TAX OPINION PRACTICE

by

Robert P. Rothman

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I. INTRODUCTION

Tax advisors render advice to their clients in any number of different forms. These forms include oral communications, informal written answers to specific questions (today, often in the form of electronic communications such as email), letters (far less prevalent than they once were), and legal memoranda. At the pinnacle of legal advice is the formal opinion.

This Article addresses a number of issues that arise in federal taxation practice with respect to formal opinions.[1] Part II begins by discussing the various functions that legal opinions perform in the tax area and Part III addresses the range of comfort levels they represent. Part IV then goes on to discuss certain regulatory and ethical rules and principles that come into play when preparing tax opinions—most notably, the Treasury Department rules of practice contained in the infamous Circular 230.[2] Finally, Part V discusses a number of specific issues and problems that frequently arise in particular contexts.

II. FUNCTIONS OF TAX OPINIONS

Not every tax opinion fulfills the same function. When a client engages tax counsel to render a formal opinion, it is generally for a particular purpose. One of the first questions a tax practitioner should ask, therefore, is why the client wants or needs the opinion. The answer to

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This Article should be read in conjunction with the Addendum on the last page, which addresses newly released guidance that effects certain portions of this Article.

[1] On legal opinions generally, see M. JOHN STERBA, JR., LEGAL OPINION LETTERS (3d ed. 2003).

[2] 31 C.F.R. pt. 10.0 (2010).

this question can drive the form and content of the opinion, and, in some cases, can affect an advisor's decision as to whether rendering the opinion is appropriate at all.

A discussion of some of the more common functions served by tax opinions follows. No attempt is made to craft precise definitions of each type of opinion, as such pigeonholing would serve no useful purpose. There is no magic to how a particular opinion is categorized. The idea, rather, is that, in preparing a tax opinion, it is always useful to keep in mind why the opinion has been commissioned and how it will be used. In some cases, a client may request an opinion that needs to perform more than one function.

A. *The Comfort Opinion*

Perhaps the most general type of tax opinion is what might be called a "comfort opinion." A comfort opinion is not designed to satisfy a particular legal or contractual requirement or to sell something or induce somebody to do something; it simply gives a taxpayer comfort that a transaction that he is considering entering into will, in fact, have the expected tax consequences. In the context of a public corporation or a privately held company in which the shareholders are not directly involved in management or as members of the Board of Directors, a comfort opinion may provide a possible defense if management or directors ultimately become defendants in a suit alleging breach of the duty of care.[3] A defendant in such a case could argue that, in seeking advice from an expert professional as to a highly technical matter, he exercised an appropriate amount of care to inquire, and obtain a satisfactory answer, as to what the tax consequences of the transaction would be. Of course, to a certain extent, this argument could be made regardless

[3] For example, directors of a corporation incorporated in Delaware generally have an obligation to act with the requisite degree of care in their dealings with the corporation. This duty, which is required in the exercise of a director's business judgment pursuant to Delaware case law, includes an obligation on the part of a director to inform himself of all "material information reasonably available to [him]" and to use the requisite care in reaching decisions based on that information. Cede & Co. v. Technicolor, Inc., 636 A.2d 956 (Del. 1994). *See generally* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

of the form of the advice, but a formal legal opinion might well carry more weight in the eyes of a finder of fact than advice delivered in a less formal manner.

Even outside the context in which management or a Board of Directors seeks protection against a possible claim of breach of fiduciary duty, a taxpayer may choose to obtain a formal opinion simply in the expectation that he will sleep better in the knowledge that an expert has "blessed" his transaction and given some degree of assurance that the tax consequences will be as expected.

B. *The Contractual Condition Opinion*

A second common type of tax opinion is a contractual condition opinion. This type of opinion is used where a taxpayer has entered into a contract to effect a particular transaction, with the obligation of one or both parties to close conditioned on the receipt of an opinion of counsel that the transaction will have the tax consequences specified in the contract. In one sense, this condition may not be strictly necessary because the taxpayer could have—and most certainly *should* have—sought tax advice, whether in the form of a formal opinion or otherwise, in advance of signing the contract. Nonetheless, the inclusion of an opinion condition to closing is useful for two purposes. First, in some cases, facts relevant to the legal conclusion may not be known with certainty until closing. For example, in some tax-free reorganizations, the ability to satisfy the continuity of proprietary interest requirement[4] may depend on the trading price of

[4] *See* Reg. § 1.368-1(e).

acquiror stock on the closing date.[5] In these situations, it may be impossible to know whether the transaction will in fact qualify as a reorganization until the closing date.[6]

Even where all the relevant facts can be known at the time of signing, sometimes a taxpayer will want to reserve one last clear chance to back out if his counsel, formerly quite sanguine about his conclusions, has an epiphany the night before closing in which he remembers the one Code section that changes everything.

In many types of transactions, a taxpayer who seeks to negotiate such an out is not likely to face a favorable response from the other party, whose response might well be along the lines of "Get your @#$%^ tax lawyer to sign off on the deal *before* you sign on the dotted line!" However, one area in which tax opinions as conditions to closing are very much the rule is in the area of corporate acquisitions that are intended to qualify as reorganizations; it is rare, indeed, to see such a deal in which the obligation of the target (and sometimes the buyer)[7] to close is *not* conditioned on a tax opinion. Selected practical issues that arise in the context of reorganization opinions are discussed below.[8]

C. *The Third-Party Inducement Opinion*

Comfort opinions and contractual condition opinions are typically rendered to one's own client in order to provide some level of assurance that the tax consequences of a transaction will

[5] Temporary Regulation section 1.368-1T(e)(2) and Notice 2010-25, 2010-141.R.B. 527, provide that, in some circumstances, continuity of interest is measured by the value of the acquiror stock on the date before a contract is signed (which would render closing-date price irrelevant); however, there may be situations in which this rule does not apply. *See* Robert P. Rothman, *Treasury Finalizes Continuity of Interest Valuation Regulations*, 51 RIA FED. TAXES WKLY. ALERT 475 (Oct. 6. 2005).

[6] As discussed *infra* in the text accompanying notes 419-21, this scenario can present problems in public transactions where the Securities and Exchange Commission (SEC) may require that an opinion be delivered at the time a registration statement becomes effective, which is likely to be a significant period of time before closing.

[7] *See infra* text accompanying notes 389–95.

[8] *See infra* text accompanying notes 384–89.

be as expected. Sometimes, however, a client will request that a tax advisor deliver an opinion to a third party in order to induce that third party to agree to some course of action.

One scenario in which this arises is where a client is already a party to a contract that restricts his actions in some way, but provides an "escape hatch" if a specified tax opinion is provided.[9] A few common examples:

- A partnership agreement or LLC operating agreement may provide that the general partner or manager may convert the entity to a corporation,[10] but only if such general partner or manager obtains an opinion of counsel that such a conversion will[11] not result in gain recognition to partners;
- A partnership agreement or LLC operating agreement may restrict transfers of interests, subject to an exception if a partner seeking to effect a transfer provides an opinion that such transfer will not cause the partnership to become a publicly traded partnership;[12]
- In connection with a corporate spin-off, the existing corporation and the spun-off corporation may enter into an agreement that restricts either of them from issuing additional stock or being acquired, subject to an exception if an opinion is

[9] Note that, although this type of opinion literally satisfies a contractual condition, in function it is quite different than the type of contractual condition opinions discussed above. The latter type of opinion is a condition to something that was expected to occur, and that frequently goes to the essence of what the contract is all about (*e.g.*, a merger or other business combination). On the other hand, in the case of a third-party inducement opinion, the action that is conditioned on an opinion is typically something that, at the time the contract was entered into, was not expected to occur. Such an opinion is provided to induce the other party to allow something that otherwise would have been prohibited, as opposed to being a condition to consummating the transaction that the contract calls for.

[10] *See* Rev. Rul. 1984-111, 1984-2 C.B. 88; Rev. Rul. 2004-59, 2004-1 C.B. 1050.

[11] As discussed *infra* in the text accompanying notes 44–135, there are a number of different "comfort levels" at which opinions can be issued, of which "will" is generally considered to be the highest. The use of the word "will" in these examples is not meant to imply that a particular contract might not call for a lesser opinion (*e.g.*, "should").

[12] *See* I.R.C. § 7704.

provided that the otherwise prohibited action will not subject the corporation to section 355(e).[13]

Opinions that are designed to induce someone other than the tax advisor's client to do something, or to refrain from doing something, are not limited to situations in which there is a pre-existing contractual relationship that conditions a party's ability to act on the receipt of a tax opinion. They can also arise, independent of any contract, where one person wishes to persuade another person to do something and the person being asked to act is concerned about the tax consequences. Although that person could, of course, seek his own tax advice, sometimes he prefers to place the onus (and the cost) of obtaining tax advice on the person who is asking him to do something.

One major issue that arises in the context of third-party inducement opinions is whether such an opinion is potentially within the scope of "marketed opinions," as defined under Circular 230.[14] As discussed below, a "marketed opinion" that is a "covered opinion" is subject to particularly onerous requirements, including an absolute prohibition on limited scope opinions.[15] Because a third-party inducement opinion is typically designed to provide comfort on one or more specific issues (rather than educate the addressee as to all potential tax issues and consequences), it would be a limited scope opinion. This means that, if it is a marketed opinion, it is crucial to avoid covered opinion status. Unfortunately, the disclaimer that transforms what would otherwise be a marketed opinion into a noncovered opinion does not fit very neatly into

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[13] I.R.C. § 355(e).

[14] See infra text accompanying notes 184–200.

[15] See infra text accompanying notes 251–60.

the context of third-party inducement opinions. These issues are discussed in greater detail below.[16]

D. *The Disclosure Opinion*

Third-party inducement opinions typically arise in the context of private negotiations between parties. For example, Party A may want to take some action that he can only do, by contract, if he provides Party B with a tax opinion. As another example, Party A asks Party B to do something; Party B, unsure of whether the action he is being asked to take will trigger a specific, and potentially adverse, tax result, asks A to buy him some comfort (in the form of a legal opinion) as a condition to doing what A asks.

Sometimes, a person (typically a corporation, partnership, or other legal entity) will ask a large number of persons to do something, not in the context of direct negotiations, but in the context of a more general solicitation. Several common contexts in which this arises are as follows:

- A company seeks approval from its shareholders or members for an extraordinary transaction, typically by issuing a proxy statement;
- A company offers to sell its stock, membership interests, notes, or other financial instruments, typically by means of some form of prospectus or offering memorandum;
- A company launches a tender offer to acquire its own stock or that of another company.

Sometimes, more than one of these scenarios may arise in the same transaction. For example, where two corporations merge and part or all of the consideration consists of stock of

[16] See infra text accompanying notes 192–200.

the surviving corporation, the documentation may include a proxy statement (possibly two, if shareholder approval is required for both companies) whereby shareholders are asked to approve the merger, as well as a prospectus or other offering document with respect to the stock being issued. These multiple functions may or may not be embodied in the same document.

The common theme in these types of transactions is that the proxy statement, offering memorandum, offer letter, or other document that solicits the requested action typically contains a general discussion of the tax consequences. The tax advisor to the person soliciting the action—who, more often than not, has actually prepared the disclosure language—may be asked to stand behind the accuracy of the disclosure with a formal opinion.

This fact pattern raises somewhat different issues from the perspective of the tax advisor delivering the opinion than the type of third-party inducement opinion discussed above. Moreover, the issues differ significantly depending on whether the solicitation document is filed with the SEC."[17]

In the case of documents that are not filed with the SEC, very often there is no formal opinion issued at all. Although drafted by the tax advisors, the disclosure may speak as a communication from the company that issues it, without attribution to a tax advisor.

In some cases (*e.g.*, a private placement of stock or debt instruments) the placement agent may request a "10b-5 opinion," which basically affirms that, to the advisor's knowledge, the document does not contain any untrue statements of material fact, and that the advisor is not aware of any material facts that are not stated and would be necessary in order to make the

[17] Note that, in many cases, the form and content of the tax disclosure itself in a document that is not filed with the SEC, such as a private offering memorandum, may not differ significantly from that in an SEC-filed document. The differences relate to the legal opinion (if any) rendered by counsel to "expertize" the disclosure.

disclosure, in light of the circumstances, not misleading,[18] and the 10b-5 opinion may encompass the tax disclosure. However, this type of opinion is far weaker than a substantive tax opinion, which affirmatively concludes that specified tax consequences will ensue from the transaction.

If an opinion is issued in connection with disclosure in a document that is not filed with the SEC, it is likely to be a potential marketed opinion under the Circular 230 written advice rules.[19] In most cases, practitioners seek to avoid marketed opinion status by including a disclaimer.[20]

Very different considerations arise where tax disclosure comprises part of a proxy statement, registration statement–prospectus, or other document filed with the SEC. First, the good news: In most cases, an SEC-filed opinion is, per se, exempt from the covered opinion rules of Circular 230, and no disclaimer is necessary.[21]

The bad news is that in many cases, the SEC requires a formal opinion with respect to tax disclosure and seems to have gotten more aggressive over time regarding what the opinion has to cover. Moreover, the time at which the opinion is required to be issued (generally, at the time a registration statement goes effective) and the scope of what the opinion has to cover raise a number of difficult issues for the practitioner. In the author's view, these problems are often exacerbated by SEC reviewers who sometimes make arbitrary demands without an adequate

[18] The reference is to Rule 10b-5 promulgated by the SEC, which, in part, declares it unlawful, in connection with the purchase or sale of any security, "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10h-5 (2010).

[19] *See infra* text accompanying notes 184–200. Because the Circular 230 written advice rules apply to *all* written advice, marketed opinion issues can arise whether or not a formal opinion is rendered. Although this Article is limited to formal tax opinions, it is noted that, in the interest of caution, many practitioners include a three-part marketed opinion disclaimer (*see infra* text accompanying note 187) in all tax disclosure that is not filed with the SEC, whether or not it is attributed to, or otherwise refers to, the advisor.

[20] *See infra* text accompanying note 187.

[21] *See infra* text accompanying notes 208–09. In those unusual situations where an SEC-filed opinion is *not* exempt per se (*i.e.*, listed transactions and principal purpose transactions), a disclaimer would not help anyway.

understanding of the substantive tax issues. Opinion issues in the context of SEC disclosure are discussed in detail below.[22]

E. *The Penalty Protection Opinion*

If this Article had been written some years ago, it is likely that protecting taxpayers against possible penalties would have been near the top of the list of functions. In the not-so-distant past, writing opinions that clients expected to rely on to avoid possible civil penalties was a fairly common activity for many practitioners. Over the years, regulatory[23] and statutory[24] developments have reflected a trend towards limiting the circumstances in which an opinion can be an effective defense against the imposition of a penalty. In addition, in 2004, Treasury completely revamped, and substantially broadened the scope of, the Circular 230 rules governing written tax advice. As discussed in greater detail below,[25] Circular 230 generally divides the world of written tax advice into "covered opinions" and all other written advice.[26] Covered opinions must comply with rather onerous and detailed formal and substantive rules. Because a covered opinion is a nuisance for a practitioner to write, and expensive for a client to obtain, most practitioners try to avoid them except when necessary. Moreover, in many cases, although not always,[27] an opinion that would otherwise be subject to the covered opinion rules can be excluded from those rules by including a disclaimer that states that no person may rely on the opinion for purposes of avoiding penalties. In an attempt to take advantage of this rule, many

[22] *See infra* text accompanying notes 408–32.

[23] *See, e.g.*, T.D. 8381, 1992-1 C.B. 374 (amending regulations under sections 6662 and 6664); T.D. 8617, 1995-2 CB. 274 (amending regulations under sections 6662 and 6664);

[24] See section 812 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 [hereinafter AJCA2004], amending sections 6662 and 6664, and adding section 6662A; and section 1409 of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152 [hereinafter Recon 2010], adding sections 6662(b)(6), 6662(i), and 6664(c)(2).

[25] See *infra* text accompanying notes 150–53.

[26] *See* 31 C.F.R. § 10.35 (2010).

[27] This is a point that many practitioners overlook. See *infra* text accompanying notes 217–18.

practitioners have taken to including the disclaimer on all written communications as a matter of course. What this means is that, unless a client specifically requests—and is willing to pay for—an opinion that is designed to protect against penalties, any opinion that he gets is likely to state specifically that it cannot be relied on for that purpose.

Nonetheless, there are still occasions when a tax practitioner is called upon to render an opinion for the purpose of insulating a client against possible penalties. Because such an opinion cannot include the no-reliance disclaimer, it will, in almost all cases, have to comply with the covered opinion rules. In addition, in order for it to achieve the client's purpose, it must comply with the rather torturous rules under sections 6662 and 6664 and a body of case law, which address when a legal opinion will provide a defense to an asserted penalty.[28] A detailed discussion of considerations in preparing penalty protection opinions is provided below.[29]

F. *The FIN 48 Opinion*

In June 2006, the Financial Accounting Standards Board issued Interpretation Number 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), which provides guidance on when a company that issues GAAP financial statements can recognize, for financial accounting purposes, a tax benefit where there is some uncertainty as to whether the benefit would ultimately be sustained.[30] In general, FIN 48 requires a company to undertake a two-part analysis with respect to each uncertain tax position.[31]

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[28] I.R.C. §§ 6662, 6664.

[29] See infra text accompanying notes 433–527.

[30] FIN. ACCOUNTING STANDARDS BD., FASB INTERPRETATION NO. 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, AN INTERPRETATION OF FASB STATEMENT NO. 109, at 1 (Fin. Accounting Ser. No. 81-B, June 2006). In 2010, the Service announced new rules that would require some taxpayers to identify, on their tax returns, positions for which a FIN 48 reserve is reflected in their financial statements. *See* Prop. Reg. § 1.6012-2(a)(4), 75 Fed. Reg. 54,802 (2010); Announcement 2010-9, 2010-7 I.R.B. 408; Announcement 2010-75, 2010-411. I.R.B. 432; Schedule UTP (Form 1120) (released September 2010); Instructions for Schedule UTP (Form 1120).

The first step of the analysis determines whether any portion of the claimed tax benefit can be recognized at all. The standard here is "more likely than not"; that is, in order to recognize, for financial statement purposes, a tax benefit with respect to which there is some legal or factual uncertainty, the company must conclude that, on its merits, the position would more likely than not be sustained.[32] In making this determination, the company is required to assume that the position will be examined by the relevant taxing authority and that such taxing authority has full knowledge of all relevant facts.[33]

If the "more likely than not" standard is *not* satisfied, the inquiry ends; the company cannot book any portion of the uncertain item.[34] If the company concludes that the item *is* more likely than not to be sustained, however, that does not necessarily mean that the company can book the entire amount. Instead, the analysis moves on to the second stage, which determines the *amount* of the tax benefit that can be recognized.[35] The standard here is that the company must assess possible outcomes if the item were challenged and determine the largest amount that is more likely than not to be realized upon settlement with a taxing authority.[36] Here again, the company must assume that the taxing authority has full knowledge of the facts. Thus, for purposes of this analysis, the risk of being challenged by a taxing authority and the possibility that an examining agent will miss relevant facts is taken off the table; however, the expected

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The author of this Article is not a CPA and claims no expertise in financial accounting. The discussion of FIN 48 presented here is for background purposes only, in connection with the discussion of practical issues faced by a lawyer who is asked to render an opinion as to the merits of a tax issue to assist his client in undertaking its analysis under FIN 48.

[31] FIN. ACCOUNTING STANDARDS BD., *supra* note 30, at 11.

[32] *Id*. at 2–3.

[33] *Id*.

[34] *Id.* at 3.

[35] *Id*.

[36] *Id.* at 3–4

assessment of litigation risk by each party, as a crucial factor in settlement negotiations, *is* taken into account.

From time to time, a tax advisor may be asked to render an opinion for the purposes of assisting a client in the client's FIN 48 analysis of a particular issue. Note that it would presumably *not* be appropriate for a tax lawyer to render a conclusory opinion that an item can be recognized for financial accounting purposes (or as to the amount of an item that can properly be so recognized); such an opinion would represent a conclusion not as to a matter of tax law, but as to a matter of accounting practice. However, it is within a tax lawyer's province to render an opinion regarding a matter of tax law, the conclusion of which would form the predicate for the financial accounting treatment under FIN 48.

With respect to the first stage in the FIN 48 analysis, the matter is straightforward. In order to get over the first-stage hurdle, a company must reach a conclusion that the uncertain position is more likely than not to be sustained. Although FIN 48 does not state that the mere receipt of an opinion per se satisfies the requirement, it stands to reason that a legal opinion directly addressing the point and reaching a "more likely than not" conclusion would provide strong support for the company to conclude (and, if necessary, to persuade its auditors of the reasonableness of its conclusion) that the "more likely than not" standard is satisfied. The requirement of FIN 48 that, for this purpose, full knowledge of the facts by the taxing authority is assumed, is perfectly consistent with standard opinion practice, and is also consistent with the requirements of the Circular 230 written advice rules.[37]

Thus, assuming he is comfortable with the substantive conclusion of law, there appear to be no particular difficulties in a tax advisor rendering an opinion that would be useful to a client

[37] *See infra* text accompanying notes 245, 279–81.

in reaching the conclusion required by the first stage of the FIN 48 analysis. Although there would not appear to be any particular formal requirements for such an opinion, an opinion that sets forth its reasoning is likely to carry more weight (particularly if there comes a time when it is necessary to persuade the company's auditors of the reasonableness of the conclusion) than a "short-form" opinion that simply states the conclusion with no analysis or legal reasoning.[38]

The second stage of the FIN 48 analysis presents some additional difficulties. As discussed below, the Circular 230 written advice rules preclude a tax advisor from issuing any written advice (whether or not it is a covered opinion) that "takes into account" the possibility that (1) a return will not be audited, (2) the issue will not be raised, or (3) the issue will be resolved through settlement.[39] While the FIN 48 analysis requires (consistent with the first two parts of the Circular 230 prohibition) an assumption that an issue be examined by the relevant taxing authority, the second stage of the analysis specifically requires an assessment of the likelihood of possible settlement outcomes.[40] Presumably, this analysis would take into account factors such as the likely perception by both parties of litigation risk, as well as an assessment of whether the taxing authority would be likely to view the issue as a sufficiently high priority to expend resources in litigation. It is difficult to see how an advisor can provide much guidance to assist a client in this endeavor without "taking into account" the possibility of resolving the issue by settlement.

As a practical matter, in the author's experience, when a client requests an opinion for purposes of assisting in a FIN 48 analysis, the opinion requested tends to be a "more likely than not" opinion for purposes of the first stage of the analysis. In the event an opinion is requested in

[38] On long-form versus short-form opinions generally, see *infra* text accompanying notes 364–65.

[39] See infra text accompanying notes 245, 279–81.

[40] FIN. ACCOUNTING STANDARDS BD., supra note 30, at 11.

connection with the second-stage analysis, the advisor should carefully consider the interplay with the Circular 230 written advice rules in assessing what is permissible.

G. *The Reporting Opinion*

Sometimes, a tax advisor may be asked to render an opinion as to the proper tax reporting of a completed transaction. If the client wants the opinion to provide penalty protection, such an opinion would also call into play the considerations related to penalty protection opinions, discussed above.[41] Regardless of whether such an opinion also functions as a penalty protection opinion, advising on the reporting of a completed transaction potentially could result in the advisor being treated as a tax return preparer with respect to the issue that is the subject of the opinion.[42] Therefore, any advisor who is asked to render an opinion with respect to reporting of a completed transaction needs to be familiar with the rules governing tax return preparers in order to avoid possible imposition of preparer penalties. The preparer rules are discussed in greater detail below.[43]

III. COMFORT LEVELS

Most issues that arise under the tax laws do not have a clear-cut answer. For this reason, tax practitioners have developed a wide range of different terms to describe various levels of comfort that a particular position will or will not be sustained.[44] These terms are used to describe the conclusion in a formal opinion; less formally, they may be used as a general shorthand to

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[41] See supra text accompanying notes 23–29.

[42] In general, advice given with respect to a transaction that has not yet occurred at the time the advice is rendered will not cause the person rendering the advice to be treated as a preparer. Advice rendered after such transaction may cause the advisor to be a preparer if the item or items at issue comprise a substantial portion of the return, subject to a *de minimis* rule where an advisor who provided pre-transaction advice also provides a small amount of post-transaction advice. Under certain circumstances, pre-transaction advice can be taken into account if it was timed primarily to avoid preparer Status. Reg. § 301.7701-15(b)(2). *See infra* text accompanying note 298.

[43] *See infra* text accompanying notes 286–321.

[44] For an in-depth discussion of comfort levels in opinions (including a few levels that are not discussed here), see Jasper L. Cummings, *The Range of Legal Tax Opinions, with Emphasis on the "Should" Opinion*, 98 Tax Notes (TA) 1125 (Feb. 17, 2003).

describe an advisor's overall level of comfort with a position. Thus, for example, an advisor might say to his client, "I'm at a 'should' level on this one," implying an overall comfort level that is consistent with rendering a formal opinion that the position at issue "should" be sustained (whether or not a formal opinion to that effect is actually requested or rendered). Particularly in the context of formal opinions, tax advisors tend to be quite precise as to the particular term they choose; in practice, the terms are most certainly not interchangeable.

Some of these terms, such as "substantial authority" and "more likely than not," have their origins in specific statutory or regulatory provisions. In these cases, the existence or nonexistence of a specified level of authority may have specific legal consequences, such as whether or not a penalty is applicable, and in addition, there may be a body of law interpreting what the term means.[45] In other cases—for example, "will" and "should"—the terms are not creatures of statute, but a more or less common understanding among practitioners has developed as to what the terms mean.[46] In the case of opinions rendered at these levels, there is no specific legal consequence to the particular level (although, if the opinion is intended to satisfy a contractual condition, the contract will generally specify the minimum acceptable level). In these situations, the comfort level at which an advisor is expected to render an opinion tends to be driven by what has become customary in the market for the particular type of transaction.

A. *"Will"*

The highest level of comfort embodied in a tax opinion is the statement that a particular consequence "will" ensue. A legal opinion is not an insurance policy,[47] and in theory, a judge

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[45] *See infra* text accompanying notes 57–99.

[46] Although, to be sure, not all advisors are in agreement as to precisely what is implied by some of these terms. *Cf.* LEWIS CARROLL, THROUGH THE LOOKING GLASS AND WHAT ALICE FOUND THERE 117 (Harper & Brothers Publishers 1902) (1871) ("When I use a word ... it means just what I choose it to mean—neither more nor less.").

[47] *See generally* Sterba, *supra* note 1, §§ 12.2, 12.3, 12.12.

could decide anything, so such an opinion stops short of a guarantee of absolute certainty; but, as a practical matter, the "will" opinion is as strong as it gets.[48] In the author's view, a "will" opinion is consistent with a conclusion that there is no material risk of being wrong. Put another way, it represents a level of comfort such that if public disclosure were prepared on the issue, it would not be necessary to disclose the risk of being wrong.[49]

In practice, the "will" opinion is most often seen in the context of specific types of transactions where the market has come to expect it. For example, "will" opinions seem to be the most common comfort level for reorganization acquisitions of public companies,[50] and are also often seen in the context of opinions on the characterization of some types of financial instruments.

In practice, "will" level opinions are often easy to give. It is, of course, necessary to take care that the transaction is implemented correctly, but if a transaction is potentially in a "will" world at all, there are probably no troublesome legal issues that would cause worry about whether one is really there or not.

Frequently, "will" level opinions are delivered as "short-form" opinions, which state the conclusion without describing the legal analysis. Presumably, the theory is that if the advisor can get to a high enough comfort level to render the opinion at all, the analysis is likely to be so straightforward that adding several pages of reasoning would add nothing of value.[51]

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[48] *See* Cummings, *supra* note 44, at 1132 ("The 'will' opinion is the clean or unqualified opinion of near certainty, or as certain as things can be in the tax world.").

[49] This seems to be consistent with the way the SEC interprets the term; in the author's experience, SEC-filed disclosure that characterizes a conclusion in any way other than "will" is likely to elicit a comment demanding additional disclosure of why the conclusion might be wrong and what would happen if it were.

[50] *Cf.* Jasper L. Cummings, *Reorganization Tax Opinions*, 96 TAX NOTES TODAY 186-81 (Sept. 23, 1996). On the other hand, the author has upon occasion seen public reorganizations that closed on "should" opinions.

[51] *See infra* text accompanying notes 364–65.

B. *"Should"*

The use of the term "should" in the context of legal opinions seems, on its face, a bit odd. In common parlance, "should" implies a normative judgment. A legal opinion that concluded that something "should," in this sense, be the law would be useless.[52] A client does not care what his lawyer thinks about what the law "should" be in some perfect world; he needs a professional prediction of his chances of winning based on the law as it actually exists. Presumably, rendering a "should" entails making such a prediction, notwithstanding the use of normative, rather than predictive, terminology.

Nonetheless, the "should" opinion is here to stay, and as used by most practitioners, it tends to imply a reasonably high level of confidence that the position will be sustained—significantly higher than "more likely than not"—but allows for a not insignificant risk of being wrong. This standard seems rather vague, and the exact level of authority required to render a "should" opinion is probably among the least well-defined of the various levels. There is a fairly wide range of transactions in which an advisor easily reaches "more likely than not," and equally easily concludes that he will not get to "will," leaving him to think long and hard about whether he can make the jump to "should."[53]

Despite (or possibly because of) their vagueness, "should" opinions are seen in a wide range of contexts. Some of the more common include the following:

- Prior to the issuance of Rev. Proc. 2003-48 in June 2003, most spin-offs under section 355 were done on the basis of a private letter ruling rather than an opinion of counsel. In Rev. Proc. 2003-48, the Service announced a no-ruling policy on

[52] One is reminded of the ancient vaudeville routine in which a doctor makes a snide comment about his patient's taste in clothing (or something else equally irrelevant to a medical diagnosis), prompting the patient to demand a "second opinion"—whereupon the doctor obliges with yet another judgmental, and equally irrelevant, comment.

[53] *See generally* Cummings, supra note 44.

the "device" and business purpose requirements for a tax-free spin-off, effectively forcing counsel to render opinions where rulings had formerly held sway.[54] However, the inherently vague nature of the device and business purpose doctrines makes it extremely difficult to render a "will" level opinion on these issues.[55] As a result, it seems to have become common practice to close spin-offs (particularly those involving public companies) on the basis of "should" opinions.

- As noted above, reorganization acquisitions of public companies are most often done on the basis of "will" opinions. However, sometimes there will be a legal issue where the law is not quite clear enough to get to "will." In these cases, reorganizations have sometimes been done on "should" opinions.
- In the context of comfort opinions on all sorts of transactions, clients typically would like the strongest opinion that their counsel can deliver. If a transaction is so clear-cut that it allows an advisor to get to a "will" opinion, it probably would not justify getting a comfort opinion in the first place. Some taxpayers prefer only to do transactions with respect to which counsel can get to "should." The bottom line is that "should" comfort opinions are fairly common.

C. *"More Likely than Not"*

Compared to the vague and normative-sounding "should," "more likely than not" sounds terribly precise. For one thing, the language itself is consistent with a prediction as to the likelihood of something happening (*i.e.*, the position being sustained), unlike "should," which, as discussed above, sounds more normative than predictive. For another, the degree of likelihood implied by the term is probably the most precise of all comfort levels. Tax lawyers are

[54] Rev. Proc. 2003-48, 2003-2 C.B. 86.

