Tax Opinions the SEC Way

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In this article, Wood and Board discuss how tax professionals can comply with SEC requirements when writing tax opinions.

Tax practitioners are often accused of not seeing the big picture. By training or by inclination, we tend to focus on the trees, on particular branches, or even on particular leaves. We rarely stand back and look at the forest.

Even if we do, it is almost always the *tax* forest we survey, not everything else. It could hardly be otherwise. When it comes to dealmaking, tax advisers usually have a limited role. It is important but limited. And it is necessarily myopic.

One job a tax adviser may be given is opinion writing. When we write tax opinions, as many of us do frequently, they are generally about technical issues that combine factual details and legal analysis. At least one portion of the opinion is conclusory: "It is our opinion that . . . ."

However, most of the opinion is likely to analyze the facts and the law in excruciating detail. The detail is necessary for reaching that hopefully succinct conclusion. Tax professionals, clients, and corporate lawyers have different views on how discursive an opinion should be.

A good tax opinion should not be one-sided. It should discuss the facts, legal arguments, and pertinent authorities in favor of — as well as against — the tax position in question. It must reach some kind of conclusion, but it should present an even-handed assessment. It should not be jingoistic, but it shouldn't be wishy-washy, either.

Ultimately, we want the opinion to satisfy the client, as well as to comply with IRS standards under Circular 230. We also hope to satisfy the corporate lawyers and bankers involved in the deal. In some transactions, however, it turns out we need to observe SEC standards, too. The corporate and securities lawyers can provide some guidance, including that perennial favorite: "This is how we did it last time." Still, it is up to the tax professional to color within the lines drawn by the SEC.

SEC Required Tax Opinions

The SEC's Regulation S-K requires opinions on tax matters for:

- filings on Form S-11 (real estate investment trusts and other specific companies whose primary business is investing in real estate or interests in real estate);
- filings to which Securities Act Industry Guide 5 applies (real estate limited partnerships);
- roll-up transactions; and
- other registered offerings in which "the tax consequences are material to an investor and a representation as to tax consequences is set forth in the filing."

The SEC says that a tax opinion can be rendered by either a lawyer, an independent public accountant, or a certified accountant. An alternative to an opinion is a ruling from the IRS. The SEC labels those as "revenue rulings," although one can infer that the SEC means a private letter ruling.

A revenue ruling, after all, is not something one can obtain from the IRS. Revenue rulings are sometimes outgrowths of private letter rulings, but they have a decidedly different legal provenance. They can be cited as authority, while a private letter ruling binds only the particular taxpayer to whom it is issued and the IRS.

In any event, SEC Staff Legal Bulletin No. 19[1] informs us that a "revenue ruling" can substitute for an opinion only if it is "a specific letter ruling addressed to the registrant and covers all of the material tax consequences of the proposed transaction." That can only be a private letter ruling.

The staff legal bulletin further states that it is not enough to get "a general revenue ruling that doesn't address the specific facts of the proposed transaction" — which plainly excludes what tax practitioners and the IRS mean by a "revenue ruling."

What if the registrant obtains a private letter ruling that does not actually cover *all* of the material tax consequences of the transaction? That can and does happen. In some cases, the registrant asks for rulings only on some issues. Alternatively, the IRS may be unwilling or unable to rule on every material tax issue.

When that occurs, it isn't the end of the road. If the ruling fails to address some of the material tax consequences, it can still be used as long as there is also a tax opinion that fills in the gaps.

Material Tax Consequences

One must have an IRS ruling or tax opinion addressing the *material* tax issues. Notably, that adjective does not mean material to you, me, or even to the SEC — although the latter is presumably the judge of this materiality standard. It is the *investor* we are talking about.

