

Tax Opinion Procedures and Policies - A Discussion

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Why Do Clients Ask for Tax Opinions?

1. Risk averse client wants written comfort that tax advisers have thought through the relevant issues and have confidence in their advice.
2. Defend against the imposition of tax penalties.
3. Satisfy contractual condition or covenant of transaction.
4. Federal securities laws require opinion to support discussion of tax consequences included in offering materials.
5. Demonstrate that Financial Accounting Standards Board (FASB) Reporting Thresholds have been met.
6. Provide a version of insurance to clients.

Structure of Tax Opinions

1. Introductory Statement
2. Facts, Representations, and Assumptions
3. Legal Analysis
4. Opinions or Conclusions

Levels of Assurance

1. Reasonable Basis
2. Substantial Authority
3. More Likely than Not
4. Should
5. Will

“Realistic Possibility of Success” Standard

- According to ABA Formal Opinion 85-352, a lawyer is prohibited from advising tax return positions that fall short of a “realistic possibility of success” standard.
- This standard is generally thought to govern any tax advice given to a client to the extent that tax return positions are or will be involved (*e.g.*, advice given in the course of structuring a transaction that ultimately will involve a tax return position or positions).
- Notably, Opinion 85-352 permits the rendering of advice that a lawyer believes will not prevail if challenged by the Service, so long as there is a “realistic possibility” of succeeding based on the lawyer’s good faith assessment of the law.

Circular 230 Standards (2014) – No Longer Include Minimum Standards for Rendering Tax Opinions, But:

A practitioner who renders any type of written advice, including a tax opinion, must:

1. Establish the relevant background facts,
2. Consider the reasonableness of assumptions and representations,
3. Consider applicable regulations and standards regarding reliance on information and advice received from a third party,
4. Apply the relevant authorities to the facts,
5. Consider the business purpose and economic substance of the transaction if they are relevant to the tax consequences of the transaction (relying on a representation that there is a business purpose or economic substance being insufficient as a general matter),
6. Consider whether the issue involves a listed transaction or reportable transaction,
7. Consider other regulations and standards applicable to written tax advice promulgated by the applicable taxing authority, and
8. Arrive at a conclusion supported by the authorities.

Tax Opinion Policies and Procedures

American College of Tax Counsel (ACTC)

Tax Force on Tax Opinion Policies and Procedures - Survey of ACTC Fellows

1. Does your firm have a formal opinion review policy for issuing tax opinions?

Yes	70	92.1%
No	<u>6</u>	7.9%
	76	

If you answered “yes,” is your firm’s policy in writing?

Yes	34	48.6%
No	<u>36</u>	51.4%
	70	

2. Does the policy apply solely to formal tax opinions, or is it broader than that?

- Although applicable authorities do not distinguish between formal tax opinions and other tax or legal advice, do practitioners treat them differently as a matter of practice?
- Model 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.*
- Thus, a tax opinion should be given only by a lawyer who possesses the requisite knowledge and skill and who treats the engagement with the thoroughness called for by the tax opinion process. Moreover, other partners in a law firm, including (in particular) other lawyers with managerial authority, must make reasonable efforts to assure that those involved in the opinion process are competent to so engage.
- AICPA Interpretation No. 1-2 (Tax Planning) to SSTS No. 1: “Although oral advice may serve a taxpayer’s needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar-value, or complicated transactions.”

Does the policy apply solely to formal tax opinions, or is it broader than that? (cont'd)

Applies solely to formal tax opinions	47	68.1%
Broader than formal tax opinions	<u>22</u>	31.9%
	69	

If broader, to what written communications does the policy apply?

Examples of responses: any written tax advice, informal tax opinions, advice in large transactions/advice “having a potentially important effect,” all legal opinions rendered by the firm

3. Does your firm have a tax opinion review committee?

- No authority specifically requires a review committee.

But see Model Rule 5.1 RESPONSIBILITIES OF PARTNERS, MANAGERS, AND SUPERVISORY LAWYERS

(a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.

(b) A lawyer having direct supervisory authority over another lawyer, including a suspended lawyer employed pursuant to Rule 34, RLDE, Rule 413, SCACR, shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.

(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

(d) Partners and lawyers with comparable managerial authority who reasonably believe that a lawyer in the law firm may be suffering from a significant impairment of that lawyer's cognitive function shall take action to address the concern with the lawyer and may seek assistance by reporting the circumstances of concern pursuant to Rule 428, SCACR.

Comment: While this rule is somewhat extreme in concept, it should be borne in mind by partners and others who review opinion letters or otherwise oversee the practice of an attorney who drafts a tax opinion.

Does your firm have a tax opinion review committee (cont'd)?

