SEC Comments on Tax Opinions

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Tax opinions are generally about technical issues that combine factual details and legal analysis. 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 detail. The detail is necessary to reaching that hopefully succinct conclusion.

Tax professionals, clients and corporate lawyers have differing views about how discursive an opinion should be. To our minds, 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 a conclusion but should present an even-handed assessment.

The opinion should satisfy the client, comply with IRS opinion standards and satisfy the corporate lawyers and bankers involved in the deal. In public company transactions, 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"), but ultimately 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, as explained in SEC Staff Legal Bulletin No. 19 (Oct. 14, 2011), requires opinions on tax matters for:

- filings on Form S-11 (REITs and certain other 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 where "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 either by a lawyer or by an independent public or certified accountant. An alternative to an opinion is a ruling from the IRS, specifically directed to the registrant, covering the material tax consequences of the transaction. If the registrant obtains a ruling that covers only *some* of the material tax consequences, as often happens, the SEC says the ruling 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, which means material to an investor. What is material to an investor? The SEC and the courts say information is "material" if there is a substantial likelihood that a reasonable investor would consider it to be important in deciding how to vote or to make an investment decision. Information is material if it would "significantly alter" the total mix of available information.

The Staff Legal Bulletin provides examples of transactions generally involving material tax consequences, including:

- Mergers or exchange transactions where the registrant represents that the transaction is tax-free (*e.g.*, a classic stock-for-stock merger).
- Transactions offering significant tax benefits or where the tax consequences are so unusual or complex that investors would need an expert's opinion to understand the tax consequences and make an informed investment decision (*e.g.*, debt offerings with unusual original issue discount issues).
- Transactions involving a foreign issuer that include a tax disclosure discussing the application of both foreign and U.S. tax provisions to U.S. purchasers, in which case, a tax opinion on the material *foreign* tax consequences may be required.

The SEC generally demands an opinion only when the registrant's disclosure states that a transaction will be tax-free. If the registrant says the transaction *will* be taxable, no tax opinion is required. The registrant still has to provide accurate and complete tax disclosure in the prospectus, but it need not support this with an opinion.

The registrant is free to provide an opinion even if the opinion is not required. If the registrant does so, the opinion must comply with all applicable requirements.

Long and Short 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 does not necessarily jibe with that of the SEC. In SEC parlance, a "long-form" tax opinion is a full tax opinion, which is filed as Exhibit 8 to the registration statement and summarized in the prospectus.

In a "short-form" opinion, the tax disclosure in the prospectus serves as the tax opinion. The lawyer or accountant providing the short-form opinion simply supplies a document stating that the tax discussion in the prospectus is his or her 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.

What Is Material?

The SEC says that tax opinions generally need to address all the material federal tax consequences of the transaction. But it is acceptable for the prospectus to punt on state tax issues, typically recommending that investors get their own tax advice from their own tax counsel or advisor regarding their particular circumstances, including the tax consequences under state law.

In the case of foreign governments or foreign private issuers, there may be material foreign tax consequences. In such an event, the SEC says that the prospectus should

discuss whether investors will be subject to foreign taxes as the result of their U.S. residence or their status as an investor. The prospectus should also identify any tax treaties between the United States and the pertinent foreign country.

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

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 Internal Revenue Code section, regulation or ruling relevant to each material federal tax consequence. Notwithstanding this expectation, citations to anything but a Code section are rare in actual practice unless a regulation or ruling is directly on point.

This may come as surprise to technical tax lawyers who get mired in details and want to jam in every nuance. But as their securities law colleagues already know, investors are more likely to be confused than enlightened by a tax opinion larded with unnecessary citations to professional-strength tax authorities. Regardless of whether the tax opinion is long or short form, it should:

- clearly identify each material tax consequence being opined upon;
- set forth the author's opinion as to each identified tax item; and
- set forth the basis for the opinion.

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 of the opinion is unable to opine on a material tax consequence, the opinion should:

- state this fact clearly;
- provide the reason for the author's inability to opine (*e.g.*, the facts are unknown or the law is unclear); and
- discuss the possible alternatives and risks to investors of that tax consequence.