What is "material" to the investor? The SEC and the courts have developed their own standards for what is considered material for securities law purposes. Information is material if there is a substantial likelihood that a reasonable investor would consider the information to be important in deciding how to vote or how to make an investment decision. Under that standard, information is material if it would "significantly alter" the total mix of available information.[2]

The staff legal bulletin provides several examples of transactions generally involving material tax consequences, including:

- Mergers or exchange transactions in which the registrant represents that the transaction is tax free (for example, spinoffs and stock-for-stock mergers).
- Transactions offering significant tax benefits or in which the tax consequences are so unusual or complex that investors would need to have an expert's opinion to understand the tax consequences and make an informed investment decision (for example, debt offerings with unusual original issue discount issues, specific rights offerings, limited partnership offerings, and specific offerings by foreign issuers).
- Rights offerings that the registrant represents to be tax free require a tax opinion. However, the SEC says that a distribution of "poison pill" rights does *not* require the filing of a tax opinion, based on Rev. Rul. 90-11,[3] which held that contingent rights distributed under a poison-pill plan do not constitute income to the recipient.
- Suppose that a foreign issuer includes a tax disclosure discussing the application of both foreign and U.S. tax provisions to U.S. purchasers. In that case, a tax opinion on the material foreign tax consequences would generally be required if the registrant's disclosure represents that the transaction will not be taxable.

As those examples suggest, the SEC generally requires an opinion only when the registrant's disclosure states that a transaction will be tax free. If the registrant states that the transaction *will* be taxable, no tax opinion is required. The registrant must still provide accurate and complete disclosure in the prospectus concerning the tax consequences to investors, but it need not support this with an opinion.

If the registrant's tax disclosure names a lawyer[4] or accountant as the source of the discussion concluding that the transaction is taxable, consent from that lawyer or accountant is required. A tax opinion would not be required.

The registrant is free to provide an opinion of counsel or an accountant if it so chooses, even if the opinion isn't required. But if the registrant includes an opinion, it must comply with all applicable requirements.

Long- and Short-Form Tax Opinions

Item 601(b)(8) of Regulation S-K allows the opining tax lawyer or accountant to render an opinion in either long or short form. Tax professionals have their own nomenclature when it comes to tax opinions, but this doesn't necessarily jibe with that of the SEC. In SEC parlance, a "long-form" tax opinion is a full tax opinion, which is filed as

[1]October 14, 2011. Staff legal bulletins summarize the SEC staff's views regarding various aspects of the federal securities laws and SEC regulations. They represent interpretations and policies followed by the SEC on any given matter. While staff legal bulletins are not legally binding, they may be considered binding de facto on issuers working through the SEC registration process.

[2]*See TSC Industries Inc. v. Northway*, 426 U.S. 438, 449 (1976).

[3]1990-1 C.B. 10.

[4]If the disclosure says that its discussion is based on advice of counsel, the registrant must name the counsel and file the counsel's consent to being named in the prospectus.

Exhibit 8 to the registration statement and summarized in the prospectus. Needless to say, the SEC insists that the opinion and the tax disclosure in the prospectus be consistent.

In a "short-form" opinion, the tax disclosure in the prospectus effectively serves as the tax opinion. The lawyer or accountant providing the short-form opinion simply provides a document stating clearly that the tax discussion in the prospectus is his opinion. This statement adopting the discussion in the tax disclosure is filed as Exhibit 8 to the registration statement, just as a long-form opinion would be.

If the registrant uses a short-form opinion, the tax disclosure in the prospectus must state clearly that it is the opinion of the named lawyer or accountant. It must clearly identify and articulate the opinion being rendered.

Material Federal Tax Consequences

Tax advisers are accustomed to being told that they cannot cherry-pick what tax issues they are addressing. For a long time under the recently retired version of Circular 230 (from 2003 to 2014), the IRS specifically required "covered" tax opinions to address all material tax issues. That version of Circular 230 also enunciated standards for assumptions and representations.

The SEC says tax opinions generally need to address only the material federal tax consequences of the transaction. Of course, that means *all* material federal tax consequences. However, it is acceptable for the prospectus to punt on state tax issues, typically recommending that investors get tax advice from their own tax counsel or adviser regarding their particular circumstances, including the tax consequences under state law. Given that U.S. investors may be located in all 50 states and the District of Columbia, there really is no practical alternative.