Yes	23	30.3%
No	<u>53</u>	69.7%
	76	

If so, how is the tax opinion review committee staffed?

Examples of responses: senior tax partners, senior attorneys, one firm committee that reviews all opinions (including tax opinions), partners with tax LL.M. degrees, tax partner not involved in the engagement, head of tax group/national tax group, managing shareholder and senior tax counsel, two other members with expertise, specified number (two, three, five partners)

4. Alternatively, in lieu of a tax opinion review committee, does your firm require at least two partners to approve the opinion?

Require approval by at least two partners	55	73.3%
Does not require approval by at least two partners	<u>20</u> 75	26.7%

5. Can one or more of the partners reviewing and approving the tax opinion be nontax partners? (For example, for an opinion on a loan transaction, can the second partner review be done by a commercial finance attorney?)

- Model Rule 1.1 (Competence) - Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary to the representation.
- Thus, a tax opinion should be given only by a lawyer who possesses the requisite knowledge and skill and who treats the engagement with the thoroughness called for by the tax opinion process. Moreover, other partners in a law firm, including (in particular) other lawyers with managerial authority, must make reasonable efforts to assure that those involved in the opinion process are competent to so engage.

Can one or more of the partners reviewing and approving the tax opinion be nontax partners? (For example, for an opinion on a loan transaction, can the second partner review be done by a commercial finance attorney?) (cont'd)

Yes	16	21.9%
No	<u>57</u>	78.1%
	73	

6. Can one or more of the individuals reviewing and approving the tax opinion be nonpartners?

Yes	14	19.7%
No	<u>57</u>	80.3%
	71	

7. Does your firm's tax opinion review policy have different approval requirements based on the type of opinion being issued (e.g., penalty protections, invalidity of a regulation, closing opinions, etc.)?

- IRC §6694(a) (Preparer Penalties)
- ABA Formal Opinion 346 (applies only to tax shelter investments)
- Model Rule 2.3 (Evaluation for Use by Third Persons)
- AICPA SSTS No. 1, Interpretation No. 1-2
- Circular 230 §10.33 (Best Practices for Tax Advisors)
- Circular 230 §10.37(a) (Requirements for Written Advice)

Does your firm's tax opinion review policy have different approval requirements based on the type of opinion being issued (e.g., penalty protections, invalidity of a regulation, closing opinions, etc.) (cont'd)?

Yes	13	18.1%
No	<u>59</u>	81.9%
	72	

Examples of responses: greater review/higher standard of review for opinions with higher level of confidence, public transactions with SEC reporting, “sticky” issue, complex opinion

8. Does your firm's tax opinion review policy have different approval requirements based on the level of opinion (e.g., will, should, more likely than not) being issued?

- IRC §6694(a) (Preparer Penalties)
- ABA Formal Opinion 346 (applies only to tax shelter investments)
- Model Rule 2.3 (Evaluation for Use by Third Persons)
- AICPA SSTS No. 1, Interpretation No. 1-2
- Circular 230 §10.33 (Best Practices for Tax Advisors)
- Circular 230 §10.37(a) (Requirements for Written Advice)

Does your firm's tax opinion review policy have different approval requirements based on the level of opinion (e.g., will, should, more likely than not) being issued? (cont'd)

Yes	3	4.1%
No	<u>71</u>	95.9%
	74	

9. Has your firm created one or more standard form(s) of opinions (or at least those portions of opinions that can be “standardized”)?

Yes	34	45.3%
No	<u>41</u>	54.7%
	75	

If your firm has created standard forms of tax opinion, can you provide examples of the types of opinions where standardization has worked well?

Examples included: tax-free reorganizations; penalty abatement and litigation; commercial and public finance; repetitive types of offerings (capital markets); entity classification; audit requests; general language such as burden of proof

10. Does your firm provide training specifically related to the issuance of tax opinions, including education relating to applicable standards such as Circular 230, opinion subject to ABA Ethics Opinions 346 or 85-352, requirements for penalty protection under the Internal Revenue Code and regulations, and applicable SEC requirements (e.g., SEC Staff Legal Bulletin No. 19)?

- Model Rule 1.1 (Competence)
- Circular 230 §10.22 (Diligence as to Accuracy): A practitioner is presumed to exercise due diligence in relying on the work product of another person if the practitioner “used reasonable care in **engaging, supervising, training, and evaluating the person**, taking proper account of the nature of the relationship between the practitioner and the person.”