[55] *See* Robert P. Rothman, *Back to the Bog: The IRS's New Policy on Spin-Off Rulings Leaves Practitioners with a Sinking Feeling*, 30 CORP. TAX'N 3, 4–5 (Sept.–Oct. 2003).

notoriously, and understandably, reluctant to try to quantify what their comfort levels mean,[56] but it is hard not to say that "more likely than not" means a greater than 50% chance.[57]

Nonetheless, the term may be deceptively simple. In some situations, issues can arise as to the practical application of "more likely than not." One situation where an issue can arise is where the weight of authority, as between two possible outcomes, is almost evenly balanced. There are two schools of thought concerning this situation. One school of thought reasons that, for any proposition of law, either that proposition or its converse must be more likely than not correct, and goes on to conclude that it should therefore *always* be possible to render a "more likely than not" opinion on one side or the other of a binary issue. According to this school of thought, if a practitioner has any doubt about whether he can render an opinion that the consequences of a particular transaction will more likely than not be *X*, he need only ask himself if he could render an opinion that the consequences would more likely than not be something other than *X*; if the answer to that question is negative, he can always give the *X* opinion.

Other practitioners, however (and the author admits to an inclination to this way of thinking) believe that the logically unassailable proposition that "either *X* or *Not X* must more likely than not be true" does not necessarily imply that "therefore, I can always render an opinion that either says '*X* is more likely than not true' or '*Not X* is more likely than not true." That conclusion requires an additional premise: namely, that it is always possible, on the basis of whatever legal authority exists, for a practitioner to decide which of the two possible outcomes he believes to be, more likely than not, the correct answer. Practitioners of the second school allow for the possibility that there can exist issues that are simply too close to call. "While it may be true that, in some abstract sense, one conclusion or the other is "more likely than not"

[56] *See infra* text accompanying note 135.

[57] If there were any doubt as to this interpretation, it is (parenthetically) confirmed by Regulation section 1.6662-4(d)(2).

correct, that does not necessarily mean that there always exists a basis (in the form of legal authority or reasoning) on which to decide.

Put another way, granted that we are working in the world of probabilities rather than certainties, the first school assumes that a practitioner can always determine what he believes the probabilities to be, whereas the second school believes that a practitioner may run into situations where all he can say is "I just don't know." Fortunately, cases that are close enough for this difference of opinion to matter are rare.[58]

Another noteworthy aspect of the "more likely than not" standard relates to its application to nonbinary situations. Unlike the binary scenario, where the issue is one of lack of an adequate legal basis on which to formulate a conclusion, this case raises more fundamental issues as to what the "more likely than not" standard really means.

For example, consider a situation in which there are three possible characterizations for a transaction; the practitioner's best assessment is that two of the possible outcomes are each 30% likely and that the third possibility has a 40% likelihood of being determined to be correct. Under these circumstances, the problem is not that the likely outcome is too close to call; the practitioner might feel quite confident that, of the three possibilities, the third is the most likely outcome. Rather, the difficulty is that, literally, the practitioner's assessment of even the most likely outcome falls short of the standard, inherent in the words and confirmed by regulations, that "there is a greater than 50% likelihood of the position being upheld."[59]

[58] A related, but analytically distinct, issue can arise when a practitioner is able to formulate a belief as to which of two outcomes he believes is more likely than not correct, but his confidence level is just barely enough to reach that conclusion. In that case, practitioners may differ on whether they would always be prepared to place their belief on the line in the form of a formal opinion. Ultimately, this is a question of the individual advisor's tolerance for risk, although some might argue that a practitioner who is able to reach a conclusion (even just barely) as to which of two possible outcomes is more likely than not correct has a responsibility to his client always to render a formal opinion to that effect, if requested.

[59] Reg. § 1.6662-4(d)(2).

It is instructive to compare the "more likely than not" standard to the approach used for financial accounting purposes under the second prong of the FIN 48 standard.[60] Under that approach, for purposes of determining the amount of a tax benefit that can be reflected in financial statements, each of the possible outcomes is identified and a probability is assigned to each. Based on that table of probabilities, the largest amount of benefit that has a greater than 50% chance of being recognized (based on the cumulative probabilities of that and all "better" outcomes) is taken into account.[61]

This cumulative approach eliminates the necessity of identifying a single outcome that has a greater than 50% chance of being determined to be correct, a standard that might well be impossible to satisfy in nonbinary situations. Unfortunately, this approach does not lend itself very well to application in the context of legal opinions. The reason is that, in the FIN 48 context, the issue is the amount of tax benefit that would be realized by a specific taxpayer.[62] For each possible legal characterization, it is possible to calculate the amount of tax benefit that would result from the characterization (taking into account the taxpayer's overall tax picture). Thus, the "outcomes" to which probabilities are assigned are numbers representing such amounts. In this context, once probabilities have been assigned, it is a purely mechanical exercise to identify an outcome that, together with all "better" outcomes, has a cumulative probability of greater than 50%. There is no issue as to what "better" means; a higher number, for this purpose, is per se better.

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[60] As discussed *supra* in the text accompanying notes 35–36, the second prong of the FIN 48 standard requires an assessment of possible settlement outcomes; the Circular 230 written advice rules specifically prohibit taking into account the possibility of settlement. A different aspect of the FIN 48 approach is considered here, namely, the notion of considering the *cumulative* likelihood of a given outcome and all "better" outcomes. This aspect is independent of whether the "outcomes" that are considered are the result of a settlement.

[61] *See* FIN. ACCOUNTING STANDARDS BD., *supra* note 30, Appendix A21–A22.

[62] *Id*. at 2–3.

In the context of legal opinions, it is more difficult (and may indeed be impossible) to apply an approach that looks at the cumulative probability of the outcome being tested and all "better" outcomes, simply because the outcomes themselves are defined not in terms of numbers, but in terms of legal characterizations and consequences. It is true that those characterizations and consequences will ultimately be reflected in a number, namely the amount of somebody's tax liability. However, it may not always be possible to determine which of multiple possible outcomes are "better" than the outcome being tested.

For example, if an issue relates to timing of an income item or deduction, a "better" characterization for one year will be a "worse" characterization for another year.[63] While the time value of money means that generally it is "better," from the taxpayer's perspective, to recognize income items later and deductions earlier, this is not always the case.[64] As another example, consider an opinion addressed to a taxpayer that is a pass-through entity, as to the character of some item of income. A conclusion that is better for some owners of the entity could well be worse for other owners. In any event, the application of a test that looks to the cumulative likelihood of a given outcome and all "better" outcomes is far less straightforward outside of the context of financial reporting (where the "outcomes" are defined simply as numbers).

Despite this difficulty, some practitioners are so troubled by the notion that it might be impossible to write a "more likely than not" opinion as to *any* of the possibilities that they believe some variation on the "cumulative probability" approach is appropriate.

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[63] Because of the treatment of deferred tax items for purposes of financial accounting, timing issues are less likely to come up at all in the FIN 48 context.

[64] For example, there could be circumstances where accelerating income (or deferring a deduction) could refresh a carryover that would otherwise expire).

In the author's view, the cumulative probability approach is not appropriate for purposes of writing a "more likely than not" opinion. For one thing, it is difficult to reconcile with the language of the regulation defining "more likely than not." In addition, the determination of which outcomes are "better" or "worse" than others would often require making predictions as to the likely effect of each possibility.[65] It is quite possible that the advisor may not have the information necessary to make such predictions; indeed, if the facts vary from taxpayer to taxpayer, there may not be a single answer to what is "better" or "worse."

Thus, in some situations, it may be impossible to write an opinion to the effect that any of the possibilities are more likely than not correct. While the possibility that there may exist an issue that is not susceptible of a "more likely than not" *opinion* is (at least to the author) not inherently troubling, what is troubling is the suggestion that, regardless of how a transaction is reported, a penalty could be imposed if the claimed position is ultimately determined not to be correct. This was more of a practical issue under the section 6694 preparer penalty as it existed after the amendments made by the Small Business and Work Opportunity Tax Act of 2007 (SBWOTA2007)[66] and before the retroactive amendments made by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (TEAMTRA2008).[67] As discussed below, under this version of section 6694, a preparer could be subject to a penalty for any nondisclosed position that was ultimately determined not to be correct, unless he reasonably believed that the

[65] These predictions are wholly apart from the prediction that is the subject of the opinion itself. For example, consider an opinion that addresses whether a particular item of income is properly treated as ordinary income, long-term capital gain, or a dividend. The "prediction" as to the likelihood that a court would determine each of these three characterizations to be correct is inherent in the opinion. Applying the "cumulative probability" approach would require making an additional prediction as to which potential characterization would be "better" or "worse" than others—a question as to which there may be no one correct answer.

[66] Pub. L. No. 110-28, 121 Stat. 112, 190 (2007).

[67] Pub. L. No. 110-343, 122 Stat. 3765, 3861 (2008).

reported position was more likely than not correct.[68] In the 30-30-40 situation discussed above (and possibly in the "almost 50-50" situation as well), literal application of this rule would lead to the somewhat absurd result that a preparer risked a penalty no matter what he did (absent disclosure). Fortunately, the TEAMTRA2008 amendments to section 6694 eliminated the issue in what was probably the most likely context for it to arise. However, there remain some circumstances in which "more likely than not" is relevant for penalty purposes, and in theory, the problem could arise in those contexts.[69]

It seems difficult to believe that the intention was to place preparers (or, for that matter, taxpayers) in such a no-win situation. In order to avoid this, in the context of penalties, as opposed to the context of writing a formal opinion, there would seem to be some justification for applying a more lenient standard.

Unfortunately, this approach is not totally satisfactory. As a practical matter, the most likely means of establishing a taxpayer's reasonable cause and good faith (particularly in the case of a complex issue) is likely to be an opinion of a professional tax advisor. Moreover, as discussed below, it may be difficult (or even impossible) for an advisor to write an opinion that can be relied on for penalty-protection purposes that is *not* at the level of at least "more likely than not."[70] Therefore, the concept that the "more likely than not" standard might be applied differently in the context of penalties than in the context of legal opinions could leave a gap, into which a taxpayer wishing to report on a multiple-outcome situation, and maybe even a close binary case, could fall.

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[68] *See infra* text accompanying notes 306–09.

[69] *See infra* text accompanying notes 77–81.

[70] *See infra* text accompanying notes 483–89.

There are a number of specific legal consequences to the "more likely than not" standard. These include the following:

- Under Circular 230, a "reliance opinion" is generally defined as written advice that concludes, at a level of "more likely than not" or higher, that one or more issues would be resolved in the taxpayer's favor.[71] Thus, under certain circumstances, an opinion at that level of comfort could fall under the covered opinion rules (subject to the ability to avoid such rules by means of a disclaimer) where it would not have been subject to the rules at a lower level of comfort.
- If an opinion is subject to the covered opinion rules, in general the opinion must *either* (1) reach a "more likely than not" conclusion as to each significant tax issue (as well as overall), *or* (2) explain why it cannot do so and include certain specified disclosures.[72] In the case of marketed covered opinions, the rules are more stringent: there is an absolute obligation to reach a "more likely than not" conclusion as to each significant tax issue (as well as overall). Thus, for a marketed opinion, if there is even one issue as to which the practitioner cannot get to "more likely than not," he is prohibited from rendering any opinion at all on any aspect of the transaction.[73]
- As discussed above, the first stage of the FIN 48 analysis requires a "more likely than not" conclusion.[74]
- Regulations impose minimum requirements that must be satisfied in order for an opinion to provide a possible mechanism to establish the reasonable cause-good

[71] *See infra* text accompanying note 177.
[72] *See infra* text accompanying notes 242–43.
[73] *See infra* text accompanying notes 251–54.
[74] *See supra* text accompanying note 30.

faith defense of section 6664(c) to avoid the imposition of the substantial understatement penalty[75] against a corporate taxpayer in connection with a tax shelter.[76] One of these requirements is that the opinion "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."[77]

- If the Service asserts a reportable transaction understatement penalty under section 6662A,[78] a taxpayer may be able to avoid the penalty by meeting the requirements of section 6664(d).[79] Among the requirements imposed by section 6664(d) is that the taxpayer must have reasonably believed that the claimed treatment was more likely than nor correct.[80]
- A tax return preparer who claims a position with respect to a tax shelter or reportable transaction may be subject to a penalty under section 6694 unless it is reasonable to believe that the position would more likely than not be sustained.[81]

D. *Substantial Authority*

There is "substantial authority" for a position if the weight of authorities in support of the position is substantial in relation to the weight of authorities supporting contrary treatment.[82] The standard is less stringent than "more likely than not," but requires more than a "reasonable basis."[83]

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[75] I.R.C. § 6662(b)(2) (discussed infra text accompanying notes 460–64).
[76] Reg. § 1.6664-4(f) (discussed infra text accompanying notes 490–98).
[77] Reg. § 1.6664-4(f)(2)(i)(B)(2).
[78] *See infra* text accompanying notes 499–517.
[79] *See infra* text accompanying notes 503–17.
[80] I.R.C. § 6664(d)(3)(C).
[81] I.R.C. § 6694(a)(2)(C).
[82] Reg. § 1.6662-4(d)(3)(i).
[83] Reg. § 1.6662-4(d)(2).

Regulations provide that a wide variety of different types of authority are taken into account in evaluating whether substantial authority exists. Significantly, "authorities" such as private letter rulings, technical advice memoranda, and general counsel's memoranda, which cannot technically be cited as precedent,[84] can nonetheless be taken into account when evaluating substantial authority.[85] Both favorable and contrary authorities are taken into account,[86] with the weight accorded to each dependent on its relevance, persuasiveness, type of authority, and in the case of some types of authority, age. There can be substantial authority, even in the absence of any decided cases or rulings on point, based on a well-reasoned construction of the applicable statutory provision.[87] The regulations specifically acknowledge the possibility that there can be substantial authority for more than one position.[88]

The substantial authority standard is a creature of statute and is relevant in specific circumstances for purposes of avoiding penalties. Those circumstances are as follows:

- One of the ways in which a taxpayer can avoid the substantial understatement penalty under section 6662(b)(2) (other than for a "tax shelter") is by establishing that there was substantial authority for the claimed position.[89]
- As noted above, minimum requirements must be satisfied in order for an opinion to provide a possible defense to the substantial understatement penalty for a corporate taxpayer in connection with a tax shelter.[90] One of those requirements—

[84] *See* I.R.C. § 6110(k)(3).
[85] Reg. § 1.6662-4(d)(3)(iii).
[86] Reg. § 1.6662-4(d)(3)(i).
[87] Reg. § 1.6662-4(d)(3)(ii).
[88] Reg. § 1.6662-4(d)(3)(i).
[89] I.R.C. § 6662(d)(2)(B)(i).
[90] *See supra* text accompanying notes 75–77.

in addition to the opinion itself being at the "more likely than not" level—is that there actually be substantial authority for the claimed position.[91]

- If the Service asserts a reportable transaction understatement penalty under section 6662A, a taxpayer may be able to avoid the penalty by meeting the requirements of section 6664(d). Among the requirements imposed by section 6664(d)—in addition to the requirement that the taxpayer have a reasonable belief that the claimed treatment was more likely than not correct[92]—is that substantial authority for the position actually exists.[93]
- One of the means by which a tax return preparer may avoid a possible penalty under section 6694, other than with respect to a "tax shelter" or reportable transaction, is to establish that there is substantial authority for the reported position.[94]

Significantly, each of the statutory and regulatory provisions under which "substantial authority" is directly relevant to avoiding a penalty looks to whether there is actually substantial

[91] Reg. § 1.6664-4(f)(2)(i)(A).

[92] *See supra* text accompanying notes 78–80.

[93] I.R.C. § 6664(d)(3)(B).

[94] I.R.C. § 6694(a)(2)(A). For a discussion of the history of this provision, see *infra* text accompanying notes 305–09.

In August 2010, the Treasury Department released proposed regulations that generally incorporate the section 6694 preparer penalty standards for purposes of the Circular 230 administrative rules applicable to those who advise on the reporting of transactions. Standards with Respect to Tax Returns and Documents, Affidavits, and Other Papers, 75 Fed. Reg. 51,713-01 (proposed Aug. 23, 2010) (to be codified at 31 C.F.R. § 10.34). Some commentators have urged the Treasury not to conform the administrative standard to that which applies under section 6694, at least for persons who are not technically "preparers" subject to the statutory penalty. *See, e.g.*, N.Y. State Bar Ass'n Tax Section, *Report on the Proposed Amendments to Circular 230 Relating to Standards with Respect to Tax Returns*, *in* 852 Practising Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin offs, Joint Ventures, Financings, Reorganizations & Restructurings 1235, 1241 (2008) [hereinafter NYSBA Preparer Report].

authority.[95] In other words, the Service, or a court reviewing the Service's determination, will make its own independent determination of whether there was substantial authority. If it determines that there was not substantial authority, the taxpayer's belief that there was, no matter how reasonable, is not relevant.[96]

What this implies is that, technically, a "substantial authority" opinion cannot function as a penalty protection opinion under sections 6662(d)(2)(B), 6664(d), or 6694(a)(2)(A). If it is determined that substantial authority did not exist, the taxpayer gains nothing under those sections by showing the Service or a court an opinion that led him to believe that it did exist.[97] A substantial authority opinion can, of course, function as a comfort opinion to provide the taxpayer with some comfort that, even if he loses on the substantive issue, he can still avoid a penalty based on substantial authority, but like any comfort opinion, the mere existence of the opinion will not help if the Service disagrees with the opinion's conclusion.

E. *Realistic Possibility of Success*

Although the phrase "realistic possibility of success" seems rather vague, regulations (no longer in effect) defined it quite precisely: a position has a "realistic possibility of success" if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such

[95] *Compare, e.g.*, I.R.C. § 6664(d)(3)(B) (which looks to whether substantial authority actually exists) *with* I.R.C. § 6664(d)(3)(C) (which looks to whether the taxpayer *reasonably believes* that his position was more likely than not correct). It is possible for the latter standard to be satisfied even if the Service or a court does not agree that, based on information available at the time of filing, the claimed position was more likely than not correct.

[96] In 1991, the Treasury Department specifically rejected a proposal to adopt a rule under which an opinion would automatically satisfy the "reasonable cause and good faith" exception to section 6664(c) where substantial authority existed for a position, and instead adopted a "facts and circumstances" approach. T.D. 8381, 1992-1 CB. 374.

[97] As discussed *infra* in the text accompanying notes 483–87, except in the case of a substantial understatement penalty imposed on a corporate taxpayer in connection with a "tax shelter," such an opinion may help in satisfying the "reasonable cause and good faith" standard of sections 6664(c)(1) and 6694(a)(3). Satisfaction of that standard would generally avoid an accuracy-related penalty or preparer penalty, except in the case of a reportable transaction (or, for purposes of the preparer penalty, a tax shelter).

person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained.[98]

The "realistic possibility" standard first appeared in ABA Formal Opinion 85-352 as a standard for the minimum level of support that an attorney should have in order to advise a client to claim a position in filing a return.[99]

The Omnibus Budget Reconciliation Act of 1989[100] adopted the realistic possibility standard for purposes of the preparer penalty under section 6694,[101] and regulations adopted under that version of section 6694 interpreted it as a one-in-three standard.[102] In 1994, the Treasury Department adopted the standard, including the one-in-three definition, as the administrative standard for return advice under Circular 230.[103] Subsequently, section 6694 was amended to impose a stricter standard,[104] and the provision of Circular 230 incorporating the "realistic possibility" standard was withdrawn.[105] Thus, it appears that, as of this writing, the only relevance of the "realistic possibility" standard is under ABA Formal Opinion 85-352.[106]

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[98] Reg. § 1.6694-2(b)(1) (as amended by T.D. 9436, 2009-3 I.R.B. 268); 31 C.F.R. § 10.34(d)(1) (as amended by T.D. 9359, 2007-2 C.B. 931).

[99] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 352 (1985).

[100] Pub. L. No. 101-239, 103 Stat. 2106 [hereinafter OBRA 1989].

[101] I.R.C. 6694(a)(l) (as amended by section 7732(a) of OBRA 1989 and prior to amendment by section 8246(b) of SBWOTA2007).

[102] *See supra* note 98.

[103] 31 C.F.R. § 10.34 (as adopted by T.D. 8545,1994-2 C.B. 415, amended by T.D. 9359, 2007-45 I.R.B. 931).

[104] *See infra* text accompanying notes 305–09.

[105] T.D. 9359, 2007-45 I.R.B. 931. As discussed *infra* in the text accompanying note 314, a replacement for the withdrawn provision has been proposed but is not yet final.

[106] For further discussion of ABA Formal Opinion 85-352 and its practical significance, *see infra* text accompanying notes 322–31.

F. *Reasonable Basis*

Regulations tell us that "reasonable basis" is a "relatively high standard," higher than "merely arguable" or "merely ... colorable."[107] Although the standard is lower than substantial authority, the regulations suggest that the analysis of whether "reasonable basis" is satisfied is based on the same types of authorities as those considered for purposes of substantial authority.[108]

In order to assess the relationship between "reasonable basis" and "realistic possibility," it is necessary to consider a bit of history. As noted above, the realistic possibility standard was introduced by ABA Formal Opinion 85-352.[109] Prior to that time, the ethical standard for attorneys, as interpreted by the ABA, was reasonable basis.[110] In explaining the reason for the change, ABA Formal Opinion 85-352 expressed a concern that "'reasonable basis' has been construed by many lawyers to support the use of any colorable claim ... to justify exploitation of the lottery of the tax return audit selection process."[111] Thus, the intention seems to have been to impose a stricter standard than reasonable basis, at least based on the manner in which reasonable basis was being interpreted at the time.

There seems to be a continuing sense among practitioners that, as between the two standards, realistic possibility is probably slightly higher (or, perhaps more appropriately now that reasonable basis has statutory significance[112] and realistic possibility does not, that

[107] Reg. § 1.6662-3(b)(3).

[108] *Id.*

[109] *See supra* text accompanying note 99.

[110] ABA Comm. on Prof'l Ethics, Formal Op. 314 (1965), superseded on this issue by ABA Formal Opinion 85-352, *supra* note 99.

[111] *Id.*

[112] *See infra* text accompanying notes 115–19.

reasonable basis is slightly lower).[113] It should be kept in mind, however, that the reasonable basis standard that the draftsmen of ABA Model Opinion 85-352 thought they were tightening up by substituting the realistic possibility standard was a lower reasonable basis than mandated by current regulations.[114] In light of this, the prevailing interpretation of reasonable basis as requiring something less than a one-in-three chance may not be totally unassailable.

Reasonable basis has significance in four contexts, three of which operate consistently:

- A taxpayer who is facing a substantial understatement penalty under section 6662(b)(2) (other than in connection with a tax shelter) can avoid the penalty if (1) he specifically discloses the position, and (2) there is a reasonable basis for the claimed treatment;[115]
- A preparer facing a possible preparer penalty under section 6694 (other than in connection with a "tax shelter" or reportable transaction) can avoid the penalty if (1) the preparer specifically discloses the position, and (2) there is a reasonable basis for the claimed treatment;[116]
- Proposed 31 C.F.R. § 10.34 effectively incorporates the section 6694 standards, which permit an advisor to advise a client to take a position on a return if (1) the

[113] *See, e.g.*, Cummings, supra note 44; NYSBA Preparer Report, *supra* note 94. *But see* Dennis J. Ventry, Jr., *Lowering the Bar: ABA Formal Opinion* 85-352, 112 Tax Notes (TA) 69 (July 3, 2006).

[114] *See supra* text accompanying note 108.

[115] I.R.C. § 6662(d)(2)(B)(ii). Alternatively, as discussed *supra* in the text accompanying note 89, the penalty can be avoided even without disclosure if there exists substantial authority.

[116] I.R.C. § 6694(a)(2)(B). Like the substantial understatement penalty imposed on taxpayers, the preparer penalty allows an alternative way out that does not require disclosure, if there is substantial authority. *See supra* text accompanying note 94.

Literally, the statute allows a preparer to claim the disclosure–reasonable basis defense only if the disclosure is actually made. This could create a problem for a preparer who advises on the treatment of specific items but does not prepare the overall return, since such an advisor will likely have no control over whether disclosure is actually made. Regulations provide that the disclosure requirement will be deemed to be satisfied, in the case of a nonsigning return preparer, if he advises the taxpayer (or, if applicable, another preparer) to disclose and documents that advice in his files. See Reg. § 1.6694-2(d)(3)(ii).

position is specifically disclosed, and (2) there is a reasonable basis for the claimed treatment.[117]

- For purposes of the negligence disregard penalty of section 6662(b)(1),[118] a taxpayer is not treated as negligent in claiming a position for which there exists a reasonable basis.[119]

As is the case for substantial authority,[120] the operative legal provisions that directly depend on reasonable basis all turn on whether a reasonable basis is actually found to exist, not on the taxpayer's belief, reasonable or otherwise.[121] Therefore, no opinion at the reasonable basis level can insulate the taxpayer from penalties, although it may assist in establishing "reasonable cause and good faith" (if applicable) and, in any event, can serve to give the taxpayer some comfort that penalties will not apply as long as disclosure is made.

G. *Not Frivolous*

Perhaps the lowest level at which there is some modicum of comfort as to a position (short of "a snowball's chance in hell") is that the position is "not frivolous." "Frivolous" was defined by regulations (no longer in effect) as "patently improper."[122]

In tax practice, the not frivolous standard seems to be most relevant where a lawyer is wearing his "advocate" hat,[123] as in the following examples:

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[117] Standards with Respect to Tax Returns and Documents, Affidavits, and Other Papers, 75 Fed. Reg. 51,713-01 (proposed Aug. 23, 2010) (to be codified at 31 C.F.R. § 10.34(a)). By incorporating the section 6694 standard, these proposed regulations would allow an alternative basis for advising a taxpayer to report, without disclosure, if a position is supported by substantial authority.

[118] *See infra* text accompanying notes 448–59.

[119] Reg. § 1.6662-3(b)(1).

[120] *See supra* text accompanying notes 95–97.

[121] Reg. § 1.6662-3(b)(3).

[122] Reg. § 1.6694-2(c)(2) (2008) (as amended by T.D. 9436, 2009-3 I.R.R. 268); *see also* Rev. Proc. 2010-1, 2010-1 I.R.B. 1, § 6.10 (for purposes of the no-ruling policy on frivolous issues, an issue is frivolous if it is "without basis in law or fact" or if it "asserts a position that courts have held frivolous or groundless").

- The rules of professional responsibility that apply to legal practice in general typically preclude attorneys from asserting frivolous positions. For example, Rule 3.1 of the ABA Model Rules of Professional Conduct (ABA Model Rules) provides that "[a] lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith agreement for an extension, modification or reversal of existing law."[124] Although the ABA Model Rules do not directly have the force of law, rules similar to or based on them have been adopted by the attorney licensing authorities in many states.[125]
- Tax Court Rules of Practice require practitioners to act "in accordance with the letter and spirit" of the ABA Model Rules, and presumably, incorporate by reference the prohibition on asserting frivolous positions.[126] Other courts are likely to have similar rules.[127]
- 31 C.F.R. § 10.34(b) provides that a practitioner may not advise a client (1) to take a position on a document, affidavit, or other paper submitted to the Service, or (2) to submit a document, affidavit, or other paper to the Service, if such position or paper is frivolous.[128] It appears that this provision is not intended to

[123] This was not always the case; prior to 2007, a practitioner was permitted to advise a client to report a transaction based on a comfort level as low as "not frivolous" if disclosure of the position was made on the return. (Alternatively, a practitioner could advise a taxpayer to take a position without disclosure if there was a "realistic possibility" of being sustained on the merits.) 31 C.F.R. § 10.34(a) (2007) (prior to amendment by T.D. 9359, 2008-22 I.R.B. 1031).

[124] MODEL RULES OF PROF'L CONDUCT R. 3.1 (2010).

[125] *See, e.g.*, N.Y. RULES OF PROF'L CONDUCT R. 3.1 (2009) (The New York Rules are identical to the ABA Model Rules language cited in text, except that they omit the specific reference to a good faith argument for an extension, modification, or reversal of existing law.)

[126] TAX CT. R. PRAC. & P. 201(a).

[127] *See, e.g.*, FED. R. CIV. P.11(b)(2).

[128] 31 C.F.R. § 10.34(b) (2010).

apply to tax return positions, which were the subject of a separate rule that was withdrawn in 2007.[129] Rather, the provision seems to apply primarily in the context of representing a taxpayer before the Service in connection with an audit or administrative appeal.

As a practical matter, the not frivolous standard does not come up very often in the context of formal opinions. An opinion at such a low level of comfort would not help a client very much, if at all, and might well do more harm than good (in effect helping the Service to establish that the taxpayer had reason to know just how weak the taxpayer's position was). One possible exception would be the rare case where an advisor is rendering advice to another attorney who is himself representing a taxpayer in connection with an audit, administrative appeal, or litigation. Since the latter attorney is generally restricted from asserting frivolous positions, he might seek comfort from his own counsel that a particular position is not frivolous.[130]

H. *Other Qualifiers*

Sometimes (particularly in the case of the higher levels of confidence) the terms used to describe the comfort level are modified by additional language, such as "although not free from doubt," "although no assurance can be given," or "although not entirely free from doubt."[131] There seems to be no consistent practice as to the use of such qualifiers or as to what, if anything, they really mean.[132]

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[129] *See* 31 C.F.R. § 10.34(a) (2007) (as amended by T.D. 9359, 2008-22 I.R.B. 1031). Although section 10.34(a) has not been replaced by final regulations, proposed regulations would specifically require a minimum standard of "reasonable basis" (and, in some cases, a higher standard) when advising on return positions.

[130] The author has never seen such an opinion, but it seems theoretically possible.

[131] *See generally* Sheldon I. Banoff & Richard M. Lipton, *Shop Talk, Tax Opinions: Weasel Words?*, 83 J. TAX'N 125 (1995).

[132] *Id*.

In general, a legal opinion is not an insurance policy; even a "will" level opinion does not guarantee absolute certainty.[133] Given this fact, is an opinion that states that certain tax consequences "will" ensue, "although the matter is not free from doubt," any different than one that simply states that the consequences "will" ensue? And is the opinion that says "not entirely free from doubt" any different than one that modifies the "will" with "not free from doubt"? A literal reading of the words suggests that there is not much, if any, difference, but some practitioners believe that some sort of qualifier connotes a slightly lower level of comfort than an unqualified "will," and that "not entirely free from doubt" smells a little stronger than "not free from doubt" (but not quite as strong as an unqualified "will"). The matter is one of personal preference, but any differences are very subtle. [134]

I. *The Numbers Game*

The hierarchy of comfort levels is often confusing to clients, who frequently press their counsel to quantify the level of risk represented by a particular comfort level. As tax lawyers, we do our best to resist this pressure. There are a number of reasons for this. We like to believe (or at least like to give the impression to our clients) that what we do is different than handicapping racehorses. In fact, the nuances involved in making judgment calls on these issues do not really lend themselves to odds-making; the use of numbers suggests a level of precision that is inconsistent with the basic process. Also, since, by definition, there can be no repeatability in a large number of independent trials, the concept of probability is not very meaningful. Finally, many lawyers (this author included) tend to think more in qualitative than in quantitative terms.

