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A COLLECTION OF COMMENTARIES ON THE CRITICAL LEGAL ISSUES IN THE YEAR AHEAD

Recent Developments in Tax Law: Impact on Corporate Tax Strategies in 2014

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Recent changes in IRS private letter ruling policy likely will result in greater taxpayer reliance on tax opinions, which may impact certain corporate strategies in the coming year.

Tax-Free Spin-Offs

During 2013, the IRS announced two significant changes to its policy on issuing private letter rulings on spin-off transactions intended to qualify as tax-free under Section 355 of the Code¹.

Background. In a typical spin-off, a corporation distributes to its shareholders (and possibly its creditors), stock (and possibly certain debt securities) of a controlled subsidiary. To qualify as tax-free under Section 355, a spin-off must satisfy numerous technical requirements. Because a spin-off transaction can potentially result in significant tax liabilities to the parent corporation and its shareholders if the transaction fails to qualify as tax-free, taxpayers historically have sought, and the IRS typically has issued, private letter rulings confirming the tax-free status of a spin-off.²

No Rulings on Specific Spin-Off Issues. In January 2013, in conjunction with issuing its annual list of areas in which it will not issue private letter rulings (the 2013 No Rulings List), the IRS announced that it would no longer issue private letter rulings on three categories of issues that arise frequently in spin-offs: (i) debt-for-debt exchanges involving the parent company issuing debt in anticipation of the spin-off and exchanging it for the subsidiary's securities on a tax-free basis, (ii) recapitalizations into control of the spun-off subsidiary and other issuances of two or more classes of stock having different voting rights in anticipation of a spin-off and (iii) North-South transactions, which frequently involve pretransaction tailoring transfers among the parent company, the spun-off subsidiary and/or related corporations at or around the time of the spin-off.³ These changes represented a departure from IRS ruling guidelines that were carefully developed and applied over the last several years. As a result, this new policy has affected significantly the execution of business-driven spin-offs that involve these issues because such transactions typically require a private letter ruling to address the dearth of judicial or administrative guidance on many of the key tax issues. The IRS has since stated that it is studying these three issues with an intent to issue guidance, but the timeline for definitive guidance remains unclear.

No Rulings on Overall Spin-Off Transactions. In June 2013, the IRS announced a broader change to its private letter ruling policy, stating that it would generally stop

¹All "Section" references are to Sections of the Internal Revenue Code of 1986, as amended (the Code).

²Since 2003, the IRS's spin-off rulings generally have not addressed three of the specific technical requirements under Section 355: the business purpose requirement, the device requirement and the anti-Morris Trust rules under Section 355(e). Accordingly, prior to August 2013, taxpayers that received a favorable private letter ruling from the IRS on a spin-off typically obtained an opinion of counsel on these three technical requirements.

³For a more detailed discussion on these specific spin-off issues, see the Skadden publication "New IRS Policies and the Future of Tax-Free Spin-Off and Split-Off Transactions" (Feb. 13, 2013), available at <http://www.skadden.com/insights/new-section-355-no-rule-policies>.

To qualify as tax-free under Section 355, a spin-off must satisfy numerous technical requirements.

issuing rulings on spin-off transactions, effective August 2013.⁴ Instead, the IRS will issue rulings only on one or more significant issues presented in a transaction — not on the entire transaction. For this purpose, the IRS generally defines a “significant issue” as “an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction.”

Certain Considerations for Future Transactions. IRS officials have stated that these policies are driven in part by resource constraints and may be followed by additional cutbacks in the agency’s private letter ruling policy.⁵ In some respects, these changes may represent judgments regarding the best use of limited budget resources, particularly to the extent that some of the requirements related to spin-offs are more clearly addressed by public guidance. However, it remains to be seen how the IRS will handle significant issues that regularly arise, including those for which there is insufficient guidance for counsel to opine with a high level of comfort, as is often required for public company transactions (public company spin-offs are rarely completed on the basis of an opinion that provides less than a “should” level of comfort). It also is unclear whether transactions implicating the issues in the 2013 No Ruling List will proceed at all, or whether they will proceed only on the basis of structural revisions or lower levels of comfort than historic norms.

No matter how events unfold, these changes will increase the importance of opinions of counsel issued in connection with spin-offs, as compared to the previous era when rulings from the IRS often could resolve most of the issues, even the thorniest ones. Now, in the absence of an IRS ruling on those issues, there will be greater focus on counsels’ opinions, which will include the exhaustive analysis required by Circular 230 and other professional standards. Moreover, as those opinions are sought by the IRS in the context of an audit or litigation, and if the opinions are not otherwise protected by privilege, they may provide roadmaps to the IRS, potentially changing the dynamic of the audit or litigation.

Increased Reliance on Legal Opinions

As opinion practice becomes more central in the spin-off context, the ability to prevent disclosure of the opinion and underlying analysis by claiming privilege, and appreciating the situations that may give rise to a waiver, will become even more important.

Background. Legal opinions generally are protected by the attorney-client privilege, by the tax-practitioner privilege or, if prepared in anticipation of litigation, by the work product doctrine. While the case law addressing the work product doctrine is inconsistent,

⁴The new policy also applies to other many nonrecognition corporate transactions (e.g., tax-free business combination reorganizations under Section 368 and tax-free contributions under Section 351) where rulings could previously be obtained for the entire transaction when the transaction presented a “significant issue.” Because of timing considerations, taxpayers tend to request rulings on these types of transactions less frequently.

