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Tax planning through the use of advance rulings

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Tax Planning Through the Use of Advance Rulings

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BEING FAMILIAR with and making use of the "rulings" program of the Internal Revenue Service can and should be an important segment of our tax practice. As tax practitioners we should know what the advantages and disadvantages of requesting a ruling are, and, perhaps most important, should be aware of the circumstances in which a ruling ***must be*** requested. As you will note from the discussion that follows, there is no doubt in my mind that practically all of us have filed ruling requests at one time or another during our careers.

At this point I think it might be well to describe my subject matter in broad terms. I shall not discuss regulations or their effect or status, nor the Service's program for "published rulings"—those appearing in the weekly issue of the *Internal Revenue Bulletin.* On the other hand, while the definition of a ruling does not technically include "determination letters," requests for "technical advice," or "information letters," a discussion of these items will be helpful, I believe, in obtaining a more meaningful understanding of the rulings program.

HISTORICAL BACKGROUND

Before getting into a discussion of rulings it might be interesting to note that while the ruling policy of the Service has been in effect since 1940, it was not until 1954, when Revenue Ruling 54-172 was published, that we had a rulings program as we know it today. Subsequently, there have been revenue rulings, i.e., published rulings and revenue procedures, offering taxpayers or their representatives, or both, guidelines with respect to the rulings program. (For example, see Rev. Proc's. 60-6, 62-28, 62-29, 62-30, 62-31, 62-32, 63-20, 64-31, 65-4, 66-34, Miscellaneous Announcement 66-63.) It is in the revenue procedures currently in force that we find the definitions applicable to our subject.

THE RULINGS PROGRAM—AS DEFINED HEREIN

A few definitions may now be in order:

Definitions

A *ruling* is a written statement issued to a taxpayer or his authorized representative by the National Office, interpreting and applying the

tax laws to a specified set of facts. This definition would thus include the National Office's response to a taxpayer's request for change of accounting period and accounting method.

A *determination letter* is a written statement issued by a District Director in response to an inquiry by a taxpayer, applying to the particular set of facts concerned, the principles and precedents previously announced by the National Office.

Technical advice is a written statement by the National Office to the District Director concerning the interpretation and proper application of internal revenue laws, statutes, regulations, etc., to a specific set of facts in connection with the examination or consideration of a taxpayer's return or claim for refund.

Briefly stated, a *ruling* is a written communication between the National Office and the taxpayer; a *determination letter* is a written communication between the District Director and the taxpayer; and *technical advice* is a written statement between the National Office and the District Director. It is worthy of note that in order for a written communication to have the status of a ruling it must come from the National Office of the Internal Revenue Service to the taxpayer or his representative.

Sometimes you hear it mentioned that a taxpayer has received a ruling in the form of an *information letter.* This is not a ruling! It is no more than a written statement issued by the District Director or the National Office, calling attention to a well-established interpretation or principle of tax law, without applying it to a specific set of facts. Accordingly, the Service is not bound by any statements contained in such a letter, since it is not a ruling.

ADVANCE RULINGS

Let us talk now about rulings, or "letter rulings," as they are sometimes called. It will be remembered from the definition that a ruling must always emanate from the National Office—with one exception. This exception dates back to 1964, when the National Office delegated authority to the District Director to act on applications for change in accounting method with respect to bad debts.

Mandatory Ruling Requests

Although it is normally discretionary with a taxpayer to request a ruling, there are certain situations in which a ruling *must* be requested.

Examples of circumstances in which rulings must be obtained are in certain transactions relating to foreign corporations (sections 367, 1491, & 1492), changes of accounting period, changes of accounting method, and changes of accounting practice.

When and in What Areas Rulings Can Be Obtained

Sometimes a circumstance arises concerning which it is felt it would be helpful to have a ruling on a particular issue. The first question to be asked is whether the ruling request would be timely filed. Other than in applications for changes of accounting method or accounting period and the like, where the Regulations impose a specific filing-date period, a ruling request may be filed at any time with respect to a prospective transaction. The only time that a ruling request can be filed with respect to a completed transaction is when the return in which the transaction is reported has not as yet been filed. Thus, it would be impossible to get a ruling on a transaction reported in a prior year's return.

Assuming, however, that a ruling request could be timely filed, it is not always possible to obtain a ruling. From time to time the Service publishes a listing, generally in the form of a Revenue Procedure, listing the areas in which the Service will not rule, or generally will not rule. The latest detailed pronouncement of this type was in Rev. Proc. 64-31, which lists some thirty areas of this nature. A listing of these areas would not serve any useful purpose here, but I might say that questions of determination of facts concerning the prospective application of the estate tax to the property of a living person, questions concerning transactions that lack bona fide business purposes, are examples of circumstances about which rulings cannot be obtained. Moreover, if the questions arise in returns already filed, no rulings can be obtained.

