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A Taxpayer's Consumer Guide to "Substantial Authority" Tax Opinions

Why are tax opinions especially relevant today? Recent changes in the tax laws have left taxpayers and return preparers grappling with challenging tax planning and return position issues.

In particular, we are seeing business owners and investors struggling with the intricacies of IRC § 199A's 20% deduction for qualified business income, the functioning of IRC § 1202's exclusion of income from the sale of qualified small business stock (QSBS)[1], and IRC § 1061's new three year holding period requirement for carried interests.

Business owners, investors and return preparers are looking to their professional tax advisors for help in navigating their way through these and other complicated tax law changes. In some cases, the most useful form for receiving this advice is a written "substantial authority" tax opinion. This article is an introduction and "consumer guide" for business owners, investors and return preparers who are considering obtaining a tax opinion

What kind of opinion should a taxpayer want?

Depending on the purpose for issuing a tax opinion, they come in different formats, each with different standards regarding the level of confidence the writer has with respect to the outcome under consideration.

An opinion issued for tax planning purposes is sometimes called a "comfort" opinion because its role is to provide a level of assurance that a respected tax practitioner has thoughtfully addressed an issue and concluded with a reasonably high (at least 40% and often more than 50%) level of confidence that the taxpayer's position has support in the tax authorities. In many cases, however, a taxpayer's goals in considering obtaining a tax opinion go beyond merely being comforted that the position isn't unreasonable. The taxpayer wants an opinion that (i) reassures both the taxpayer and his return preparer that the position at issue is reasonable based on the

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available authority, (ii) substitutes for the need to disclose the position on Schedule 8275, and (iii) can help avoid the imposition of various penalties. While a "substantial authority" opinion doesn't entirely satisfy each of the items on this bucket list, it comes closer that a mere "comfort" opinion. There is no guaranty that the IRS or the courts will waive penalties because a taxpayer obtained a tax opinion, but it can be a mitigating factor in a facts and circumstances analysis.

A brief introduction to "substantial authority" tax opinions.

A substantial authority opinion is one that concludes there is "substantial authority" as defined in IRC § 6662 supporting a taxpayer's position on a federal tax return. Under IRS rules, the tax treatment of an item has "substantial authority" only if the weight of published cases, rules and other legal and administrative authorities is substantial in relation to the weight of opposing authorities. [2] Treatises, articles and opinions written by tax professionals are not considered to be authoritative, but the authorities analyzed in those opinions may constitute substantial authority. The literal language of an applicable statute could weigh heavily in the determination of whether there is substantial authority if there is a dearth of other authoritative interpretive authorities.

Here is an example of the opinion from a "substantial authority" opinion addressing one of today's topics:

Therefore, based solely upon the analysis set forth in this letter and subject to all representations, assumptions and qualifications set forth above and below, it is our opinion that there is "substantial authority" (within the meaning of Treasury Regulation 1.6662-4(d)) for the conclusion that the trade or business conducted by XXX as described in Section I ("Background") above was a "qualified trade or business" under IRC § 1202(e)(3).

Circular 230's tax opinion requirements.

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Under Circular 230[3], a tax opinion is subject to the following requirements: (i) the opinion must be based on reasonable [4] factual and legal assumptions (including assumptions as to future events); (ii) the opinion must reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know; (iii) the practitioner must use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter; (iv) the practitioner must not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable); (v) the opinion must relate applicable laws and authorities to the facts, and (vi) the practitioner and the opinion must not, in evaluating the applicable Federal tax matters, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. Tax professionals typically base the facts set forth in their opinions on a combination of independently gathered facts and facts certified to by the taxpayer. The typical substantial authority opinion identifies and analyzes in detail authorities supporting and opposing the tax position under consideration. The drafters of a tax opinion cannot take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue may be settled.

What are the benefits of a "substantial authority" tax opinion"?

- ***Comfort***. A substantial authority tax opinion always serves as a "comfort." A comfort opinion is intended to give a taxpayer comfort that the matter at issue will have the expected tax consequences, based on the knowledge that an experienced tax professional has carefully and thoroughly analyzed the matter and concluded that the weight of authority supports the taxpayer's intended tax return position. Taxpayers are interested in validating their tax positions and winning their tax cases. Having in hand an understandable and well-reasoned opinion from an experienced tax professional confirming that there is substantial authority supporting the

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correctness of the taxpayer's position provides the evidence available to the taxpayer that their tax position is, in fact, a valid and supportable one. In the end, a tax opinion is just a professional's reasoned opinion and isn't binding on the IRS or the courts, but where the issue is a difficult one, it seems reasonable to place reliance on the best available advice.

