented not only the facts of the transaction, but also conspirators’ conclusions.
regarding the application of the law to the facts. Thus, while the opinions state that certain tax treatments of certain facts (falsely) described in the opinion letter are more likely than not to survive IRS challenge, the Government alleges that conspirators did not, in truth, believe that to be so.” (Emphasis added.)

2. Similarly, in a criminal information filed in the U.S. District Court for the Southern District of New York on January 10, 2007, charging Stephen Acosta with violating Code sections 7206(1) and 7206(2), the Justice Department stated:

“In order to conceal the true nature of the tax shelters from the IRS, to attempt to evade the wealthy clients’ U.S. individual income taxes, and to shield the clients from IRS penalties for underpayment of income taxes, KPMG, Greenberg and/or the Orange County CPA provided the clients with opinion letters containing false and fraudulent representations and statements and claiming that the tax shelter losses were “more likely than not” to survive IRS challenge. The law in effect from at least 1997 provided that if a taxpayer claimed a tax benefit that was later disallowed, the IRS could impose substantial penalties, ranging from 20%-40% of the underpayment of tax attributable to the shelter, unless the tax benefit was supported by an independent opinion relied on by the taxpayer in good faith that the tax benefit was “more likely than not” to survive IRS challenge. Thus, the conspirators issued false and fraudulent opinion letters with the intent that the clients would claim the fraudulent tax shelter losses on tax returns and provide the opinion letter and other false and fraudulent transactional documents and/or the false and fraudulent representations and statements contained therein to the IRS if and when the client was audited.”

C. Judicial reaction to asserted application of Code section 7206(2) to tax opinions containing false representations

1. In an April 28, 2006, ruling in United States v. Jeffrey Stein, et al., the U.S. District Court for the Southern District of New York denied the defendants’ motion to strike allegations regarding the role of tax opinions as the basis for violations of Code section 7206, stating:

“In essence, defendants ask the Court to determine as a matter of law that the tax shelters – as described in defendants’ briefs and the template opinion letters – were legal. The government has made clear, however, that it
intends to prove that the transactions as described in the
template opinion letters never actually happened. Instead,
according to the government, defendants developed a series
of fraudulent transactions designed solely to produce tax
losses and then drafted opinion letters intended to disguise
the true nature of the transactions and to mislead the IRS.
The government intends to prove, for example, that the
BLIPS transactions – which defendants claim involved
nonrecourse premium loans to tax shelter clients to finance
seven-year, multi-stage investments in emerging market
currencies – actually were “designed to be terminated
before year-end for tax purposes” and to involve “no real
loan premium, no realistic possibility of making a
reasonable pre-tax profit, no contingency to the obligation
to repay the loan premium, and no purpose for the
purported borrowing except to generate a tax loss. Given
this theory, the question whether the transactions described
in the allegedly phony opinion letters were lawful is
immaterial. Defendants’ motions therefore are denied.

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“Defendants first move to strike allegations that they
conspired to violate Internal Revenue Code Sections 7201
and 7206 by issuing opinion letters to KPMG clients
concerning the FLIPS, OPIS, and BLIPS transactions. They
argue that “the opinion letters cannot form the basis of
violations of Sections 7201 and 7206 . . . because [they]
neither concerned the actual amount of tax owed by the
clients nor advised as to how the clients’ tax returns should
be prepared, either of which is a fundamental element of
those statutes.” As noted above, however, the government
intends to prove that defendants knowingly issued
misleading opinion letters in order to disguise the true
nature of the transactions, thereby enabling clients to report
fraudulent losses without detection by the IRS. Allegations
regarding the opinion letters are relevant to this theory.”

D. Bottom line

1. As a logical matter, the part of a legal opinion that may be “fraudulent or . . . false
   as to any material matter” is the ultimate statement of tax consequences. Thus, if
   an attorney knowingly gives an incorrect opinion on the tax consequences of a
   transaction, it may not matter whether that ultimate statement is fraudulent
   because (a) the attorney willfully bases the opinion on facts that the attorney
   knows are false or (b) the attorney willfully bases the opinion on legal analysis
   that the attorney believes is incorrect. The following statements appear to be
justified by the language of Code section 7206(2) and preliminary judicial rulings to date:

a. An attorney who willfully bases a legal opinion on material facts that the attorney knows are false may be in violation of Code section 7206(2).

b. An attorney who bases a legal opinion on true facts but willfully reaches a material legal conclusion that the attorney knows is incorrect also may be in violation of Code section 7206(2).