[133] It is often stated that a lawyer who renders an opinion as to the law of a jurisdiction where he is not admitted does become an insurer, see STERBA, *supra* note 1, § 12.9, although the case most often cited for that proposition does not really seem to hold that. Degen v. Steinbrink, 195 N.Y.S. 810 (1922), *aff'd*, 236 N.Y. 669 (1923).

[134] One has to wonder whether, if "not free from doubt" implies a weak "will," might it be long before somebody adds "and we really mean it!" to imply a strong "will"?

Nonetheless, if one were to put a gun to the heads of a large number of experienced tax lawyers[135] and demand that they quantify their comfort levels, chances are the answers would average out somewhere near the following:

Will	90-95%+
Should	70-75%
More Likely than Not	>50%
Substantial Authority	35-40%
Realistic Possibility of Success	33⅓
Reasonable Basis	20-30%
Not Frivolous	?

IV. THE REGULATORY FRAMEWORK

Regardless of the purpose of an opinion, and regardless of its comfort level, the practice of rendering opinions is potentially subject to several sets of rules. In order to ensure that he will not be subject to potential sanctions or penalties, a tax attorney must be familiar with these rules (in addition, of course, to the substantive rules of tax law that address the issue that is the subject of the opinion). The following is a discussion of the regulatory framework in which tax opinions are rendered.

A. *Circular 230 Written Tax Advice Rules*

In 2004, the Treasury Department released completely revamped versions of the rules governing written advice on tax issues, embodied in 31 C.F.R. §§ 10.35 and 10.37.[136] The effect

[135] The author wishes to assure all readers that the scenario described in the text is purely hypothetical, and that no tax lawyers were harmed in the preparation of this Article. Of course, some would argue that putting a gun to the heads of a large number of tax lawyers would be a good thing to do on general principles.

[136] These rules are not limited to formal opinions; they cover all written advice, from a formal opinion down to a quickly scribbled note or email communication. However, the issues addressed in this Article are generally limited to those that have relevance in the context of formal opinions.

of this cannot be overstated; virtually overnight, the environment in which tax lawyers prepare and render legal opinions changed dramatically.

To the layman, the most visible effect of this development was that, all of a sudden, every communication received from a tax lawyer began to include a boilerplate "Circular 230 Disclaimer." [137] There is far more to these rules, however, than simply adding some boilerplate.

1. Historical Background

The Treasury Department's authority to regulate persons who practice before the Department derives from 31 U.S.C. § 330(a)(1), which provides, in pertinent part, that "the Secretary of the Treasury may ... regulate the practice of representatives of persons before the Department of the Treasury.[138] Pursuant to this authority, Treasury has issued Circular 230, which provides rules governing a wide range of issues relating to practice before the Treasury.[139]

In 1984, Treasury amended Circular 230 by adding rules governing "tax shelter opinions."[140] Although far narrower in scope than today's rules, the tax shelter opinion rules were remarkable in one important respect: they regulated the form and content of advice that an attorney or other practitioner could give in connection with an area of the law that is administered by the Treasury Department, but in a context that does not involve the practitioner representing a client in any proceeding before the Treasury Department itself.[141] In other words, the Treasury Department interpreted 31 U.S.C. § 330 as authorization to regulate not only the conduct of practitioners in the context of representation in connection with ruling requests, tax

[137] The ubiquity of Circular 230 disclaimers has not gone unnoticed by the Service. *See* Sheryl Stratton, *IRS Considering Principle-Based Rules for Opinion Standards*, 2006 TAX NOTES TODAY 43–13 (Mar. 6, 2006).

[138] 31 U.S.C. § 330(a)(1) (2006).

[139] 31 C.F.R. pt. 10. Circular 230 addresses a wide range of topics, and includes the written advice rules as well as the administrative preparer rules discussed *infra* in the text accompanying notes 310–21. Colloquially, the term "Circular 230" is often used to refer specifically to the written advice rules.

[140] 49 Fed. Reg. 6719 (Feb. 23, 1984).

[141] *Id*.

audits, and administrative appeals, but to regulate communications by a practitioner that have nothing to do with the Treasury Department, except that the subject of the communication is tax.

Although this raised an obvious issue as to whether Treasury actually had the authority that it claimed, the author is not aware of any challenges to the rules on this ground. One reason for this may be that, due largely to substantive changes in the law in 1986, transactions of the type likely to be subject to the 1984 tax shelter opinion rules became far less prevalent.[142] Perhaps a more important reason, however, was the *in terrorem* effect: not many practitioners would be sufficiently confident that the rules were not valid that they would risk their licenses by intentionally violating them.

It took twenty years before two additional developments would change the world (or at least the rather narrow world in which tax practitioners live). The first such development was the enactment of the American Jobs Creation Act of 2004 (AJCA2004), which amended 31 U.S.C. § 330 to provide that

> [n]othing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.[143]

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[142] In general, the 1984 tax shelter opinion rules applied where a practitioner rendered tax advice that would appear or be referred to in offering materials or sales promotion efforts, as to the tax consequences of a transaction that had, as a significant and intended feature, (1) deductions in excess of income in any year, which would be available to reduce income from other sources, or (2) credits in excess of tax attributable to the investment in any year, which could be used against tax on other income. 31 C.F.R. § 10.33(c)(2)–(3) (2004) (as amended by T.D. 9165, 2005-1 C.B. 357). These rules were designed for "1980's-style" tax shelters; typically, in these transactions a group of investors would invest directly or through an entity in property (such as real estate or film rights) that would be acquired using a large amount of nonrecourse leverage. The intention was that the property would generate depreciation deductions, interest deductions, and/or tax credits that exceeded the taxpayer's investment and that could be used to reduce tax on other income. Largely as a result of the enactment of section 469 by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, this type of transaction largely disappeared.

[143] 31 U.S.C. § 330(d) (2006).

Interestingly, the legislative history of this provision characterized it as "confirming" existing authority, implying that, even in the absence of the amendment, Treasury had the authority to regulate written advice rendered outside the context of a proceeding before the Department (at least if the advice involved a potential tax-avoidance transaction).[144]

Regardless of whether Congress's characterization of the AJCA2004 amendment as merely confirming existing law was correct or was simply a self-serving attempt to enact a retroactive amendment, it seems clear that, under 31 U.S.C. § 330 as amended by AJCA2004, the Circular 230 tax shelter opinion rules in their 1984 form would be authorized. However, approximately two months after the enactment of AJCA2004, Treasury promulgated the new, and greatly expanded, Circular 230 written advice rules.[145] As discussed below, the new rules (or at least some of them) apply to all written tax advice.[146] Thus, unless one believes that *every* transaction has a potential for tax avoidance or evasion (which would effectively render the qualification in 31 U.S.C. § 330(d) meaningless), there is an argument that the new rules exceed Treasury's authority even after the confirmation (or extension) enacted by AJCA2004.

Again, however, the author is unaware of any practitioners who would stake their licenses on this argument (and this author most certainly does not recommend doing so).[147] The written advice rules have inspired a flurry of commentary, and there seems to be something of a consensus that Treasury has overreached in the level of its interference in communications

[144] *See* H.R. REP. No. 108-548, at 203 (2004).

[145] T.D. 9165, 2009-1 C.B. 357.

[146] *Id.*

[147] There is a story (perhaps apocryphal) of a distinguished probate lawyer whose last gift to the profession was to write his own will so as to raise a number of unanswered legal questions—an approach to drafting that would probably constitute malpractice if done on behalf of a client, but that set the stage for the issues to be litigated and hence answered for future generations. Perhaps somewhere there is a retiring tax lawyer who would be willing to write his last opinion in violation of the Circular 230 written advice rules, raising the issue of whether the rules are in fact authorizied.

between tax advisors and their clients.[148] There have been indications that Treasury may reconsider the basic approach of the rules,[149] but for now, the 2004 written advice rules are a fact of life.

2. *Basic Approach*

As now in effect, Circular 230 divides the world of written advice into two categories: covered opinions and everything else. Covered opinions must comply with detailed, and rather onerous, rules governing form and content.[150] An opinion other than a covered opinion is subject to a different, and far less onerous, set of rules.[151]

In practice, most practitioners try very hard to avoid "covered opinion" status wherever possible. It is for this reason that most practitioners have taken to including the Circular 230 disclaimer on all written communications as a matter of course.[152] In the author's view, every tax practitioner should write a covered opinion once in his professional life—and nobody should have to do so more than once.[153]

3. *What Is a Covered Opinion?*

The Circular 230 written advice rules define six categories of covered opinions:[154]

- Written advice concerning a listed transaction (or a transaction that is substantially similar to a listed transaction);

[148] See, e.g., NYSBA Preparer Report, supra note 94, at 1125; Robert A. Rizzi, Circular 230 and Current Opinion Practice: Two Years Later, 34 CORP. TAX'N 3 (2007); Deborah H. Schenk, The Circular 230 Amendments: Time to Throw Them Out and Start Over, 110 TAX NOTES (TA) 1311 (Mar. 20, 2006).

[149] *See, e.g.*, Stratton, *supra* note 137, at 62.

[150] 31 C.F.R. § 10.35(c), (e) (2010).

[151] 31 C.F.R. § 10.37 (2010).

[152] As discussed *infra* in the text accompanying notes 217–18, the disclaimer is not automatically effective to avoid covered opinion status in all cases—a point that many practitioners forget.

[153] Having already written one covered opinion, the author is safe under this rule.

[154] 31 C.F.R. § 10.35(b)(2) (2010).

- Written advice concerning a transaction of which *the principal purpose* is tax avoidance or evasion;
- Written advice concerning a transaction of which *a significant purpose* is tax avoidance or evasion, but only if the opinion is
  – a reliance opinion;
  – a marketed opinion;
  – subject to conditions of confidentiality; *or*
  – subject to contractual protection.

a. *Listed Transaction Opinions*. An opinion concerning one or more tax issues arising from a listed transaction (as defined in Regulation section 1.6011-4(b)(2)), or a transaction substantially similar to a listed transaction, is per se a covered opinion.[155] Neither a disclaimer nor anything else can avoid this result (unless one of the exceptions, discussed below, applies).[156]

A detailed discussion of listed transactions, and of the meaning of "substantially similar," is beyond the scope of this Article. It is noted, however, that, subject to possible issues on what "substantially similar" means in close cases, most of the time, if a practitioner is rendering an opinion on a listed transaction, he will (or certainly should) know it. Thus, the good news is that

[155] 31 C.F.R. § 10.35(b)(2)(A) (2010).
[156] *See infra* text accompanying notes 206–16.

a practitioner is not likely to have to face difficult judgment calls as to whether something is a listed transaction, with the risk of violating Circular 230 if he calls it wrong.[157]

b. *Principal Purpose Opinions*. An opinion concerning one or more tax issues arising from "any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion" of tax, is, per se, a covered opinion unless an exception applies.[158]

"The principal purpose" for a transaction is tax avoidance or evasion if that purpose exceeds any other purpose.[159] At the risk of oversimplifying a qualitative determination by trying to quantify it, consider a situation where a transaction is motivated 40% by a tax-avoidance purpose and 30% by each of two separate "good" (*i.e.*, non-tax-avoidance) purposes. Even though less than one-half of the taxpayer's overall motivation is tax avoidance, it would appear that this would nonetheless be the "principal purpose" of the transaction because the tax-avoidance purpose exceeds any other single purpose. However, a transaction is not a principal purpose transaction if the purpose is to claim tax benefits in a manner consistent with the statute and congressional purpose.[160]

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[157] The bad news is that if you are giving an opinion on a listed transaction, Circular 230 is probably the least of your problems. If the Service has identified something as a listed transaction, it almost always means that it has already (1) determined that the transaction is abusive; (2) determined, and publicly stated, that it intends to challenge it; (3) given serious thought to identifying every possible attack; and (4) committed to devoting significant resources to the fight. Aside from substantive difficulties in sustaining the taxpayer's position, treatment as a listed transaction (and hence automatically as a reportable transaction, *see* Reg. § 1.6011-4(b)(2)), calls into play a number of taxpayer-unfriendly procedural rules. From the taxpayer's perspective (1) a special disclosure statement must be filed with the return (Reg. § 1.6011-4(a)); (2) any understatement of tax resulting from the transaction is potentially subject to a 20% (or, if the disclosure statement is not filed, 30%) penalty under section 6662A, rather than the 10% accuracy-related penalty under section 6662; and (3) the standards for avoiding the penalty are more stringent. I.R.C §§ 6662A, 6664(d); *see infra* discussion in the text accompanying notes 499–517). From the advisor's perspective, the material advisor reporting, I.R.C § 6111, and list maintenance, I.R.C § 6112, rules are likely to come into play, and if the advisor is also a tax return preparer, it may be more difficult to avoid a preparer penalty. *See* I.R.C. § 6694(a)(2)(C).

[158] 31 C.F.R. § 10.35(b)(2)(B) (2010).

[159] *Compare*, 31 C.F.R. § 10.35(b)(10) (2010), *with* Reg. § 1.269-3(a) (interpreting "the principal purpose" as used in section 269).

[160] 31 C.F.R. § 10.35(b)(10) (2010).

As is the case for listed transaction opinions (and, as discussed below, significant purpose–conditions of confidentiality and significant purpose–contractual protection opinions), a principal purpose opinion is automatically and unavoidably a covered opinion (unless an exception applies).[161] However, unlike a listed transaction, whether a transaction is properly treated as a principal purpose transaction is not always clear-cut. Because this issue may well determine whether a disclaimer is effective (and hence whether the opinion must comply with the covered opinion rules), this means that a practitioner may face a difficult judgment call as to whether a transaction is a principal purpose transaction.[162] This is in addition to (but may be analytically related to) the substantive judgment call on the underlying legal issue. At stake is a potential violation of Circular 230, regardless of whether the underlying substantive legal conclusion is ultimately held to be correct.[163]

c. *Significant Purpose Opinions—In General*. As noted above, some (but not all) opinions that are in connection with a transaction that has "a significant purpose" of tax avoidance or evasion are covered opinions. Interestingly, Circular 230 does not define "a significant purpose."[164] The same term is used in the definition of "tax shelter" under section 6662(d) (2) (C)(ii), and also was used in the "confidential corporate tax shelter" rules of section

[161] 31 C.F.R. § 10.35(b)(2)(B) (2010).

[162] Although this Article is limited to formal opinions, it is noted that the uncertainty as to whether a transaction is a principal purpose transaction may be a greater practical problem in the case of informal written advice. For one thing, it is almost impossible for informal advice to comply with the requirements for a covered opinion, so that if such advice is rendered on what is ultimately determined to be a principal purpose transaction, a violation of the rules is virtually guaranteed. On the other hand, in some cases a formal opinion might well come close to complying with the covered opinion rules even if not specifically intended to comply, so that a practitioner rendering such an opinion based on a conclusion that it is not in connection with a principal purpose transaction might have a backup argument if his conclusion as to principal purpose is ultimately determined to be wrong. Moreover, a practitioner rendering informal advice might well give less thought to the issue, assuming the boilerplate disclaimer protects him.

[163] For a discussion of the consequences of noncompliance with Circular 230, *see infra* text accompanying notes 282–85.

[164] For a discussion of the significance of this, see Nathan Giesselman, *A Significant Problem Defining a "Significant Purpose" and the Significant Difficulties that Result*, 111 TAX NOTES (TA) 1119 (June 5, 2006).

6111 (d) in effect between 1997 and 2004.[165] Regulations under the latter section provide some guidance as to what the term might mean.[166]

The confidential corporate tax shelter regulations tell us generally[167] that a transaction is treated as having a "significant purpose" if it has been structured to produce tax[168] benefits "that constitute an important part of the intended results of the transaction,"[169] *unless* (1) the taxpayer enters into the transaction in the ordinary course of business in a form consistent with customary commercial practice, *and* (2) there is a generally accepted understanding that the expected tax

[165] Section 6111(d), prior to its repeal by section 815(a) of AJCA2004, *supra* note 24, defined certain transactions as "tax shelters" for purposes of the tax shelter registration rule of section 6111(a) as then in effect. Part of the definition referred to transactions "a significant purpose *of the structure of* which is the avoidance or evasion of Federal income tax." I.R.C. § 6111(d) (emphasis added). This seems to focus on the purpose for the particular structure chosen (as opposed to the purpose of the transaction itself). However, at the same time as section 6111(d) was enacted, the definition of "tax shelter" in section 6662(d)(2)(C)(ii), which previously used "the principal purpose" as its standard, was amended to substitute "a significant purpose" for "the principal purpose." As so amended, it is virtually identical to the definition of a "significant purpose" transaction in the Circular 230 written advice rules (which, on its face, appears to focus on the purpose for the transaction as opposed to its structure). The legislative history of the Taxpayer Relief Act of 1997, Pub L. No. 105-34, 111 Stat. 788, states that the purpose of this amendment was to conform the section 6662(d)(2)(C)(ii) definition of tax shelter to the newly enacted section 6111(d) definition. H.R. REP. No. 105-220 (1997) (Conf. Rep.). This suggests that Congress intended the two provisions to be interpreted consistently, notwithstanding the difference in language. What is not dear is whether the proper reading is to look at the purpose of the particular structure chosen (as suggested by the language of section 6111(d)), or the overall purpose of the transaction (as suggested by the language of section 6662(d)(2)(C)(ii) and 31 C.F.R. § 10.35(b)(2)(C) (2010)).

[166] Reg. § 301.6111-2. Note that regulations under section 6662(d) still reflect the pre-1997 version of that section, which used a standard of "the principal purpose" rather than the current standard of "a significant purpose." Reg. § 1.6662-4(g)(2). Thus, these regulations provide no guidance as to the meaning of the latter term.

[167] In addition to the general definition, under the confidential corporate tax shelter regulations a listed transaction was automatically treated as having a significant purpose of tax avoidance or evasion. Reg. § 301.6111-2(b)(2). Because an opinion with respect to a listed transaction is independently a covered opinion, *see supra* text accompanying notes 155–57, this part of the definition is largely irrelevant in interpreting "significant purpose" under the Circular 230 written advice rules.

[168] The confidential corporate tax shelter regulation only considered federal income tax benefits. Reg. § 301.6111-2(b)(3). Unlike the confidential corporate tax shelter rules, the tax-avoidance purpose under the Circular 230 written advice rules is not limited to income taxes, but covers any tax imposed by the Code. Thus, to the extent the confidential corporate tax shelter definition of "a significant purpose" is applicable in interpreting the written advice rules, presumably the "[f]ederal income tax" language of the regulation should be read as referring to all federal taxes under the Code.

[169] Reg. § 301.6111-2(b)(3). The confidential corporate tax shelter regulation also included a second element of the definition, namely that "the tax shelter promoter . . . reasonably expects the transaction to be presented in the same or substantially similar form to more than one potential participant." *Id*. This appears to be a function of the purpose and overall operation of the pre-2004 version of section 6111, which presupposes a transaction that is offered by a "promoter" who was required to register the type of transaction. Although, in form, the requirement that the transaction be offered to multiple potential buyers was embodied in the section 6111 regulations as part of the definition of "significant purpose," this part of the definition does not appear to have relevance in the context of the Circular 230 written advice rules.

benefits are properly allowable.[170] An exception was provided if the promoter (or other person potentially responsible for registering the transaction) reasonably determined that the Service would have no reasonable basis for a challenge to any significant portion of the tax benefits from the transaction.[171] Regulations also provided that the Service could determine that specific transactions were not covered, either by published guidance[172] or by private ruling.[173]

As a practical matter, in the author's experience, most practitioners do not spend a lot of time or energy trying to figure out what significant purpose means for purposes of the Circular 230 written advice rules (including worrying about whether, or how, the definition from the confidential corporate tax shelter regulations would apply in this context). Instead, it is generally taken for granted that the term is so vague that we do not really know what it means and that any transaction might be considered to have a significant purpose.[174] Fortunately, in this context, we usually need not face the issue squarely because there is another way out.[175] Of the four types of significant purpose opinions that are covered opinions, two (significant purpose–conditions of confidentiality opinions and significant purpose–contractual protection opinions) tend to be relatively rare and the other two (significant purpose–reliance opinions and significant purpose–marketed opinions) can generally avoid covered opinion status by including appropriate

[170] Reg. § 301.6111-2(b)(3).

[171] Reg. § 301.6111-2(b)(4)(i). "Reasonable basis" for this purpose had the same meaning as it has in applying the rules of section 6662 that consider whether a position had a "reasonable basis" in determining whether a substantial understatement penalty can be avoided. See supra text accompanying note 115.

[172] Reg. § 301.6111-2(b)(4)(ii).

[173] Reg. § 301.6111-2(b)(4)(iii).

[174] Speaking informally, Cono Namorato, the then-head of the Service's Office of Professional Responsibility, has acknowledged the overbreadth of the "significant purpose" definition. Stratton, *supra* note 137.

[175] Although we can usually avoid the need to make a "significant purpose" determination for purposes of the Circular 230 written advice rules, the issue must sometimes be squarely faced for purposes of sections 6662(d)(2) (*see infra* text accompanying note 462) and 6694(a)(2) (*see infra* text accompanying notes 301–02), since the standards for avoiding a substantial understatement penalty or a preparer penalty differ depending on whether or not the transaction is a "tax shelter" (which, as defined in section 6662(d)(2), incorporates the "significant purpose" standard). In practice, these issues are most likely to arise in the context of penalty protection opinions and reporting opinions.

disclaimers.[176] Thus, most practitioners just put a disclaimer on everything, except in the rare cases where they are writing (and their client has agreed to pay for) an opinion that satisfies the covered opinion requirements, and do not worry about whether a particular transaction might be viewed as a significant purpose transaction.

d. *Significant Purpose–Reliance Opinions*. Assuming a transaction has (or might be considered to have) a significant tax-avoidance purpose, an opinion with respect to that transaction is a reliance opinion if it concludes, at a level of at least "more likely than not," that one or more "significant federal tax issues" would be resolved in the taxpayer's favor.[177] An issue is "significant" if (1) the Service has a reasonable basis for a successful challenge, and (2) its resolution could have a significant impact, whether beneficial or adverse and under any foreseeable circumstance, on the overall federal tax treatment.[178]

There are three potential escape routes from reliance opinion status. Two are suggested by the elements of the definition of reliance opinion. First, if an advisor does not reach a comfort level of at least "more likely than not" on any issue that is the subject of the opinion, then the first element of the definition is not satisfied. However, if the "more likely than not" level is reached on even one issue, then the entire opinion is a reliance opinion, unless one of the other escape routes applies. While this escape route might theoretically be available in appropriate cases, one would not often try to take advantage of it. Generally, a practitioner serves his client best by writing the strongest opinion with which he feels comfortable; so if a practitioner is legitimately at "more likely than not" status on any issue, he would not want to downgrade his opinion just to escape reliance opinion status.

[176] *See infra* text accompanying notes 217–18.
[177] 31 C.F.R. § 10.35(b)(4)(i) (2010).
[178] 31 C.F.R. § 10.35(b)(3) (2010).

The second potential escape route relies on the definition of "significant tax issue." Rarely, one might believe the conclusion reached to be so inescapable that the Service would have no reasonable basis for a challenge as to any issue, in which case no issue addressed in the opinion is "significant."[179] Perhaps even more rarely, one might conclude that the resolution of any of the issues addressed by the opinion could not, under any foreseeable circumstance, affect overall tax treatment.[180]

In practice, it is rare indeed that any practitioner relies on either of these two escape routes. Fortunately, there is a better way. An opinion is exempt from the definition of "reliance opinion" if it contains prominent disclosure that the opinion was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties.[181] This is the standard "Circular 230 disclaimer" that has become ubiquitous on written communications relating to tax matters.[182]

The standard disclaimer is a useful tool, provided that the practitioner keeps in mind what it does and does not accomplish. The standard disclaimer works its magic by automatically excluding an opinion from the definition of reliance opinion. Therefore, it is effective to avoid covered opinion status *if the only reason why the opinion would otherwise be a covered opinion is because it would be a significant purpose–reliance opinion*. If an opinion falls into any of the

[179] According to one commentator, an unnamed "colleague" has suggested that "reasonable basis" is the flip side of a "strong should" comfort level, so that a comfort level of "should" on the taxpayer's side (at least near the higher end of the "should" continuum) implies "no reasonable basis" on the Service's side (and vice versa). Sheldon I. Banoff, *New Regs*, *Merrill Lynch Settlement Highlight Tax Shelter News*, 95 J. TAX'N 254 (Oct. 2001). However, there does not seem to be any consensus on this theory.

[180] If this is the case, a scrupulous practitioner might consider advising his client not to waste money on an opinion as to issues that do not matter.

[181] 31 C.F.R. § 10.35(b)(4)(ii) (2010).

[182] Many practitioners add a second component to their "standard" disclaimer, stating that the opinion may not be used to promote, market, or recommend a transaction to another party." Although not strictly required to avoid covered opinion status, this is an attempt to prevent the opinion from inadvertently becoming a marketed opinion (which, as discussed *infra* in the text accompanying note 187, would require a different type of disclaimer to avoid covered opinion status).

other categories of covered opinion, the standard disclaimer is totally ineffective. This point is crucial and is often overlooked by practitioners.[183]

e. *Significant Purpose–Marketed Opinions*. The second type of significant purpose covered opinion is a "marketed opinion." Before addressing the definition of "marketed opinion," it is worth noting that a tremendous amount often rides on the question of whether an opinion satisfies the definition. As discussed below, the covered opinion rules that apply to a significant purpose–marketed opinion are among the most onerous of all the covered opinion rules.[184] In some circumstances, depending on the substantive level of comfort that is reached, the rules can even preclude the rendering of the opinion at all. Thus, in analyzing the issue of whether an opinion is a marketed opinion, the stakes are very high.

Assuming a transaction has (or might be considered to have) a significant tax-avoidance purpose, an opinion with respect to that transaction is a marketed opinion "if the practitioner knows or has reason to know that it will be used or referred to by a person other than the practitioner [or his firm] in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more [taxpayers]."[185]

The escape route from marketed opinion status is a three-part disclaimer that prominently discloses that:[186]

- the opinion was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties;
- the opinion was written to support the promotion or marketing of the transactions or matters addressed therein; and

[183] For more on disclaimers, *see infra* text accompanying notes 217–23.
[184] *See infra* text accompanying notes 251–60.
[185] 31 C.F.R. § 10.35(b)(5)(i) (2010).
[186] 31 C.F.R. § 10.35(b)(5)(ii) (2010).

- "the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor."[187]

The quintessential marketed opinion is prepared in connection with an offering of some type of investment (*i.e.*, it is what was described above as a disclosure opinion)[188] that is either provided to potential purchasers of what is being offered or referred to in the offering materials.[189] However, the definition seems broader than that fact pattern.[190] For example, it is clear that an opinion can be a marketed opinion even if it is not part of a traditional offering to a relatively large number of persons; the definition specifically refers to use of, or reference to, the opinion in marketing, promoting, or recommending the transaction "to one or more taxpayers."[191]

A somewhat less clear issue is whether the term could encompass a typical third-party inducement opinion.[192] In one sense, such an opinion can be said to be used to "promote, market or recommend" to the third party whatever it is the third party is being asked to do or consent to.[193] There is a highly technical argument that suggests such an opinion may not be a marketed opinion. Consider the "principal purpose" definition: the "thing" that is tested to see if it has the principal purpose of tax avoidance or evasion is "any partnership or other entity, any investment

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[187] *Id.*

[188] *See supra* text accompanying notes 17–22.

[189] As discussed *infra* in the text accompanying note 208, most opinions filed with the SEC are exempt from the covered opinion rules, so in practice this encompasses opinions in connection with private offerings.

Although outside the context of formal opinions, one issue that often arises is whether tax disclosure that is prepared by counsel and included in offering materials, without attribution or reference to counsel, can be a marketed opinion. In the author's experience, the prevailing practice is to take the cautious approach and include the three-part disclaimer in such materials. Compare the current rules with 31 C.F.R. § 10.33(c)(3) in its pre-2004 version, which specifically exempted tax disclosure that neither mentioned the practitioner by name nor referred to the fact that advice was obtained from a tax practitioner. 31 C.F.R. § 10.33 (2003).

[190] Speaking informally, Cono Namorato, the then-head of the Service's Office of Professional Responsibility acknowledged that the definition is broader than it should be. Stratton, *supra* note 137.

[191] 31 C.F.R. § 10.35(b)(5)(ii) (2010).

[192] *See supra* text accompanying notes 13–16.

[193] *See* 31 C.F.R. § 10.35(b)(5) (2010).

plan or arrangement, *or any other plan or arrangement*."[194] Similar terminology is used in the flush language defining significant purpose transactions.[195] The marketed opinion definition, on the other hand, looks to whether the opinion is used or referred to in promoting, marketing, or recommending a "partnership or other entity, investment plan or arrangement"; the "other plan or arrangement" language is conspicuous by its absence.[196] Thus, an argument can be made that a third-party inducement opinion is not a marketed opinion unless the action the third party is being induced to take involves either the acquisition of an interest in a partnership or other entity or an investment. This argument would suggest that, for example, an opinion furnished to the general partner of a partnership to induce the general partner to permit a proposed transfer of interests by an existing limited partner to a third party would not be a marketed opinion, on the theory that the thing the general is being asked to do—namely, to permit the transfer—is neither the acquisition of an interest in an entity nor an investment.

In light of the uncertainty as to whether this theory would ultimately carry the day, most practitioners would prefer to include the three-part disclaimer on all third-party inducement opinions. However, including this disclosure may trigger some resistance from the third party. Unlike in the offering context, where people are accustomed to seeing the three-part disclaimer and where it makes sense on its face, the required wording of the disclaimer does not fit very neatly into the world of third-party inducement opinions. In particular, the second component of the disclaimer, which requires a statement that the opinion was written to support the "promotion or marketing" of the transactions addressed therein, works well where interests in something are being sold, but represents an odd choice of language where, for example, the third party is being

[194] 31 C.F.R. § 10.35(b)(2)(B) (2010) (emphasis added); *see supra* text accompanying note 158.
[195] *See supra* text accompanying notes 164–76.
[196] 31 C.F.R. § 10.35(b)(5)(i) (2010).

asked to consent to something that he otherwise has a contractual right to block.[197] The concept that the request for his consent is being "promoted" or "marketed" may be difficult to explain to a layman.

An additional reason why a third party may object to the three-part marketed opinion disclaimer relates to the third required component: the instruction to consult one's own tax advisor. Presumably, a major reason why the third party is demanding the opinion in the first place is because he does not want to seek advice from his own counsel. Thus, this component of the disclaimer could be viewed as undercutting the very purpose for the opinion.