A moment ago I mentioned that Rev. Proc. 64-31 lists the areas in which the Service will not, or generally will not, rule. If you have an issue on which you are contemplating filing a ruling request, you might think that all that is necessary is to compare your issue with the areas detailed in that Revenue Procedure; that if your issue is not listed you are home free. Generally, that would be true, but unfortunately it does not always happen that way. The Service makes a conscientious effort, I firmly believe, to keep the taxpayers and their representatives informed of the questions on which a ruling may be obtained; nevertheless, this area (like most parts of our tax practice) constantly vacillates and therefore a question on which a ruling can be obtained today might

not have such an advantage tomorrow, and vice versa. Consequently, my purpose in making this point is that if you believe it would be prudent to obtain a ruling in a specific instance, be sure to check all sources to satisfy yourself that you have a question on which the Service will rule.

Informal Conferences

The last suggestion leads to another thought. Those of you who are members of national firms, or who are represented in Washington through local attorneys or CPAs, should consult such Washington representatives on questions concerning which there is doubt that the National Office will rule, or when there is cause for concern that an adverse ruling would issue. If you do not have Washington representation you should consider making the trip yourself for an informal conference with a National Office representative if the matter warrants it and if it is practical to do so.

These so-called informal conferences serve a very useful purpose. Although the conclusions reached therein are in no way binding on the Service, you will obtain a fairly conclusive answer to the question of whether the Service will or will not rule on the transaction. Additionally, you ought to be able to get a fairly good "feel" for the question of whether, if the Service does rule, it will rule favorably. And perhaps one of the most fruitful aspects of these conferences is that even though the proposed form of the transaction many times would not meet with National Office approval, the same business and tax result will be obtained, together with a favorable ruling, because of the suggestions concerning form the National Office conferee will make.

A word of advice here with respect to your approach to the National Office conferee: Be prepared, be candid, and be honest about the proposed transaction. Don't ask detailed and involved questions but, rather, tailor your presentation to those areas in which you believe you have to know what the National Office position is. If the conferee's position is solely that of expressing the National Office position, you will usually get a much better informed answer.

ORGANIZATION OF THE OFFICE OF ASSISTANT COMMISSIONER (TECHNICAL)

Rulings are issued through the Office of Assistant Commissioner (Technical), so a brief discussion of the organization of that Office might be of interest.

It is composed of four divisions, each of which is further divided into branches and then into sections or groups. Thus, the lineup is as follows:

Exempt Organizations and Pension Trust Division T:EP
- Exempt Organizations Branch T:EP:ED
- Pension Trust Branch T:EP:PT

Income Tax Division T:I
- Corporation Tax Branch T:I:C
- Depreciation, Depletion and valuation Analysis Branch T:I:D
- Individual Income Tax Branch T:I:I
- Reorganization Branch T:I:R

Miscellaneous Tax Division T:M
- Actuarial Branch T:M:A
- Administrative Provisions Branch T:M:AD
- Estate and Gift Tax Branch T:M:EG
- Excise Tax Branch T:M:EX

Technical Publications and Services Branch T:PS
- Administrative Services Branch T:PS:A
- Forms and Form Letters Branch T:PS:F
- Technical Publications Branch T:PS:P

Each of these divisions is headed by a Director and, as mentioned previously, the branches are broken down further into groups or sections or both. My principal purpose in referring to the organization of the National Office is that if you have a problem, you should discuss it with those persons who are specialists in a given area. It is not uncommon to find people in the National Office whose sole responsibility is a single section of the Internal Revenue Code. Therefore, in order to have as fruitful a conference as possible, we should make every effort to discuss our problems with the appropriate persons.

When to Request a Ruling

Suppose that, either on the basis of the informal conference or on the basis of other factors, consideration is to be given to filing a formal ruling request. What criteria or guidelines should be followed in determining whether or not a ruling request should be filed, assuming that it is not mandatory to do so? The answer, of course, would depend on several factors, and each case would have to be decided on its merits.

Generally, it can be said that a ruling should be requested when there are large sums at stake, when the answer to the proposed transaction is not clear or when the contemplated transaction is novel or complicated, or both. In addition, the time required to obtain a ruling would also have to be considered.

On the other hand, there are definitely times when a ruling should not be requested. This is so when the answer is perfectly clear, and when an adverse answer is almost assured—especially if the client is going to proceed with the transaction in any event. The reason for the last statement is that when a ruling request is submitted, the file and all supporting documents are retained by the National Office. If the National Office indicates a favorable ruling will not issue, the taxpayer has the right to withdraw the ruling request. He does this simply by writing a letter to the Commissioner, asking that the request be withdrawn from further consideration. Nothing, however, precludes the National Office from sending the file to the District Director, and if it does, such action could amount to a mandate for the District Director's office to examine the particular taxpayer's return for that transaction. To my knowledge, the policy of the National Office regarding the forwarding of files to the District Director is not published, and very little is said about it in the commentaries or informally. My own experience would indicate that a file is forwarded very infrequently, but this type of assurance is risky to rely on.