Foreign tax issues are somewhat different. In the case of foreign governments or foreign private issuers, there may be material foreign tax consequences. In that event, the SEC says the prospectus should discuss whether investors will be subject to foreign taxes that result from their U.S. residence or their status as an investor.

Moreover, the prospectus should identify any tax treaties between the United States and the pertinent foreign country. Venturing into that exotic territory does not impose an undue burden on the registrant and its (foreign) tax advisers, at least if the number of foreign countries is not too great. (If it *is* too great, the registrant can thank itself or its bankers for that complication.)

The heading and introductory language in the prospectus's tax disclosure may state that the opining lawyer or accountant is addressing the transaction's "federal income tax consequences" or "material federal income tax consequences." But the SEC warns against using limiting terms, such as stating that the disclosure discusses only "certain" or the "principal" tax issues because that suggests that the tax opinion omits something that is material.

Of course, on each material tax matter, the SEC requires the tax opinion to reach a conclusion and to express it. According to the staff legal bulletin, the SEC also "expects" the opinion to cite the code section, regulation, or ruling relevant to each material federal tax consequence. Despite that expectation, citing anything but a code section is rare in actual practice.

In fact, citations beyond the black letter of the IRC typically occur only when the regulation or ruling in question is "highly relevant or directly on point."[5] It is hard to argue with actual practice in this case. It also may be eye-opening to technical tax lawyers who are mired in details and want to jam in every nuance. It can be sobering for tax lawyers to learn that citing beyond the code is inappropriate. Investors are much more likely to be confused than enlightened by a tax opinion that is larded with unnecessary citations to professional-strength tax authorities.[6]

Regardless of whether the tax opinion is long or short form, it should:

- clearly identify each material tax consequence;
- set forth the author's opinion for each identified tax item; and
- set forth the basis for the opinion.[7]

Item 12 to Securities Act Industry Guide 5 (dealing with real estate limited partnerships) contains useful guidance for tax opinions in all SEC contexts:

> The function of the tax opinion is to inform investors of the tax consequences they can reasonably expect from an investment in the partnership. If, with respect to an intended tax benefit, counsel are unable to express an opinion that such benefit will be available because of uncertainty in the law or for other reasons, the opinion should so state and also disclose that there is or may be a material tax risk the particular benefit will be disallowed on audit. The tax effect of such disallowance should be explained. Each material risk of disallowance

[5]New York State Bar Association Tax Section, "Report on Tax Opinions in Registered Offerings," at 6 (Apr. 4, 2012).

[6]The authors of the NYSBA report diplomatically observe that they "interpret the Bulletin as being consistent with this aspect of current market practice, as well as the SEC's plain English rule." *Id*.

[7]In the case of a short-form opinion, those requirements may be met in the tax disclosure in the prospectus.

of an intended tax benefit should be disclosed in the tax opinion and under the appropriate heading in the prospectus.

Unresolved Issues

Tax opinions are supposed to cover all material federal tax issues. But the SEC stops short of saying that the opinion must in fact *resolve* each point. The SEC recognizes that some issues may be in the fuzzy category, however material they may be. If the author is unable to discuss a material tax consequence, the opinion should:

- state that fact clearly;
- provide the reason for the author's inability to discuss a material tax consequence (for example, the facts are currently unknown or the law is unclear); and
- discuss the possible alternatives and risks to investors of that tax consequence.