If the third party cannot be persuaded to accept the three-part marketed opinion disclaimer, an advisor may have no choice but to bite the bullet and try to get comfortable with the proposition that the opinion falls outside the definition of a marketed opinion. The alternative of trying to write a Circular 230–compliant covered opinion, even if one's client were willing to pay for it, is typically not an option in the context of third-party inducement opinions. There are two reasons for this. The first reason is that a marketed opinion cannot be a limited scope opinion; it must address, and reach a "more likely than not" conclusion about, every significant tax issue, and if that is not possible, the opinion cannot be rendered at all.[198] Generally, a third-party inducement opinion is intended to address one or more specifically identified issues of concern to the third party, and often it would not be feasible to expand the scope of the opinion to cover all significant tax issues, as defined for this purpose.[199]

The second reason why writing a covered opinion is often not a viable alternative where the third party objects to the three-part disclaimer pertains to the second and third components of

[197] 31 C.F.R. §10.35(b)(5)(ii)(B) (2010).

[198] 31 C.F.R. § 10.35(c)(3)(iv) (2010).

[199] *See supra* text accompanying note 178.

the three-part disclaimer—that is, the recital that the opinion was written to support the "promotion or marketing" of the matters addressed therein and the injunction to consult one's own tax advisor.[200] These same components are also mandatory in a covered opinion that is a marketed opinion. Thus, if the third party objects to the disclaimer because of either or both of these components, presumably his objection would be equally vehement if he were handed an opinion that is several times longer, and that addresses a myriad of additional issues—none of which he cares about—but that still includes the objectionable language.

f. *Significant Purpose–Conditions of Confidentiality Opinions and Significant Purpose–Contractual Protection Opinions*. An opinion "is subject to conditions of confidentiality if the practitioner imposes on one or more recipients a limitation [whether or not legally binding] on disclosure of the tax treatment or tax structure," to protect the "confidentiality of the practitioner's tax strategies."[201] An opinion is the subject of contractual protection if (1) "the taxpayer has the right to a refund of fees paid to the practitioner" if the expected tax results are not sustained, or (2) such fees "are contingent on the realization of tax benefits."[202] If either of these conditions is true, the opinion is, per se, a covered opinion. Covered opinion status cannot be avoided by disclaimer.

The definitions of conditions of confidentiality and contractual protection for this purpose are substantially the same as the identical terms used under the reportable transaction regulations,[203] and in general, any transaction containing such terms will be a reportable

[200] *See infra* text accompanying notes 259–60.
[201] 31 C.F.R. § 10.35(b)(6) (2010).
[202] 31 C.F.R. § 10.35(b)(7) (2010).
[203] Reg. § 1.6011-4(b)(3)–(4).

transaction.[204] Because reportable transaction status triggers a number of unpleasant procedural and penalty-related consequences, taxpayers often try to avoid reportable transactions.[205] Possibly for this reason, it is not all that common for an advisor to be asked to render an opinion on a transaction that is subject to conditions of confidentiality or contractual protection.

g. *Exceptions from Covered Opinion Status*. Even if an opinion otherwise would be a covered opinion, it may be subject to one of a number of general exceptions.

- Preliminary written advice provided to a client is not a covered opinion if it is reasonably expected that the advisor will later render advice "that satisfies the requirements of this section [31 C.F.R. § 10.35]."[206] The referenced section is entitled "Requirements for covered opinions" and includes both the definition of covered opinion and the rules that must be satisfied if an opinion is a covered opinion. Rules governing written advice other than covered opinions are contained in 31 C.F.R. § 10.37.

  If the intention, at the time preliminary advice is rendered, is to deliver an opinion that falls outside the covered opinion rules (and is not expected to meet the requirements that would have been applicable if it had been a covered opinion), it appears that the preliminary advice would not qualify for the

[204] *Id*. It is theoretically possible for a transaction to have conditions of confidentiality but not be a reportable transaction, if the advisor's fees are below the thresholds set forth in Regulation section 1.6011-4(b)(3)(iii). If an advisor prepares a covered opinion and his fees do not exceed the reportable transaction thresholds, he's probably not charging enough.

[205] *See supra* note 157.

[206] 31 C.F.R. § 10.35(b)(2)(ii)(A) (2010).

exception.[207] Although the expected final opinion would not violate 31 C.F.R. § 10.35, it is hard to say that it would *comply* with that section, as the operative rules applicable to a noncovered final opinion would be those of § 10.37, not § 10.35.

- An opinion filed with the SEC, other than one regarding a listed transaction or a principal purpose transaction, is exempt from the covered opinion rules.[208] For this reason, a marketed opinion disclaimer is not needed for public filings.

  Because this exception is not available for listed transactions and principal purpose transactions, a possible problem exists in the (hopefully rare) case in which a public filing is needed for such a transaction. Because these transactions would automatically be covered transactions, the opinion would need to comply with the applicable rules. Moreover, most likely the opinion would also be a marketed opinion and, accordingly, subject to the most onerous rules of all. The difficulty would be to craft an opinion that both complies with the Circular 230 written advice rules and would also pass muster with the SEC. The mere fact that such an opinion would look different than what SEC reviewers are accustomed to seeing might well cause them to look askance, and the required language telling people to consult their own tax advisors might elicit a specific comment.[209] The unlucky tax advisor faced with such a task might well find himself learning

[207] As a practical matter, this may not be of great significance, since whatever theory is expected to take the final opinion out of the covered opinion world should likewise be available for the preliminary advice. If the expectation is to rely on a disclaimer in the final opinion, it is necessary to remember to put the disclaimer in the preliminary advice as well, but most practitioners include the standard disclaimer as a matter of course in everything they write.

[208] 31 C.F.R. § 10.35(b)(2)(ii)(B)(3) (2010).

[209] *See infra* text accompanying notes 427–32.

firsthand the answer to the age-old conundrum of the irresistible force and the immoveable object.

- An opinion, other than with respect to a listed transaction or a principal purpose transaction, is exempt from the covered opinion rules if it (1) relates to the qualification of a qualified plan,[210] or (2) is a state or local bond opinion.[211]

- Written advice prepared after a return has been filed is generally exempt from the covered opinion rules, unless the practitioner knows or has reason to know that it will be relied upon in filing a future return.[212]

- Written advice provided to an employer by an employee for purposes of determining the employer's tax liability is exempt from the covered opinion rules.[213] Thus, in-house counsel generally need not worry about these rules.

- Written advice that does not resolve any issue in the taxpayer's favor at any level of comfort is generally exempt from covered opinion status.[214] However, this exemption is lost if a conclusion is reached as to even a single issue at any level of comfort at all (even as low as "not frivolous").[215] As a practical matter, an opinion that would qualify for this exemption is likely to be of little practical use, although an opinion that a certain position *is* frivolous might conceivably provide

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[210] 31 C.F.R. § 10.35(b)(2)(ii)(B)(1) (2010).

[211] 31 C.F.R. § 10.35(b)(2)(ii)(B)(2) (2010). The Treasury Department has proposed a separate set of rules for state and local bond opinions. Requirements for State or Local Bond Opinions, 69 Fed. Reg. 75887, 75890 (proposed Dec. 20, 2004) (to be codified at 31 C.F.R. § 10.39). A discussion of these rules is beyond the scope of this Article.

[212] 31 C.F.R. § 10.35(b)(2)(ii)(C) (2010).

[213] 31 C.F.R. § 10.35(b)(2)(ii)(D) (2010).

[214] 31 C.F.R. § 10.35(b)(2)(ii)(E) (2010).

[215] *Id*. Recall, however, that written advice will only fall into the definition of "reliance opinion" if it reaches a comfort level of at least "more likely than not" on at least one issue. *See supra* text accompanying note 177. Thus, an opinion that reaches some comfort level, but lower than "more likely than not," will not necessarily be a covered opinion (notwithstanding the failure to qualify for the exemption) unless it falls within one of the other categories of covered opinions.

some comfort in a situation where management is concerned that it might face a lawsuit alleging that it is not aggressive enough in its tax positions.[216]

4. More on Disclaimers

Although the basic rules on when a disclaimer is effective to avoid covered opinion status have already been discussed, the subject is of sufficient importance to warrant a few more words.

a. *Review of When a Disclaimer Is Effective*. The "standard" disclaimer is effective to avoid covered opinion status where the only reason an opinion would otherwise be a covered opinion is because the opinion would be a significant purpose–reliance opinion.[217] Similarly, the three-part marketed opinion disclaimer is effective to avoid covered opinion status where the only reason an opinion would otherwise be a covered opinion is because it would be a significant purpose–marketed opinion.[218]

This leaves four categories of covered opinions for which a disclaimer is *not* effective:

- listed transaction opinions;
- principal purpose transaction opinions;
- significant purpose–conditions of confidentiality opinions; and
- significant purpose–contractual protection opinions.

The lesson for the practitioner, though frequently overlooked, is clear: Do not assume that the boilerplate standard disclaimer means you do not have to worry about the covered opinion rules.

b. *Formal Requirements*. In those circumstances where a disclaimer can be effective to avoid covered opinion status, it will only be effective if it is "prominently

[216] The author has yet to meet a client with this concern.
[217] *See supra* text accompanying notes 181–83.
[218] *See supra* text accompanying note 187.

disclosed."[219] To be "prominent," it must, on the basis of the facts and circumstances, be "readily apparent to a reader."[220] Additionally, certain minimum standards must be satisfied:

- The disclaimer must be in a "separate section."[221] Although the rules do not define "section," in practice the disclaimer is usually included either near the beginning or at the end and is structurally or typographically set off in some way from the body of the opinion.
- The disclaimer may not be in a footnote.[222]
- The disclaimer must be in a typeface that is the same size or larger than that used for the discussion of the facts or law.[223]

5. Requirements for Covered Opinions

Sometimes, despite one's best efforts, it is necessary to write a covered opinion. If you are in that unhappy situation, take a deep breath (and perhaps a healthy swallow of an appropriate beverage) and read the rules discussed in this Section of the Article.

a. *Factual Matters*. A practitioner writing a covered opinion must use reasonable efforts to "identify and ascertain" the relevant facts, and the opinion itself must identify which facts are relevant.[224] Presumably, determining which facts are relevant to the opinion is something that any responsible practitioner would do anyway when rendering an

[219] 31 C.F.R. § 10.35(b)(4)(ii), (b)(5)(ii) (2010).

[220] 31 C.F.R. § 10.35(b)(8) (2010).

[221] *Id*.

[222] *Id*.

[223] *Id*. This requirement can be easily complied with for formal opinions, but can be a trap in the context of informal electronic communications (email). Many law firms append the standard Circular 230 disclaimer automatically to all outgoing emails, sometimes in a way that is outside the control of individual attorneys. If an attorney sets up his email so as to use a typeface for text that happens to be larger than that used for the automatic disclaimer, he can inadvertently run afoul of this technical requirement.

[224] 31 C.F.R. § 10.35(c)(1)(i) (2010).

opinion,[225] but it is not clear whether the "ascertain" language of 31 C.F.R. § 10.35(c)(l)(i) should be read to imply a heightened standard of due diligence.[226]

A covered opinion may not be based on unreasonable factual assumptions.[227] To a certain extent, this is good news—it implies that it is permissible to base an opinion on assumptions, as long as they are reasonable. This should serve to avoid any concerns that the "ascertain" requirement might be interpreted so broadly as, in effect, to turn every tax advisor into an auditor, with an obligation independently to verify every fact relevant to an opinion.

In general, an assumption is unreasonable if the practitioner knows or has reason to know that it is incorrect or incomplete.[228] Where an assumption involves reliance on a projection, financial forecast, or appraisal, it is unreasonable if the practitioner knows or has reason to know that the projection is incorrect or incomplete or that it was prepared by a person without adequate qualifications. Moreover, it is treated as inherently unreasonable to assume that a transaction has a business purpose or that it is potentially profitable without regard to tax benefits.[229]

Factual assumptions must be identified in a separate section of the opinion.[230] The rules for establishing facts by means of representations (which must also be set forth in a separate section) are similar to those involving assumptions. Thus, it is impermissible to rely on an unreasonable representation, that is, one that the practitioner knows or has reason to know is

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[225] For a discussion of issues related to establishing the factual predicates for an opinion, *see infra* text accompanying notes 376–83.

[226] *Cf.* 31 C.F.R. § 10.37(a) (2010) (applicable to written advice other than covered opinions and discussed infra in the text accompanying notes 269–81, and which precludes writing an opinion that "does not consider" facts that the practitioner knows or should know, but omits the language imposing an affirmative obligation to "identify and ascertain" the facts).

[227] *See* 31 C.F.R. § 10.35(c)(1)(ii) (2010).

[228] *Id*.

[229] *Id*.

[230] *Id*.

incomplete.[231] Moreover, a conclusory representation that a transaction has a business purpose, which does not include a specific description of such purpose, is inherently unreasonable.[232]

b. *Relate Law to Facts*. A covered opinion must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.[233] Presumably, it is impossible to reach any conclusion of law without relating the law to the facts, but the requirement that a covered opinion explicitly set forth this analysis, together with the requirement that the opinion describe the reasons for each conclusion,[234] means that it is not possible to render a covered short-form opinion.[235]

In general, in reaching his conclusions, a practitioner may not assume the resolution of any other significant federal tax issues. However, two exceptions are allowed. First, where a limited scope opinion is permissible (and subject to the special requirements for such opinions),[236] a practitioner may assume the resolution of an issue that forms the basis for another issue that is the subject of the opinion, provided that (1) such assumed resolution is reasonable, and (2) any such assumed issues are identified in a separate section of the opinion.[237] Second, a practitioner may rely on the opinion of another practitioner as to certain issues relevant to the resolution of other issues on which the practitioner is opining, provided that the practitioner relying on the other opinion does not know or have reason to know that the other practitioner's opinion should not be relied on.[238] This allows, for example, a general practitioner to rely on the opinion of a specialist with respect to matters that are not within the generalist's competence, but

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[231] 31 C.F.R. § 10.35(c)(1)(iii) (2010).
[232] *Id*.
[233] 31 C.F.R. § 10.35(c)(2)(i) (2010).
[234] *See infra* text accompanying notes 240–45.
[235] *See infra* text accompanying notes 364–65.
[236] *See infra* text accompanying notes 246–50.
[237] 31 C.F.R. § 10.35(c)(2)(ii), (c)(3)(v)(B) (2010).
[238] 31 C.F.R. § 10.35(c)(2)(ii), (d) (2010).

form part of the analysis underlying a conclusion on a more general point. A practitioner who relies on the opinion of another practitioner must (1) identify the other opinion, (2) set forth the conclusions reached therein, and (3) be satisfied that the combined analysis and the overall conclusions comply with the requirements for covered opinions.[239]

c. *Conclusions as to Each Issue*. In general, a covered opinion must (1) state a conclusion, and describe the reasoning for the conclusion, as to the likelihood that the taxpayer will prevail on each significant federal tax issue (or, if a conclusion cannot be reached, so state and explain why),[240] and (2) provide an overall conclusion, and explain the reasoning for the conclusion, as to the likelihood that the claimed treatment is the proper treatment (or, if a conclusion cannot be reached, explain why that is the case).[241] If, with respect to any issues, the practitioner does not reach a comfort level of at least more likely than not, the opinion must include prominent[242] disclosure to that effect, which warns taxpayers that they may not rely on the opinion for protection against penalties with respect to those issues.[243]

In some situations, it is permissible to render a "limited scope" opinion that addresses less than all of the significant federal tax issues. The rules as to when such an opinion is permissible, and special requirements that must be satisfied, are described below.[244]

In reaching his conclusions, the practitioner may not take into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement.[245]

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[239] *Id*.

[240] 31 C.F.R. § 10.35(c)(3)(ii) (2010).

[241] 31 C.F.R. § 10.35(c)(4)(i) (2010).

[242] On the meaning of "prominent," see *supra* text accompanying notes 219–23.

[243] 31 C.F.R. 10.35(e)(4) (2010). As discussed *infra* in the text accompanying notes 251–54, in the case of a marketed opinion the option of rendering an opinion that does not reach "more likely than not" on one or more issues is not available.

[244] *See infra* text accompanying notes 246–50.

d. *Limited Scope Opinions*. In the case of an opinion *other than* (1) a listed transaction opinion, (2) a principal purpose opinion, or (3) a marketed opinion,[246] it is permissible to render a "limited scope" opinion that addresses less than all of the significant federal tax issues,[247] provided that the taxpayer agrees that his potential reliance on the opinion for purposes of penalty protection is limited to those issues that are addressed.[248]

A limited scope opinion is required to contain prominent[249] disclosure to the effect that (1) the opinion is limited to those issues addressed therein, (2) additional issues may exist that could affect the tax treatment of the transaction, and the opinion does not consider or provide a conclusion with respect to any such issues, and (3) the opinion may not be relied on for penalty protection with respect to any issues outside its scope.[250]

e. *Marketed Opinions*. Special, and particularly onerous, rules apply to marketed opinions. First, as noted above, a marketed opinion cannot be a limited scope opinion.[251] Thus, a marketed opinion can only be rendered, if at all, if *every* significant federal tax issue is addressed. If the client is only interested in a limited class of issues, and is not willing to pay for the practitioner to address all other significant issues as well, the opinion cannot be rendered.

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[245] 31 C.F.R. § 10.35(c)(3)(iii) (2010). For further discussion of these requirements, *see infra* text accompanying notes 279–81.

[246] 31 C.F.R. § 10.35(c)(3)(v)(A)(2) (2010).

[247] 31 C.F.R. § 10.35(c)(3)(v)(A) (2010).

[248] 31 C.F.R § 10.35(c)(3)(v)(A)(l) (2010). Technically, the requirement of such an agreement is separate from the requirement, discussed *infra* in the text accompanying note 250, that the opinion contain disclosure limiting such reliance. Although arguably it might be possible to infer the existence of such an agreement from the taxpayer's acceptance of an opinion containing the required disclosure, a safer course of action would be to include the agreement explicitly in the engagement letter or some other document that is signed by the client.

[249] On the meaning of "prominent," see *supra* text accompanying notes 219–23.

[250] 31 C.F.R. § 10.35(e)(3) (2010).

[251] *See supra* text accompanying note 246.

Second, marketed opinions are subject to an absolute requirement that the practitioner reach a comfort level of at least more likely than not on every significant federal tax issue, as well as overall.[252] Unlike other types of covered opinions, there is no option to explain (and include disclosure) as to why such a conclusion cannot be reached.[253] If, as to even a single issue, the practitioner cannot reach a conclusion at all, or reaches a conclusion at a lower comfort level than more likely than not, an opinion may not be rendered on any issue.[254]

The practical effect of these rules is quite remarkable. In general, the covered opinion rules, other than the special rules for marketed opinions, impose certain minimum requirements as to form, including requiring various warnings to the reader as to what the opinion does not accomplish.[255] However, they do not limit the substance of the advice that a practitioner can give. In the case of marketed opinions, however, the rules go much farther. The marketed opinion rules create a class of situations—namely, any case in which a tax advisor, in his professional judgment, concludes that there is even a single issue as to which the level of certainty is less than more likely than not—where a tax advisor is prohibited from communicating any advice at all in writing![256]

Fortunately, as discussed above, it is often possible to avoid covered opinion status for what would otherwise be a marketed opinion by means of the three-part disclaimer.[257] However, this is not effective where, in addition to being a marketed opinion, an opinion is given with

[252] 31 C.F.R. § 10.35(c)(3)(iv) (2010).
[253] *See supra* text accompanying notes 242–43.
[254] 31 C.F.R. § 10.35(c)(3)(iv) (2010).
[255] *See* 31 C.F.R. § 10.35(c)(3)(ii) (2010).
[256] *See* 31 C.F.R. § 10.35(c)(3)(iv) (2010).
[257] *See supra* text accompanying note 187.

respect to a listed transaction or a principal purpose transaction.[258] As a practical matter, this creates tremendous pressure to get comfortable that a transaction is not a principal purpose transaction in a case where an opinion is being rendered that, but for the disclaimer, would be a marketed opinion.

If one is writing a marketed opinion that does comply with the covered opinion rules (assuming the opinion can be rendered at all) the opinion must prominently[259] disclose that (1) the opinion was written to support the promotion or marketing of the transactions or matters addressed therein, and (2) the taxpayer should seek advice based on his particular circumstances from an independent tax advisor.[260]

f. *Competence*. A practitioner rendering a covered opinion is required to be knowledgeable in the relevant areas of federal tax law (although, as discussed above,[261] a practitioner may rely on the opinion of another practitioner as to particular issues, the resolution of which is relevant to the conclusions reached in his own opinion).[262] Presumably, an attorney has a professional responsibility not to render advice unless he is competent to do so,

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[258] If, in addition to being a marketed opinion, an opinion is with respect to a transaction that has conditions of confidentiality or contractual protection, the three-part disclaimer will not avoid covered opinion status, but it apparently will avoid marketed opinion status (so that the somewhat less onerous rules for covered opinions other than marketed opinions apply). However, if a marketed opinion is also with respect to a listed transaction or a principal purpose transaction, the disclaimer is not even effective to remove the opinion from marketed opinion status. 31 C.F.R. § 10.35(b)(5)(ii) (2010).

[259] On the meaning of "prominent," see *supra* text accompanying notes 219–23.

[260] 31 C.F.R. § 10.35(e)(2) (2010). Note that these very same statements form two of the three prongs of the three-part disclaimer.

[261] *See supra* text accompanying notes 238–39.

[262] 31 C.F.R. § 10.35(d)(1) (2010).

even without regard to Circular 230.[263] Perhaps the only remarkable thing about the specific inclusion of this principle in Circular 230 is that Treasury thought it was even necessary.[264]

g. *Disclosure of Certain Relationships*. A covered opinion must prominently[265] disclose the existence of

- any compensation arrangement, such as a referral fee or fee-sharing arrangement, between the practitioner and any person (other than the client, for whom the opinion is prepared) with respect to promoting, marketing, or recommending the entity, plan, or arrangement (or a substantially similar one) that is the subject of the opinion,[266] or
- any referral agreement between the practitioner and a person (other than the client for whom the opinion is prepared) engaged in promoting, marketing, or recommending the entity, plan, or arrangement (or a substantially similar one) that is the subject of the opinion.[267]

6. Requirements for Opinions Other than Covered Opinions

Unlike the rules for covered opinions, which set forth a number of detailed requirements, both affirmative and negative, the Circular 230 rules applicable to written advice other than

[263] *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.1 (2006) ("A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill and thoroughness and preparation reasonably necessary for the representation."); *see also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 52(l) (2000) ("[A] lawyer . . . must exercise the competence and diligence normally exercised by lawyers in similar circumstances"); discussion *infra* in the text accompanying notes 344–49.

[264] Interestingly, there is no explicit requirement of competence in 31 C.F.R. § 10.37, which governs written advice other than covered opinions, discussed infra in the text accompanying notes 269–81. In the author's view, this omission should *not* be interpreted to mean that a practitioner should feel free to render advice (other than in the form of a covered opinion) without knowing what he is doing.

[265] On the meaning of "prominent," see *supra* text accompanying notes 219–23.

[266] 31 C.F.R. § 10.35(e)(1)(i) (2010).

[267] 31 C.F.R. § 10.35(e)(1)(ii) (2010). As discussed *infra* in the text accompanying notes 506–12, some types of financial arrangements involving a practitioner rendering an opinion can disqualify the opinion from certain penalty-protection functions.

covered opinions set forth only four operative rules, each of which is phrased in the negative.[268] In determining whether a taxpayer has complied with the rules,[269] all of the facts and circumstances, including the scope of the engagement and the specificity of the advice sought by the client, are considered. However, an opinion that the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan, or arrangement, a significant purpose of which is federal tax avoidance or evasion—in other words, something that, if it were a covered opinion, would be a marketed opinion—is subject to heightened scrutiny.[270] The stated reason for this is the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.[271]

The following are the four specific prohibitions for written advice other than covered opinions:

- The opinion may not be based on unreasonable factual or legal assumptions.[272] Unlike the corresponding rule for covered opinions,[273] 31 C.F.R. § 10.37 does *not* tell us that it is inherently unreasonable to assume business purpose or potential pre-tax profitability. While the import of this omission is not entirely clear, the author believes that, in the world of written advice other than covered opinions, an assumption as to these matters is neither inherently reasonable nor inherently unreasonable; the extent to which a practitioner may have to make additional

[268] 31 C.F.R. § 10.37(a) (2010).

[269] Interestingly, the actual language of the regulation says that facts and circumstances are considered "in determining whether a practitioner has *failed* to comply." 31 C.F.R. § 10.37(a) (2010) (emphasis added).

[270] *Id*.

[271] *Id*.

[272] *Id*.

[273] *See supra* text accompanying note 229.

inquiry, as opposed to relying on a conclusory assumption, will depend on the facts and circumstances. Thus, for example, if the existence and strength of a nontax business purpose is, as a substantive matter, crucial to the tax analysis and not apparent on the face of the transaction, it might be unreasonable to assume such purpose, particularly if there also appears to be some component of tax motivation for the transaction. On the other hand, where an opinion relates to a transaction in the ordinary course of business that is not expected to result in a particular tax benefit, and where the existence of or strength of a nontax business purpose is not a fundamental part of the tax analysis, such an assumption might be reasonable.

- The opinion may not unreasonably rely on representations.[274] This is phrased slightly differently than the corresponding rule for covered opinions. The latter speaks in terms of whether a *representation* is reasonable,[275] whereas the rule under 31 C.F.R. § 10.37 looks to whether the *reliance* is reasonable. Perhaps some clever graduate student seeking a joint degree in taxation and metaphysics will write a thesis addressing whether it is possible reasonably to rely on an unreasonable representation (or vice versa), but this discrepancy in language does not seem to have much in the way of practical effect.

  Perhaps more importantly, 31 C.F.R. § 10.37, unlike the corresponding rule for covered opinions[276] (and *like* the corresponding rule for reliance on

[274] 31 C.F.R. § 10.37(a) (2010).
[275] *See supra* text accompanying note 232.
[276] *See supra* text accompanying note 232.

assumptions)[277] does not inherently preclude reliance on a nonspecific representation as to business purpose. As is the case for assumptions as to business purpose, the practitioner will need to evaluate each case on its facts to determine whether reliance on such a conclusory representation is reasonable.

- The opinion may not be given if it does not consider all relevant facts that the practitioner knows or should know.[278]
- The opinion may not "take into account" the possibility that (1) a return will not be audited, (2) an issue will not be raised on audit, or (3) an issue will be resolved through settlement.[279] Presumably, this is intended to preclude practitioners from basing their written advice on the "audit lottery," but it seems to go beyond that (particularly the prohibition against taking settlement potential into account). The full extent of this prohibition may not be entirely clear. Consider the following examples:

  Example (1): A practitioner is asked to render an opinion on an issue that arises from a technical drafting ambiguity in the language of the Code. There is no authority directly interpreting the language, and the Service has never indicated its position. It is the practitioner's professional judgment, taking into account the policy underlying the provision, that the taxpayer-favorable interpretation does not present any potential for abuse, and that the Service would therefore not be

[277] *See supra* text accompanying notes 272–73.

[278] 31 C.F.R. § 10.37(a) (2010). *Cf.* 31 C.F.R. § 10.35(c)(1)(i) (2010) (applicable to covered opinions and discussed *supra* in the text accompanying notes 224–26, and which requires practitioner to use reasonable efforts to "identify and ascertain" the relevant facts).

[279] 31 C.F.R. § 10.37(a) (2010). As discussed *supra* in the text accompanying note 245, corresponding language (thankfully, without any cryptic textual differences) is included in the rules that apply to covered opinions.

inclined to challenge it. If he considers this in reaching a conclusion, has he violated Circular 230?

Example (2): A practitioner is asked to render an opinion on an issue that, by its nature, is a double-edged sword. For example, the issue may involve whether a particular transaction is a recognition transaction; the answer that is favorable to a taxpayer holding an asset at a gain is likely to be unfavorable to a taxpayer holding at a loss. In reaching a conclusion on the merits, the advisor considers the fact that the Service is often sensitive to the possible precedential effect of what initially seem to be victories but are then used affirmatively by taxpayers.[280] The practitioner concludes that the Service, assuming the Service's full knowledge of the facts, would not likely challenge the particular taxpayer because a victory could easily backfire. If he renders written advice as to his conclusion, has he violated Circular 230?

Example (3): A practitioner is asked to render an opinion on an issue that at least one court has resolved in the taxpayer's favor, but that is not entirely stated. There exists a General Counsel's Memorandum (GCM) or other internal Service document in which personnel within the Service discussed the Service's future litigating position with respect to the issue. Although the GCM concludes that the anti-taxpayer position is correct, it acknowledges that contrary judicial authority would make litigation risky. Accordingly, it suggests that an effort be made to

[280] Service "victories" that turned out, in the long run, to be bonanzas for taxpayers are legion (and legendary). The classic example is *Crane v. Commissioner*, 331 U.S. 1 (1947), which held that the amount realized on disposition of property subject to nonrecourse debt includes the amount of the debt. The flip side of this — that the amount of nonrecourse debt incurred to acquire property is included in the taxpayer's basis in the property — formed the basis for a whole generation of tax shelters. *See supra* note 142.

settle future cases involving the issue rather than risking litigation.[281] If a practitioner considers this GCM (including the Service's acknowledgement of the weakness of its position) in rendering written advice, has he violated Circular 230?

These examples present two common themes. First, in none of these cases is a practitioner potentially relying, in any way, on a lack of knowledge on the part of the Service. An assessment of the likelihood of being "caught"—in other words, the audit lottery—is not involved. Second, in each case, what a practitioner *is* potentially relying on is his assessment of whether the Service (assuming it had full knowledge) would perceive the issue as an appropriate one to challenge (or, if challenged, to pursue to the extent of litigation)—a perception that itself is closely tied to how the Service would view the merits of the issue. Is a practitioner required, in all cases, to assume not only that the Service knows what is going on but also that the Service will always decide to challenge what is going on? Such an assumption is wholly unrealistic; probably more tax questions are "decided" in the taxpayer's favor by administrative determination than by litigation, and assuming that the Service will challenge every position skews the assessment of the merits against the taxpayer's position and is likely to result in bad advice. Nonetheless, the precise scope of the prohibition on taking into account the possibility of nonchallenge or settlement may not always be clear.

7. Consequences of Noncompliance

What is at stake if an advisor fails to comply with Circular 230? The Treasury Department has statutory authority to disbar or suspend an advisor from practice before the

[281] *See, e.g.*, F.S.A. 1993-584 (May 3, 1993), 1993 WL 1469616 (acknowledging a "significant litigating hazard" with respect to the Service's position).

Treasury, as well as to censure the advisor or impose a monetary penalty.[282] Regulations implementing this authority provide that any or all of such penalties may be imposed for a violation of 31 C.F.R. §§ 10.35 or 10.37 that is willful, reckless, or through gross incompetence.[283] In the case of a monetary penalty, the amount will not exceed the gross income derived (or to be derived) from the misconduct.[284]

Fortunately, officials of the Service have publicly stated on several occasions that they will take a "reasonable approach" to enforcement of the rules.[285] Hopefully, we do not need to worry about losing our license for an inadvertent foot fault. Nonetheless, most practitioners tend to be careful when treading in the murky waters of the Circular 230 written advice rules.

B. *Preparer Rules*

A practitioner who renders advice as to the proper reporting of a transaction may, under certain circumstances, be treated as a tax return preparer (and hence potentially subject to statutory preparer penalties). In addition, whether or not a "preparer" for this purpose, a person who advises on how to report a transaction may be subject to Circular 230 rules, which address

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[282] 31 U.S.C. § 330(b) (2006). The authority to impose the latter two penalties was added by section 822 of AJCA2004, *supra* note 24.

