Yahoo's Alibaba Spinoff Revisits Tax Opinion vs. Private Letter Ruling Dynamics

By Robert W. Wood • Wood LLP

In January 2015, Yahoo CEO Marissa Mayer announced the spinoff to shareholders of Yahoo's remaining 384 million shares in Alibaba, now worth $23 billion. But now, the IRS told Yahoo it would not issue a private letter ruling. On these numbers, this is not a little issue. A ruling is an advance blessing from the IRS, a binding letter you attach to your tax return, worth its weight in gold.

At this writing, it is not yet clear if the deal will go ahead as planned based on a law firm's tax opinion, or if the deal will change or perhaps even be scuttled. Plainly, the fact that the IRS will not rule does not mean it will be taxable even if it proceeds exactly as advertised. But the IRS certainly *knows* about it.

There is a kind of *in terrorem* effect of asking for a ruling and not getting it. You can almost hear Clint Eastwood in a new role as IRS Commissioner, on refusing to issue an IRS ruling, "Well, punk, do you feel lucky today?"

If the deal proceeds and is taxable, and if the tax lawyers do not fight about it—which they would—there is talk about what it could mean. Some say that Yahoo alone would face a tax bill of about $7 billion on the distribution to its shareholders. Yahoo shareholders would be hurt too.

But whatever happens to Yahoo's mega-spin, it is causing renewed discussion of the proverbial opinion-versus-ruling fork in the road. "Do you want a tax opinion or a private letter ruling?" is rarely a simple question. You may not have a choice. Cost, speed, certainty and risk must be considered.

Not all factors point to seeking a ruling either. A ruling involves costs and delays. Besides, there are risks of asking for a ruling and not getting it. At a minimum, you will have alerted the IRS. It is better not to ask than to ask and be denied. Many tax professionals understand the mix of these issues.

Many clients do not. Even among sophisticated business people and savvy investors, the reasons for wanting one or the other should be teased out. Since the subject is invariably taxes, there are invariably technical issues too. Adding the technical and practical issues surrounding each path makes the discussion harder. When one adds the inside baseball terminology, it can all be downright dizzying.

Binding vs. Not

Start with the rule that rulings are binding, tax opinions are not. Opinions never bind the IRS, rulings always do. That is one reason you must attach a copy of the ruling to the pertinent tax return when you file it. You never attach an opinion to a tax return.

An opinion may bind the author, but never binds the IRS. Of course, most opinion authors leave plenty of room for disagreement. Saying that it is more likely than not that the IRS or the courts will uphold a given tax treatment is not a guarantee.

Rulings are formal and certain, and certainty is good. Every tax lawyer has seen a situation in which, despite strong taxpayer positions, taxing agencies audit, become entrenched in their positions and then litigate them against the taxpayer. The costs and time spent on such efforts can be substantial even if they are ultimately successful. A ruling avoids that risk.

No-Rule Areas

A tax opinion can be written on just about anything. Not rulings. The IRS has long lists of subjects on which it will not rule. The lists change periodically. A first line of query should be whether your subject is on a no-rule list.

Appropriate Ruling Questions

A tax opinion can be about almost anything. But for rulings, there is a subjective sweet spot. If the tax issue is plain vanilla in character, it may not be possible to get a ruling even if it is not on a no-rule list. If the issue is plain vanilla and the result is well established, the IRS will often decline to rule and call your request one for a "comfort ruling," something the IRS usually will not issue.

Conversely, if the tax issue is unique or difficult, it may be outside the realm of rulings on the other extreme. Many taxpayers feel that the middle ground—where you *can* get a ruling from the IRS—is generally, where you do not need one. Rulings can typically be obtained only on issues and fact patterns within a narrow bandwidth. If the law is unclear and you really need a ruling, you may not be able to get it. If the law is settled and you are perceived as too needy for comfort, you cannot get that either. Opinions fill the gaps.

Do Not Ask Unless You Know

An old adage says you should not ask a question if you do not know the answer, and it applies to rulings. One generally should not ask for a ruling unless there is a high likelihood that you can get the answer you want. A ruling is gold-plated certainty, but the IRS does not usually give it in close or tough cases. There are consequences for asking, too.

When you request a ruling, you generally must pay a fee. There is a range of fees, but one common fee is $28,300. If the IRS's answer is no, practitioners customarily withdraw their ruling request, and they may get their fee back. Still, one generally does not want a "no" answer on the books.

If the IRS says it cannot rule and you withdraw your request, the IRS sends an audit notice to the IRS field office in your area. The notice does not direct an audit. However, it informs field IRS employees that you asked for a ruling, did not get it and withdrew your request. If you proceed with the transaction, your return could be flagged.

Rulings Take Time

An opinion can be knocked out in days or weeks. A ruling takes weeks or months. In general, you should assume six months or more. There are exceptions and ways to leapfrog, but rulings are always more time consuming than opinions.