Mere Descriptions of the Tax Law

Tax opinions are not supposed to just say what the law is and fail to apply it. The SEC specifies that a description of the law does not satisfy the requirement to provide an opinion on the material tax consequences of the transaction. For example:

- ''In the opinion of counsel, a partnership is taxed in the following manner.'' That statement describes the law without applying it to the specific facts of the transaction and is unacceptable as an opinion.
- ''In the opinion of counsel, a preponderance of the tax consequences described is likely to occur.'' This statement fails to identify the specific tax consequences on which counsel is rendering an opinion and is unacceptable as an opinion.
- ''In the opinion of counsel, the following discussion is a fair and accurate summary of the material tax consequences.'' This statement fails to identify the specific tax issue on which the lawyer or accountant is opining. According to the staff legal bulletin, the ''fairness'' or ''accuracy'' of the prospectus disclosure is not the appropriate subject of the opinion. The SEC says that the lawyer or accountant must discuss the tax consequences of the offering, not the manner in which they are described in the prospectus.[8]

Assumptions and Qualifications

Tax opinions can be conditional or qualified without violating SEC standards.[9] Nevertheless, the conditions or qualifications must be adequately described in the registration statement. The lawyer or accountant issuing the opinion must disclose in the opinion the assumptions upon which the opinion is based.

Moreover, those assumptions must be consistent with the proposed transaction. Assumptions about future facts or conduct, if limited and reasonable, are common and acceptable. For example, in an exchange offer, it is acceptable to state the assumption that the exchange will be conducted in the manner described in the registration statement.

However, the tax opinion cannot assume the tax consequence at issue. The author must discuss the material tax issue. Suppose that the question is whether the registrant will be classified as a partnership for tax purposes. It is unacceptable to merely discuss the tax treatment of partnerships generally. It is also inappropriate to assume any legal conclusion underlying the tax opinion.

Example: Suppose that the tax treatment depends on the legal conclusion that the registrant is a partnership. The opinion must actually discuss this matter. It cannot simply be assumed. It is unacceptable for an opinion to state, ''Assuming the registrant is a partnership, then the tax treatment is. . . .'' Finally, it is inappropriate for the tax opinion to assume facts relevant to the particular opinion that are known or readily ascertainable.

Opinions Subject to Uncertainty

Sometimes, of course, the tax treatment of an issue is unclear. That may be true even for an important or pivotal issue. In fact, this situation is probably more common than the SEC seems to assume. The SEC acknowledges this possibility and directs what the opinion is supposed to say.

What if there is a lack of authority directly addressing the tax consequences of a transaction? What if there is conflicting authority or significant doubt about the tax consequences of the transaction? In any of these events, the SEC allows the tax lawyer or accountant to issue a ''should'' or ''more likely than not'' opinion.

Some tax lawyers may be amused by this allowance. A ''will'' opinion, after all, is a relative rarity, and rightly so. And one might have assumed that a ''should'' or ''more likely than not'' opinion is usually pretty reassuring. The truly uncertain or

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[8]The SEC seems to be straining here, at least regarding accuracy. There is no difference, in terms of truth values, between asserting that ''the statement 'Bolivia's principal export is tin' is accurate'' and asserting that ''Bolivia's principal export is tin.'' Similarly, opining that a summary of material tax consequences is accurate is ultimately no different from opining that the transaction will have those material tax consequences. The two opinions are correct or incorrect in exactly the same circumstances.

[9]Regulation S-K, Item 601(b)(8).

dicey opinion might well be significantly less than a "more likely than not" or "should" opinion!

For example, how about substantial authority, or even reasonable basis? The SEC does not address these. Instead, the SEC focuses on how the opinion expressing the uncertain "should" or "more likely than not" conclusion might enunciate the nature and impact of that uncertainty.

The SEC gives these examples:

1. "In the opinion of counsel, the registrant should be taxed as a partnership." In those cases, the staff expects the lawyer or accountant to explain why he cannot give a "will" opinion and to describe the degree of uncertainty in the opinion.

2. The registrant's status as a passive foreign investment company may be unable to be determined before the effective date of the registration statement. In that situation, disclosure of the registrant's potential status as a PFIC — and its tax consequences to investors — may be required in the registration statement. The registrant should provide risk factor or other appropriate disclosures setting forth the risks of uncertain tax treatment to investors.

3. The lawyer or accountant could state that it is "possible but highly unlikely" that the IRS would disagree, but, if it did, that the exchange would be treated as taxable. The tax opinion could then explain how holders would be taxed in that unlikely event.