X. Disclosure of tax opinions

A. IRS summons authority

1. Code section 7602 empowers the IRS to “examine any books, papers, records, or other data which may be relevant to” determining a taxpayer’s tax liability.

2. In United States v. Arthur Young & Co., 465 U.S. 805 (1984), the Supreme Court held that, under Code section 7602, the IRS generally has the power to obtain from a company’s auditors documents supporting the company’s tax reserve for deferred or contingent tax liabilities and related representations in the company's audited financial statements (“tax accrual workpapers”).

3. Although the IRS has generally exercised restraint in requesting tax accrual workpapers, in Announcement 2002-63 the IRS announced that it may request tax accrual workpapers from taxpayers that have engaged in aggressive transactions known as “listed transactions.”

B. Doctrines protecting legal opinions from disclosure

1. Attorney-client privilege

a. In general, in order for the attorney-client privilege to attach to a communication, the communication must be made: (1) in confidence; (2) in connection with the provision of legal services; (3) to an attorney; and (4) in the context of an attorney-client relationship. Evergreen Trading, LLC v. United States, 80 Fed. Cl. 122 (2007).

b. Tax opinions from counsel that, if disclosed, would reveal client communications described above, also are protected by the attorney-client privilege. Boca Investerings Partnership v. United States, 83 AFTR2d 99-2316 (D. D.C. 1999).

c. An opinion is not protected by the attorney-client privilege if it is intended to be disclosed to a third party, such as the IRS. Therefore, a tax opinion that is obtained for penalty-protection purposes, and must be disclosed in whole or in part to the IRS for that purpose, may not be privileged. Long-Term
Similarly, an opinion otherwise protected from disclosure under the attorney-client privilege may lose the protection if the opinion is in fact disclosed to the taxpayer’s auditors. United States v. Textron, Inc., 507 F. Supp 2d 138 (D. R.I. 2007).

2. Work-product doctrine

a. Rule 26(b)(3) of the Federal Rules of Civil Procedure provides: “[A] party may obtain discovery of documents and tangible things otherwise discoverable . . . prepared in anticipation of litigation or for trial by or for another party or by or for that other party’s representative (including the other party’s attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party’s case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.” (Emphasis added.)

b. Disclosure of a tax opinion to a third party does not cause a waiver of the protection of the work product doctrine is the disclosure is not inconsistent with the taxpayer’s intent to maintain the confidentiality of the opinion from litigation adversaries. E.g., United States v. Textron, Inc., 507 F. Supp 2d 138 (D. R.I. 2007).

c. The critical threshold issue in connection with the application of the work-product doctrine to tax opinions is whether they were “prepared in anticipation of litigation.”

d. In Textron, the taxpayer successfully obtained work-product protection for legal analyses prepared in connection with establishing GAAP tax reserves (i.e., tax accrual workpapers). The taxpayer successfully argued that “its workpapers were prepared because it anticipated the possibility of litigation with the IRS regarding various items on its return.” Importantly, the taxpayer had carefully documented its litigation concerns and the relationship between those concerns and the requested analyses. The government has appealed the Textron decision to the First Circuit Court of Appeals, filing its brief on January 25, 2008.

i. Note that Textron involved tax accrual workpapers prepared for years before FIN 48 became effective. 

ii. It is possible that the following key factual finding in the district court’s decision in Textron would not have been made if periods to which FIN
48 were involved: “[W]hile it may be accurate to say that the workpapers helped Textron determine what amount should be reserved to cover any potential tax liabilities and that the workpapers were useful in obtaining a ‘clean’ opinion from [Textron’s auditors] regarding the adequacy of the reserve amount, there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding.” (Emphasis added.)

iii. Under FIN 48, a company’s determination of its income tax reserve may not take audit risk into account. FIN 48 unequivocally mandates: “It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.” (FIN 48, ¶7.a)

iv. It follows that a company must determine its tax exposure, and document its determination to the extent required by its auditors, regardless of whether it expects that the IRS or any other taxing authority will challenge, or even examine, its tax positions. For this reason, courts may conclude that FIN 48 generally undermines Textron’s determination that tax accrual workpapers would not be prepared but for the possibility of disputes. It will be important for companies to separately identify, contemporaneously, (1) the opinions it is obtaining for purposes of determining its tax reserves and (2) the opinions it is obtaining because of the prospect of litigation.