⁵Indeed, these policies of not issuing private letter rulings in the spin-off context appear to be part of a far broader trend. For example, in the 2014 version of its “no ruling list,” the IRS announced that it will no longer issue private letter rulings on disaffiliation transactions preceding a subsidiary liquidation (so-called “*Granite Trust*” transactions) and transactions involving subsidiary ownership of parent company stock (so-called “hook stock”). See Revenue Procedure 2014-3, 2014-1 I.R.B. 111 (Jan. 2, 2014). The IRS has also been studying its policies on key technical issues involving REITs and its private letter ruling practice in this area. For a more detailed discussion on this, see the Skadden publication “IRS Completes Review of REIT Ruling Standards and Resumes Issuing Rulings” (Nov. 15, 2013), available at <http://www.skadden.com/insights/irs-completes-review-reit-ruling-standards-and-resumes-issuing-rulings>.

“The case law addressing whether providing a legal opinion to independent auditors waives the work product doctrine has been in flux.”

multiple courts have held that the “in anticipation of litigation” requirement can be met even where a legal analysis is performed prior to the transaction being finalized.⁶ In the context of an audit, a taxpayer may be required to turn over an opinion to the IRS if protection already has been waived, or a taxpayer may decide to produce the opinion to counter a penalty assertion by the IRS.

Privilege Waivers. The question of whether the taxpayer’s provision of an opinion to its financial auditors effects a privilege waiver is an evolving issue both as a matter of administrative practice and in the courts. Historically, the IRS has refrained from asserting that this disclosure waives privilege, but there have been some exceptions to this policy of restraint.⁷ In 2010, the IRS reaffirmed a policy of restraint with Announcement 2010-76, stating that if a document is otherwise protected under the attorney-client, tax-practitioner or work product doctrines, and the document was provided to an independent auditor as part of an audit of the taxpayer’s financial statements, the IRS will continue to not assert during the audit phase that privilege had been waived by such disclosure.⁸ However, Announcement 2010-76 is clear that it relates only to the examination phase, which leaves open IRS Appeals and litigation.⁹ Moreover, despite this expressed policy of restraint, our recent experience shows that the IRS is more frequently asking taxpayers to provide legal opinions through Information Document Requests (IDRs). These IDRs often come early in the audit phase and are sometimes, but not always, linked directly to fact gathering associated with the determination of whether to assert a penalty.

In addition, the case law addressing whether providing a legal opinion to independent auditors waives the work product doctrine has been in flux, with a general trend toward finding no waiver to have occurred. The U.S. Court of Appeals for the D.C. Circuit — the only circuit court that has addressed this issue — has held that analyses prepared by a company’s employees or outside counsel that were provided to independent financial auditors did not waive work product protection.¹⁰

Waivers: Public Company Disclosures. Understanding the limitations of the work product doctrine is particularly important because the attorney-client privilege attaching to tax planning advice may be waived in the context of public company disclosures. The effects can be far-reaching: It generally is recognized that where a party relies on

⁶The U.S. Court of Appeals for the Second Circuit held in *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), that the work product doctrine applies to protect memoranda evaluating the tax consequences of anticipated litigation with the IRS over a proposed corporate reorganization transaction. Similarly, the U.S. Court of Appeals for the Sixth Circuit in *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006), also found the work product doctrine to protect an analysis of the strengths and weaknesses of the taxpayer’s position prepared after closing of a loss transaction but before the return was filed, stating that “the IRS would appear to obtain an unfair advantage by gaining access” to such an analysis. However, the U.S. Court of Appeals for the First Circuit more recently determined in *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009), that the work product doctrine did not extend to tax accrual workpapers which were prepared internally by attorneys and others to support tax reserve entries on its audited financial statements.

⁷ See Announcement 2002-63, 2002-2 C.B. 72 (June 17, 2002).

⁸ See Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010).

⁹ See the Skadden publication “IRS Issue Final Rules on Disclosing Uncertain Tax Positions; Policy Restraint Clarified” (Sept. 24, 2010), available at <http://www.skadden.com/insights/irs-issues-final-rules-disclosing-uncertain-tax-positions-policy-restraint-clarified>.

¹⁰ See *United States v. Deloitte, LLP*, 610 F.3d 129 (D.C. Cir. 2010); see also *Wells Fargo & Co. v. United States*, 2013 WL 2444639 (D. Minn. June 4, 2013); *SEC v. Roberts*, 254 F.R.D. 371 (N.D. Cal. 2008) (finding no waiver of work product protection based on disclosures to independent auditors).

or discloses the advice of counsel concerning the tax consequences of a transaction, it waives the attorney-client privilege not only as to the disclosed information but also as to the details underlying that information. For example, in *In re Pioneer Hi-Bred Int'l*, the U.S. Court of Appeals for the Federal Circuit, applying Eighth Circuit law, held that a company's disclosure to the SEC of the advice of counsel concerning the tax consequences of a merger waived the company's privilege with respect to the documents forming the basis for the advice.¹¹ Furthermore, in some recent cases, courts have questioned whether tax planning is subject to the attorney-client privilege at all.¹²

Even though the rationale behind these holdings and arguments should not withstand systemic appellate review, they do illustrate the risks taxpayers face in asserting the attorney-client privilege. Consequently, it is critical to understand the vulnerabilities to claiming privilege at any stage of a transaction, from the planning stage through IRS audit scrutiny. As such, it can be extremely valuable to consult with tax counsel who understand the sensitivities involved with respect to privilege issues as applied to legal opinions and who have the experience to navigate the audit process.

¹¹ See *In re Pioneer Hi-Bred Int'l*, 238 F.3d 1370 (Fed. Cir. 2001).

¹² See, e.g., *Schlicksup v. Caterpillar, Inc.*, No. 09-CV-1208, 2011 WL 4007670, at *7 (C.D. Ill. Sept. 9, 2011) (finding documents imparting tax analysis and tax-saving proposals by a tax practitioner to the company did not constitute legal advice from an attorney, and therefore was not protected by the attorney-client privilege).