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A Year Under SEC Bulletin No. 19

Changes in tax opinion standards have altered how tax counsel should be implemented in complex securities offerings.

On October 14, 2011, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) issued Staff Legal Bulletin No. 19 (the Legal Bulletin), which, among other things, provides certain enhanced standards for tax opinions filed in connection with registered offerings of securities.[1] Specifically, this guidance elaborates on the particular offerings for which tax opinions are required as well as the required substance of those opinions. At the time of its issuance, there was much speculation as to whether the heightened tax opinion standard of the Legal Bulletin would materially change the tax opinion preparation process for registered securities offerings and registration statement tax disclosures. After almost a year since its issuance, it is clear that this has been the case for more complicated offerings, although the effect has not been as dramatic as some had speculated.

Background

SEC Regulation S-K under the Securities Act of 1933 (Securities Act) requires that a tax opinion be submitted for filings on Form S-11, filings to which Securities Act Industry Guide 5 applies (for interests in real estate investment partnerships), filings for roll-up transactions, and other filings "where the tax consequences are material to an investor and a representation as to tax consequences is set forth in the filing." These tax opinions generally take the form of so-called "short-form opinions" filed as Exhibit 8 to the registration statement, for which the tax disclosure in the prospectus serves as the tax opinion.

Based on this limited guidance, securities and tax counsel historically took the position that, even if a tax opinion was necessary, tax counsel would not necessarily opine on all federal tax consequences of an offering. Instead, prospectus tax disclosures would often generically describe a tax issue without reaching a particular opinion for the offering, state that the issuer (and not counsel) was taking a particular tax position, or qualify or provide caveats to conclusions reached in the opinion. Due to this perceived limited opinion standard, it was common for tax counsel to become involved in the securities disclosure process only at the final drafting stage. Additionally, because tax opinion assumptions and qualifications were generally used in lieu of issuer tax opinion representations, tax counsel often had limited client involvement.

Requirements of the Legal Bulletin

Although it has been expressed that the Legal Bulletin "was not intended to revise substantially the existing practice with respect to tax opinions,"[2] it is our view that the terms of the Legal Bulletin indicate the SEC Division of Corporate Finance's intention to require greater legal counsel accountability in securities offering tax opinions.

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1. Legality and Tax Opinions in Registered Offerings, SEC Legal Bulletin No. 19 (Oct. 14, 2011), *available at* http://www.sec.gov/interps/legal/cfslb19.htm.

2. *See* Description of comments made by Tom Kim, Chief Counsel in the SEC's Division of Corporation Finance, *ABA Section of Business Law, Committee on Legal Opinions, Legal Opinion Newsletter* (James F. Fotenos ed., Winter 2011), *available at* http://apps.americanbar.org/buslaw/committees/CL510000pub/newsletter/20111221000000.pdf.

The Legal Bulletin provides guidance as to when tax consequences are "material" for purposes of the tax opinion filing requirement, as well as how tax opinions should be drafted. It clarifies that "[i]nformation 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 make an investment decision or, put another way, to have significantly altered the total mix of available information." Specific examples include tax-free transactions (e.g., nontaxable spin-offs and reorganizations) and transactions that offer significant tax benefits or have unusual or complex tax consequences (e.g., debt offerings with unusual original issue discount issues, certain rights offerings, limited partnership offerings, and certain offerings by foreign issuers). On the other hand, a taxable exchange offer or merger does not require a tax opinion.

When a tax opinion is required, the Legal Bulletin states that the tax opinion must address all material federal tax consequences. Therefore, the terms "certain" or "principal" may not qualify the described "U.S. federal income tax consequences" either in the heading or introductory language in the prospectus tax disclosure because this may indicate that the opinion may be omitting a material tax consequence. Moreover, a general description of the law applying to these material consequences is not sufficient; tax counsel must specifically opine on each material federal tax consequence. While the Legal Bulletin accepts less than a "will" level of opinion for each federal tax consequence (such as a "should" or "more likely than not" level), the tax opinion must explain the reason for not being able to reach a "will" level and discuss the possible alternative treatments and risks. Additionally, tax opinions may rely on limited factual assumptions. They may not, however, rely on assumptions as to any tax consequence at issue or legal conclusion underlying the opinion or assumption as to relevant facts that are known or readily ascertainable. Furthermore, the Legal Bulletin requires that all tax opinion assumptions, conditions, and qualifications be disclosed in the tax opinion itself.

The Legal Bulletin also requires that both the prospectus and Exhibit 8 opinion state that the disclosure in the prospectus is the opinion of the named tax counsel. In addition, investors' ability to rely on the tax opinion may not be limited.

Practical Consequences

Due to its heightened tax opinion standard, the Legal Bulletin has caused a significant change in the way tax counsel operate in many registered securities offerings. For offerings not covered by the specific categories of required tax opinions, tax counsel must now first determine whether an offering is of a type with "material" tax consequences. For routine offerings of common stock and senior debt issued at par value (with no complicated payment terms that raise imputed interest issues) as well as fully taxable mergers and exchange offers, material tax consequences that would implicate the Legal Bulletin are generally not present. Accordingly, the tax disclosures for these types of routine offerings will remain the same. For most other offerings, however, material tax issues are present, requiring revisions to pre–Legal Bulletin precedent language in the way tax issues and related factual matters are described in the tax disclosure, as well as new representation letters from the issuers with respect to many of the factual matters that are critical to the tax opinion. Such changes are necessary for tax counsel to comply with the Legal Bulletin requirement to reach a specific legal conclusion on these material tax issues.

Examples of offerings where we have observed the greatest change in tax disclosure and increase in tax counsel involvement include master limited partnership equity offerings (MLP offerings). In MLP offerings, tax counsel now must address issues such as whether the MLP's income and loss allocations will be respected for tax purposes. This is a very fact-specific issue involving many uncertain legal issues as to industry practice, and tax counsel have historically not opined on this issue at the high level of comfort required by the Legal Bulletin. Other examples of offerings where increased tax counsel involvement and changes to the tax disclosure have been necessary include certain subordinated debt offerings and other debt offerings, where classification of the offered security as debt or equity for tax purposes must now be addressed. Hybrid "equity unit" debt instrument offerings and other debt offerings involving complicated original issue discount issues also now require enhanced tax disclosure, representation letters, and tax counsel involvement. "Rights offerings" and other stock dividends represent another area where we have observed a significant change in tax opinion practice and disclosure.

Implications

For more complex securities offerings, tax counsel should be involved early in the securities disclosure preparation process to review substantive federal tax issues. Tax counsel may also require increased client contact to facilitate any necessary tax diligence and representation letter correspondence. The ability to deliver effective and efficient tax opinion support for registered securities offerings in the post–Legal Bulletin world will depend on this increased engagement.

Contacts

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