[283] 31 C.F.R. §§ 10.50, 10.52 (2010).

[284] 31 C.F.R. § 10.50(c)(2) (2010). Note however that, under section 162(f), any such penalty would not be deductible, so the combined effect of the penalty and the denial of the deduction could be in excess of the income realized by the advisor.

[285] See, e.g., Common Sense Urged by IRS at Circular 230 Program, 2005 TAX NOTES TODAY 90-3 (May 11, 2005); Korb Responds to Lawyers' Circular 230 Hypotheticals, 2005 TAX NOTES TODAY 190-5 (Oct. 3, 2005).

that issue.[286] Accordingly, it behooves a practitioner who writes opinions (particularly reporting opinions) to be familiar with these rules.

1. Statutory Rules

a. *Who Is a Preparer?* The statutory definition of a tax return preparer (which specifically applies for purposes of the preparer penalty under section 6694[287]) is found in section 7701(a)(36) and the regulations thereunder. Under this definition, a preparer is "any person who prepares ... for compensation ... all or a substantial portion of any return ...."[288] The regulations go on to provide additional guidance for "signing tax return preparers" (who have primary responsibility for the overall substantive accuracy of a return[289]) and nonsigning preparers. As a practical matter, it is the nonsigning preparer category that is more likely to encompass an advisor who is asked to write an opinion as to the reporting of a particular transaction.

A nonsigning preparer is any tax return preparer (other than a signing preparer) who (1) prepares (2) all or a substantial portion of a return (3) with respect to events that have occurred at the time the advice is rendered.[290] Let us examine each of these three elements.

First, to be a nonsigning return preparer, one must "prepare" all or part of a return. A person is treated as having "prepared" an entry on a return if he renders tax advice that is

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[286] In January 2010, the Service released a comprehensive set of new rules relating to preparers. See IR-News Rel. 2010-1, 19 Stand. Fed. Tax Rep. (CCH) ¶ 46,237; Standards with Respect to Tax Returns and Documents, Affidavits, and Other Papers, 75 Fed. Reg. 51,713-01 (proposed Aug. 23, 2010) (to be codified at 31 C.F.R. § 10.34). Most of these rules generally impose registration, competence, and continuing education requirements on preparers. Since the proposals generally do not address standards for reporting of particular transactions, their relevance to practitioners writing reporting opinions is limited. Therefore, the 2010 proposals are beyond the scope of this Article. The exception is the amendment to 31 C.F.R. § 10.34(a), which generally conforms the administrative "preparer" rules of Circular 230 to the statutory standards imposed by section 6694. For a discussion of the 2010 rules under 31 C.F.R. § 10.34(a), see *infra* text accompanying note 317.

[287] I.R.C. § 6694(f).

[288] Reg. § 301.7701-15(a).

[289] Reg. § 301.7701-15(b)(1).

[290] Reg. § 301.7701-15(b)(2)(i).

"directly relevant to the determination of the existence, characterization or amount" of such entry.[291] It is not necessary that one physically enter the line item on the return or even be involved in calculating the amount of the entry.

The second element of the "nonsigning preparer" definition requires that the item that one "prepares" represent all or a "substantial portion" of the return. Whether an item is a "substantial portion" is based on whether the potential preparer knows or reasonably should know that the tax attributable to such item is a substantial portion of the total tax required to be shown on such return.[292] Factors taken into account in making this determination include (but are not limited to) (1) the size and complexity of the item relative to the taxpayer's gross income, and (2) the size of the understatement attributable to the item compared to reported tax liability.[293]

A safe harbor provides that an item is not substantial if it involves an amount of gross income, a deduction, or an amount on the basis of which a credit is determined that is (1) less than $10,000, *or* (2) less than (a) $400,000 *and* (b) 20% of the gross income item on the return.[294] The definition of "substantial" is so vague as to be almost meaningless, and there does not seem to be much in the way of interpretive authority.

Frequently, a practitioner who is asked to opine as to the reporting of a particular transaction may have no information at all about the rest of the taxpayer's return, and he may not even know the amount of the item on which he is opining as to the proper legal characterization. As noted above, the definition of "substantial" is phrased in terms of what the preparer "knows or has reason to know." It is not clear whether this could be interpreted to mean that a

[291] Reg. § 301.7701-15(b)(3)(i); *see also* Reg. § 301.7701-15(b)(2)(ii), Ex. (2).
[292] Reg. § 301.7701-15(b)(3)(i).
[293] *Id*.
[294] Reg. § 301.7701-15(b)(3)(ii)(A).

practitioner whose knowledge is limited to the qualitative facts relating to the specific issues on which he is opining is, per se, not a preparer because his lack of knowledge renders the item not "substantial" regardless of its actual magnitude.

Although the basic definition of "substantial" is phrased in terms of knowledge, the safe harbor appears to require that the amount of the item *actually* be less than the stated threshold. Thus, without knowledge of the overall contents of the return,[295] a practitioner may have no way of knowing whether this safe harbor is available.[296]

The third element of the preparer definition is that the advice be rendered after the occurrence of the events to which it relates. Thus, the general rule is that a person who advises on the reporting of a completed transaction can be a preparer; a person who advises on a transaction not yet complete cannot.

An exception to this principle provides that where a practitioner who has advised on a transaction before the fact also gives advice after the fact, the post-closing advice is not taken into account provided that the time spent on post-closing advice is less than five percent of the aggregate time spent on the item.[297] In effect, this means that a practitioner who has spent significant time in structuring and implementing a transaction and who is asked a quick question by the client or the client's accountant after it has closed, can answer this question without fear of becoming a preparer. However, this exception cannot be relied on where advice is given pre-closing primarily to avoid preparer status and is confirmed post-closing.[298]

[295] Note that the safe harbor does not apply to a signing preparer (who presumably would have such overall knowledge). Reg. § 301.7701-15(b)(3)(ii)(c).

[296] Even after a penalty is asserted, a practitioner may not be able to obtain this information unless the taxpayer consents. *See* I.R.C. § 6103.

[297] Reg. § 301.7701-15(b)(2)(i).

[298] *Id*.

b. *The Preparer Penalty*. Section 6694 imposes a penalty, equal to the greater of $1,000 or 50% of the income derived by the preparer with respect to the return, if there is an understatement of tax due to a position for which there did not exist adequate support.[299] The penalty can be avoided if there is reasonable cause for the understatement, and the preparer acted in good faith.[300]

The required level of support falls into one of three categories:

- If an item relates to a tax shelter (as defined in section 6662(d)(2)(c)(ii)[301]) or a reportable transaction, it must be reasonable to believe that the position would more likely than not be sustained;[302]
- If an item does not relate to a tax shelter or reportable transaction and it is not specifically disclosed on the return, there must be substantial authority for the position;[303]
- If an item does not relate to a tax shelter or reportable transaction and is specifically disclosed on the return, there must only exist a reasonable basis for the position.[304]

Prior to SBWOTA2007, section 6694 only required a "realistic possibility of being sustained on the merits.[305] SBWOTA2007 amended section 6694 to require a "reasonable belief

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[299] I.R.C. § 6694(a)(1). Although the amount of the preparer penalty is not dependent on the amount of the understatement (unlike the section 6662 accuracy-related penalty imposed on taxpayers), the existence of an understatement is a necessary element for imposition of the penalty. *See* I.R.C. § 6694(d), (e).

[300] I.R.C. § 6694(a)(3). For a discussion of the reasonable cause–good faith defense to the taxpayer accuracy-related penalty, *see infra* Part V.E.2.d.

[301] *See infra* text accompanying note 462.

[302] I.R.C. § 6694(a)(2)(C).

[303] I.R.C. § 6694(a)(2)(A).

[304] I.R.C. § 6694(a)(2)(B).

[305] I.R.C. § 6694(a)(1) (prior to amendment by SBWOTA2007, § 8246(b). 121 Stat. 190, 203.)

that the position would more likely than not be sustained" for all nondisclosed positions.[306] This created an anomaly in that, for nondisclosed positions with respect to transactions that are not tax shelters or reportable transactions, the standard for preparers was higher than that imposed by section 6662 for purposes of the substantial understatement penalty imposed on taxpayers.[307] Thus, a preparer could be subject to a penalty for advising a taxpayer to claim a position, even though the level of authority in support of that position was such that no penalty could be imposed on the taxpayer.[308] In TEAMTRA2008, the Code was amended to eliminate this odd state of affairs.[309] The current three-level approach is generally consistent with that which applies for purposes of the substantial understatement penalty, so that a taxpayer and preparer advising him are generally subject to the same standard.

2. The Circular 230 "Preparer" Rules

a. *Required Level of Authority*. In 1994, the Treasury Department issued regulations under Circular 230 imposing standards for advice as to the reporting of a transaction on a tax return.[310] Under those rules, a practitioner could only advise a client to claim a position on a return if *either* (1) the position met the "realistic possibility" (*i.e.*, one-in-three chance) standard, *or* (2) the position was not frivolous *and* the practitioner advised the client of any opportunity to avoid penalties by disclosing the item on the return.[311]

[306] SBWOTA2007, § 8246(b), 121 Stat. 190, 203.

[307] *See infra* text accompanying notes 462–64.

[308] *Cf.* N.Y. State Bar Ass'n v. Reno, 999 F. Supp. 710 (N.D.N.Y. 1998) (holding unconstitutional a law that made it a crime to advise a person to dispose of assets in order to become eligible for Medicaid, where disposing of such assets was not itself a crime).

[309] TEAMTRA2008, § 506(a), 122 Stat. 3861, 3880 (amending I.R.C. § 6694(a)(2)).

[310] T.D. 8545,1994-2 C.B. 415.

[311] Reg. § 10.34(a) (prior to amendment by T.D. 9359, 2007-45 I.R.B. 931).

This standard was generally consistent with those that applied for purposes of the section 6694 preparer penalty in effect at the time.[312] Significantly, however, the rule was not limited to "preparers" as defined for purposes of section 6694. Thus, a practitioner who gave advice as to reporting prior to the consummation of a transaction or with respect to an item that did not constitute a "substantial portion" of a return would not be a "preparer" potentially subject to the section 6694 penalty,[313] but would be subject to the same standards under Circular 230.

In 2007, the Treasury withdrew 31 C.F.R. § 10.34(a) and issued a proposed replacement.[314] The proposed replacement would have conformed the standard to that which applied under section 6694, as in effect at the time the proposal was issued. However, section 6694, as in effect at the time (and which the 2007 proposed amendments to 31 C.F.R. § 10.34(a) followed) had the anomalous effect of imposing, in some circumstances, more onerous rules on preparers than section 6662(d) imposed on taxpayers.[315]

TEAMTRA amended section 6694 to conform the preparer standards to the taxpayer penalty standards under section 6662(d).[316] However, for a time, the 2007 proposed amendments to 31 C.F.R. § 10.34(a) remained outstanding, even though the statutory provision on which they were based had been amended. Finally, in 2010 the Treasury Department withdrew the 2007 proposals and issued a new proposed version of 31 C.F.R. § 10.34(a) that is generally consistent with the current standards imposed by section 6694.[317]

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[312] I.R.C. § 6694(a) (prior to amendment by SBWOTA2007, § 8246(b), 121 Stat. 190, 203).

[313] *See supra* text accompanying notes 286–98.

[314] 72 Fed. Reg. 54,621, 54,621–22 (proposed Sept. 26, 2007) (to be codified at 31 C.F.R. § 10.34).

[315] *See supra* text accompanying notes 305–08.

[316] *See supra* note 309.

[317] Standards with Respect to Tax Returns and Documents, Affidavits, and Other Papers, 75 Fed. Reg. 51,713-01 (proposed Aug. 23, 2010) (to be codified at 31 C.F.R. § 10.34).

As of this writing, except for the penalty advice rules discussed below, there are no Circular 230 rules currently in effect governing advice as to reporting of a transaction on a return. Based on the 2010 amendments, it appears that Treasury will likely issue final regulations that retain the basic approach of section 6694 conformity, although commentators have argued for the adoption of a more liberal standard.[318]

b. *Advice Concerning Penalties*. One aspect of the Circular 230 "preparer" rules is currently in effect. Specifically, a practitioner (whether or not a "preparer") who advises a taxpayer on the reporting of a transaction must inform a client of any penalties that are "reasonably likely" to apply.[319] In addition, if the relevant rules governing taxpayer penalties provide an opportunity to avoid penalties by making disclosure on the return,[320] the practitioner must so advise the client (as well as advising as to the requirements for adequate disclosure).[321] The regulations do not specify how the required advice as to penalties is to be communicated. However, if the basic advice as to reporting is in the form of a formal opinion, it would seem to be good practice to include the required advice as to penalties in that same opinion.

C. *ABA Standards*

From time to time, the Committee on Ethics and Professional Responsibility of the American Bar Association issues formal opinions interpreting the Model Rules of Professional Conduct. Although neither the Model Rules nor opinions interpreting them have the force of law, states often have rules of conduct that are based on the Model Rules, and state licensing authorities may look to ABA interpretations in applying their own rules. Quite aside from the

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[318] *See* NYSBA Preparer Report, *supra* note 94.

[319] 31 C.F.R. § 10.34(c)(1)(i)(A) (2010).

[320] *See* I.R.C. § 6662(d)(2)(B)(ii)(I).

[321] 31 C.F.R. § 10.34(c)(2) (2010).

issue of enforcement, ABA ethics opinions may provide helpful guidance to attorneys on issues of professional responsibility.

At the present time, the practical utility of existing guidance in the form of ABA ethics opinions is limited. As a result of changes in the statutory and regulatory framework over the past several years, in many cases the standards of conduct prescribed by ABA ethics opinions have, in effect, been preempted by stricter standards imposed by the Code or regulations. Nonetheless, there are some circumstances in which these stricter standards do not apply, and in those cases the ABA opinions retain some relevance.

1. Formal Opinion 85-352

Formal Opinion 85-352[322] addresses the responsibilities of an attorney who advises a client on the reporting of a transaction on a return. The opinion notes that generally, different standards apply to an attorney acting as advisor than those that apply when acting as advocate. In the former role, an attorney is obligated to render "candid" advice.[323] When acting as advocate, a lawyer is precluded from taking frivolous positions.[324] There is an overriding prohibition on counseling a client to engage in or assisting a client in fraudulent conduct.[325]

Formal Opinion 85-352 notes that counseling as to a return filing position implicates both roles, reasoning that "[i]n many cases a lawyer must realistically anticipate that the filing of the tax return may be the first step in a process that may result in an adversary relationship between

[322] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 85-352 (1985).

[323] MODEL RULES OF PROF'L CONDUCT R. 2.1 (2006).

[324] *Id*. R. 3.1.

[325] Id. R. 1.2(d).

the client and the [Service]."[326] The opinion concludes that a lawyer may advise a client to take a return position as long as there is a "realistic possibility of success."[327]

What is the relevance of Formal Opinion 85-352 today? A "preparer" is subject to stricter standards imposed by statute, and therefore risks a penalty if he advises a client to take a return position based on no more than a "realistic possibility."[328] Thus, for "preparers," Formal Opinion 85-352 has effectively been preempted by section 6694. In the case of an advisor other than a "preparer," however, currently there are in effect no specific Code provisions or regulations that impose a higher standard.[329] Accordingly, for these advisors the "realistic possibility" standard of Formal Opinion 85-352 may still have relevance.

Because the "realistic possibility" standard is lower than that which applies for a taxpayer to avoid a substantial understatement penalty under section 6662(d) (unless the position is disclosed),[330] a practitioner who advises a client to take a position based on that standard must, of course, also advise his client of the risk of incurring a penalty (as well as the possibility of avoiding it by disclosure).[331]

One practical limitation on the continuing relevance of Formal Opinion 85-352 is that typically the nonpreparer advisor rendering the advice will not have the last word on the subject.

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[326] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 85-352 (1985).

[327] *Id.* As discussed *supra* in the text accompanying notes 98–106, the "realistic possibility" standard originates in Formal Opinion 85-352 and was subsequently adopted under a (since-amended) version of section 6694 and a (since-withdrawn) version of the Circular 230 preparer rules. The interpretation of the standard to mean a one-in-three chance of success was added by regulations under section 6694 and Circular 230; it is not found in Formal Opinion 85-352 itself.

[328] *See supra* text accompanying notes 301–04.

[329] As discussed *supra* in the text accompanying notes 314–17, the Treasury Department has issued proposed regulations that would apply the higher section 6694 standard to all practitioners who advise on reporting, whether or not they are "preparers."

[330] *See infra* text accompanying notes 463–64.

[331] 31 C.F.R. § 10.34(c) (2010) (discussed supra in (the text accompanying notes 318–21. Formal Opinion 85–352 itself also states that a lawyer "should" counsel his client as to potential penalty consequences of taking the position. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 352 (1985).

A taxpayer (having been advised of the risk of penalties) may wish to take an aggressive position and report based on a "realistic possibility" standard, in effect wagering the potential penalties if he loses against the potential tax savings if he wins. However, in many cases, there will also be a signing preparer who has overall responsibility for the return. Unlike the advisor giving the "realistic possibility" opinion, he is potentially subject to preparer penalties under section 6694; unlike the client, he has everything to lose and nothing to gain. As a practical matter, therefore, the signing preparer may refuse to sign a return based on no more than a realistic possibility of success, even when the nonpreparer advisor is free to render advice on that basis.

2. Formal Opinion 346

ABA Formal Opinion 346 addresses opinions in connection with "tax shelter investment offerings."[332] The types of opinions to which this opinion applies are essentially the same as those to which the pre-2004 tax shelter opinion rules applied under Circular 230[333]—that is, opinions that are referred to, in offering materials or in connection with sales promotion efforts, with respect to a "tax shelter." For this purpose, a "tax shelter" is an investment that has, as a "significant feature"[334] in any year, either (1) deductions in excess of income from the investment, or (2) credits in excess of tax attributable to income from each investment, that, in each case, can be used to reduce tax on income from other sources.

The requirements imposed by the Formal Opinion are also generally similar to those imposed by the pre-2004 Circular 230 rules. In general, these requirements are as follows:

- The advisor must make inquiry, and receive answers, as to the relevant facts.
- The advisor must relate the law to the facts.

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[332] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 346 (1982).

[333] *See supra* note 142.

[334] This language is similar to the pre-2004 Circular 230 tax shelter opinion rules, which spoke in terms of a "significant and intended" feature. 31 C.F.R. § 10.33(c)(2) (2010) (prior to amendment by T.D. 9165, 2005-1 C.B. 357). The difference in language does not appear to have been intended to be significant.

- The advisor must make reasonable efforts to ascertain that a good faith effort has been made to comply with nontax laws.
- The advisor must (1) consider, or satisfy himself that another competent professional has considered, all material tax issues, and (2) fully and fairly address each material tax issue as to which there is a reasonable possibility that the Service will seek to challenge the intended tax effect. For this purpose, a "material tax issue" is any income or excise tax issue that would have a significant effect in sheltering from federal taxes income from other sources by providing, in any year, deductions in excess of income or credits in excess of tax.
- With respect to each material tax issue, the advisor must state his opinion as to the probable outcome, or if that is not possible, so state and explain the reasons.
- The advisor must provide an overall evaluation of the extent to which significant tax benefits, in the aggregate, are likely to be realized. If such an overall evaluation is not possible, the advisor should fully explain the reasons why that is the case and assure full disclosure of the risks. However, the formal opinion cautions that this is limited to "rare instances."
- The advisor must assure that potential investors will not be misled as a result of the opinion being mischaracterized in offering materials or in connection with sales promotion efforts.

As discussed above,[335] transactions of the type that fit the definition of "tax shelter," as used for this purpose, are relatively rare in today's world. If such a transaction were done, any opinion in connection therewith would most likely fall within the "marketed opinion" definition

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[335] *See supra* text accompanying note 142.

under the Circular 230 written advice rules,[336] in which case the generally stricter covered opinion rules would effectively pre-empt those of the ABA Formal Opinion, unless marketed opinion status is avoided by means of a three-part disclaimer. However, the disclaimer is only effective if the transaction is not a principal purpose transaction.

Thus, for all practical purposes, any continuing relevance of ABA Formal Opinion 346 is limited to situations in which (1) a transaction satisfies the definition of "tax shelter" as used in the formal opinion, *and* (2) it is not a principal purpose transaction.

D. *Securities Law Issues*

When an opinion is rendered in connection with the disclosure included in a registration statement filed with the SEC, the potential exists for liability under section 11 of the Securities Act of 1933.[337] That section imposes civil liability on certain enumerated persons where a registration statement contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading. Among the class of persons subject to liability under section 11 of the Securities Act of 1933 is "every accountant, engineer, or appraiser, *or any person whose profession gives authority to a statement made by him*, who has with his consent been named as having prepared or certified any part of the registration statement, ... with respect to the statement ... which purports to have been prepared or certified by him."[338] Such persons are generally referred to as "experts."

In general, an attorney is not considered to be within the class of "experts" subject to liability under this section merely by virtue of having participated in the preparation of a

[336] *See supra* text accompanying note 185.

[337] 15 U.S.C. § 77k (2006). See generally HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK ch. 26, pt. III (2009–2010 ed. 2009).

[338] 15 U.S.C. § 77k(a)(4) (2006) (emphasis added).

registration statement.[339] However, it has been held that an attorney can be within the purview of section 11 of the Securities Act where he provides a legal opinion and expressly consents to a reference to such opinion in a registration statement[340]—which, as discussed below,[341] is precisely what the SEC often requires practitioners to do with respect to tax disclosure.

An expert subject to potential liability under this provision has a defense if he can prove that "he had, after reasonable investigation, reasonable ground to believe, and did believe ... that the statements ... were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[342]

A detailed discussion of liability under section 11 of the Securities Act is beyond the scope of this Article. However, it is worth noting that, as discussed below,[343] over time the SEC staff seems to have become more demanding in terms of the scope of the opinions that they are likely to require: the broader the scope of such an opinion, the greater the potential for falling within the purview of section 11 of the Securities Act.

E. *Other Professional Responsibility Issues*

In addition to the specific rules and regulations discussed above, an attorney preparing a tax opinion needs to keep in mind general principles of professional responsibility. In general, an attorney owes his client (and, in some cases, persons other than clients)[344] a duty of competence and a duty of diligence,[345] and failure to comply with these duties can result in civil

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[339] *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

[340] *See, e.g., In re* Am. Cont'l Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. 1424, 1453 (D. Ariz. 1992).

[341] *See infra* text accompanying notes 417–18.

[342] 15 U.S.C. § 77k(b)(3)(B)(i) (2006).

[343] *See infra* text accompanying notes 417–18.

[344] *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 51 (2000).

[345] *See id*. § 52.

liability for professional negligence.[346] Rules of professional conduct also generally impose on attorneys a duty to provide competent representation.[347]

Of course, most attorneys prefer to work to a higher standard than the minimum required to avoid civil liability and to keep one's license. Aside from pride in workmanship, gaining a reputation for writing bad opinions is, in the long run at least, not likely to be good for business. Most attorneys view formal opinions as the type of work product that calls for the highest standard of care.

At the other extreme, when a formal opinion goes bad, it can go really bad. One commentator has identified a litany of legal headaches that could face a practitioner who has furnished an opinion in a truly disastrous transaction, noting that all of these could confront the giver of a bad tax shelter opinion.[348] These include (1) common-law civil liability under theories of negligent malpractice, negligent misrepresentation, fraud, breach of trust, and breach of fiduciary duty, (2) statutory civil liability under securities laws, the RICO statute, and unfair trade practice legislation, (3) penalties under sections 6700 and 6701, (4) administrative sanctions for violations of Circular 230, and (5) criminal prosecution under the securities laws, mail fraud, wire fraud and false statements statutes, tax fraud statutes, and RICO. Hopefully, most readers of this Article will not find themselves in this situation.[349]

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[346] *See id*. § 48.

[347] *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.1, 1.3 (2006).

[348] See STERBA, *supra* note 1, § 12.1.

[349] *Id*. Reading this list of horrors is almost enough to make one consider a safer line of work (*e.g.*, hazardous waste disposal).

V. PRACTICAL ISSUES

A. *Form of the Opinion*

Typically, a legal opinion is in the form of a letter that follows a fairly structured format. Although the precise format and boilerplate vary from firm to firm, most "long-form" opinions include the basic components described below.

1. *Role of Counsel*

Where an opinion is rendered in connection with a specific transaction, it is customary to begin by stating the opining counsel's role in the transaction. Although terminology in this area is not precisely defined, "We have acted as counsel to ________________________ in connection with _____________________" is generally read to imply that the law firm rendering the opinion (1) has overall responsibility for representing the client in this particular transaction, *and* (2) has an ongoing relationship with the client, such that it can be expected to have a fairly high degree of familiarity with the clients' overall legal situation. "Special counsel" implies overall responsibility for the transaction, but does not imply familiarity with matters outside the scope of the particular transaction. "Special tax counsel" suggests that the advisor's role is limited to providing tax advice in connection with the particular transaction; it is typically used where another law firm is handling corporate and overall transactional representation.

2. *Purpose of Opinion*

In some types of opinions, it is customary to state the purpose of the opinion up front. For example, in a contractual condition opinion, typically the opinion will identify the particular section of the underlying contract that imposes the condition and state that it is being delivered in satisfaction of such condition. A third-party inducement opinion will typically state what it is the third party is being induced to do, and acknowledge that he will rely on the opinion in so doing.

Other types of opinions often simply say “You have requested our opinion as to ________ __________________,” without specifying why the opinion has been requested.

3. *Documents Reviewed*

In the case of an opinion with respect to a specific transaction, the introductory paragraphs typically identify documents that have been reviewed in connection with, and the contents of which are material to the conclusions reached in, the opinion. These might include the following:

- The fundamental operative legal documents that effect the transaction that is the subject of the opinion are specifically identified.
- Other descriptive documents—for example, a proxy statement or registration statement prepared in connection with the transaction—are identified.
- Other legal opinions that have been relied on are identified. These may include opinions as to the nontax legal issues; in some cases, they may include “specialist” opinions as to specific points of tax law that are passed on by another practitioner, but that form the basis for the conclusion reached in the opinion.
- Nonlegal professional reports, such as appraisals, are identified.
- Frequently, one sees a catch-all reference to “such other documents as we have considered necessary.”

The documents, together with representations and assumptions, are the basic material for establishing the factual predicates for the legal conclusions reached in the opinion. Issues that arise in connection with establishing such factual predicates are discussed below.[350]

[350] *See infra* text accompanying notes 366–83.

4. Disclaimers

Given the formality of a legal opinion and the potential legal exposure it can create, most practitioners are quite careful about delineating the scope of their responsibility. In this connection, many firms use forms of opinion that include specific disclaimers as to the scope. The following are typical:

- Tax opinions often identify, in general terms, the types of legal authority upon which the opinion is based; these would include the Code, regulations, and administrative and judicial interpretations, all in effect as of the date of the opinion.[351] Often there is a warning that the law could change (possibly retroactively), and a disclaimer of any undertaking to notify the client if any such changes in law occur that could affect the conclusions reached in the opinion.[352]
- Typically, opinions include a warning that a court or the Service could reach a contrary conclusion to that reached in the opinion. In effect, this places the reader on notice that a legal opinion—even one at the "will" level of comfort—is not an insurance policy.
- Opinions often include a specific statement that the opinion is based on, and is only as good as, the facts, representations, and assumptions identified therein. Moreover, there is often a specific disclaimer of any independent verification of the facts or of the accuracy of the representations or assumptions.[353]

[351] Occasionally, a practitioner may be called upon to opine as to the state of the law as of an earlier point in time. Obviously, in such a case the description of legal authorities would need to be appropriately adjusted.

[352] Of course, if the practitioner has a continuing relationship with the client he might well decide, as a matter of good business, to inform the client if such a change in law occurs. Nonetheless, most practitioners include the disclaimer to avoid any possible implication that he is undertaking a legal obligation to do so.

[353] Of course, under the Circular 230 written advice rules, discussed *supra* in the text accompanying notes 272–77, the practitioner must feel comfortable that the representations and assumptions are reasonable.

- Today, it is rare indeed to see a tax opinion that does not include a Circular 230 disclaimer (in either the standard form or the three-part form, depending on the nature of the opinion).[354] The exception is penalty protection opinions, which are generally written to comply with the Circular 230 covered opinion rules.

5. Description of Facts

Typically, the first "substantive" section of an opinion, following the boilerplate, is a description of the facts. Issues that arise in connection with establishing facts, including the interrelationship between the facts section and representations and assumptions, are discussed below.[355]

6. Representations and Assumptions

These important components of an opinion, and their role in establishing facts, are discussed below.[356]

7. Legal Analysis

Typically the longest part of an opinion, this is the section that discusses the law and explains the reasoning behind the conclusions that are reached.

8. Opinions

In the broad sense, an "opinion" refers to the entire document;[357] in the narrow sense, the term refers to the section of the opinion (in the broad sense) where the practitioner states his conclusions as to the specific legal issues on which he has been asked to opine. The wording is almost formulaic: most firms use something like "Based upon the foregoing, and subject to the assumptions set forth above, we are of the opinion that ____."

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[354] *See supra* text accompanying notes 217–18.
[355] *See infra* text accompanying notes 366–83.
[356] *See infra* text accompanying notes 372–79.
[357] Perhaps a better term for the entire document is "opinion letter."

Precision is important for opinions (in the broad sense); for opinions (in the narrow sense), it is crucial. The practitioner should choose his language carefully, so as to leave no doubt as to the precise proposition of law that he is proffering as his opinion. In the case of a contractual condition opinion, the language should conform, verbatim, to that required by the contract. In any case, the terminology used should reflect the practitioner's comfort level.

In a sense, almost everything else in the opinion (in the broad sense) is there because the lawyer who is writing the opinion needs or wants it to be there. The only thing the recipient needs or cares about is this one section.[358] This is where the rubber meets the road.

9. Covered Opinion Required Disclosures

As discussed above, Circular 230 covered opinions are required to include, prominently,[359] certain "required disclosures."

- Certain financial arrangements involving the advisor rendering the opinion must be disclosed.[360]
- If the opinion is a marketed opinion, it must disclose that it was written to support the promotion or marketing of the transactions or matters addressed therein, and must advise taxpayers to seek advice, based on his particular circumstances, from an independent tax advisor.[361]
- If the opinion is a limited scope opinion it must disclose that (1) it is limited to the one or more federal tax issues addressed therein; (2) additional issues may exist that could affect the tax treatment of the transaction or matter that is the subject of

[358] *But see infra* text accompanying notes 518–27 (discussing *Long Term Capital Holdings v. United States*, which rejected a taxpayer's claimed reliance on an opinion as a defense against penalties based, in part, on factual findings that principals of the taxpayer did not read the analysis but only cared about the level of comfort set forth in the conclusion).

[359] For the meaning of "prominent," see *supra* text accompanying notes 219–23.

[360] *See supra* text accompanying notes 266–67.