Opinions Are Interactive, Rulings Are Not

You need to be specific in a ruling request and typically cannot tweak facts and keep modifying your transaction and your ruling request. It is static. In contrast, simultaneously planning a transaction and writing an opinion can make sense. An opinion can be done in parallel with the transaction to help shape it.

There are often adjustments that can be made in the transaction. The tax opinion may be prepared pre- or post-transaction before the filing of the return. Often, some aspect of the transaction can be tweaked and made better because the spadework of the opinion is being done while it can have maximum benefit.

The opinion can become part of shaping the transaction itself. In contrast, the ruling request is static. Even when the transaction is closing or closed at the time the opinion is being written, it is not uncommon for additional documentation to be solicited and provided as part of the opinion due diligence. Certificates, declarations, *etc.*, may help the strength and scope of the opinion.

They can shore up documentation and plug perceived holes. Such documents are likely to be more helpful if prepared contemporaneously with the closing or, at the latest, at tax return time when the transaction is being reported. Certificates, declarations and the like are rarely effective if prepared several years later during an audit. Conversely, they can often be helpful if prepared simultaneously with the closing or in connection with an opinion written before returns are filed.

Pre-Ruling Conference

Today, almost no ruling is submitted without an informal trial run. You talk to the IRS and get their general view on your proposed ruling. Afterwards, you submit a short (five pages or so) memo about the facts, the client, the issue and the ruling you want.

The IRS meets informally in person or by phone, usually with two to five IRS attorneys covering different areas or aspects of the topic. The IRS reacts orally to the memo and often can suggest a tentative positive or negative result. If all is positive, you prepare and submit your ruling request. If not, you do not.

Either way, the informal request is not official and triggers no fee. If it does not go well or if you never make a formal ruling request, it triggers no audit notice (that I know about!). But given the limited IRS resources, you must proceed in good faith in a pre-ruling conference and *intend* to actually

make a formal ruling request if all goes well. You might change your mind or the situation might change, but the IRS does not like fishing expeditions.

Opinions Cover Pro and Con, Rulings Do Not

Rulings give a binding conclusion by the IRS. Although they give the reasons for the conclusion, the reader typically just wants the answer. In contrast, a good opinion should argue both sides.

The opinion's bottom line may be that there is substantial authority (or some other level of confidence) for the position. But for the opinion's conclusion to have meaning, it should be accompanied by a thorough examination of the facts and relevant authorities. Moreover, an opinion should develop and document the reasons against the tax position as well as the reasons for it.

Clients want their tax lawyer to be an advocate, and the want their case stated as strongly as can be justified. Clients may *really* like an opinion that is one-sided (in their favor). An opinion that argues both sides can be perceived by the client as wishy-washy.

Clients may like conclusory or short form opinions because they are mercifully short. Even if they do not prefer it, I believe clients are better off with a fully informed statement of the facts and the law.

A client should want a tax opinion that thoroughly documents and develops the case and its legal theories. An argument can be made that it is safer from a disclosure perspective to refrain from laying out the government's case too well. But how can an assertive opinion really be helpful if it is one-sided and just says what the client wants to hear?

For many years, the Treasury Regulations contained rules stating that tax opinions could not be based upon unreasonable assumptions about the facts or the law, or unreasonably rely on representations, statements, findings or agreements. The rules were recently changed, but it is still true that the assumptions should be stated and should be reasonable and realistic. Of course, an opinion should not take into account the likelihood of an audit or settlement. Plus, an opinion should consider all relevant legal authorities and relate the law to the facts.

A practitioner can rely on the advice of another person if, in light of the facts and circumstances, that reliance is reasonable and made in good faith. But reliance is not reasonable if the practitioner knows or reasonably should know that: (1) the opinion of the other person should not be relied upon; (2) the other person is not competent or lacks the necessary qualifications to provide the advice; or (3) the other person has a conflict of interest.

Penalty Protection

You do not need to consider penalty protection if you get a ruling. In contrast, the most commonly stated reason to get a tax opinion is to avoid penalties. Even so, I do not believe most tax opinions are written primarily for purposes of penalty protection. True, clients want penalty protection so penalties are not added to taxes due.

Depending on the standard of the opinion (reasonable basis, substantial authority or more likely than not), there are varying degrees of protection from an assertion of penalties. Yet no client wants or expects the claimed tax position to fail. If the opinion merely saves penalties, it has largely failed. Clients want to win, to have their tax position upheld. At the very least, they want to compromise it on an acceptable basis. An opinion is really not all about the penalties, or it *should not* be anyway.

Opinions When Audited

If you get a ruling, you should not worry about an audit unless you go outside your ruling or change the facts. But if you want an opinion, do not wait until an audit. There is rarely time to obtain a good and thoughtful opinion at the audit stage. Even if there were, it would hardly be the same as one done before the transaction or before tax return filing.

Besides, if an opinion is to have any value for penalty protection, it must be done before the tax return is filed. Clients commonly think writing an opinion later if the IRS audits is sensible. I have three responses.