4. The opinion may also state which position the registrant intends to take if challenged by the IRS.

Limitations on Reliance

Be careful with attempts to limit liability or to limit those who can rely upon the opinion. The SEC warns against any language that states — or even implies — that the tax opinion is "only" for the benefit of the board or the registrant. Similarly, do not say that only the board or the registrant is entitled to rely on the opinion.

The SEC says those kinds of limitations are unacceptable. Investors are entitled to rely on the opinion expressed. The SEC lists examples of inappropriate disclaimers:

- "This discussion is being provided for informational purposes only"; and
- "Investors should seek and rely upon their own tax advisers as to the consequences of this transaction."

Of course, telling investors to get their own tax advice about their own circumstances is common. And the SEC acknowledges that it is common to say it. This is particularly true regarding the personal tax consequences of the investment. After all, tax consequences may well vary for investors in different tax situations. The SEC does not object to this kind of language as long as the recommendation does not disclaim reliance for tax matters on which counsel has opined.

Opinion Timing

In general, when a tax opinion is required, there is a deadline. The opining lawyer or accountant must render the opinion, or the IRS must give its revenue ruling (meaning private letter ruling), and the registrant must file that opinion (or IRS ruling) *before* the registration statement is declared effective.

One exception to this general rule applies when a merger transaction will be treated as a tax-free reorganization. In that case, the SEC does not object if a tax opinion is not filed before the effectiveness of the registration statement if:

- the merger agreement includes a non-waivable condition that the transaction will receive a tax opinion at closing that states that the merger will be treated as a tax-free reorganization;
- the prospectus discusses the substance of the opinion that will be provided at closing; and
- the opinion is filed before closing as an exhibit in a post-effective amendment or, if the transaction is registered on Form S-3 or Form F-3, in a Form 8-K or Form 6-K that will be incorporated by reference into the filing.

Waiving Closing Tax Opinions

Frequently, the consummation of a merger or another transaction will be conditioned on the receipt of a favorable tax opinion by the registrant or the other party to the transaction at closing. But the SEC notes that both parties may reserve the right to waive the condition. In those cases, the registrant must:

- file an executed opinion of counsel before effectiveness, even though the merger agreement is conditioned on the receipt of one or more favorable tax opinions at closing; and
- recirculate the disclosure and re-solicit the shareholders if the condition is waived and the change in tax consequences is material.

Signed Consents

Section 7 of the Securities Act requires the registration statement to be accompanied by the written consent of "any person whose profession gives authority to a statement made by him, [who] is named as having prepared or certified any part of the registration statement."

Any lawyer or accountant providing a tax opinion must consent to the prospectus's discussion of that opinion. The consent must allow reproduction of the opinion as an exhibit and must approve the tax opinion author being named in the registration statement. The opining lawyer or accountant isn't required to admit in the consent that it is an expert within the meaning of sections 7 and 11 of the Securities Act.

Conversely, the SEC says that it would be inappropriate for the author of the tax opinion to deny that it is an expert within the meaning of sections 7 and 11 of the Securities Act.

Corporate vs. Tax

Some tax advisers may never have worried about whether their opinions mesh with the SEC rules. If they are relying on corporate and securities lawyers to do so, they may find their proposed opinions attracting critical comments from SEC reviewers. In a way, that makes sense. The SEC is hardly as sophisticated about tax opinion practice as the IRS or even many clients.

In a transaction that is dependent on an IRS ruling, reliant upon a tax opinion, or both, the tax adviser and opinion author may have their hands full just dealing with the substantive tax issues. Even so, it behooves the tax adviser to work through the SEC aspects too. Not surprisingly, the SEC views tax opinions from an investor-centric perspective.

Opinion authors may find themselves under unfamiliar pressure to reach definite conclusions. And they may discover that the SEC is far less tolerant of the kind of expressions of uncertainty that are customary in tax opinions rendered outside the SEC's purview. Tax advisers may find a cozy familiarity in expressing uncertainty. Corporate and securities lawyers and the SEC may be far more critical, pushing for that elusive "will."