COULD AN I.R.S. EMPLOYEE'S COMMENT CAUSE YAHOO! STOCK TO FALL?

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Recently, the Internal Revenue Service ("I.R.S.") Office of the Associate Chief Counsel (Corporate) announced that it may hold off on issuing ruling requests to taxpayers seeking assurance on the "active trade or business" requirement ("A.T.B.") of a tax-free spinoff under Code §355. In light of recent market transactions, the I.R.S. is in the process of considering, how much A.T.B. is enough for a spinoff to qualify for nonrecognition treatment.

YAHOO! CIRCUMSTANCES

The announcement also placed doubt on whether ruling requests already submitted to the I.R.S. would be issued. Speaking at a District of Columbia Bar Association event, a senior technical reviewer at the Office of the Associate Chief Counsel (Corporate) stated that the I.R.S. will hold off on issuing new ruling requests starting on May 19, 2015. He said that requests that were submitted before that date will be reviewed in the normal course, but that position may also change depending on what is decided in the next few months.

This was bad news for Yahoo! Inc. ("Yahoo!"), which announced earlier this year that it is planning to spinoff its stake in the Chinese e-commerce giant, Alibaba Group Holding Ltd. ("Alibaba"). Yahoo! holds shares in Alibaba worth approximately $40 billion and has been under pressure by key investors to return the value of the Alibaba shares to Yahoo! shareholders. However, if it simply sold those shares or distributed the shares in a taxable dividend, Yahoo! would face a hefty Federal tax bill of 35% on the sale. That amount would be increased by applicable state and local taxes.

Yahoo! Chief Executive Officer Marissa Mayer, said that after considering many alternatives, the company decided it would spinoff the shares of Alibaba, in a transaction under which Yahoo! would contribute its Alibaba shares to a new company, along with a relatively small legacy operating business. The new company, known as a "spinco" in corporate reorganization parlance, is designed to meet the A.T.B. requirement under Code §355(b). Shares in Spinco would then be distributed to the Yahoo! shareholders, thus separating shares in the operating business of Yahoo! from shares in the legacy business and Alibaba.

Since the value of the Alibaba shares is considerable, it is expected that the legacy operating business dropped into Spinco to meet the A.T.B. requirement will represent a relatively small percentage of Spinco's total assets.

YAHOO! STOCK FELL 10% A FEW MINUTES LATER

Though the I.R.S. employee did not mention Yahoo! by name, his comments were apparently enough to cause the company's stock price to fall that day to $40.90, down from $44.36 on the day before.

THE ROLE OF A.T.B. IN A TAX-FREE SPINOFF

In order to be tax free, the Yahoo! spinoff must meet four basic statutory[1] requirements under Code §355, as follows:

- Only the stock or securities of Spinco must be distributed to Yahoo! shareholders with respect to the stock of Yahoo!, or to the security holders in exchange for Yahoo! securities;
- The distribution must not be a device for distributing earnings and profits;
- Both Yahoo! and Spinco must be engaged in an A.T.B.; and
- Yahoo! must distribute all of the Spinco stock and securities it holds or enough to constitute control (as defined) of Spinco.

The A.T.B. requirement is imposed by Code §355(b)(1)(A) and requires, in the Yahoo! context, that both Yahoo! and Spinco be engaged in an A.T.B. immediately after the spinoff.

Yahoo! and Spinco will be considered to be engaged in an A.T.B. immediately after the spinoff if they were engaged in an A.T.B. throughout the five-year period ending on the date of the spinoff and those businesses were not acquired in a taxable transaction within that five-year period.[2]

Neither the Code nor the I.R.S. regulations require that a specific percentage of Spinco's assets be devoted to the A.T.B. In a past revenue ruling, the I.R.S. approved a spinoff in which only 5% of the corporation's assets met the A.T.B. requirement.[3]

HOW MIGHT THE I.R.S. RETHINK A.T.B.?

Though it is unclear at this time what sort of guidance the I.R.S. might provide, one possibility is that it might establish a bright-line, objective test, which would require a certain threshold percentage of the assets of Spinco to be engaged in an A.T.B.

However, since the Code does not require a specific percentage of Spinco's assets to be engaged in an A.T.B. in order to meet the aforementioned requirement under

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1 In addition to the four basic statutory requirements under Code §355(a)(1), described above, a spinoff must also meet the requirements prescribed by the case law, that is: the business purpose, the continuity of business enterprise, and the contituity of interest requirements.

2 Code §355(b)(2).

3 Rev. Rul. 73-44, 1973-1 C.B. 182, clarified by, Rev. Rul. 76-54, 1976-1 CB 96.

Code §355(b)(1)(A), taxpayers such as Yahoo! may feel emboldened to proceed with a spinoff and challenge a bright-line, objective test in court.

It is believed that the focus of this rethinking is not taxpayer-specific; the concern is cash-rich spinoffs (*i.e.*, spinoffs with spincos that hold off cash and marketable securities with a relatively small trade or business) and R.E.I.T. spinoffs.[4] This is illustrated by the following hypothetical, designed in the extreme to prove the point being made:

> Company A has a legacy business involving a hot dog stand. It has been operating for the requisite five-year period. Company A drops the hot dog stand into Spinco. At that point, Spinco is worth $1 million. Company A then drops $99 million in highly appreciated securities into Spinco. Is it believable that Company A would drop in $99 million in securities to be used as collateral in support of a loan to Spinco to provide funds to expand its newly-acquired hot dog stand?

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YAHOO! MOVING FORWARD?

It was reported on July 22, 2015 that Yahoo! will move forward with the plan to spinoff its Alibaba shares even without a favorable I.R.S. ruling. One possible reason for its confidence is that its legal team includes an alumnus of the Associate Office of the Chief Counsel (Corporate) who was involved in rulings for companies seeking to spinoff cash and marketable securities with a relatively small trade or business.[5]

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4 In 2001, the I.R.S. ruled that R.E.I.T.'s can be engaged in an active trade or business within the meaning of Code §355(b). Rev. Rul. 2001-29, 2001-26, I.R.B. 1348.

5 Bloomberg BNA Tax and Accounting Center, Weekly Report, *Yahoo's Tax-Free Alibaba Deal Could be Held Up, But It's Not Dead*, Laura Davison, Jesse Drucker, and Richard Rubin, May 20, 2015.