[361] *See supra* text accompanying notes 259–60.

the opinion, and the opinion does not consider or provide a conclusion with respect to any additional issues; and (3) the opinion was not written, and cannot be used for the purpose of avoiding penalties, with respect to any issues outside its scope.[362]

- If the opinion does not reach a conclusion, at a level of at least "more likely than not," with respect to any significant federal tax issues, it must so state, and must also disclose that it was not written, and cannot be used to avoid penalties, with respect to those issues.[363]

10. Restrictions on Use

Given the potential liability that may arise from a formal opinion, practitioners generally want to avoid any implication that an opinion may be used or relied on other than by the specific addressee and for the specific purpose for which it was written. Accordingly, opinions often conclude with a restriction on the addressee's ability to show or give it to any other person, and if the specific purpose of the opinion was stated in the introductory material, a restriction on using it for any other purpose, in each case without the consent of the advisor. Of course, if the intended purpose of the opinion requires that it be shown or given to a third party, that would be carved out of the restriction.

11. Signature

As rendered by most law firms, a formal opinion is signed, not in the name of an individual attorney, but in the name of the firm itself. This befits the notion that a formal opinion represents the firm's going on record, in the most formal way possible and after careful deliberation, as to its views on the particular legal question at hand.

[362] *See supra* text accompanying notes 249–50.
[363] *See supra* text accompanying notes 242–43.

12. Short-Form Opinions

Sometimes, opinions are rendered in "short-form." A short-form opinion differs from a long-form opinion in that it states its conclusion but does not explain the legal reasoning underlying that conclusion. Thus, the "legal analysis" section would be omitted. A short-form opinion might also go into less detail as to the representations on which it is based. Thus, such an opinion might state that it is based, in part, on representations as to certain factual matters, without specifying the substance of those representations. Assumptions should be explicitly stated even in a short-form opinion.

As noted above, the Circular 230 covered opinion rules specifically require that the reasoning behind each legal conclusion be explained.[364] Thus a short-form opinion cannot be used for a covered opinion.

Generally, short-form opinions are only used for high comfort levels. One commentator has implied that a short-form opinion is only appropriate for a "will" level of comfort, and has described it as "unfortunate" that some practitioners render "should" level opinions without stating their reasoning.[365] The theory behind reserving short-form opinions for the highest comfort levels is that if there is sufficient uncertainty as to the conclusion so as to require a lower level opinion, the reasons for that uncertainty should be fully explained to the recipient.

Assuming that a short-form opinion is permissible (*i.e.*, it is not a covered opinion) and that the comfort level is sufficiently high, whether or not a short-form opinion is appropriate in a particular case will depend largely on the function of the opinion. Thus, for example, in the case of a contractual condition opinion, the condition is satisfied by the receipt of an opinion that reaches the required conclusion; the reasoning underlying that conclusion is not relevant. Short-

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[364] *See supra* text accompanying note 240.
[365] *See* Cummings, *supra* note 44.

form opinions are in fact frequently seen in this context. On the other hand, opinions for other purposes may be more useful or persuasive if they explain their reasoning.

B. *Establishing the Factual Predicates for the Opinion*

The conclusion reached in a legal opinion is the result of applying the law to a particular set of facts. While the essence of the lawyer's job is to interpret and apply the law, he cannot (or, at least, should not) render an opinion as to what the facts are. Therefore, in order to render an opinion, it is necessary to identify every fact the existence of which is necessary for the conclusion being reached and ensure that each such fact is established, for purposes of the opinion, so as to avoid implicitly opining as to any factual matters.

The basic tools for establishing factual matters are (1) transactional documents, (2) representations, and (3) assumptions. The handling of these basic sources for establishing the factual predicates for an opinion is a fundamentally important aspect of opinion practice.

1. The Basic Factual Contexts

Tax opinions are rendered in a number of different factual contexts, and the approach to establishing the necessary factual basis for the opinion can vary depending on the context.

a. *Opinions on Specific Transactions*. Probably the most common factual context in which a tax opinion is rendered is with respect to a specific transaction. This is also probably the easiest context in which to render an opinion since the advisor has the opportunity to read the relevant transactional documents (if he is not actually involved in preparing them). In this context, the primary source of factual material (factual, that is, with respect to the tax analysis) is those documents.

Although precisely what comprises transactional documents will vary depending on the nature of the transaction, in general they are likely to fall into two categories. First are the contracts or other operative legal documents that effect the transactions or legal relationships that are the subject of the opinion. Examples of this type of document would be a merger agreement or an LLC operating agreement.

In addition to the operative legal documents, there may be additional transactional documents that do not themselves effect the transaction or create legal relationships but that are more descriptive in nature. For example, if the transaction that is the subject of the opinion is subject to a shareholder vote, there may be a proxy statement describing the transaction for the benefit of shareholders who are being asked to vote on it.

It should go without saying that, before rendering an opinion on a specific transaction, a lawyer should—nay, *must*—read the transactional documents. The client may have described the transaction to you in general terms, but a layman's understanding may not accurately reflect the actual legal form of the transaction. Even if the general description is accurate, there may be additional nuances, the relevance of which might not be apparent except to a tax practitioner. The facts that govern for purposes of the opinion are those reflected in the operative legal documents, not those reflected in an informal conversation with the client.[366] Failure to read the transactional documents may very well violate the Circular 230 written advice rules, which prohibit an advisor from rendering an opinion that does not consider all relevant facts that the advisor knows or should know;[367] in any event, it would be very sloppy work.

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[366] If there is a fundamental inconsistency between the two, a careful practitioner may want to ask some additional questions to be sure that there is no misunderstanding as to what is really happening.

[367] *See supra* text accompanying note 278. This is the rule for written advice other than a covered opinion. In the case of a covered opinion, the rules require that the practitioner "identify and ascertain" the relevant facts. *See supra* text accompanying note 224.

Typically, not every fact can be established on the face of the transactional documents. Facts that cannot be so established should be the subject of representations. Of course, any representations must be reasonable.[368]

In some cases, all of the relevant facts can be established from a combination of the transactional documents and representations. When that is the case, assumptions would typically be limited to those that establish the ability to rely on the transactional documents. Typically these would include assumptions that (1) the copies of the transactional documents furnished to the tax advisor conform to the executed versions of those documents, (2) the transactions will in fact be consummated in accordance with the transactional documents, (3) all representations of any party included in any of the transactional documents are correct, and (4) all covenants of any party in any of the transactional documents will be complied with.

In some cases, there may be additional facts that are necessary to the conclusion, but that cannot be determined from the transactional documents and as to which a representation is not feasible. In these cases, if the client asks the advisor to render an opinion on the basis of an assumption, the advisor will need to determine whether the assumption is both reasonable and appropriate.[369]

The "Facts" section of an opinion delivered in connection with a specific transaction generally summarizes the transaction and the relevant facts. In the case of a short-form opinion, the summary may be quite abbreviated. A long-form opinion would typically go into greater detail. In any case, all the facts set forth in that section (as well as any other facts on which the conclusion rests) should be directly traceable to either a transactional document, a representation, or an assumption.

[368] *See supra* text accompanying notes 274–77. For further discussion of representations, see *infra* text accompanying notes 372–77.

[369] For further discussion of when assumptions are appropriate, see *infra* text accompanying notes 378–79.

b. *Opinions on Hypothetical Transactions*. Sometimes, an advisor is asked to render an opinion without the benefit of a specific, fully documented, transaction. Instead, a client may seek formal advice based on a more general description of a type of transaction. For example, a client may be considering entering into a particular transaction, but may want some comfort as to the tax consequences before committing resources to negotiating all of the details and preparing documentation. Alternatively, a client may regularly enter into trades that have common features, on which he wants comfort as to the tax consequences, but where it is not economically feasible to render a separate formal opinion as to each trade.

As a threshold matter, a determination must be made as to whether it is appropriate to render a formal opinion at all on hypothetical facts. One issue that arises in the context of covered opinions is the requirement that the practitioner "ascertain" the relevant facts.[370] It is not clear whether this language presupposes the existence of "actual" facts to be "ascertained," possibly precluding the issuance of a covered opinion on facts that are too hypothetical to be "ascertained." Even outside the context of covered opinions, a practitioner may wish to be particularly careful about rendering an opinion on hypothetical facts where the opinion is expected to be for the benefit of a third party (*e.g.*, a third-party inducement opinion or a disclosure opinion), because the third party may not have adequate information on which to assess whether the actual facts conform to the hypothetical facts on which the opinion is based, and might easily be misled into believing that the advisor has investigated such actual facts. An opinion based on hypothetical facts may be less troublesome if it is to function as a comfort opinion, a reporting opinion, or a FIN 48 opinion. In any case, of course, the utility of the

[370] *See supra* text accompanying notes 224–26.

opinion in achieving its intended purpose will depend on the actual facts conforming to those on which the opinion is based.

Sometimes, it may be possible to provide a client with an adequate level of comfort by some means other than a formal opinion. For example, where a client is considering a transaction but wants written tax advice before spending money on documenting it, an advisor might suggest a legal memorandum addressing the issues; if the client decides to move ahead with the transaction and wants more formal advice, a formal opinion could be prepared once documentation is complete.

If a formal opinion is rendered on hypothetical facts, the handling of facts is necessarily quite different from that which applies to opinions on specific transactions. By definition, it is not possible to ascertain facts by examining transactional documents because there are no documents. In a sense, *all* of the facts in this type of opinion are assumptions. In terms of form, however, it would often read quite awkwardly to include a full-blown description of the transaction in the list of assumptions. Instead, a more typical way to handle it would be to describe the assumed transaction itself in the "Facts" section; the first entry in the "Assumptions" list would be the assumption that the transaction is in fact consummated in accordance with that description. Facts that do not directly relate to the transaction, but that are more in the way of background, would be established by representations or, if appropriate, assumptions.

Two points are of crucial importance in writing an opinion of this type. First, the practitioner must be very careful to identify every fact that is necessary to the conclusion, and state all of such facts in the "Facts" section. This includes "negative" facts; thus, if the conclusion depends on a contract not containing certain terms, the "Facts" section of the opinion needs to say so. Unlike an opinion on a specific transaction (where the "Facts" section is a summary that aids the reader but the actual documents are controlling), in an opinion on a hypothetical transaction the description *is* the transaction. Effectively, the practitioner is opining on any transaction the terms of which are consistent with the description, so the boundaries of the description had better be precise.

Second, an opinion in a hypothetical transaction needs to be very clear, on its face, that it is just that. The reader must be left in no doubt that (1) the attorney rendering the opinion has not examined any documents or otherwise reviewed an actual transaction, and (2) the validity of the opinion is entirely dependent on any actual transaction conforming precisely to the facts as assumed.

c. *Mixed Questions of Fact and Law*. Perhaps the most difficult type of opinion to give is one that involves a mixed issue of fact and law. Often, this may relate not to a single specific transaction, but to an overall course of dealing. Examples are opinions as to whether a foreign taxpayer is engaged in a U.S. trade or business, or whether a taxpayer is a dealer.

Unlike opinions on hypothetical transactions, where there are no real facts (just assumptions), the problem in writing this type of opinion is that there are too many facts. Moreover, the facts may be such that it is impossible to identify them by examining a limited group of documents, and it may actually be impossible even to list what the facts are without being overly conclusory. In effect, in writing this type of opinion a practitioner steps beyond the traditional role of expressing a conclusion of law with respect to identifiable facts. To a certain extent, the process involves making a prediction as to the conclusion that would likely be reached by a trier of fact. For these reasons, most practitioners prefer to avoid giving these types of opinions, if possible. Unfortunately, we do not always have the luxury of only doing what we would prefer to do.

Ultimately, a practitioner rendering this type of opinion will have to consider quite carefully (1) how much investigation to make as to “primary” facts, and (2) how to deal with factual material in the context of the opinion itself. Such an opinion is likely to rely quite heavily on detailed representations. In some cases, the practitioner may wish to undertake additional “due diligence” activities, such as interviewing employees or reviewing business records.

The precise scope of representations and assumptions is important in this context. Given the close relationship between the factual characterization and the legal conclusion, it may be particularly difficult to strike a balance that adequately protects the practitioner without being so conclusory as to render the opinion meaningless.[371]

2. Representations

Facts that cannot be established on the face of transactional documents (in the case of an opinion on a specific transaction), or that are important to the conclusion but are not part of the description of the transaction itself (in the case of an opinion on a hypothetical transaction) are sometimes established by representations. Of course, representations should be made by a person who is in a position to have knowledge of the facts as to which he is representing. This may be an officer or other responsible employee of the client, or may be some other person, depending on the facts at issue.

Sometimes, a person may be unable to make an absolute representation that a particular fact is true, but can represent that it is true to the best of his knowledge. In such a case, two considerations arise. First, in order for reliance on the representation to be “reasonable,” the

[371] For more on this issue (in the context of assumptions) see *infra* text accompanying notes 378–79.

practitioner may want to exercise particular care to satisfy himself that the overall responsibilities of the person making the representation are such that his knowledge of the subject matter would be expected to be reliable.[372] Second, because a representation limited by knowledge can be true even if the underlying fact turns out to be false, the opinion must explicitly assume that all facts that are the subject of representations are true *without regard to any knowledge qualifiers*. Of course, a judgment call must be made as to whether this approach, which technically protects the opinion writer but leaves the risk of inaccurate or incomplete knowledge on the recipient of the opinion, is acceptable under the circumstances. The concern is likely to be greater in the case of a third-party inducement opinion or a disclosure opinion, where somebody other than the advisor's client is expected to rely on the opinion. Of course, where the third party is himself the person giving the knowledge-limited representation, it seems perfectly reasonable that he should bear the risk of any inaccuracy or lack of completeness in his knowledge.

Because nobody can predict the future with certainty,[373] technically a representation can only speak to the past and present. This technicality is not always honored. Thus, it is not uncommon for an officer of a corporation to make a representation that the corporation will or will not do something; despite the technical impropriety, this does not seem unreasonable provided the future action that is the subject of the representation is generally within the corporation's control.

If the person making the representation is advised by one of those persnickety lawyers who refuses to allow his client to make a representation as to future events, often a representation can be made as to the existence of a "plan or intention" as to the future action. In that case, a

[372] *See infra* text accompanying note 377.

[373] It often seems, however, that we, as tax lawyers, are expected to do so.

substantive determination must be made as to whether the legal conclusion depends on the future action *actually* occurring (or not occurring, as the case may be) or whether the plan or intention itself is enough.

By way of example, consider a reorganization opinion, for which the advisor needs to know that the acquiring corporation will not, in connection with the transaction, redeem any of the stock issued as consideration in order to ensure that the continuity of proprietary interest requirement is not violated.[374] In theory, if it were conclusively established that there was no intention to redeem any stock at the time of the reorganization, the requirement would be satisfied even if, the very next day, something happened to cause the acquiror to change its mind and it did in fact redeem some of the stock, since, under normal step-transaction principles, an unexpected subsequent event would generally not be treated as "in connection with" the transaction.[375] Thus, in this case, a "plan or intention" representation should be adequate.

On the other hand, there could be situations where it is essential to the substantive conclusion that certain future events *actually* occur; even if the intention was that they occur, a failure to occur due to an unexpected intervening event would affect the legal conclusion. As a practical matter, in this type of situation most practitioners would try to structure the transaction so that the parties are contractually committed to effect the subsequent actions;[376] if so documented, the issue as to the representations disappears since the opinion would rely not on a representation but on the assumption that the contract would be performed by all parties. If for

[374] *See* Reg. § 1.368-1(e)(1)(i).

[375] Of course, there may be practical difficulties in proving such a lack of factual integration where the Service has the benefit of hindsight, but for purposes of the opinion the practitioner should be able to rely on representations, as long as they are reasonable, without worrying about how they could be proved.

[376] If the legal analysis depends on the subsequent action being integrated with the "main" transaction, this approach is safer even if the subsequent action actually does occur because it would satisfy even the strict "binding contract" formulation of the step-transaction doctrine, rather than relying on the "end result" formulation of the doctrine. *See* McDonald's Rests. of Ill., Inc. v. Commissioner, 688 F.2d 520, 524–25 (7th Cir. 1982).

some reason there was no binding contract and the advisor felt comfortable in opining based on a "plan or intention" representation, the opinion would have to include an explicit assumption that the future actions will in fact occur consistent with the plan or intention. Of course, the practitioner would have to make a judgment call as to whether this would be acceptable given the purpose of the opinion.

If a legal conclusion depends on a future event that is not generally within the control of any of the parties, it would seem inappropriate to establish that event by means of a representation. A better approach would be to use an assumption—provided, of course, the matter is not so fundamental as to preclude the issuance of the opinion at all.

Representations on which an opinion is based are usually provided in the form of a certificate or letter addressed to the attorney rendering the opinion, signed by the person making the representations. It should identify the person providing it, either by title or otherwise, so as to make it clear that each person's responsibilities are such that he would be expected to have knowledge of the matters represented to. In some cases, the certificate explicitly states that the representations are being made "after due inquiry." As noted above,[377] establishing the reliability of the source takes on added importance where any of the representations are explicitly qualified by knowledge. The certificate should recite that it is being provided in connection with the opinion, and should specifically acknowledge that the advisor will rely on it in rendering the opinion.

In the case of a long-form opinion, typically either the certificate is attached to the opinion as an exhibit, or it is referred to in the opinion and all the representations contained

[377] *See supra* text accompanying note 372.

within it are specifically enumerated. In a short-form opinion, the certificate should be referred to, but it may not be necessary to state its contents in detail.

3. Assumptions

Like representations, assumptions can only be relied upon if they are reasonable.[378] Some assumptions may be necessitated by the other sources that are being relied on to establish facts. For example, in a typical opinion on a specific transaction where the bulk of the facts regarding the transaction are established by means of the transactional documents, the practitioner needs to make assumptions to the effect that the documents he examined conform to those actually executed and that all parties will perform their respective obligations under the documents. Similarly, if any facts are established by means of representations, the practitioner needs to assume that the representations are correct. These types of assumptions are found in virtually all opinions and do not tend to raise significant issues.

When an assumption is the sole source for establishing a necessary fact, more difficult issues may be raised as to whether it is appropriate. Ultimately, the answer to this question will tend to be driven by the purpose of the opinion. For example, as discussed above,[379] where an opinion is rendered on a hypothetical transaction, essentially all of the facts are assumed. If such an opinion is provided to one's own client to function as a comfort opinion, this may be perfectly acceptable so long as the client understands its limitations and can be expected to have sufficient knowledge of any actual transaction to determine whether it conforms to the assumed facts. On the other hand, contractual condition opinions in reorganization transactions, particularly in the public context, typically do not make significant assumptions beyond those necessary to allow reliance on the transactional documents and representations. The contractual conditions in such

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[378] *See supra* text accompanying notes 272–73.
[379] *See supra* text accompanying note 370.

deals typically call for an opinion that is based only on "customary" assumptions, and an opinion that assumes away crucial facts might well not satisfy the condition. In the case of a third-party inducement opinion, the issue of what assumptions are appropriate really turns on what the third party is willing to accept. However, the practitioner does need to be careful to ensure that the third party is not misled as to what is being opined to and what is assumed. Concern about whether the third party understands what he is getting is likely to be alleviated if the third party is represented by counsel.

There is an inherent tension between a practitioner's understandable desire to broaden his assumptions (thus effectively narrowing the scope of the opinion) and the necessity to provide a meaningful opinion. As noted above, a lot will depend on the purpose of the opinion, but in the extreme case assumptions can become so broad and conclusory that they effectively assume away the entire opinion. In the author's view, such a "non-opinion" is rarely if ever justified. The fact that an opinion is being delivered at all implies—or at least creates an impression—that it says something. Where the assumptions are so broad and conclusory that, read literally, the opinion says nothing, there is a concern that it could be viewed as inherently misleading. If a practitioner cannot say something meaningful, it may be better not to opine at all.

Regardless of the scope of the assumptions, and regardless of the purpose of the opinion, all assumptions need to be stated explicitly on the face of the opinion.

4. Appraisals and Other Expert Opinions

Often, an opinion relies on reports or opinions of other professionals to establish facts[380] that are necessary to the legal conclusion being reached. Perhaps the most common example would be an appraisal to establish the value of property. Another example would be a report of a

[380] Similar considerations apply where an opinion relies on another legal opinion as to a specific sub-issue that is outside the competence of the advisor preparing the "main" opinion.

financial expert in connection with an opinion that debt would be respected as such for tax purposes. Like representations and assumptions, these materials may not be relied on unreasonably.

The first issue that arises in this context relates to the competence of the professional who prepares the report being relied on. Presumably, the attorney relying on a report of another professional does not have an obligation independently to verify the competence of such other professional. For example, where the other professional claims to have one or more degrees related to the subject matter of the report, or claims membership in a professional society or organization, most attorneys would not, as a matter of course, find it necessary to confirm such claims with the educational institution or professional societies. On the other hand, the attorney probably will want to satisfy himself that, at least facially, the person rendering the report appears to have expertise in the area. The gold standard, of course, would be to rely on a report prepared by a nationally known expert whose reputation speaks for itself,[381] but not every deal warrants the expense of such high-end advice.

Once the attorney is satisfied as to the competence of the other professional, the attorney must also ensure that the report itself is adequate. He is not expected to verify the accuracy of the conclusion, or to reach his own independent conclusion as to whether it is correct—after all, the reason for relying on another expert in the first place is that the subject is outside the competence of an attorney in his capacity as such. However, at a minimum, the attorney should be sure that (1) the facts on which the report is based are consistent with those of the actual transaction, and (2) the methodology and reasoning used by the expert in preparing his report appear to make sense. The moral of the story is that it is not enough to flip to the back of the

[381] Of course, even an impeccable reputation is not always warranted. Recent newspaper reports tell of an individual, previously highly respected and generally regarded as a pillar of the securities industry, who turned out to have perpetrated one of the largest frauds ever committed.

report and read just the conclusion. The only way to be sure that the report does its job is to read the whole thing.

5. Nontax Legal Conclusions as Facts

Often, legal conclusions as to matters of nontax law are effectively "facts" for purposes of tax analysis. This means that any tax opinion is implicitly also an opinion as to any such nontax legal issues, unless the nontax issues are otherwise established.

Sometimes, this is perfectly appropriate; in other cases it may not be. Consider the following examples:

- A tax attorney is representing a client in connection with a corporate transaction; the scope of the representation includes involvement in the preparation of the transactional documents as well as the rendering of a tax opinion on the transaction. The law governing the transaction is that of a jurisdiction in which the attorney is admitted to practice.

  In this situation, it seems perfectly reasonable that the attorney should render an opinion on the tax consequences that implicitly embodies a nontax opinion that the documents are effective to create the legal relationships on which the tax analysis is based. From the clients' perspective, he has hired the attorney to prepare documentation that "works" to achieve the desired tax result, and is entitled to an unqualified opinion that it does so work.

- The facts are the same as in the immediately preceding example, except that the transactions are governed by the law of a jurisdiction in which the attorney is not admitted to practice, but with the laws of which he is generally familiar.

In this situation the practitioner might feel comfortable rendering a tax opinion, even though the opinion implicitly embodies within it a conclusion as to the legal effect of the document under applicable law. For example, many tax attorneys routinely opine on the federal tax treatment of corporate transactions governed by Delaware law, even though they are not admitted to practice in Delaware.

- The facts are the same as in the immediately preceding example, except that the transactions are governed by the laws of a foreign country.

  In this situation, the better practice would be to obtain an opinion of local counsel as to the legal effect of the documents, and to rely on this in rendering the U.S. tax opinion. The precise scope of the foreign law opinion may vary depending on the circumstances. Thus, where the documentation is clear on its face and does not involve legal concepts that are unique to foreign law, all that may be needed to support the tax analysis might be an opinion of local counsel that the documents are enforceable and have legal effect in accordance with their terms. On the other hand, if the transaction involves legal concepts that do not exist in U.S. law, the local law opinion may need to cover additional information as to those concepts. For example, consider a transaction structured as an "amalgamation" under Canadian law, which is intended to qualify as a reorganization for U.S. tax purposes under section 368(a)(1)(A). In this situation, the local law opinion should not only assure the reader that the transactional documents are effective to create an "amalgamation," but should provide sufficient explanation of what happens in an amalgamation to allow the U.S. tax advisor to conclude that it satisfies the definition of "statutory merger or consolidation" in Regulation section 1.368-2(b)(ii).

- A tax attorney is asked, after the fact, to opine as to the tax consequences of an ongoing contractual relationship. He was not involved in the drafting or negotiation of the contract. The terms of the contract are clear on their face, and the governing law is that of a jurisdiction in which he is admitted (or at least a jurisdiction with whose laws he is familiar).

  In this case, because the attorney was not involved in the preparation of the governing documentation, the argument that he should implicitly opine as to its legal effect is less compelling. Nonetheless, if the documentation is sufficiently clear that any issues regarding its legal effect are trivial, he may feel comfortable rendering the opinion. If he does so, presumably he would want to obtain a representation that, to date, all parties have actually performed in accordance with the terms of the contract.

- The facts are the same as in the immediately preceding example, except that the governing documents contain an ambiguity such that the validity of the tax conclusion depends on how the ambiguity is resolved.

  This presents a more difficult situation. Some help may be provided if the client (and possibly other parties to the contract) can represent as to (1) their intention at the time of entering into the contract, and (2) the manner in which the contract has actually been applied to date, so as to help establish the "favorable" interpretation.[382] Ultimately, however, the only way to render a clean tax opinion

[382] Note that this is very different than a conclusory representation as to the actual legal effect of the contract. *See infra* text accompanying note 383.

would be if the advisor can reach the requisite comfort level not only as to the tax: issues, but as to the nontax issue relating to the proper interpretation of the contract. If he cannot do so, it may, depending on the purpose of the opinion, be possible to deal with the nontax issue by way of an assumption.

In the author's view, one approach to dealing with nontax legal issues that is rarely, if ever, appropriate is to ask the client to make a representation as to a conclusion of the law (such as the legal effect of a particular document).[383] This is particularly true where the document in question has been prepared by the same lawyer who is asking for the representation. Even outside that context, however, it would seem that as between an attorney and a layman, the attorney is in a better position to reach a conclusion as to legal issues. If he cannot do so, it would seem inappropriate to expect a client to do so, particularly given that the client may not even understand that that is what he is effectively doing in making such a representation.

C. *Issues Involving Opinions in Corporate Acquisitive Reorganizations*

Most of the time, corporate acquisition transactions that are intended to qualify as reorganizations (within the meaning of section 368(a)) provide that the obligation of one party (and, in some cases, both parties) to close is conditioned on the receipt of a tax opinion. This Section of the Article discusses issues that arise in this context.[384]

1. Function of the Tax Opinion

As an initial matter, it is worth noting that the tax opinion in a typical reorganization transaction performs a different function from most of the corporate opinions delivered in

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[383] For a discussion of one area in which this approach is frequently (and, in the author's view, unfortunately) used, see *infra* text accompanying notes 404–07.

[384] If one or both of the parties is a publicly traded corporation, this type of transaction may require an SEC opinion in addition to the contractual condition opinion. SEC opinions are discussed *infra* in the text accompanying notes 408–32.

For a general discussion of reorganization opinions, see Jasper L Cummings, *Reorganization Tax Opinions*, 96 TAX NOTES TODAY 186-81 (Sept. 23, 1996).

connection with such transactions. The corporate opinions are typically provided to each party by the *other* party's counsel, and address matters relating to the legal status of that other party. Although the delivery of these opinions is a condition to the recipients' obligation to close, their function is more akin to that of a third-party inducement opinion.[385] The tax opinion, on the other hand, is typically provided to a party by its own counsel,[386] and serves the function of a contractual condition opinion as discussed above.[387]

2. Who Gives the Opinion?

One important question in these types of transactions is which party (or parties) gets the benefit of the condition. In order to address this issue, it is necessary to consider the consequences if a putative reorganization were to *fail* to qualify as such. In any acquisition transaction, failure to qualify as a reorganization generally means that shareholders of the target, who receive acquiror stock in exchange for their target stock, would recognize gain (if any) that would have gone unrecognized if the transaction had qualified.[388] Thus, in order to protect its shareholders, the target will virtually always want its obligation to close conditioned on an opinion that the reorganization will qualify.

On the buyer side, the consequences of failure to qualify as a reorganization will depend on how the transaction is structured. If the target survives and becomes a subsidiary of the acquiror (*i.e.*, in a transaction that was intended to qualify as a type "B"[389] or "(a)(2)(E)"[390]

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[385] *See supra* text accompanying notes 9–16.

[386] Occasionally, an agreement will provide that if a party's counsel does not render the required opinion, the party will still be required to close if the other party can arrange for its counsel (or a third advisor who is otherwise not involved in the transaction) to render the opinion. This does not provide adequate protection to the party receiving the opinion because he may be required to close even if the attorney whose judgment he trusts is not comfortable that the transaction works.

[387] *See supra* text accompanying notes 4–8.

[388] *See* I.R.C. §§ 354(a)(1), 1001(c).

[389] *See* I.R.C. § 368(a)(1)(B).

[390] *See* I.R.C. § 368(a)(1)(A), (a)(2)(E).

reorganization), failure to qualify will have no adverse tax consequences to the buyer. If the transaction is structured as a merger of the target into the acquiror[391] or the acquiror's subsidiary,[392] failure to qualify would result in the target itself recognizing any gain on its assets, and any tax liability flowing from such gain recognition would be inherited by the surviving corporation in the merger. Thus, in this scenario the acquiror has a stake in whether the transaction qualifies or not. The third scenario is that of an asset transfer (other than by merger) that is intended to qualify as a type "C" reorganization.[393] In this structure, failure to qualify will result in gain recognition by the target; whether or not the burden of any tax resulting from such recognition will fall on the buyer will depend on whether tax liabilities of the target are assumed by contract (as well as whether any doctrines of local law could potentially result in the acquiror becoming liable even without an express contractual assumption).[394]

In the author's view, a buyer-side opinion condition is generally only justified if a failure to qualify as a reorganization would result in potential liability to the buyers—that is, if the transaction is structured as a direct merger of target into buyer, a forward triangular merger of target into a subsidiary of buyer, or an asset transfer where the buyer assumes (or under applicable law is otherwise subject to) tax liabilities of the target. It is not justified in the case of a stock transfer or a reverse triangular merger.

[391] *See* I.R.C. § 368(a)(1)(A).

[392] *See* I.R.C. § 368(a)(1)(A), (a)(2)(D).

[393] *See* I.R.C. § 368(a)(1)(C).

[394] The issue of whether a person other than the taxpayer can be liable for taxes as a transferee is not determined by federal tax law, but rather by applicable principles of creditors' rights law, *see* Commissioner v. Stern, 357 U.S. 39 (1958) — although the procedural rules for collecting tax from a person who is so liable are set forth in the Code. *See* I.R.C. §§ 6901, 6902. In general, under U.S. principles of creditors' rights law, a good-faith purchaser of assets who pays fair value takes such assets free and clear of liabilities of the transferor, other than those expressly assumed. This is, however, subject to certain conditions (including proper notice to creditors) and certain exceptions, including, potentially, secured lienholder interests and successor liability claims. *See generally* 3 COLLIER ON BANKRUPTCY ¶ 363.06 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010); Anheuser-Busch, Inc. v. Miller, 895 F.2d 845 (lst Cir. 1990).

