A Whole New World: The 2017 Tax Act, Tax Advice, and Lawyer Ethics

Standards of Tax Practice Committee
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Panelists

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Overview

• Significant tax law changes with short-term effective dates, such as the Tax Cuts and Jobs Act (TCJA), may require positions to be taken by taxpayers in the absence of significant authorities.

• Changes in law may also be ambiguous, or contrary to other provisions.

• Tax professionals must consider ethical rules promulgated by the ABA, AICPA, and under Circular 230 in order to appropriately advise taxpayers.
ABA Model Rules to Consider

• Rule 1.1 (Competence): A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

• Rule 1.3 (Diligence): A lawyer shall act with reasonable diligence and promptness in representing a client.
  • Comment: A lawyer should pursue a matter on behalf of a client . . . and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf.

• Rule 2.1 (Advisor): A lawyer shall exercise independent professional judgment and render candid advice. In doing so may refer not only to law, but also to moral, economic, social and political factors.
Circular 230 Considerations

• Rule 10.22: Diligence as to accuracy
• Rule 10.34: Standards with respect to tax returns and documents, affidavits, and other papers
• Rule 10.35(a): Competence
• Rule 10.37: Requirements for Written Advice
AICPA Considerations

• Statements on Standards for Tax Services
  • No. 1, “Tax Return Positions”
    • Incorporates Treasury regulations into determination of recommending a tax return position.
    • Advising return preparers of potential penalty consequences
    • Return preparer has “both the right and the responsibility to be an advocate for the taxpayer with respect to any position” satisfying the standards for tax services.
  • No. 4, “Use of Estimates”
    • May use estimates if not practical to obtain exact data if reasonable under facts and circumstances unless prohibited by statute or rule.
Penalties

• Accuracy-Related Penalties
  • Section 6662(a): Accuracy-related penalties of 20% on underpayments.
  • Section 6662(c): Negligence or disregard of rules or regulations
  • Section 6662(d): Substantial understatement of income tax

• Defenses to Penalties
  • Most penalties may be abated upon a showing of reasonable cause (6664(c))
  • Accuracy-related penalties may be avoided by reaching a return position that has substantial authority under Treas. Reg. § 1.6662-4(d).
  • If no substantial authority, but only reasonable basis, then disclosure is required to avoid penalties.
  • Rules are different for nondisclosed / noneconomic substance transactions
What are authorities?

• Treas. Reg. § 1.6662-4(d)(3)(iii):
  – The Code and other statutory provisions
  – Proposed, Temporary, or Final Regulations
  – Revenue Rulings and Revenue Procedures
  – Tax Treaties, regulations and explanations thereunder
  – Court cases
  – Congressional intent as reflected in committee reports, joint explanatory statements, floor statements
  – The JCT's Bluebook
  – Certain PLRs, TAMs

• What is NOT authority?
  – Authorities that have been overruled or withdrawn
  – Conclusions reached in legal periodicals, treatises, legal opinions or opinions rendered by tax professionals.

• These are not all in-conclusive lists.

• What is the treatment of informal, non-IRB guidance, like Forms, Publications, FAQs?
Substantial Authority

• Objective standard involving analysis of law and fact.

• Weight of authorities supporting treatment must be substantial in relation to the weight of authorities supporting contrary treatment.

• All relevant authorities must be taken into account.

• Nature of the analysis:
  • Relevance and persuasiveness of the authority
  • How analytical the authority is
  • Extent to which authority is redacted
  • Age of the authority (PLR, TAM, GCM or AOD, if older than 10 years, “accorded very little weight”)
Types of Authorities - Regulations

• Section 7805(a) provides a general grant of authority to the Treasury Secretary (and through Delegation, subordinate officials) to “prescribe all needful rules and regulations.”
  • **Proposed**: Not binding on a taxpayer but generally may be relied upon by a taxpayer as authority if indicated in preamble. Provides for notice and comment.
    • *See Estate of Shelfer v. Commissioner*, 103 T.C. 10, 17 (1994) (“Proposed regulations are not entitled to our deference, and in fact carry no more weight than an argument advanced by respondent on brief.”).
    • IRS shouldn’t take a position in litigation that would leave the taxpayer in a worse-off position (IRM 32.1.1.2.2(3))
  • **Temporary**: Immediately binding for up to three years (Section 7805(e)(2)), without notice and comment.
  • **Final**: Binding following notice and comment.
Types of Authorities - Regulations

• **Retroactivity:** Under Section 7805(b), a regulation generally may not apply retroactively before the earliest of:
  - Date regulation is filed with the Federal Register;
  - If a final regulation, the date which any proposed or temporary regulation was filed with the Federal Register;
  - The date on which any notice substantially describing the expected comments of any regulation is issued to the public.

• **Exceptions:**
  - Regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which the regulation relates – (note: TCJA deadline is June 22, 2018)
  - Prevention of abuse
  - Correction of procedural defect
  - Regulations applying internally to the IRS
  - Congressional authorization
  - Taxpayer election
  - Application to rulings
Overview of the Tax Regulatory Process

• EO 12291, “Federal Regulation” (Feb. 17, 1981)
• EO 12866, “Regulatory Planning and Review” (Sept. 30, 1993)
• EO 13789, “Identifying and Reducing Tax Regulatory Burdens”
  • Notice 2017-38
• Memorandum of Agreement: “The Department of the Treasury and the Office of Management and Budget Review of Tax Regulations Under Executive Order 12866” (April 11, 2018)
• Policy Statement on the Tax Regulatory Process (March 5, 2019)
Are Authorities still Authorities?