Mere Descriptions of Tax Law

The SEC says tax opinions cannot just say what the law is and fail to apply it. For example:

- "In the opinion of counsel, a partnership is taxed in the following manner." This statement describes the law without applying it to the specific facts of the transaction and is not acceptable.
- "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 not acceptable.
- "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. Although such opinions were formerly acceptable, the SEC now says that the lawyer or accountant must opine on the tax consequences of the offering directly, not indirectly by opining on the accuracy of the disclosure in the prospectus.

Assumptions and Qualifications

Tax opinions can be conditional or qualified without violating SEC standards. However, the conditions or qualifications must be described in the registration statement and disclosed in the opinion.

The assumptions must of course be consistent with the proposed transaction. Assumptions as to *future* facts or conduct, if limited and reasonable, are common and acceptable. For example, in an exchange offer, the opinion can assume that the exchange will be conducted as described in the registration statement.

Nevertheless, the tax opinion cannot assume the tax consequence at issue. The author of the opinion must opine on the material tax issue.

For example, suppose that the tax treatment depends on the legal conclusion that a

transaction is a "statutory merger" under the reorganization provisions. The opinion must actually opine on the question. It is not acceptable for the opinion to state, "Assuming that the transaction is a statutory merger, 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 and Uncertainty

What if there is a lack of authority directly addressing the tax consequences of a transaction? What if there is conflicting authority? In such cases, the SEC allows that the tax lawyer or accountant rendering a tax opinion can issue a "should" or "more likely than not" opinion.

Some tax lawyers may be amused by this allowance. In tax, a "will" opinion is a relative rarity, and rightly so. Most clients find a "should" or "more likely than not" opinion pretty comforting. A truly uncertain or dicey tax opinion may be significantly less certain than a "more likely than not" or "should" opinion!

For example, how about opinions concluding only that there is "substantial authority" for a tax position, or even just a "reasonable basis" for it? Such tax opinions are not particularly uncommon, but they imply that the tax professional cannot conclude that the position is "more likely than not" to be upheld. The SEC does not address this fact of tax life. Instead, it focuses on how an opinion expressing an uncertain "should" or "more likely than not" conclusion should explain 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 such cases, the staff expects the lawyer or accountant to explain why he or she 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 (PFIC) may not be capable of determination before the effective date of the registration statement. In this 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 and/or other appropriate disclosure setting forth the risks of uncertain tax treatment to investors.
3. The opining lawyer or accountant may 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 should 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

Tax professionals must 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 that implies—that the tax opinion is "only" for the benefit of the board or the registrant or that they are the only persons entitled to rely on the opinion. The SEC also rejects any statement telling investors that they "should seek and rely upon their own tax advisors as to the consequences of this transaction."

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 so with respect to the personal tax consequences of the investment.

After all, tax consequences will vary for investors in different tax situations. The SEC does not object to this kind of language. However, the recommendation should not disclaim reliance for tax matters on which counsel has opined.

Timing

When a tax opinion is required, there is generally a deadline. The opining lawyer or accountant must render the opinion, or the IRS must provide a private letter ruling, and the registrant must file that opinion (or ruling) *before* the registration statement is declared effective. There are some exceptions, including one that may permit an opinion to be filed after the fact in a tax-free merger.

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 the reproduction of the opinion as an exhibit and must approve the author of the tax opinion being named in the registration statement.

Opining lawyers or accountants are not required to expressly *admit* in the consent that they are experts within the meaning of Sections 7 and 11 of the Securities Act. However, they may not expressly *deny* that they have that status, either.

Corporate vs. Tax

Some tax advisors 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 transaction that is dependent on an IRS ruling, reliant upon a tax opinion or both, the tax adviser may have his or her hands full just dealing with the substantive tax issues.

Even so, it behooves the tax adviser to work through the SEC learning too. Not surprisingly, the SEC views tax opinions from an investor-centric perspective. This means that opinion authors may find themselves under unfamiliar pressure to reach definite conclusions.

In fact, they may discover that the SEC is less tolerant of expressions of uncertainty than many consumers of tax opinions. Tax advisers may find a certain cozy familiarity in expressing uncertainty. Corporate and securities lawyers and the SEC may have different ideas, pushing for that elusive "will."

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