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Robert W. Wood

THE TAX LAWYER

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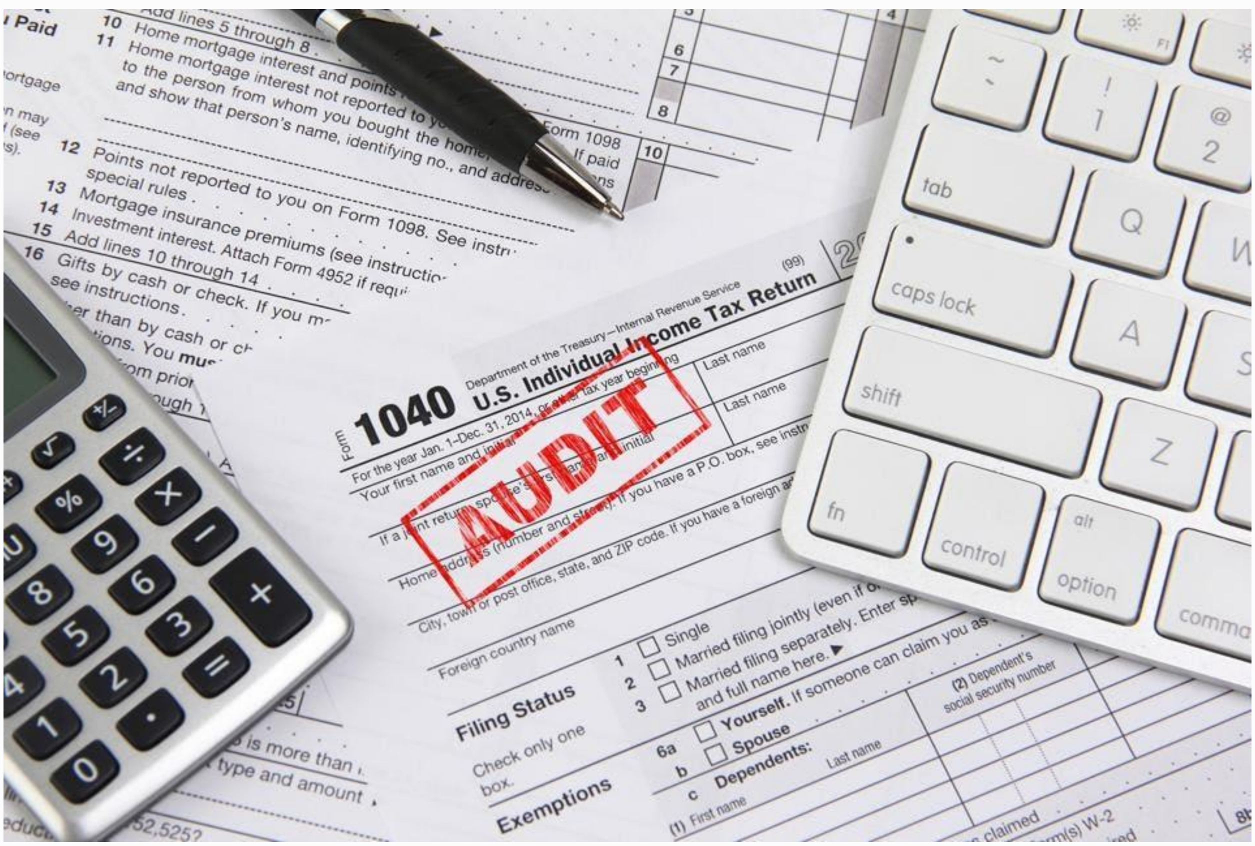
How Tax Opinions Help Solidify Tax Positions And Prevent Penalties



With a big or tricky transaction or a major income item, someone may tell you that you should get a tax opinion. But what does that mean? A tax opinion can be written about any subject. It is formal written advice about your own facts and tax circumstances, whatever they are. You might have settled some litigation and received money, or paid big legal fees. You might have moved states, liquidated a business, sold or exchanged stock, assets or crypto, or had an involuntary conversion or casualty loss.

You might have received a legal settlement you hope is tax free because of physical injuries or sickness. You might be claiming that your stock sale proceeds are tax exempt as qualified small business stock under section 1202 of the tax code. Whatever your situation, you may want formal tax advice about the strengths and weaknesses of your position before you file your tax return.

Tax opinions should be thorough, discussing your facts and numbers, and the legal authorities. But when it comes to the bottom line conclusion, tax opinions generally conform to one of the following choices:

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

Under IRS standards, the tax practitioner must assume there will be an audit. That way, the opinion's conclusion is not based on audit lottery. In reality, of course, audits are rare. Does a tax opinion bind the IRS or state tax authorities? No, but it still can help enormously in an audit. That leads to perhaps the most common question of all. To what extent will a tax opinion get you out of penalties if the IRS disagrees with your treatment? In general, the higher the standard of opinion, the more it can help with penalties.

However, even a lower level opinion helps. Even an opinion that you have a reasonable basis for your tax position can be enough to protect you if you disclose your position on your return. Of course, penalty protection is only one of the benefits you should get from a tax opinion. After all, you don't want to end up paying all of the tax and all of the interest, even if there are no penalties. In that sense, what you *really* want from a tax opinion is to have your tax position upheld, so that penalties don’t even come into play.

The timing of tax opinions is also worth discussing. To return to the customized type of tax opinion, try to plan ahead and get some tax advice before you sign documents or make major decisions that will impact your taxes. Often, that kind of tax advice can precede a formal tax opinion. That way, the tax adviser is part of the process and can help shape the tax opinion and make it stronger.

And once the tax opinion is written and your tax returns are filed, you have a ready source of authority if the IRS comes knocking. If they do, don't hand the opinion to the IRS. Instead, use it as a ready source to cut and paste into targeted responses to the IRS. Having all that work done in advance can make a world of difference.

How late is too late to prepare a tax opinion? In some cases, they can be done after a tax return is filed, to help justify the position. Normally though, a tax return should be prepared and completed before you file your tax return. That way, you can be relying on the tax opinion when you sign and file your tax return. And that gives you the best argument for avoiding penalties.

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