Does your firm provide training specifically related to the issuance of tax opinions, including education relating to applicable standards such as Circular 230, opinion subject to ABA Ethics Opinions 346 or 85-352, requirements for penalty protection under the Internal Revenue Code and regulations, and applicable SEC requirements (e.g., SEC Staff Legal Bulletin No. 19)? (cont'd)

Yes	25	33.8%
No	<u>49</u>	66.2%
	74	

11. Does your firm have a policy relating to the cataloging and retention of tax opinions?

Yes	26	34.7%
No	<u>49</u>	65.3%
	75	

If so, please describe your policy.

Examples of responses: opinions stored in a data bank or accounting departments, both digital and hard copies kept, firm maintains a directory of opinion letters, all legal opinions in common binder, cataloged within document management system

Linda Galler's Recommendations for Law Firms

1. *Firms should periodically review their tax opinion policies and practices.*
2. *Firms should decide whether tax opinion review policies should conform to review policies applicable to other types of opinions.*
3. *Firms should maintain and make available indexed or searchable databases or files of previously issued tax opinions.*
4. *Firms should consider using standard language for parts of tax opinion letters.*
5. *Firms should consider using standard language for parts of tax opinions.*
6. *Firms should decide what constitutes a tax opinion for purposes of their review policies.*
7. *Firms should consider whether to formally require tax opinion preparers to consult with another tax professional or professionals prior to delivering a tax opinion for review.*
8. *Firms should consider and define the role of reviewers.*
9. *Firms should consider including non-partners in the opinion review process.*

Commissioner of Internal Revenue, Petitioner, v. Mary Archer W. Morris Trust, North Carolina National Bank, Trustee - 367 F. 2d 794 (4th Cir. 1966)

- In 1966, a merger agreement was negotiated between American Commercial Bank, a North Carolina corporation based in Charlotte, and Security National Bank of Greensboro. American was larger than Security but it was found desirable to merge American into Security under Security's national charter as North Carolina National Bank.
- To avoid a violation of national banking laws, American had to divest itself of its insurance department. This was done by distributing the insurance subsidiary to its shareholders (a "Spinoff").
- The Commissioner ruled that the distribution was taxable to the shareholders, since active business requirement was not met since American's banking business was not continued in unaltered corporate form, and also found an inherent incompatibility in substantially simultaneous divisive and amalgamating reorganizations.
- Richard E. Thigpen and Robert L. Hines, Charlotte, North Carolina, representing a trust which owned a block of stock in American Commercial Bank (now NCNB) challenged the IRS position in the Tax Court. The Tax Court found that the double reorganization was tax free under Section 368(a)(1)(D) and Section 355, and no gain or loss was recognized to the shareholders.
- The Tax Court decision was affirmed by the 4th Circuit Court of Appeals, resulting in the Morris Trust Doctrine which continued to permit tax free spinoffs followed by tax free mergers until reversed by the enactment of Section 355(e) in 1998, supposedly to curb the circumvention of the General Utilities Doctrine.

NCNB Corp Acquisition of First RepublicBank Corp (1988)

- First RepublicBank Corp, a Texas bank with \$32.5 billion in assets and \$3 billion in losses, was taken over by the FDIC.
- In 1988, the FDIC auctioned off the assets of First Republic.
- NCNB and Hugh McColl offered the FDIC \$700 million more than Wells Fargo, with tax benefits factored in.
- Tim Hartman of NCNB engaged Frank Blanchfield of Johnston and Blanchfield, Charlotte, North Carolina to request a private letter ruling from the IRS that the net operating losses belonged to the depositors, who essentially owned control of the Bank, and the acquisition of the Bank by NCNB did not result in a change in control limiting future use of the NOLs.
- Using this novel theory, Blanchfield obtained a favorable ruling within a short time frame and NCNB won the auction, resulting in \$5 billion of NOLs for future use.
- NCNB soon became the leading bank in four of Texas's five largest regions, Austin, Dallas, Ft. Worth, and San Antonio, and fueled the growth that led eventually to the acquisition of Bank of America.

Fulton Corporation v. Janice H. Faulkner, Secretary of Revenue of North Carolina - 516 U.S. 325 (1996)

- The NC trial court ruled for the Secretary of Revenue on a motion for summary judgment, upholding the NC intangibles tax.
- The NC Court of Appeals reversed and held for the Petitioner, finding that the NC intangibles tax discriminated against interstate commerce.
- The North Carolina Supreme Court reversed the Court of Appeals, holding that the State's scheme imposed a valid compensatory tax under Darnell v. Indiana, 226 U. S. 390 (1912).
- The Supreme Court granted certiorari. Jasper L. Cummings, Jr. for the Petitioner
- Justice Souter delivered the opinion of a unanimous Court, reversing the NC Supreme Court and finding that the intangibles tax facially discriminates against interstate commerce, fails justification as a valid compensatory tax, and accordingly it cannot stand. Chief Justice Rehnquist filed a concurring opinion.