What You Should Know About Obtaining IRS Private Letter Rulings

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Clients may not like drawing attention to their business affairs, but a private letter ruling may be the way to remove many uncertainties from a transaction.
(Each year the IRS reissues the “no rule” areas revenue procedure, and often during the year supplements it by adding or subtracting “no-rule” areas. In addition, each year the IRS reissues the same basic procedural guidance, and it periodically issues one or more additional revenue procedures prescribing tax ruling prerequisites in specific Code areas.) If the IRS agrees with the taxpayer’s views, it will issue favorable tax rulings in a formal signed letter commonly called a “private letter ruling.”

Since obtaining favorable tax rulings from the IRS always works to the taxpayer’s benefit, questions arise regarding the circumstances when a taxpayer can or should obtain a private letter ruling and how the request for a private letter ruling should be prepared for the greatest chance of success. This article provides some general advice in answer to these practical questions. It highlights the most important procedural prerequisites for obtaining a private letter ruling and discusses common practical impediments to obtaining private letter rulings, including client reluctance. But before discussing these matters consider an important “what if.”

“WHAT IF” THE IRS DISAGREES? • If the IRS disagrees with the taxpayer’s views, as a matter of routine, it will give the taxpayer the opportunity to withdraw from IRS consideration the controversial requested tax ruling or rulings. Often, when one of several tax rulings is withdrawn, the IRS rules favorably on the remaining issues. Sometimes the IRS will exercise its discretion to set forth in a ruling letter an express “no opinion,” which action will highlight withdrawn issues for the possible benefit of the IRS examination division should it choose to audit the taxpayer. The author’s experience is that such a “no opinion” is not truly prejudicial, however. Sometimes an entire transaction, the subject of certain requested rulings, is disfavored by the IRS, in which event when the taxpayer withdraws all of the requested rulings, the proposed transaction is removed from the IRS’s immediate purview. In this instance, the taxpayer is left to rely on an opinion of counsel whether to proceed with the transaction without the IRS’s approval.

DETERMINING IF A PRIVATE LETTER RULING IS ADVISABLE • The quest for a private letter ruling begins with the perception that a private letter ruling is advisable after taking into account all of the facts and circumstances concerning one or more proposed transactions. The perception may be that of tax counsel, who recognizes that the proposed transaction’s failure to satisfy the relevant provisions of the Code would have serious adverse tax consequences to the client. The classic transaction giving rise to this perception is a pro rata spin-off of a corporate subsidiary by a parent corporation to its shareholders. Such a distribution is either taxable under sections 301 and 311 to the shareholders and distributing corporation, respectively, or is tax-free to both of them, if the conditions of section 355 are met. (All section references are to the Code unless otherwise indicated.) Because the application of section 355 to a proposed spin-off involves subjective determinations about such matters as the exigency of business reasons and the degree of activity of the businesses, it is prudent to attempt to obtain favorable tax rulings beforehand rather than to plunge ahead at the risk of encountering a skeptical IRS agent upon examination of the affected tax returns.

Client Perception

Or, the perception of need may be that of the client. A good example concerns a client board of directors that is considering approval of a major corporate reorganization (acquisition of a
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target corporation solely for acquiring corporation common stock, or has under review a generous executive stock compensation plan. For any number of motivations, the board may desire the certainty given by a private letter ruling, in addition to the comfort of opinions of the board’s accountants or legal counsel upon whom the board relies to satisfy its fiduciary duties under corporate law.

The perceived need or advisability of obtaining a private letter ruling may also arise in the context of a negotiated, arms-length transaction between unrelated parties. The common fact pattern is one party’s perception that the Federal tax rule properly understood should be “x” against the other party’s perception the Federal tax rule should be “not x, but should be y plus z.” In such circumstances, a private letter ruling can often definitively answer the uncertainties over the contested meanings and applications of the Code.

Finally, the need or advisability of obtaining a private letter ruling may arise because the IRS issues regulatory or other guidance, such as a notice, implying that the IRS seeks to learn more and to decide the unanswered questions through the rulings process. The IRS thus, in effect, invites requests for rulings. In this context, a taxpayer may have an opportunity to shape the evolving, unsettled law to its benefit by a persuasive presentation.

THE IRS: WHY ARE THESE ISSUES NOT ALREADY ADDRESSED? • Uncertainty of outcome is necessarily a part of the analysis in determining whether to seek a private letter ruling. Today, in its most recent revenue procedures, the IRS asks taxpayers applying for private letter rulings to address the following question: Why are the issues or questions raised not already adequately addressed by the relevant authorities? The tax attorney or accountant must be able to answer this question on a client’s behalf before proceeding to prepare a private letter ruling request.

A number of general responses come to mind. First, the application of relatively well-settled tax law to the facts may be uncertain owing to the subjective nature of the determinations in question. An example is the “active business” and “business purpose” requirements of section 355. Either an active business or a recognized business purpose can be in the eye of the beholder (the IRS).

Second, many Code sections today have been relatively recently enacted and are capable of two or more interpretations. Often none of the interpretations is unambiguously offensive to what is known of the legislative history. Consequently, the taxpayer, absent a private letter ruling, is left with the imponderable question of what a court might decide.

An example of this is section 2702. It addresses the gift tax consequences of the formation of certain kinds of trusts, which may or may not have unfavorable gift tax consequences, depending upon the precise interpretation of the section. For example, a question arises: does a split-purchase residence trust satisfy the definition of a personal residence trust? Such a trust is one that involves life and remainder beneficiaries as settlors of a trust, each contributing their actuarially determined shares of trust corpus to enable the trustee to purchase a personal residence.

Another example is the interplay of sections 108 and 1366/1377 that gave rise to the questions whether cancellation of indebtedness income was excluded by section 108 at both the S corporation level (on account of the insolvency exception) and at the shareholder level. Further, whether, even if the income is excluded at both levels, the measure of the excluded income nonetheless passes through to shareholders as an increase in S corporation stock tax basis. The