C. Bottom line: Risk of disclosure of different types of tax opinions provided by counsel

1. Legal opinions provided to a client generally will be protected from disclosure under the attorney-client privilege unless (a) they are expected to be disclosed to a third party, or (b) they are actually disclosed to a third party. In assessing the likelihood that protection will be lost by reason of disclosure, counsel should take into account the client’s probable use of the opinion.

2. Transaction-planning opinions: There is a good chance that such an opinion will be protected from disclosure.

3. Tax-return assistance opinions: There is a good chance that such an opinion will be protected from disclosure if the client prepares its return “in house.” There is little chance of protection if the client is expected to provide the opinion to an outside return preparer.

4. Taxpayer penalty-protection opinions: There is little chance of protection of such an opinion; since the purpose of a penalty-protection opinion is defeated if it cannot be shown to the IRS, it will be difficult to establish that the opinion was prepared with an expectation of confidentiality.
5. *Return preparer penalty-protection opinions:* There is little chance of protection of such an opinion if the taxpayer is the client. If the return preparer is the client, the chance of protection is good if the preparer requests the opinion only to aid in analysis and not to demonstrate reasonable reliance on the opinion. If the preparer requests or uses the opinion for the latter purpose, there is little chance of protection for the reason stated in the preceding paragraph.

6. *FIN 48 opinions:* There is a high probability of protection if the client does not disclose the opinion to outside auditors. There is no chance of protection under the attorney-client privilege if the opinion is disclosed to auditors. There is a possible chance of protection under the work-product doctrine even if the opinion is disclosed to auditors, as long as the client can demonstrate that the opinion would not have been obtained but for the client’s anticipation of litigation.

XI. Comfort levels and formulations of opinion

A. Comfort levels

1. Traditional list
   a. Will
   b. Should
   c. More likely than not
   d. Substantial authority
   e. Realistic possibility of success
   f. Reasonable basis
   g. Non-frivolous

2. There is no science in reaching a specified level of comfort.

3. There is no standard formulation of what “should” means.

B. Formulations of opinion

1. There is no standard formulation of what is being predicted when percentages are used.

2. Examples
   a. Will be deductible
   b. Will be allowed as a deduction
c. More likely than not to be sustained

d. More likely than not to be sustained if analyzed in a well-reasoned opinion

3. What formulation is needed for particular purposes?

C. Exercising judgment

1. When must judgments be made?
   a. Determining whether or not an analogy is close.
   b. Applying competing rules of statutory construction.

2. Not everyone makes the same judgment.
   a. Some tax attorneys are more willing than others to take analogous rulings or legal trends into account.
   b. An attorney who has first-hand familiarity with a private letter ruling may give more or less weight to it than attorneys who have only read it.
   c. An experienced attorney may be more willing to criticize a weakly reasoned case and predict that it will be overturned or ignored.
   d. An attorney who is familiar with an industry or market may be more willing than an outsider to predict that certain doctrines won’t be applied to transactions in that industry or market because of the resulting consequences.

D. Meaning of “should”

1. There is no definition, in the tax laws applicable to taxpayers or in the rules of tax practice, of the term “should” as used in the phrase “x should be treated in the y manner.”

2. There has developed a perception among certain consumers of tax opinions (e.g., institutional investors, corporations undergoing reorganizations, and rating agencies) that the word “should” suggests a belief by the opinion writer that the taxpayer’s position has significantly more than a 50% chance of prevailing if it is challenged. As a result, some practitioners who issue tax opinions to clients for the benefit of such consumers have developed a practice of using the term “should” only when they believe that there is at least, e.g., a 70% chance that the tax position in question will be sustained if it is challenged. See Jasper Cummings, “The Range of Legal Tax Opinions, With Emphasis on the ‘Should’ Opinion,” Tax Notes, February 17, 2003.

   a. Arguably, a tax practitioner who issues a “should” opinion for the benefit of such a client but does not have such a belief is misleading the client.
3. The term “should” does not inherently have such a meaning, however, and not all practitioners agree as to its meaning. (See “Shop Talk: Tax Opinions – Weasel Words?” Journal of Taxation (August 1995).)

4. There is no reason to expect that a client not in the category described above has any particular expectation of what the practitioner means by “should” other than that the practitioner believes that the proposed tax treatment is correct.

5. Some practitioners use the word “should”, not as a prediction of what a court would do, but as a statement of what the court ought to do if it applies the law to the facts in the manner the practitioner believes to be correct. Such a practitioner may be willing to give a “should” opinion but may not be willing to give a “more likely than not” opinion that actually predicts the outcome if the position in question is challenged by the IRS.