- ***Penalty mitigation***. A substantial authority tax opinion can also provide protection against the assessment of possible penalties. Under IRC §§ 6662 and 6664, the penalties discussed below can be avoided where the taxpayer limits return positions to those where they have a reasonable basis for concluding that there is substantial authority for their position. Obtaining an experienced tax professional's advice should always be the first step in determining whether there is a reasonable basis for concluding that there is substantial authority for a tax return position. In connection with obtaining that advice, a formal tax opinion can be a useful additional step if it appears that the tax authorities supporting the tax return position are complicated or unclear. A well-reasoned tax opinion discussing the applicable authorities and reaching the conclusion that there is substantial authority can be treated by the IRS as being relevant in determining whether there is substantial authority or a reasonable basis for a tax return position, although the opinion is not itself substantial authority and doesn't bind the IRS or the courts.[5]

IRC § 6664(c) provides an additional exception to the IRC § 6662(a) accuracy-related penalty if there was reasonable cause for the portion of the underpayment subject to the penalty and the taxpayer acted in good faith with respect to that portion. The determination as to whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. These factors can include such considerations as the extent of a taxpayer's efforts to determine the proper tax liability, the taxpayer's tax knowledge, education and experience, and whether the taxpayer sought the advice of a competent professional tax advisor. Obtaining a credible formal tax opinion that reaches the conclusion that there is substantial authority for a position after thoughtfully

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analyzing all of the relevant authorities should help make the taxpayer's case that the requirements of IRC § 6664(c) for penalty mitigation have been met.

But in the end, the IRS and the courts will make their own independent determination of whether or not substantial authority for the underlying position exists and in connection with the possible assessment of penalties, a taxpayer's reliance on a substantial authority opinion should weigh in the "facts and circumstances" determination of whether there is "reasonable cause and good faith" but won't by itself be dispositive.

Applicable penalties – in general.

Taxpayers and tax return preparers need to have a basic understanding of how the IRS' penalty provisions function to fully understand where tax opinions fit into the process. A taxpayer may be subject to penalties for fraud, negligence or disregard of rules or regulations, substantial understatements of Federal income tax, and understatements with respect to reportable transactions. This article doesn't address the penalty provisions applicable to fraud or tax shelters (listed or reportable transactions) or criminal tax penalties.

Applicable penalties – taxpayer penalties.

IRC § 6662 imposes a 20% negligence penalty on the portion of any understatement of tax to which the penalty applies if a taxpayer fails to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary or reasonable care in the preparation of a tax return. Separately, IRC § 6662(d) imposes a substantial understatement penalty, but provides that this penalty does not apply to an understatement which is attributable to a position for which the taxpayer has substantial authority.[6] There are other penalties in the Internal Revenue Code, but these are the most common civil penalties for taking unreasonable and unsupported positions on a tax return.

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Applicable penalties – the income tax return preparer penalties.

An income tax return preparer may also be subject to a penalty under IRC § 6694(a) if the preparer knows or should have known that a tax return position taken by the client would or did result in an understatement of taxable income.[7] But for purposes of the penalty calculation, IRC § 6662(d)(2)(B) provides that the amount penalized as an understatement can be reduced by the portion attributable to an item for which the taxpayer had "substantial authority." Understandably, tax return preparers are often the driving force behind the decision of taxpayers to obtain a tax opinion from a credible professional supporting the conclusion that there is substantial authority.

Penalty mitigation through disclosing (i.e., red flagging) a tax return position on Form 8275.

One approach to avoid the negligence and substantial understatement penalties is to adequately disclose a tax position on the return, and only take positions for which there is a reasonable basis. Some taxpayers may be reluctant to "adequately disclose" a return position in their return.[8]

More resources

In spite of the potential for significant tax savings, many experienced tax advisors are not familiar with Sections 1202 and 1045 planning. Venture capitalists, founders and investors who want to learn more about Sections 1202 and 1045 and related planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning

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- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson if you want to discuss QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] Section 1202's benefits are becoming a hot topic and planning idea in the aftermath of the reduction of the corporate tax rate from 35% to 21%.

[2] Treasury Regulation § 1.6662-4(d)(3)(iii) provides a list of what constitutes authority for purposes of the substantial authority exception. In the absence of opposing authority, the language of a statute itself can constitute "substantial authority."

[3]Circular 230 contains the regulations setting forth rules governing many aspects of Federal tax practice.

[4] Circular 230 provides that reliance on representations, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based are incorrect, incomplete, or inconsistent.

[5] Treasury Regulation § 1.6662-4(d)(3)(iii). Technically, a "substantial authority" opinion doesn't function as a penalty protection opinion, but should weigh in the "facts and circumstances" analysis under IRC § 6664(c). Taxpayers who want to argue that the existence of a "substantial authority" opinion should mitigate against the imposition of penalties should be prepared to waive attorney-client privilege and provide the IRS with a copy of the opinion.

[6] For individuals, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—

> (i) 10 percent of the tax required to be shown on the return for the taxable year, or
>
> (ii) $5,000.

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For corporations, in general, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of—

(i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or

(ii) $10,000,000.

[7] The penalty is the greater of $1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim.

[8] The IRS requires taxpayers and tax return preparers to use Form 8275 to disclose positions that are not otherwise adequately disclosed on a tax return to avoid certain penalties. The form is filed to avoid the portions of the accuracy-related penalty due to disregard of rules or to a substantial understatement of income tax for non-tax shelter items if the return position has a reasonable basis. Form 8275 is also used for disclosures relating to the economic substance penalty and the preparer penalties for tax understatements due to unreasonable positions or disregard of rules.

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