First, if the return position precedes the opinion, a reliance defense may not apply. A taxpayer must first *receive* tax advice in order to claim good-faith reliance on it. Although tax advice may be verbal, it may be risky to file the return before a written opinion

is issued. The timing and content of verbal advice can be challenging to prove if it is not well documented. At a minimum, the opinion may fluctuate until it is nailed down in writing.

Second, if the tax position has been attacked, it is unlikely that anyone at that point will take a reasoned or balanced view of both sides of the equation. At that stage, all writing will understandably be geared toward advocacy. Third, in developing the opinion and assessing the positive and negative, the nuances about reporting and disclosure should be explored *then*. Whether and how to disclose the tax position must be considered *before* the return is filed.

Ideally, the tax opinion should be written in parallel with the event or transaction, not after the fact. That is the best way to help shape the transaction or issue. There are often adjustments that can be made in the position, investment or transaction. The tax opinion may be prepared pre-transaction, or it may be prepared post-transaction but before the filing of the return. Pre-transaction (or at least pre-closing) is always best.

Often, some aspect of the transaction can be profitably tweaked and improved because the spadework of the opinion is being done while it can have maximum benefit. The opinion thus becomes part of the shaping of the transaction itself. Even when the transaction is closing or closed at the time the opinion is being written, it is not uncommon for additional documentation to be solicited and provided as part of the opinion due diligence.

Certificates, declarations and other such documents may be helpful to the strength and scope of the opinion. They can often shore up documentation and plug perceived holes. Of course, such documents are likely to be far more compelling if prepared contemporaneously with the closing or at the latest, at tax return time when the transaction is being reported.

Certificates, declarations and the like are rarely effective if prepared several years later during (or in the face of) an audit. Conversely, they can often be quite helpful if prepared simultaneously with the closing or in connection with an opinion written before returns are filed.

Opinions and Disclosure

A copy of a ruling is attached to a tax return. In contrast, a legal opinion is generally prepared by lawyer for client and is subject to attorney-client privilege. Be careful whom you copy, including return preparers, since that simple act may waive the privilege. For preparers, a short directive letter about what to put on the return and what to disclose that states that the opinion is privileged and will not be provided should work.

Some authors of tax opinions may not want to review the tax return in question to confirm that whatever mechanics the tax opinion states are in fact followed. But given the subtle variations in presentation, disclosure, etc., it is almost always appropriate for the author of the opinion to do so. Some tax opinions now are expressly conditioned on having access to the draft tax return before filing so any issues can be addressed.

Waivers

With opinions, watch out for the implied waiver doctrine. Invoking reliance on counsel as a defense to penalties can constitute an implied waiver of attorney-client privilege. If proponents of the "it's all about the penalties" mantra are to be believed, would they not be willing to hand over the legal opinion to the IRS in order to achieve penalty protection? In my experience, rarely.

Handing the IRS a veritable roadmap of all of the authorities and all of the arguments, both good and bad, usually will not make sense unless the tax position has entirely failed and the only thing left on the table is the penalties. The opinion may make arguments the IRS might not discover or might not make with the skill or thoroughness of the opinion.

If penalty protection is the real goal, the prudent course may be to assume that the opinion will ultimately wind up in the hands of the IRS. But unless the "I want penalty protection" white flag is raised, the courts have not been liberal in granting the IRS access to tax opinions. The most famous instances of disclosure have occurred in tax shelter cases, where it often seems that the rules are different. The worse the shelter, the more the opinions will be fair game.

Controversies

If you have a ruling, there should be no controversy unless the IRS claims you went outside the ruling or changed your transaction.

With an opinion, you typically do not have a controversy, but you might. And in that setting, opinions can be really helpful, usually not as a whole, but as a resource to mine for ready-made advocacy materials.

For the small percentage of tax cases that ultimately end up in controversy, audit, Appeals or court, there will be deadlines. If a client has 30 days to respond to an Information Document Request or a notice about why a particular position was claimed, that may be enough to do a thorough job. There is rarely enough time to do everything you want to do. To be able to open the file and withdraw a thorough legal opinion on the very facts and covering the pertinent authorities is a luxury. It can often spell the difference between a good and a bad result, or at least between an outstanding and a middling one.

Conclusion

The nature of ruling dynamics can seem counterintuitive. If the taxpayer's position is weak or uncertain, the government will not rule. Conversely, if the taxpayer's position is plainly correct, the government may also not rule, considering it a comfort ruling. If you are in the sweet spot, a ruling can make sense. And, if the dollar consequences of being wrong are catastrophic, say with a Code Sec. 355 spinoff, a ruling may be the only practical option.

Elsewhere, rulings and tax opinions each have their place. Sometimes you can actually debate pluses and minuses of each. Sometimes you cannot get a ruling and should not ask. Opinions, in contrast, are a kind of everyman, a more flexible and adaptable document. And they probably deserve more credit.

It is too bad that many people think tax opinions are just about penalty protection. If *any* tax opinion is all about the penalties, then it is surely those of the shelter variety. The more sanguine variety of tax opinion (which I hope and believe is a far larger category) can be viewed quite differently.

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