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Tax Treatment of Yahoo's Planned Alibaba Spin-Off Remains Uncertain

By Grace Meador, J.D. Candidate 2016 | September 15, 2015

In a securities filing from September 8, 2015, Yahoo disclosed that the IRS had declined to rule on the tax consequences of their long-planned Alibaba spin-off.

Yahoo announced its intentions to spin off its holdings in Alibaba into a new company, Aabaco Holdings, in January 2015. Yahoo currently owns 384 million shares in Alibaba, which are collectively worth around 23 billion dollars.

The transaction was expected to be tax free under current spin-off rules in Internal Revenue Code section 355. This code section allows companies to spin-out one (or more) businesses that have been actively conducted for five or more years, provided that the transaction is undertaken for a legitimate business purpose.

Yahoo was planning to include a small business division along with the Alibaba shares in the formation of Aabaco. This newly formed small business division, Aabaco Small Business, LLC, would own Yahoo Small Business, a currently operating business of Yahoo, after the transaction.

In late February, Yahoo requested a private letter ruling from the Internal Revenue Service as to whether the transaction would satisfy the "active trade or business" (ATB) requirement under section 355. However, in May 2015, the IRS Office of the Associate Chief Counsel announced that they were considering policy changes to the ATB requirement of section 355, and therefore would hold off on any new requests for letter rulings on such transactions.

The Wall Street Journal reported on Yahoo's tax bill wariness in early July. Yahoo warned shareholders that the spin-off plan of shares in Alibaba could result in unexpected and hefty tax consequences from either China or the United States. This concern was triggered by the IRS' May statements that the service was considering changes to its rules regarding spin-offs.

The end of July brought about another blow for Yahoo: the IRS announced on July 31 that it was studying new potential administrative guidance regarding 355 issues.

On September 2, 2015, the IRS refused to issue tax guidance regarding consequences of an Alibaba spin-off. This refusal is not to be confused with an adverse ruling—the IRS has simply refused to comment on the tax-free status of the intended Aabaco spin-off.

Yahoo now faces a choice between proceeding with the spin-off on the basis of a letter from outside tax counsel Skadden, Arps and possibly facing a costly tax bill, or scrapping the deal altogether.

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Gary Friedman, a tax partner at Debevoise & Plimpton LLP, has told the Wall Street Journal "[i]t would be difficult for outside counsel to provide Yahoo with a tax opinion that reaches a very high level of certainty now that the IRS has refused to rule".

New York Times columnist Victoria Fleischer describes the potential consequences as a "blood bath from a tax point of view." The tax bill could range from 7-9 billion dollars should the transaction be wholly taxable.

The twist in this case is that Yahoo has proposed to structure the spin-off to indemnify Yahoo from any tax costs, which would leave Aabaco shareholders holding the hot potato from a tax perspective, but without the liquidity to meet the potential burden.

Whatever Yahoo's decision, their shareholders will be following developments closely. In the wake of the company's September 8 announcement, Yahoo's stock price dropped almost 4%.