• Treasury Tax Regulatory Statement Section III:
  • “[S]ound tax administration necessitates less formal guidance to efficiently advise the public about the meaning of tax laws.”
  • Subregulatory guidance can provide clarity and certainty concerning legal interpretation by IRS but not intended to affect rights or obligations independent from underlying statutes and regulations.
  • Subregulatory guidance “does not have the force and effect of law” and IRS will not take positions inconsistent with such guidance when it is in effect.
  • IRS won’t seek deference under Auer or Chevron for subregulatory guidance.

• How does this apply to Treas. Reg. § 1.6662-4(d)(3)(iii)?
<table>
<thead>
<tr>
<th>Return Position</th>
<th>Meaning</th>
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<tbody>
<tr>
<td>Frivolous</td>
<td>Without a basis in law or fact; advanced in bad faith; patently improper</td>
</tr>
<tr>
<td>Reasonable Basis</td>
<td>&quot;Significantly&quot; higher than not frivolous, but contains less than a realistic possibility of success. Must be accompanied with a disclosure for ability to avoid certain penalties. See Treas. Reg. § 1.6662-3(b)(3)</td>
</tr>
<tr>
<td>Substantial Authority</td>
<td>Weight of supporting authorities must be substantial in relation to weight of contrary authorities. See Treas. Reg. § 1.6662-4(d)</td>
</tr>
<tr>
<td>More likely than not</td>
<td>There is a greater than 50% likelihood of the position being upheld. See Treas. Reg. § 1.6662-4(d)(2)</td>
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Should? Will?

• Tax opinions may advise a taxpayer that a position “should” or “will” pass muster by the IRS.
• Though not a formal designation under the regulations, such opinions are common and generally may be relied upon by taxpayers in determining their tax positions and generally, for penalty protection as a basis for reasonable cause.
  • But see, e.g., Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 209 (D. Conn. 2004), aff’d 150 Fed. Appx. 40 (2d Cir. 2005) (should-level opinion was not sufficient for reasonable cause/good faith defense)
• Taxpayer and advisor must assume that return will be examined—you cannot make a determination based on audit risk or lack thereof.
Potential Risks in Issuing an Advisory Tax Opinion

• Potential risks for law firms
  • Can be sued for additional tax liability if opinion did not adequately analyze the issue
  • Circular 230 duties for those overseeing a firm’s opinion practice (ensuring adequate procedures for complying with rules)

• Potential risks for attorneys
  • Common law civil liability (negligent malpractice, negligent misrepresentation, fraud, breach of trust, breach of fiduciary duty)
  • Statutory civil liability (securities laws, RICO, unfair trade practices)
  • Criminal prosecution (securities laws, mail fraud, wire fraud, tax fraud, RICO)

• Potential Penalties
  • Return preparer penalties (Section 6694); Promoting abusive tax shelters (Section 6700); Penalties for aiding and abetting understatement of tax liability (Section 6701); Circular 230 penalties (covered opinion rules withdrawn)
Ethical considerations in giving an advisory tax opinion

• Beyond civil and criminal statutory and administrative liability, issuing opinions can also implicate ethical considerations under rules of professional responsibility and Circular 230

• Although certain cases have invalidated parts of Circular 230 (*Loving, Ridgely*), not a good idea to assume invalidity
  • Duty of competence and due diligence
  • Reasonable practitioner standard under Circular 230
  • Reading all transactional documents; relying only on reasonable facts, representations, and assumptions

• Tension between advisor and advocate roles

• Potential conflicts of interest and confidentiality issues (e.g., an attorney who issues an opinion may be called as a witness in future litigation)

• Duties to non-clients?
Disclosure

• Consider disclosing tax positions that are at a reasonable basis. Penalties under Section 6662 are generally not imposed where the position contrary to a rule or regulation has been adequately disclosed. (Treas. Reg. § 1.6662-3(c))
  • Ex.: Understatement reduced to the extent there is reasonable basis and disclosure (6662(d)(2)(B)(ii))

• Totally different rules for transactions that are determined to lack economic substance.
How do you disclose?

• Treas. Reg. § 1.6662-3(c)(2):
  • Disclosure is adequate on Form 8275 or 8275-R, as appropriate

• Methods of disclosure
  • Form 8275
  • Form 8275-R
  • White paper disclosure
  • Schedule UTP

• See also application of Rule 10.34(a)
Sample disclosure

At the time ABC, Inc. ("Taxpayer") filed Form 1120, Taxpayer was not able to perform a complete analysis of its qualified research expenditures to calculate the amount of the Section 41 credit for increasing research activities (the “R&D Credit”). After completing its analysis of the R&D Credit, Taxpayer intends to correct its filing if necessary.
Burning Questions

• What if your client does not want to disclose the reasonable basis position?
  • Ex.: You determine that the position your client intends to take on its tax return is not without controversy. In fact, you believe that there is a less than 50% chance the position would be sustained. You advise your client to file a Form 8275 disclosing the position. Your client does not want to do so, fearing that such a disclosure would almost certainly result in an audit.
    • No protection against penalties (10.34(c) requires advising)
    • If you prepared the return, can you sign it? (10.22 – diligence as to accuracy)
    • Will your return get audited?
Burning Questions

• What do you do in the absence of authority?
  • Ex. A taxpayer incurring a short taxable year beginning after December 31, 2017, for which only proposed regulations exist at the time the tax return is filed.
  • If binding authority is eventually promulgated, which is contrary to the position taken by the taxpayer, what should the taxpayer do?

• Treas. Reg. Sec. 1.6662-4(d)(3)(ii): “There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.” There can be substantial authority for more than one position.
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