Not all tax advisors agree with this approach; some advisors seek a buyer-side opinion condition for all reorganizations regardless of whether failure to qualify would result in any tax liability to the acquiror. One argument sometimes made by these advisors is that if a putative reorganization fails and target shareholders become subject to tax, the plaintiffs' lawyers will come out of the woodwork looking to sue anybody in sight—including the acquiror. A more common—but less persuasive—"argument" is "that's the way we've always done it."

The author has even run into situations where seller's counsel has insisted that the buyer's obligation to close be conditioned on buyer's counsel rendering an opinion. Such an insistence by seller's counsel, which is contrary to his own client's interests, can only be explained by a desire to have somebody to share the blame if the deal comes a cropper.[395]

3. Comfort Level

The next issue relates to the comfort level. Because the economics of an acquisition, to both buyer and seller, are integrally tied to whether the acquisition is taxable or tax-free, the parties' tolerance for risk tends to be fairly low. This is particularly true where the target is publicly traded. For this reason, opinion conditions typically call for a high comfort level—most often "will," although sometimes parties will settle for a "should" opinion.

4. Scope of Opinion

In the author's experience, more often than not the tax opinion condition is limited to qualification issues, *i.e.*, that the transaction will qualify as a reorganization and that the acquiror and the target will be treated as parties to the reorganization.[396] Usually (although not always)

[395] Technically, of course, a buyer in this situation could waive the condition at closing, thus depriving the seller's counsel of his potential co-defendant. As a practical matter, however, putting the condition in the contract creates an expectation that the opinion will be delivered, and a client may resist waiving the condition. In the case of a public deal, a waiver might also trigger a knee-jerk reaction from the SEC, regardless of whether the condition served any useful purpose in the first place.

[396] *See* I.R.C. § 368(b). The latter conclusion is usually trivial once the conclusion has been reached as to qualification of the transaction as a reorganization.

the operative consequences that derive from qualification as a reorganization—nonrecognition to shareholders[397] and corporate transferors,[398] basis carryover,[399] and holding period tacking[400]—are not specifically addressed in the closing opinion,[401] although if the deal involves an "outbound" transfer of property the opinion may cover section 367(a) issues.

5. Form of Opinion

Reorganization opinions, particularly those at the "will" level of comfort, are often delivered in short form. Since the condition is satisfied by delivery of an opinion that reaches the conclusion specified in the contract, there is nothing to be gained by adding a lengthy explanation for how that conclusion was reached. Of course, as discussed above,[402] there is a stronger case for a long-form opinion where the comfort level is lower than "will."

6. Officers' Certificates

Reorganization opinions are usually based on minimal assumptions; facts that cannot be established on the face of the documentation are usually addressed by representations contained in officers' certificates. At the dawn of time, when the tax bar was developing its standard forms of Ur-certificates, the starting point was the set of representations that the Service required before it would entertain a request for a private letter ruling on a reorganization.[403] While these representations provide the basis for a useful checklist to ensure that all necessary points are covered, blindly following them for purposes of representations in connection with opinions has resulted in a common and, in the author's view, unfortunate practice.

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397 I.R.C. §§ 354, 356.

398 *See* I.R.C. § 36l.

399 *See* I.R.C. §§ 358, 362.

400 *See* I.R.C. § 1223(1), (2).

401 As discussed *infra* in the text accompanying note 418, the SEC may demand that these matters be addressed in the disclosure opinion regardless of whether they are the subject of the closing opinion.

402 *See supra* text accompanying note 365.

403 *See* Rev. Proc. 1977-37, 1977-2 C.B. 568; Rev. Proc. 1983-81, 1983-2 C.B. 598; Rev. Proc. 1984-42, 1984-1 C.B. 521; Rev. Proc. 1986-42, 1986-2 C.B. 722; Rev. Proc. 1989-50, 1989-2 C.B. 631.

Specifically, the private letter ruling guidelines require representations as to certain matters that are legal conclusions as to the effect of the documents. For example, in a ruling request on a type "B" reorganization, a taxpayer must represent that the acquiror will acquire target stock solely in exchange for acquiror voting stock.[404] This is a conclusory representation that the "solely for voting stock" requirement for a type B reorganization[405] will be satisfied.

It is understandable that, in issuing private letter rulings, the Service does not wish to assume the burden of reaching a conclusion as to a matter of nontax law (namely, the legal effect of the operative documents) and accordingly requires representations as to those matters from a taxpayer requesting a ruling. The same cannot be said for taxpayer's counsel, particularly if he is the draftsman of the very documents in question. Thus, in the example given above, counsel should be able to determine from the deal documentation what the consideration paid to target shareholders is. This, together with (1) a representation that nothing is being paid except as provided in the documents, and (2) if necessary, an opinion of local counsel that the documents are enforceable in accordance with their terms,[406] should enable a tax advisor to reach a conclusion as to whether the requirement is satisfied. Asking a client to make the conclusory representation is tantamount to asking the client to warrant to the lawyer that the lawyer has done his job properly.[407] Nonetheless, the practice seems to have become so entrenched that many advisors refuse to be dissuaded from doing just that.

D. *Issues Involving SEC-Required Opinions*

Where a transaction requires a filing with the SEC, a formal opinion may be required in support of the tax disclosure in the filing. This is in addition to any opinion that is delivered in

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[404] Rev. Proc. 1986-42, 1986-2 C.B. 722, § 7.04(7).

[405] *See* I.R.C § 368(a)(1)(B).

[406] *See supra* text accompanying notes 382–83.

[407] *See supra* text accompanying note 383.

satisfaction of a contractual condition or that is otherwise prepared in connection with the transaction.

Unfortunately, the rules relating to disclosure opinions in connection with SEC filings have sometimes been applied by the SEC staff in a manner that reflects a lack of understanding of the practicalities of tax practice, as well as of the substantive issues involved. This sometimes causes difficulties for a practitioner, who strives to maintain professional standards while facing sometimes unreasonable demands from an SEC reviewer, all the while being pressured by his client and colleagues to accede to whatever the reviewer demands in the interest of getting the deal done.

1. Regulatory Background[408]

The regulatory basis for the tax opinion requirement is Item 601 of SEC Regulation S-K, which identifies the circumstances under which a tax opinion is required.[409] Regulation S-K identifies seven specific types of filings, all of which are under the Securities Act of 1933,[410] for which an "opinion re tax matters" may be required[411]—namely, Forms S-1, S-3, S-4, S-11, F-1, F-3, and F-4. In the case of filings on Form S-11[412] and those to which SEC Industry Guide5[413] applies, a tax opinion[414] must be provided "supporting the tax matters and consequences to the

[408] The author claims no expertise in securities law; the discussion of SEC rules presented here is for background purposes only, in connection with the discussion of practical issues faced by a lawyer who is asked to render a tax opinion in connection with an SEC filing.

[409] SEC Regulation S-K, 17 C.F.R. § 229.601 (2010).

[410] 15 U.S.C. §§ 77a–77aa (2006).

[411] SEC Regulation S-K, 17 C.F.R. § 229.601 (a) (2010), Exhibit Table, entry (8).

[412] Form S-11 generally is used to register securities of real estate investment trusts and certain other companies whose primary business is real estate.

[413] Industry Guide 5 applies to registration statements for interests in real estate limited partnerships. SEC Regulation S-K, 17 C.F.R. § 229.801(e) (2010).

[414] Alternatively, Regulation S-K states that the requirement can be satisfied by a "revenue ruling" from the Service. SEC Regulation S-K, 17 C.F.R. § 229.601 (b)(8) (2010). Presumably, what is actually meant is a private letter ruling addressed to the registrant, and not a "revenue ruling" (which is a published ruling that sets forth the Service's view as to a point of law but does not apply that rule to a specific taxpayer or transaction).

shareholders as described in the filing when such tax matters are material to the transaction for which the registration statement is being filed."[415] For other filings, an opinion is required "when the tax consequences are material to an investor and a representation as to tax consequences is set forth in the filing."[416]

2. *Application of the Rules by SEC Staff*

While Regulation S-K sets forth the particular forms for which a tax opinion is required, it provides little guidance as to the scope of the required opinion, other than the mandate that it "support" the tax disclosure. Over time, the SEC staff seems to have become increasingly demanding as to the scope of the opinion.

At one time, the staff would often accept an opinion to the effect that "the discussion under the heading 'Certain Material Federal Income Tax Consequences' fully and fairly describes the federal income tax consequences of the transaction," or a similar formulation. Literally, this approach would appear to satisfy the Regulation S-K requirement that the opinion "support" the disclosure. However, it is not technically an opinion as to the specific substantive tax consequences. Alas, it seems that the staff these days is no longer willing to accept this type of opinion.

Somewhat more recently, the staff would require a substantive opinion as to the tax consequences (as opposed to an opinion addressing the adequacy of the disclosure); however, they were often willing to forego the opinion if (1) the contract included an opinion condition, and (2) the beneficiary of that condition undertook that it would not waive the condition (or, that if it did waive, it would resolicit votes, presumably with appropriately revised tax disclosure).

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[415] *See supra* note 414.

[416] *See supra* note 414. Presumably, the disclosure as to Material Tax Consequences, typically required by the specifications for the particular form in use, would constitute such a "representation."

This approach avoided the timing issues that can arise under the current approach;[417] perhaps more importantly, when a deal included a contractual opinion condition, under this approach the scope of the opinion required by the contract limited the scope of the opinion required by the SEC.

More recently, the SEC staff seems generally to require that counsel render a substantive opinion at the time the registration statement goes effective as to everything that is said in the "Material Tax Consequences" section of the registration statement.[418]

3. Issues Raised by the Staff's Current Approach

Requiring an opinion, at the time the registration statement becomes effective, as to everything stated in the tax disclosure presents a number of difficulties for the advisor rendering the opinion. Many of these difficulties flow from the fact that tax disclosure and an opinion supporting that disclosure perform two different functions; an approach that "works" for one does not always make sense for the other.

a. *Timing.* As discussed above,[419] one of the reasons why many transactions call for an opinion condition to closing is that there may be facts relevant to the tax consequences that cannot be known until closing. Requiring a substantive tax opinion at the time the registration statement becomes effective can therefore be problematic because facts that are critical to the opinion may not be known at that time.

If the contract does have an opinion condition, sometimes a reviewer can still be persuaded not to demand an effective time opinion *as to matters within the scope of the closing*

[417] *See infra* text accompanying notes 419–21.

[418] The form in which this is provided can vary. One approach is for the disclosure itself to state that it is the opinion of named counsel (who then provides consent to the reference to his name). Alternatively, counsel can provide a separate opinion that tracks the disclosure language verbatim or that states that he adopts the disclosure language as his opinion.

[419] *See supra* text accompanying notes 4–8.

opinion, if the company undertakes not to waive the closing condition.[420] However, the staff would still probably insist that an effective date opinion be issued with respect to any statements in the disclosure that go beyond the (usually limited)[421] scope of the closing opinion.

If there is no opinion condition (or if there are facts, unknowable at the effective time, that relate to a legal conclusion outside the scope of the closing opinion), or if the SEC reviewer is unwilling to accept a no-waiver undertaking in lieu of an effective date opinion, the advisor may have no choice but to give the full opinion at the effective time. In order to do so, of course, it will be necessary to make assumptions as to those future facts. This may result in difficult negotiations if the reviewer, not understanding the substantive issues, takes exception to the necessary assumptions and demands an opinion that is impossible to give. Sometimes, this can result in the practitioner struggling to find words that the reviewer reads as giving a "clean" opinion, but that allow the practitioner to claim an interpretation as qualified by the necessary assumptions. Though unfortunate, these types of word games are sometimes necessary when dealing with an intractable and unreasonable reviewer.

b. *Materiality*. Tax disclosure is limited by materiality. This is as it should be; in order to address every last nuance that could possibly affect any taxpayer, it would be necessary to write a treatise, which in addition to being cumbersome, would be useless (from the perspective of disclosure) at best and misleading at worst.

A formal opinion, on the other hand, strives to be quite precise as to its conclusions and limitations, with none of the vagueness that goes into judgment calls as to materiality.[422] Thus,

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[420] *See supra* text accompanying note 417.

[421] *See supra* text accompanying notes 396–401.

[422] This is the case even where the opinion is of the type that the SEC routinely accepted in happier times, *i.e.*, that refers to tax disclosure and states that such disclosure "fully and fairly reflects the material tax consequences of _____________."

there is an inherent tension that surfaces when a tax advisor is asked to take tax disclosure, necessarily (and properly) limited by materiality, and state that it is his opinion.

Most of the time, we attempt to deal with the issue by trying to choose words that embody the notion of materiality in the opinion itself. For example, the opinion might read, "The discussion under the heading 'Material Federal Tax Consequences' represents our opinion as to the material tax consequences of the transaction." Alternatively, counsel might simply say, "The discussion under the heading 'Material Federal Tax Consequences' is our opinion," relying on the fact that the very first sentence of the referenced disclosure says (typically) something like "The following is a description of the *material* federal income tax consequences of the transaction" (emphasis added).

This approach seems unavoidable given the SEC staff's insistence on an identity between the tax disclosure and the opinion supporting it. As a practical matter, it "works." Nonetheless, from the perspective of how a "proper" opinion ought to be written, it is somehow unsatisfying. It lacks the precision for which opinion writers strive.

c. *Statements that Are Not Conclusions of Law*. As discussed above, when writing a "traditional" legal opinion, a great deal of care is taken to distinguish legal conclusions from the facts on which they are based.[423] To the extent the facts are based on representations or assumptions, the practitioner is quite clear to disclaim any responsibility for their accuracy, save perhaps for a conclusion that he believes them to be reasonable. The "opinions" (in the narrow sense) are limited to a very precise, terse statement of the conclusions of law.

[423] *See supra* text accompanying notes 366–83.

Since tax disclosure is not organized in this way—nor should it be, given its primary function as disclosure—the distinction between what is opined to and what is taken as a fact can easily become blurred when an advisor must adopt disclosure as his opinion.

Consider typical reorganization disclosure, which might begin with something along the lines of "The Company's obligation to consummate the transaction is conditioned on having received an opinion from Howard, Fine & Howard, LLP that the transaction will be a reorganization within the meaning of section 368 of the Code." The idea embodied in that sentence is certainly important for shareholders who are being asked to vote on the transaction to know; there is no question that as a matter of appropriate disclosure, the point properly belongs front and center in the "Material Tax Consequences" section.

Once that sentence (along with the rest of the disclosure) is adopted as an opinion, however, a question arises as to what, if anything, has been opined with respect to the sentence describing the opinion condition. There appear to be three possibilities. One possibility is the literal reading: the practitioner has opined that the deal does in fact have an opinion condition. As a conclusion of nontax law (*i.e.*, the legal interpretation of the contract[424]), this conclusion is correct (assuming the contract does so provide); it is also probably trivial. As a conclusion of tax law, it is meaningless. While there is nothing to prevent a lawyer from rendering an opinion on the nontax issue, such an opinion appears to have nothing to do with the tax opinion required by Item 601 of Regulation S-K.

The second possible interpretation—and the one that most practitioners probably intend in this situation—is that nothing has been opined to. Because the sentence in question is a statement of fact (at least as far as the tax law is concerned) and not a conclusion of law, it

[424] *See supra* text accompanying notes 382–83.

cannot be the subject of an opinion; hence, it cannot be part of the opinion that embodies the disclosure.

There is, however, a third possible interpretation—namely, that the statement implies a legal conclusion as to the subject of the anticipated opinion that is stated to be a condition. Under this interpretation, the factual statement that the closing is conditioned on the receipt of an opinion that the transaction will be a reorganization, in the context of an opinion that embodies the entire disclosure, could be read to imply that Howard, Fine & Howard, LLP is rendering a *current* opinion on reorganization status. This leads directly to the timing problems discussed above.[425]

To take another example, consider a statement in the disclosure to the effect that, with respect to a particular tax issue, "the Company believes, and intends to take the position, that ___ ___________________." In this case, the literal interpretation (*i.e.*, that it is the lawyer's opinion that the Company so believes and intends) is simply absurd. No lawyer can render an opinion as to his client's state of mind, which is not an issue of either tax law or any other body of law. What the lawyer undoubtedly intends in this situation is that he is rendering no opinion at all on the point, even though it is an important *fact* to be disclosed.

However, again, a third interpretation is possible. When disclosure stating that "the Company believes, and intends to take" a certain tax position is combined with an opinion that adopts the disclosure as the opinion, it is not beyond the realm of possibility that counsel could be viewed as having implicitly "blessed" that position. This possibility is somewhat disturbing; more often than not, the reason the "Company believes" language was chosen in the first place was because counsel did not believe there was adequate authority upon which to base an opinion.

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[425] *See supra* text accompany notes 419–21.

One approach that is sometimes used in this type of situation (if the SEC reviewer will accept it) is for the opinion to say something along the lines of "The discussion under the heading 'Material Tax Consequences,' to the extent it consists of statements as to matters of tax law, represents our opinion." While this helps, it does not totally eliminate the "implicit opinion" interpretation.

As a practical matter, in situations like this there is often little choice but to rely on the "no opinion" interpretation, which would generally be consistent with counsel's intention. What makes this reliance less than totally satisfying, however, is the likelihood that if counsel had written the opinion in a manner that expressly disclaimed any opinion with respect to the issue, it would have elicited an SEC comment demanding that the opinion cover the point.[426] The ability to rely on the "no opinion" interpretation becomes somewhat muddied where it appears that the party demanding the opinion (in this case, the SEC reviewer) thought that the opinion did cover the point.

d. "*Consult Your Own Tax Advisor*." It is an article of faith among tax advisors that any opinion prepared for the benefit of a large number of third parties who may have different individual tax postures should include language urging each such third party to consult his own tax advisor. In the case of opinions that are not filed with the SEC, such language is mandatory; the Circular 230 written advice rules require that it be included both in marketed opinions[427] and as part of the three-part disclaimer necessary to *avoid* marketed opinion status.[428] These rules do not, by their terms, apply to SEC-filed opinions (which are

[426] Sometimes, counsel might have actually tried to do just that, only to have the express "no opinion" language rejected by the reviewer.

[427] *See supra* text accompanying note 260.

[428] *See supra* text accompanying note 187.

generally exempt from covered opinion status without the need for a disclaimer"[429]); however, they are reflective of what is generally considered to be sound practice. Even before the 2004 written advice rules, virtually all tax disclosure (and the opinions supporting them) included this language.

Typically, tax disclosure includes (often as part of the introductory boilerplate) a general statement to the effect that persons should consult their own tax advisors as to the application to them of the rules discussed therein. In addition to the "general" "consult your own tax advisor" statement, specific suggestions to do so with respect to particular issues are often included in at least three situations:

- Sometimes, the practical effect of a tax rule may be so inextricably tied to a particular person's individual tax position that it is impossible to provide meaningful general guidance. For example, a prospectus for a debt offering might state that interest on the debt is expected to be foreign source. The practical effect of this depends on a particular holder's overall foreign tax credit limitation situation,[430] and the rules regarding the foreign tax credit limitation are far too complicated to be described in any meaningful way short of writing a treatise. In this situation, most advisors would consider it appropriate to refer holders to their own tax advisors for advice on how the receipt of foreign-source interest income would affect them.

  As another example, consider a transaction where certain of the tax consequences depend on an election that can be made by each shareholder or investor. The disclosure can describe the effect of the election in general terms,

[429] *See supra* text accompanying note 208.
[430] *See* I.R.C § 904.

but whether or not it would be a good idea for a holder to make the election might depend on his overall tax picture. It would be prudent to refer readers to their own tax advisers on this issue.

- Sometimes, there may be an issue for which there is not sufficient authority for counsel to determine the proper treatment. If the issue is one that directly affects shareholders or investors (*i.e.*, that will affect the reporting on their individual returns), it may be necessary to refer them to their own advisors as to how to report. Of course, the consequences of each possible characterization would have to be described, and if the issue is one that also requires reporting by the Company, it would generally be appropriate to state how the company intends to report it.[431]
- Frequently, it is possible to reach a conclusion as to the proper characterization of a transaction, but that conclusion may be less than certain. In that case, adequate disclosure would generally entail identifying other possible characterizations and (in most cases) describing the consequences of those characterizations. Sometimes, however, a judgment may be made that a particular "other" characterization is possible (and hence should be mentioned) but is nonetheless sufficiently unlikely that it does not warrant full-blown disclosure as to its consequences. In such a case, a "consult your own tax advisor" statement might be appropriate.

Recently, the author has encountered (and has heard anecdotal reports that others have encountered) resistance from SEC reviewers to telling people to consult their own tax

[431] For other issues that arise with respect to this type of statement, see *supra* text accompanying notes 425–26.

advisors.[432] The author is not aware of any registration statements in which a reviewer successfully insisted that the "consult your own tax advisor" language be removed entirely; however, there have been situations in which reviewers have insisted that the wording be changed to downplay the importance of consulting one's own tax advisor, thus making it more likely that a reader would get the impression that he could learn all he needs to know without doing so.

From the perspective of the opinion writer, this is bad news; by removing (or at least reducing the effectiveness of) a built-in safety valve, it exacerbates the pressure that already exists when an advisor is forced to take a necessarily somewhat general description and say that it is his opinion. In the author's view, this is a trend that should be vigorously resisted.

E. *Issues Involving Penalty Protection Opinions*

Both the ability of a taxpayer to obtain relief from penalties based on an opinion of counsel and the ability of advisors to write an opinion that could potentially serve that function are significantly more restricted today than was the case in simpler times. Nonetheless, practitioners are still sometimes called upon to write opinions for the purpose of trying to prevent possible imposition of penalties. This Section of the Article addresses issues that arise in the context of writing such an opinion.[433]

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[432] The author is at something of a loss to understand the reason for this resistance. Not only is this language important from the opinion perspective, it is important (some would say essential) for disclosure that adequately informs people who are being asked to make a decision. Thus, by resisting this language, it would seem that reviewers are actually impeding full disclosure.

[433] In many cases, a penalty protection opinion may also function as a reporting opinion. Thus, the issues discussed *supra* in the text accompanying notes 41–43, should also be considered.

1. Covered Opinions Only, Please

As discussed above,[434] almost all written advice that is not written to comply with the covered opinion requirements includes a disclaimer to the effect that it cannot be used to avoid penalties. The reason is that because the concept of "a significant purpose" of tax avoidance is so broad and ill-defined,[435] virtually any opinion is potentially a "significant purpose" opinion, and hence a "reliance opinion" if it reaches a comfort level of at least "more likely than not."[436]

Interestingly (and somewhat surprisingly), there does not appear to be any specific rule of law that precludes a taxpayer from asserting reliance on an opinion of counsel as a penalty defense just because the opinion *says* that it cannot be so used. However, one of the requirements for reliance on professional advice as a defense is that the reliance be reasonable:[437] A taxpayer would likely face an uphill battle in trying to argue that it was reasonable to rely (for penalty-protection purposes) on an opinion that on its face states that it cannot be so relied on.

What this implies, in practical terms, is that an opinion that is intended to serve a penalty-protection function cannot include a no-penalties-protection disclaimer. This in turn means that, except for the rare situation where the advisor is confident that the transaction does not have a significant tax-avoidance purpose (and the opinion is not otherwise a covered opinion), a penalty protection must be written as to comply with the covered opinion rules.

[434] *See supra* text accompanying notes 25–27.

[435] *See supra* text accompanying notes 164–66.

[436] In theory, a disclaimer would be unnecessary if the opinion did not reach a "more likely than not" (or stronger) conclusion on any issue or fall into any other category of covered opinion. However, an opinion at less than the "more likely than not" comfort level would probably not be particularly effective for purposes of penalty avoidance. *See infra* text accompanying notes 483–89.

[437] *See infra* text accompanying note 472.

2. *Accuracy-Related Penalty*[438]

Four types of penalties are most likely to be involved in a penalty protection opinion. The negligence–disregard of rules penalty,[439] the substantial understatement penalty,[440] and the substantial valuation misstatement penalty[441] are all components of the section 6662 "accuracy-related penalty,"[442] and they are subject to a uniform (for the most part) set of rules as to potentially available defenses.[443] A separate penalty applies to understatements of tax from reportable transactions;[444] this is subject to a separate, and more stringent, set of rules governing available defenses.[445] Only one of these penalties—generally, whichever is highest—will apply to any particular understatement of tax.[446] The accuracy-related penalty is discussed here; the reportable transaction understatement penalty is discussed below.[447]

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438 The discussion of penalties herein is limited to issues that are important from the perspective of an opinion writer and to background that is relevant in that context. It is not intended to provide a comprehensive discussion of penalties. For such a comprehensive discussion, see generally MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE, ch. 7B (rev. 2d ed. 2002-2005) or Allen J. Tarr & Pamela Jensen Drucker, *Civil Tax Penalties*, 634-2d TAX MGMT. PORT. (BNA) (2005).

439 I.R.C. § 6662(b)(1).

440 I.R.C. § 6662(b)(2).

441 I.R.C. § 6662(b)(3).

442 There are three other components of the accuracy-related penalty, namely the penalties for substantial overstatement of pension liabilities, I.R.C. § 6662(b)(4); for substantial understatements of estate or gift tax valuation, I.R.C. § 6667(b)(5); and for tax benefits disallowed under the economic substance doctrine, I.R.C. § 6662(b)(6), added by section 1409(b) of Recon 2010, which was signed into law by President Obama on March 30, 2010, 124 Stat. 1029, 1068-69. The application of the first two of those penalties is more likely to depend on questions of valuation or on actuarial computations, issues that are not likely to be the subject of legal opinions. Hence, these penalties are beyond the scope of this Article. In the case of the third penalty, section 6664(c)(2) specifically provides that it cannot be avoided under the reasonable cause–good faith defense. Thus, although the economic substance doctrine (which was codified as section 7701(0) by section 1409(a) of Recon 2010,124 Stat. 1029, 1067–68) is, as a substantive matter, likely to be of great importance in any number of transactions that are the subject of tax opinions, an opinion itself will not be useful in avoiding this penalty. Hence, a detailed discussion of the penalty for tax benefits disallowed under the economic substance doctrine is beyond the scope of this Article.

443 I.R.C. § 6664(c).

444 I.R.C. § 6662A.

445 I.R.C. § 6664(d).

446 I.R.C. §§ 6662(b), 6662A(e).

447 *See infra* text accompanying notes 499–517.

a. *Negligence–Disregard of Rules*. Section 6662(b)(l) imposes a penalty (generally at the rate of 20%[448]) on the portion of any underpayment that is attributable to negligence or disregard of rules or regulations.[449]

For purposes of this penalty, "negligence" includes any failure to make a reasonable attempt to comply with the Code[450] or to exercise ordinary and reasonable care in the preparation of a return.[451] Disregard of rules or regulations means any disregard that is "careless" (which is the case if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to a rule or regulation),[452] reckless (*i.e.*) if the taxpayer makes little or no effort to determine whether a rule or regulation exists, if such failure, under the circumstances, is a substantial deviation from the conduct of a reasonable person),[453] or intentional.[454]

The definitions of "negligence," "careless," and "reckless" suggest that, at least under some circumstances, reliance on advice of a tax professional could negate the state of mind necessary for a taxpayer to be "negligent," "careless," or "reckless," and hence avoid imposition of the penalty. For example, a taxpayer facing a potential negligence penalty might argue that, in obtaining and relying on professional advice, he made a reasonable effort to comply with the Code and exercised reasonable care in the preparation of his return, and hence was not negligent. Prior to 1989 (when the formerly separate negligence-disregard penalty was incorporated into the

[448] I.R.C. § 6662(a).
[449] I.R.C. § 6662(b)(1).
[450] I.R.C. § 6662(c).
[451] Reg. § 1.6662-3(b)(1).
[452] Reg. § 1.6662-3(b)(2).
[453] *Id*.
[454] I.R.C. § 6662(c).

newly created accuracy-related penalty[455]), cases had, in at least some circumstances, accepted this argument.[456] The 1989 amendments did not change the definition of negligence.[457]

Under current law, the negligence-disregard penalty is, like the other components of the accuracy-related penalty (other than the penalty for tax benefits disallowed under the economic substance doctrine), subject to a defense if the taxpayer can demonstrate reasonable cause and good faith under section 6664. The relationship between reliance on professional advice as a factor negating negligence, carelessness, or recklessness, and reliance on professional advice as a factor demonstrating reasonable cause and good faith for purposes of the affirmative defense under section 6664, is not entirely clear. As a practical matter, however, it appears that the standards for when reliance on professional advice can avoid a negligence penalty are no different than those that apply (under section 6664) to other components of the accuracy-related penalty.[458] These standards are discussed below.[459]

b. *Substantial Understatement of Income Tax*. The second component of the accuracy-related penalty applies if there is an understatement of income tax that exceeds (1) in the case of most C corporations, the *lesser* of ten percent of the correctly determined amount or $10 million, or (2) in the case of other taxpayers, the *greater* of 10% of the correct tax or $5,000.[460] This penalty is imposed at a rate of 20%.[461]

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[455] OBRA 1989. § 7721, 103 Stat. 2106, 2395.

[456] *See, e.g.*, Beeson v. Commissioner, 802 F.2d 365 (9th Cir. 1986); Hill v. Commissioner, 63 T.C. 225 (1974).

[457] *See* I.R.C. § 6653(a)(3) (prior to amendment by OBRA 1989. § 7721, 103 Stat. 2106, 2395).

[458] This is consistent with the legislative history of the 1989 amendments, which described the amendments as providing "standardized exception criteria" for all components of the accuracy-related penalty. *See* H.R. REP. No. 101-247 at 1392 (1989).

[459] *See infra* text accompanying notes 466–67.

[460] I.R.C. § 6662(d)(1).

[461] I.R.C. § 6662(a).

Except in the case of "tax shelters,"[462] the substantial understatement penalty does not apply if either (1) there is determined to be substantial authority for the position claimed by the taxpayer,[463] or (2) there is determined to be a reasonable basis for the claimed position and the relevant facts were disclosed on the return.[464] While this is of great importance to a taxpayer seeking to avoid a potential penalty, it is not directly relevant from the perspective of writing an opinion that is designed to provide protection from the penalty. The reason is that the relevant standard is whether substantial authority (or if disclosure is made, a reasonable basis) for the position actually exists, not whether the taxpayer had a belief (however reasonable or in good faith) that the requisite level of authority existed. Thus, if a court ultimately determines that the level of authority did not exist, nothing is accomplished, as far as the section 6662(d)(2)(B) defense is concerned, by establishing that the taxpayer relied on an opinion. For purposes of the substantial understatement penalty, the taxpayer's state of mind is irrelevant, except insofar as it relates to the "reasonable cause and good faith" defense of section 6664.

c. *Substantial Valuation Misstatement*. The substantial valuation penalty applies if the value or basis claimed by taxpayer for any property is 150% or more of what is ultimately determined to be correct,[465] but only if the amount of the understatement

[462] I.R.C § 6662(d)(2)(c). For this purpose, a "tax shelter" is defined as (1) any partnership or other entity, (2) any investment plan or arrangement, or (3) any other plan or arrangement, if, in each case, "a significant purpose" is the avoidance or evasion of federal income tax. I.R.C § 6662(d)(2)(c)(ii). As discussed *supra* in the text accompanying notes 164–66, the concept of "a significant purpose" is not well defined and is potentially quite broad.

[463] I.R.C. § 6662(d)(2)(B)(i).

[464] I.R.C § 6662(d)(2)(B)(ii). For the rules governing how to make disclosure that will be adequate for this purpose, see Regulation section 1.6662-4(e) and (f).

[465] I.R.C § 6662(e)(1)(A). The substantial valuation misstatement penalty also applies to certain understatements attributable to incorrect transfer pricing. I.R.C § 6662(e)(l)(B). Due to the inherently factual nature of transfer pricing, it is not likely to be the subject of a formal legal opinion in the traditional sense. Thus, the transfer pricing leg of the substantial valuation misstatement penalty (including issues related to preparation of transfer pricing reports) is beyond the scope of this Article.

attributable to the error exceeds $5,000 (or $10,000 in the case of most C corporations).[466] The basic rate for the penalty is 20%,[467] but it is increased to 40% in the case of a "gross valuation misstatement."[468]

At first glance, it might appear that this penalty is not likely to be relevant to a writer of legal opinions, given the inherently factual nature of valuation issues. However, the penalty can apply not only when a taxpayer claims that property has a value that is determined to be incorrect but also where a taxpayer claims a *basis* that is determined to be incorrect. Based on this statutory language, it has been held that the penalty can apply where a legal recharacterization of a transaction results in the taxpayer not having the basis claimed.[469]

While the precise limits of this doctrine may not yet be fully defined,[470] it is clear that the substantial valuation misstatement penalty (and its gross valuation misstatement big brother) can apply where the Service does not mount a factual attack on a taxpayer's valuation but instead successfully argues that a transaction should be recharacterized on legal grounds. Thus, the penalty is potentially relevant where an advisor is asked to write a legal opinion in an attempt to provide protection against possible imposition of the penalty based on such a legal recharacterization.

Like the substantial understatement penalty, the substantial valuation misstatement penalty has no scienter requirement. If basis (or value) is determined to differ from that claimed by the requisite amount, the penalty automatically applies, unless the taxpayer can establish a

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[466] I.R.C. § 6662(e)(2).

[467] I.R.C. § 6662(a).

[468] A "substantial valuation misstatement" becomes a "gross valuation misstatement" if the claimed value or basis is at least 200% of the correct amount. I.R.C. § 6662(h)(2)(A)(i).

[469] Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991); *see also Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, *Long-Term Capital Holdings v. United States*, 2005-2 U.S.T.C ¶ 50,575, 96 A.F.T.R.2d 6344 (2d Cir. 2005).

[470] *See Long Term Capital Holdings*, 330 F. Supp. 2d at 199 n.99.

section 6664 affirmative defense based on reasonable cause and good faith. Thus, the only significance of an opinion in this context is with regard to that affirmative defense.

d. *The Reasonable Cause–Good Faith Defense*. The accuracy-related penalty (other than the penalty for tax benefits disallowed under the economic substance doctrine) does not apply if the taxpayer can demonstrate that there was reasonable cause for taking what (with hindsight) was determined to be an incorrect position and that he acted in good faith.[471] From the perspective of an advisor writing a penalty protection opinion, the most significant aspect of the accuracy-related penalty is the possibility that reliance on an opinion of a professional tax advisor may help in establishing reasonable cause and good faith. In this connection, there are two primary questions: First, when can an opinion be relied on at all for this purpose? Second, how strong must the opinion be?

Regulations tell us that while reliance on professional advice does not *necessarily* demonstrate reasonable cause and good faith, it can do so if, under the circumstances, the reliance was reasonable and the taxpayer acted in good faith.[472] The regulations specify certain minimum standards that must be met in order for reliance on an opinion to constitute reasonable cause and good faith;[473] assuming those minimum standards are satisfied, all facts and circumstances are considered in determining whether reasonableness and good faith in fact exist.[474]

The specific minimum requirements are as follows:

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[471] I.R.C. § 6664(c)(1). Special rules apply where a taxpayer claims a charitable contribution deduction with respect to contributed property. I.R.C. § 6664(c)(3). Since the latter rule is likely to come into play only in connection with a challenge to the claimed *value* of the contributed property, it is beyond the scope of this Article.

[472] Reg. § 1.6664-4(b)(l).

[473] Reg. § 1.6664-4(c)(1).

[474] *Id*.

- The opinion must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances. These facts and circumstances include the taxpayer's purpose for the transaction, as well as for the particular structure. The taxpayer must disclose to the advisor all facts that he knows, or reasonably should know, are relevant.[475]
- The opinion must not be based on unreasonable assumptions.[476] Since the Circular 230 written advice rules impose this requirement on the writer of the opinion anyway,[477] this does not add very much from the perspective of the opinion writer.[478]
- If the taxpayer takes the position that a regulation is invalid, he can only rely on an opinion to that effect if, in addition, the position is disclosed on the return.[479] Since the Circular 230 preparer rules require that any advice as to reporting must also include advice as to the possibility of avoiding penalties by disclosure,[480] this means that any penalty protection opinion that supports a position that a regulation is invalid must also advise disclosure.

Beyond the specific minimum requirements mandated by the regulations, all facts and circumstances are considered in determining whether reliance on professional advice is reasonable and in good faith. These facts and circumstances include the taxpayer's education,

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[475] Reg. § 1.6664-4(c)(1)(i).

[476] Reg. § 1.6664-4(c)(1)(ii).

[477] *See supra* text accompanying notes 272–73.

[478] It does mean that if the advisor relies on an unreasonable assumption in violation of Circular 230, his client is per se precluded from relying on the opinion for penalty protection purposes.

[479] Reg. § 1.6664-4(c)(1)(iii).

[480] *See supra* text accompanying notes 319–21.

sophistication, and business experience.[481] In addition, the Service takes the position that reliance on professional advice can support relief from penalties only with respect to "technical or complicated" issues.[482]

Assuming the reasonableness standard is satisfied, the second issue that arises in connection with establishing reasonable cause–good faith by means of an opinion is what comfort level must the opinion be at. Perhaps surprisingly, except in the case of corporate tax shelters,[483] neither the regulations nor case law[484] provides meaningful guidance on this issue. Interestingly, in 1991, the Treasury Department specifically rejected a proposal under which a "substantial authority" opinion would have been adequate for the reasonable cause–good faith defense.[485] However, the Treasury also did *not* indicate that a "substantial authority" opinion was necessarily inadequate; rather it said that it was adopting a "facts and circumstances approach."[486] While this formulation is practically useless to the practitioner, it does leave open the possibility that, at least under some circumstances,[487] an opinion at the "substantial authority" level (or perhaps even at a lower comfort level) could be sufficient.

One possible fly in this ointment is the result of the Circular 230 written advice rules applicable to covered opinions. As discussed above, a covered opinion that does not reach a "more likely than not" level of comfort as to any issue must include disclosure stating that the opinion may not be relied on for penalty protection with respect to that issue.[488] Since it would

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[481] Reg. § 1.6664-4(c)(1).

[482] I.R.M. 20.1.1.3.3.4.3(3).

[483] *See infra* text accompanying notes 496–98.

[484] In *Southgate Master Fund v. United States*, 651 F. Supp. 2d 596 (N.D. Tex. 2009), a taxpayer who had received a "more likely than not" opinion was held to have satisfied the reasonable cause–good faith standard. However, the court's opinion does not have much discussion of the issue.

[485] T.D. 8381,1992-1 C.B. 374.

[486] *Id*.

[487] Unfortunately, it provides no guidance as to what those circumstances might be.

[488] *See supra* text accompanying notes 242–43.

seem difficult to argue that it is reasonable to rely, for penalty-protection purposes, on an opinion that specifically states that it may not be so relied on, this rule could have the practical effect of requiring at least a "more likely than not" comfort level for almost all penalty protection opinions. In addition to being inconsistent with the more flexible approach suggested by T.D. 8381, this could also have some very anomalous results. Consider the following examples:

- A practitioner renders an opinion with respect to a transaction that is neither a principal purpose transaction nor a listed transaction and that does not involve conditions of confidentiality or contractual protection. The opinion will not be used in marketing, recommending, or promoting any transaction, plan, or arrangement. The opinion addresses two legal issues; it reaches a "more likely than not" comfort level on Issue 1, and a "substantial authority" level on Issue 2.

  Because the opinion reaches "more likely than not" on Issue 1, it is probably a reliance opinion[489] and hence a covered opinion; therefore, under the covered opinion rules it would be required to include a statement that it cannot be relied on for penalty-protection purposes as to Issue 2. This, in turn, would probably *actually* preclude reliance as to Issue 2 because such reliance would not be reasonable.

- The facts are the same as in Example (1), except that the opinion only reaches a "substantial authority" conclusion as to both issues. Since the opinion does not reach a "more likely than not" (or stronger) conclusion, it is not a reliance opinion; since it does not fall into any other category of

[489] *See supra* text accompanying note 177.

covered opinion, the advisor is free to write the opinion without either the "required disclosure" included in Example (1) or a standard no-penalties-protection disclaimer. If it were written in this way, technically there would be nothing to prevent the taxpayer from asserting it as a defense to a penalty on both issues, under the "facts and circumstances" standard of T.D. 8321. Since this opinion, as compared to that of Example (1), is weaker overall and of the same strength on Issue 2, it seems absurd that it should provide a potentially greater level of protection.

- The facts are the same as in Example (1), except that instead of addressing both issues in a single opinion, the practitioner prepares (1) a limited-scope covered opinion addressing Issue 1 (and reaching a conclusion at the "more likely than not" level), and (2) a separate opinion addressing Issue 2 (and reaching a conclusion at the "substantial authority" level). As required by the covered opinion rules, the Issue 1 opinion would include a statement that it could not be relied on, for purposes of penalty protection, as to any issue other than Issue 1. The Issue 2 opinion, for the reasons discussed under Example (2), would not be a covered opinion (and would not have to include a "no-penalties-protection" disclaimer). Thus, it would seem that, technically, a taxpayer could try to use the Issue 2 opinion to establish reasonable cause–good faith under the "facts and circumstances" standard—a result that seems absurd when compared with the substantively identical single opinion in Example (1).

e. *Special Reasonable Cause–Good Faith Rules for Corporate Tax Shelters*. Regulations provide a more restrictive set of rules for establishing reasonable cause–good faith in the case of corporate taxpayers who are facing a substantial understatement penalty in connection with a "tax shelter."[490]

The reasons for imposing more restrictive rules in this context are not entirely clear; the only explanation provided by the Treasury in the preamble to the regulations[491] are a discussion of statutory changes to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of l993[492] (OBRA93) and the Uruguay Rounds Agreements Act of 1994[493] (URAA94), together with the statement that the Treasury and the Service "believe that the regulations ... properly implement the statute and Congressional intent."[494] Aside from the lack of explanation, the fact that these rules apply only for purposes of the substantial understatement component of the accuracy-related penalty seems inconsistent with the stated congressional intent that all components of the accuracy-related penalty have "standardized exception criteria."[495] Whether justified or not, however, the regulations say what they say.

Insofar as is relevant from the perspective of using an opinion to establish reasonable cause–good faith, in the context of corporate tax shelters the regulations require, at a minimum, that (1) there actually exist substantial authority[496] *and* (2) the opinion "unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax

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[490] Reg. § 1.6664-4(f).

[491] T.D. 8617.1995-2 C.B. 274.

[492] Pub. L. No. 103-66, 107 Stat. 312.

[493] Pub. L. No. 103-465, 108 Star. 4809. The amendments made to the accuracy-related penalty by OBRA93 and URAA94 (which have since been generally made more restrictive by AJCA2004) do not have any apparent relationship to the rules of Regulation section 1.6664-4(f).

[494] T.D. 8617, 1995-2 C.B. 274.

[495] *See supra* note 458.

[496] Reg. § 1.6664-4(f)(2)(A).

treatment of the item will be upheld if challenged."[497] Thus, in this context, the minimum opinion level that could be useful is effectively "more likely than not,"[498] although a careful practitioner might wish to track the actual language of the regulation.

3. The Reportable Transaction Understatement Penalty

Section 6662A imposes a penalty on any understatement of tax[499] that results from (1) any listed transaction, or (2) any other reportable transaction if a significant purpose of the transaction is tax avoidance or evasion.[500]

The penalty is imposed at a rate of 20%,[501] which is increased if the reportable transaction is not properly disclosed.[502]

Section 6664(d) provides special rules under which reasonable cause–good faith can be a defense to the reportable transaction understatement penalty. In general, these rules impose minimum requirements that are more stringent than those that apply to the reasonable cause–good faith defense to the accuracy-related penalty.

Section 6664(d) sets forth three requirements that, at a minimum, must be satisfied in order to establish reasonable cause–good faith for a reportable transaction understatement. First,

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[497] Reg. § 1.6664-4(f)(2)(B)(2).

[498] As discussed *supra* in the text accompanying note 488, even outside the context of corporate tax shelters the practical effect of the Circular 230 covered opinion rules may be to impose this same minimum standard in many situations.

[499] For purposes of computing the amount of the penalty, the amount of the understatement is based on the highest tax rate for corporate or noncorporate taxpayers (as the case may be), rather than the actual understatement. I.R.C. § 6662A(b)(l).

[500] I.R.C. § 6662A(b)(2). Thus, in the case of a reportable transaction other than a listed transaction, it is theoretically possible that the penalty might not apply, although, as discussed *supra* in the text accompanying notes 164–76, the definition of "a significant purpose" may be quite broad.

[501] I.R.C. § 6662A(a).

[502] I.R.C. § 6662A(c). The "disclosure" referred to here is the Reportable Transaction Disclosure Statement required to be filed on Form 8886, I.R.C. §§ 6662A(c), 6664(d)(3)(A); Reg. § 1.6011-4(d); this is different than the disclosure required under section 6662(d)(2)(B)(ii)(1) discussed *supra* in the text accompanying note 464.

It should also be noted that the reportable transaction understatement penalty is in addition to the penalty imposed under section 6707A (for failure to file Form 8886 when required). The section 6707A penalty, which applies regardless of whether the taxpayer's claimed treatment of the transaction is upheld, is beyond the scope of this Article.

an accurate and complete Form 8886 must have been filed for the transaction.[503] Second, there must actually be substantial authority for the claimed position.[504] Third, the taxpayer must have reasonably believed the claimed tax treatment was more likely than not correct.[505]

An opinion is of no use in establishing the first two requirements. However, an opinion can, subject to certain conditions, be useful in establishing the taxpayer's reasonable belief, for purposes of the third condition.

The first point that is suggested by the statutory language is the strength of the required opinion. Since the whole point of the opinion is to support the taxpayer's reasonable belief, and since the belief that the Code requires is to the effect that the claimed position is more likely than not correct, it would seem that, in order to achieve its purpose, the opinion would have to be at (at a minimum) the "more likely than not" comfort level.

Second, the Code specifically provides that certain opinions may (regardless of their strength) not be relied on to establish a taxpayer's reasonable belief for this purpose. Specifically, an opinion may not be so relied on if (1) it is rendered by a "disqualified tax advisor,"[506] or (2) it is a "disqualified" opinion.[507]

A "disqualified tax advisor" includes (1) a material advisor (as defined in section 6111 (b)(1)) who participates in the organization, management, promotion, or sale of the transactions, or who is related to such a person,[508] (2) any person who is compensated, directly or indirectly, by a material advisor,[509] (3) any person whose fee is contingent on the intended tax benefits

[503] I.R.C. § 6664(d)(3)(A).
[504] I.R.C. § 6664(d)(3)(B).
[505] I.R.C. § 6664(d)(3)(C).
[506] I.R.C. § 6664(d)(4)(B)(i)(I).
[507] I.R.C. § 6664(d)(4)(B)(i)(II).
[508] I.R.C. § 6664(d)(4)(B)(ii)(I).
[509] I.R.C. § 6664(d)(4)(B)(ii)(II).

being sustained,[510] and (4) any other advisor who has a "disqualifying financial interest" in the transaction (as determined under regulations).[511]

As a practical matter, perhaps the most significant aspect of this definition is the inclusion of "material advisors" who participate in the "organization" of the transaction. Effectively, this means that in the case of a reportable transaction, any advisor who has significant involvement in the planning and implementation of the transaction is likely to be effectively disqualified from rendering a penalty protection opinion.[512]

A "disqualified opinion" is any opinion that (1) is based on unreasonable factual or legal assumptions,[513] (2) unreasonably relies on representation, statements, findings, or agreements of the taxpayer or any other person,[514] (3) does not identify and consider all relevant facts,[515] or (4) fails to meet other requirements prescribed by the Service.[516] Other than the last requirement (which is currently inapplicable because the Service has not prescribed any such requirements), compliance with these rules is effectively mandated anyway by the Circular 230 written advice rules.[517] Thus, from the advisor's perspective, the disqualified opinion rules of section 6664(d)(4)(B)(iii) do not add much of practical significance.

4. *The Impact of Long Term Capital Holdings*

Perhaps the most significant recent authority on the issue of opinion reliance to establish reasonable cause–good faith was the 2004 decision in *Long Term Capital Holdings v. United*

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[510] I.R.C. § 6664(d)(4)(B)(ii)(III).

[511] I.R.C. § 6664(d)(4)(B)(ii)(IV). As of this writing no such regulations have been promulgated.

[512] Perhaps the tax bar should thank Congress for enacting this rule, since it presumably would have the effect of increasing the aggregate amount of legal work (and legal fees) generated by any given transaction.

[513] I.R.C. § 6664(d)(4)(B)(iii)(I).

[514] I.R.C. § 6664(d)(4)(B)(iii)(II).

[515] I.R.C. § 6664(d)(4)(B)(iii)(III).

[516] I.R.C. § 6664(d)(4)(B)(iii)(IV).

[517] *See supra* text accompanying notes 272–78.

States (LTCH).[518] In that case, the court rejected the taxpayer's claim of reliance on an opinion of counsel as a defense to the accuracy-related penalty, despite the fact that the opinion was at the "should" level of comfort.[519]

LTCH involved a complicated series of transactions that began with a foreign person's leasing property that was already subject to an existing lease and then subleasing its position to a third party. The rent on the subleases was prepaid; the taxpayer took the position that the prepaid rent was income for U.S. tax purposes at the time it was received. However, the recipient of that income, which was a foreign person, was not subject to U.S. tax on that income.

The foreign lessee–sublessor then transferred its position to a corporation in exchange for stock of the corporation in a transaction intended to qualify under section 351. The taxpayer claimed that, in this transfer, the basis in the transferred assets included the amount of cash received as prepaid rent on the sublease (which was transferred to the corporation along with the lessee-sublessor position), but was not reduced to reflect the obligation to use that cash to pay rent on the master lease. The result was a claimed basis in the stock received that substantially exceeded its economic value. That stock was later transferred to a partnership, which ultimately disposed of it at a loss (as compared to the inflated basis) that was allocated to U.S. partners.

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[518] 330 F. Supp. 2d 122 (D. Conn. 2004), *affd*, Long-Term Capital Holdings v. United States, 2005-2 U.S.T.C ¶ 50,575, 96 A.F.T.R.2d 6344 (2d Cir. 2005). For a discussion of *Long Term Capital Holdings*, *see* Richard M. Lipton, *Reliance on Tax Opinions: The World Changes Due to* Long Term Capital Holdings *and the AJCA*, 101 J. TAX'N 344 (Dec. 2004).

[519] *Long Term Capital Holdings*, 330 F. Supp. 2d at 211. In fact, the taxpayer had obtained two opinions, both at the "should" level, addressing separate aspects of the transaction. The court reasoned that because the claimed position as to both aspects would have had to have been upheld in order for the taxpayer to succeed, a failure of reasonable reliance on either opinion would be fatal to the reasonable cause–good faith defense. Having concluded, for the reasons described in text, that the taxpayer did not reasonably rely on one of the opinions, the court did not find it necessary to address the issue of reasonable reliance on the other opinion.

For another case in which a "should" opinion was held inadequate to avoid an accuracy-related penalty, see *Canal Corporation v. Commissioner*, 135 T.C. No.9 (Aug. 5, 2010), discussed in Kathryn M. Sneade, *What Is the value of a ''Should'' Opinion?*, 30 ABA SEC. OF TAX'N NEWSQUARTERLY 1, 15 (Winter 201l).

After holding for the government on the merits (based on economic substance and step-transaction analysis), the court went on to address the issue of penalties. For several reasons, it concluded that the opinion could not be relied on to establish the reasonable cause–good faith defense.

The first ground for the court's rejection of the opinion as a defense was that the formal written opinion was not actually furnished to the taxpayer until after the return had been filed. Thus, according to the court, the taxpayer could not have relied on that opinion in claiming the position that it claimed. Although there was evidence that oral advice had been rendered prior to the return being filed, the court found, as a factual matter, that the taxpayer failed to prove the substance of that oral advice with sufficient specificity.

The lesson to be learned from this part of the LTCH opinion is a simple one: If you have been asked to render a penalty protection opinion, be sure to deliver it before the taxpayer files his return.

The second reason cited by the court for its rejection of the opinion was the fact that the opinion stated, on its face, that it was prepared as part of the taxpayer's litigation strategy, in anticipation of possible future litigation. There was testimony, and the court concluded, that the purpose of this language was to lay the groundwork for a possible claim of the attorney work product privilege. This, according to the court, "casts doubt on its contents as serving the purpose of providing a reasoned opinion on the application of tax law to the facts of the ... transaction for client guidance in future actions."[520]

In effect, the court is saying that an attorney who writes an opinion as to a transaction that may become the subject of litigation has to make a choice, at the outset, as to whether to seek to

[520] *Id*. at 209.

preserve the ability to assert the work product privilege or to seek to preserve the ability to assert the opinion as a defense against penalties. This is troublesome in several respects.

As noted in ABA Formal Opinion 85-352,[521] an attorney who provides advice as to the reporting of a transaction necessarily wears both the hat of an advisor and that of an advocate. In attempting to force such an attorney to choose one role or the other, the LTCH court is arguably interfering with the fundamental nature of the attorney-client relationship and may effectively force an attorney to make a choice that is inconsistent with his professional responsibilities.

The second respect in which this aspect of the LTCH opinion is troublesome is a practical one. To a large extent, the tax bar tends to be specialized. Although there are undoubtedly exceptions, many lawyers (including this author) whose practices are primarily transactional have limited experience in litigation, and the converse also holds true. From the perspective of a transactional lawyer (who is most likely to be called upon to write an opinion), it is tempting, after reading the LTCH opinion, to conclude that the best course of action is simply to omit any attorney work product language, thus depriving a future court of this rationale for rejecting the opinion as a defense to penalties. However, transactional lawyers may not have the experience and practical strategic sense necessary to appreciate fully the implications of such a choice. In theory, perhaps one answer is always to consult with a tax controversy specialist, but this is not likely to be practical.[522]

[521] *See supra* text accompanying notes 322–27.

[522] Presumably, the Service could seek to argue that the mere fact of having consulted with a litigator is inconsistent with the "advisor" function, even if the attorney work product language is ultimately omitted from the opinion. This could potentially leave a taxpayer in the worst possible situation, having effectively waived the ability to claim the privilege, and yet still not able to rely on the opinion to establish reasonable cause–good faith.

Ultimately, this tension is part of a larger issue: in a number of respects, the Service (and, to a certain extent, the courts) are attempting to force tax practitioners into acting as enforcers.[523] This role necessarily creates a tension with our professional responsibilities to our clients.

The third reason cited by the LTCH court for rejecting reliance on the opinion as a defense was its finding that the opinion unreasonably relied on assumptions and representations by the taxpayer that it had a nontax business purpose and a reasonable expectation of earning a material pre-tax profit from the transaction.

The opinion in LTCH was prepared prior to the 2004 Circular 230 written advice rules. As discussed above, currently those rules preclude unreasonable reliance on assumptions or representations, and in the case of a covered opinion, preclude reliance on (1) any assumptions as to business purpose or profit motive, and (2) representations as to such matters that are not sufficiently specific.[524] In one sense, therefore, this aspect of the LTCH opinion has less significance after 2004, since the flaws that the court found fatal are now prohibited anyway. What remains significant, however, is the manner in which the court approached the issue of proof of reasonableness of the advisor's reliance. Evidently, the Court seemed to view such reliance as presumptively unreasonable, unless the taxpayer provided proof to the contrary (which, the court found, it failed to do).

The court also cited the absence of any analysis on the part of the law firm (such as internal memoranda) addressing business purpose or profit expectation. Ordinarily, one would expect that internal analytical materials prepared by a legal advisor would have, if anything, the strongest possible claim to the attorney work product privilege. In looking to such materials, the

[523] *See, e.g.*, Donald L. Korb, *What Is the Role of a U.S. Tax Advisor in a Changed Law Enforcement Environment?*, *in* 28 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1175, 1175 (2008) (in which then-Chief Counsel Donald Korb characterized tax advisors as "'the first line of defense' for the IRS and the U.S. tax system").

[524] *See supra* text accompanying notes 229, 232.

court could be suggesting that, in order to rely on an opinion of counsel, a taxpayer would have to waive any claim of the privilege not only with respect to the opinion itself (as discussed above), but also with respect to internal files maintained by its legal advisors with respect to the transaction that is the subject of the opinion. This is a very troublesome idea.

The fourth reason why the LTCH court rejected the taxpayer's claim of reliance on the opinion was that the opinion did not contain, in the Court's view, adequate analysis of cases and doctrines that the court believed were important to the conclusion. This failure, reasoned this court, meant that the opinion was not (as required by regulations) "based upon all pertinent facts and circumstances *and the law as it relates to those facts and circumstances*.[525]

For at least two reasons, this aspect of the LTCH decision is quite troublesome. First, the concept that reliance on professional advice can provide a defense to penalties is premised on the notion that a layman cannot be expected to understand all of the complexities of the tax law and should therefore be entitled to rely on professional advice as to matters that a reasonable nonprofessional would not be expected to know. As the Supreme Court has stated,

> When an accountant or attorney advises a taxpayer on a matter of tax law . . . it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the work of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[526]

Yet the LTCH court seems to expect a taxpayer to do just that. In effect, the court is saying that it will make an independent determination as to whether an opinion that a taxpayer relied on cites the "correct" cases and applies the "correct" legal doctrines. If the court

[525] Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 206 (D. Conn. 2004), *aff'd*, Long-Term Capital Holdings v. United States, 2005-2 U.S.T.C ¶ 50,575, 96 A.F.T.R.2d 6344 (2d Cir. 2005) (emphasis added); *see supra* text accompanying note 475.

[526] United States v. Boyle, 469 U.S. 241, 251 (1985).

concludes that it does not, the opinion fails as a penalty defense. Significantly, the question of whether the taxpayer should have known that the advisor was applying the "wrong" legal analysis is not even considered.

The second reason why this aspect of the LTCH decision is troubling is that, in concluding that the opinion failed to analyze crucial legal doctrines and cases, the court looked not only to the opinion itself, but also to the fact that the taxpayer did not proffer any internal legal memoranda or other materials to demonstrate that the advisors had considered such theories and cases. This consideration of internal materials prepared by a legal advisor raises the same privilege-related issues as the consideration of such internal materials in the context of assessing the reasonableness of assumptions and representations.

The fifth reason for rejecting the taxpayer's opinion defense in LTCH was that only one of the taxpayer's principals was shown actually to have read the opinion. The fact that a "should" level opinion would be delivered was orally communicated to other principals, but they did not actually read the opinion. In the court's view, this negated good faith and reasonable reliance.

Aside from the obvious allusion to less-than-thirsty equines, taking this theory to its logical conclusion would effectively eliminate opinion reliance as a penalty defense for all but the smallest organizations. Typically, an organization of any size is likely to be based on division of labor and delegation of responsibilities. Many corporations have a director of taxes or other individual who is responsible for tax matters. That individual (or somebody on his staff) is likely to be the only person in the organization who actually reads the lengthy and detailed gobbledygook produced by the company's outside tax advisors. An abbreviated version of the substance of the gobbledygook is then communicated to that individual's direct superior (perhaps the in-house general counsel or chief financial officer), who in turn communicates an even more abbreviated version, and so on up the chain, ultimately to top management and perhaps the Board of Directors. The idea that all members of top-level management might be expected to read the nonsense produced by a bunch of lowly tax geeks might give management a good laugh, but it would never happen in practice. Yet LTCH found a lack of reasonable reliance and good faith where the principals, one individual excepted, did not read the opinion but were told, in an abbreviated form, of its substance.

Finally, the LTCH court found that the manner in which the taxpayer reported the item in question on its return (offsetting the loss claimed against other gains) was designed to conceal the fact that a large loss was being claimed, thus making it less likely that the item would be flagged for audit.[527] According to the court, this was inconsistent with the taxpayer's claim of good faith.

A number of aspects of the LTCH decision are, as discussed above, quite troublesome. It is certainly possible that the court, distressed at the aggressiveness of the taxpayer's position (which, in effect, claimed a deduction for a non-economic loss), may have gone out of its way to ensure that the taxpayer could not avoid a penalty. Nonetheless, the court's reasoning, if taken to its logical extension, could make it for more difficult to avoid a penalty based on advice of counsel even for less blatant transactions.

[527] Currently, a transaction resulting in recognition of a large loss would in most cases be a reportable transaction pursuant to Regulation section 1.6011-4(b)(5), thus necessitating the filing of Form 8886. The transactions involved in LTCH pre-dated the reportable transaction rules.

ADDENDUM TO TAX OPINION PRACTICE

ROBERT P. ROTHMAN

Shortly before this issue of *The Tax Lawyer* went to press, the Treasury Department released final regulations under the Circular 230 rules of practice, relating to regulation of tax return preparers and other practitioners who advise on the reporting of transactions for tax purposes.[1] Among other matters, the final regulations generally conform the standards of 31 CFR section 10.34 (which apply to any practitioner who advises on the reporting of a transaction) to the statutory standards for imposition of the preparer penalty under section 6694. Thus, even if one is not technically a “tax return preparer,” as defined in section 7701(a)(36), the administrative rules of Circular 230 now generally prohibit advising a client to take a reporting position unless either (1) there is substantial authority for the position, or (2) there is a reasonable basis and proper disclosure is made. “Tax shelters,” as defined in section 6662(d)(2)(C)(ii), and reportable transactions, are subject to a stricter standard, *i.e.*, it must be reasonable to believe that the position would more likely than not be sustained.

Due to publication deadlines, it was not possible to reflect this development in *Tax Opinion Practice*. The matters that are the subject of the new rules (including previously issued proposed regulations) are the subject of Part IV.B.2.a of the Article (The Regulatory Framework; Preparer Rules; The Circular 230 “Preparer” Rules; Required Level of Authority), and also relate to material discussed in Part III.D (Comfort Levels; Substantial Authority); III.E (Realistic Possibility of Success); III.F (Reasonable Basis); and IV.C.l (The Regulatory Framework; ABA Standards; Formal Opinion 85-352).

[1] T.D. 9527, Regulations Governing Practice Before the Internal Revenue Service, Fed. Reg. 2011-13666 (filed May 31, 2011, publication date June 3, 2011), *available* at http://www.ofr.gov/OFRUpload/OFRData/2011-13666_Pl.pdf