Form of Ruling Request

Assume that it is now decided to file a ruling request. Must it take any particular form? Other than for changes of accounting method, period, or practice, there is no prescribed form—the request would take the form of an ordinary letter. It should, of course, be addressed to the Commissioner of Internal Revenue, Washington, D. C., to the attention of the particular branch and perhaps even to the particular section or group concerned. Generally speaking, only the original of the letter need be submitted unless, for example, there is more than one issue. The letter, I would advise, should always be submitted in duplicate. On many occasions I have observed that the technician uses the extra copy for his draft of the ruling. If a good ruling request has been written, it will make the technician's job simpler, and if he has a choice he might be more likely to work on that case.

In writing the ruling request, great care should be exercised. Be as

concise as possible; choose your words carefully; and be precise with the questions you want answered. If you have done a good job you will be surprised at the number of your sentences that will show up in the ruling. Hopefully, then, you will have exactly what you asked for.

Although the taxpayer has great latitude with respect to the form of his ruling request, it must contain certain information. Accordingly, it should include:

1) The names, addresses, and identification numbers of the parties concerned
2) The District Director's office in which the taxpayer(s)' returns are filed
3) The taxable year of the taxpayer(s)
4) A complete statement of facts relating to the transaction
5) The business reason(s)
6) Copies of the supporting documents (never send the originals)
7) A "brief" in support of the taxpayer's position
8) A statement to the effect that the same issue is not pending in any other office of the Internal Revenue Service
9) A listing of the rulings requested
10) A request for a conference in the event an adverse answer is to issue

If you are filing a ruling request for a client, you should request that all correspondence, or at least a copy, be sent to you. In addition, if the ruling request is with respect to a particular type of transaction—a corporate reorganization, for example—the latest financial statements will also have to be submitted. For more detailed information on what must be submitted, a review should be made of the Revenue Procedures and Rulings mentioned previously.

Processing a Ruling Request

Once a ruling request has been filed, most taxpayers are anxious to know how it is progressing. Can this be determined, and if so, how? The "status" of a ruling can be checked, and normally in one or two ways: by personal appearance or by telephone. For those of you with Washington representation your regular "bird dogs" casually drop into the National Office each day to see how things are going. In the process they attempt to find out how the technician is getting along with the ruling request. If additional information is required, your correspondent

learns of it quickly, and, of course, responds as soon as possible. There is no question as to whether a Washington representative is a great advantage. He is, especially from the time standpoint.

If it is not feasible to have personal contact with the technician, he can, if he is known, be called directly; or you can telephone to the Branch office and they may put you in touch with the technician. However, the secretaries do a good job of protecting their men, and unless the technician wants to talk to you, the secretary will be the one who will give you the status report.

Your telephone number should be indicated on all ruling requests, together with a statement to the effect that if there are any questions or if additional information is required that you be called collect. By so doing, you will relieve the technician of the necessity of writing to you, and much valuable time may be saved.

Conference Procedures

A taxpayer is entitled to only one conference with respect to a ruling request. Sometimes exceptions are made, but this is by administrative grace, so we should count on only a single conference. Sometimes the taxpayer or his representative insists on a conference at the time the ruling request is filed, for the alleged purpose of meeting the technician who will be working on the case, and/or for the reason of explaining the ruling request to him, and telling him why a favorable ruling should issue. Things just don't work that way! The pre-filing conference could constitute the one conference, so I would discourage one on that basis. More important, however, the conferee usually cannot take the time, nor will he venture a guess on whether a favorable ruling will issue. He won't have had time to consider the issues, and any opinion he does give will not be binding on the Service. Additionally, the taxpayer or his representative will not meet the technician who will be getting the case (unless by happenstance) because the cases are usually not assigned to a specific technician until two weeks or more after the filing date.

Time for Processing Ruling

By this time I guess we are all wondering how long it takes to get a ruling. My answer is that I don't know. It would depend on many factors, such as the technician's work load, the branch to which it is assigned, whether more than one branch is engaged, how complicated

the transaction is, how well written the ruling request is. I should say, however, that the normal time is 30 to 90 days. Applications for change of accounting period will probably take around 30 days, other ruling requests would be in the 60–90-day range. Realistically, for most ruling requests we should count on 90 days.

Parenthetically, I might mention that sometimes it is possible to have the National Office process a ruling request out of order. The general rule is that ruling requests are assigned on a time basis—the earliest ones in are assigned first. Exceptions are made, but it is incumbent on taxpayers to demonstrate compelling business reasons why this should be done.

Reliance on Rulings and Revocability

Once a ruling has been obtained, what do we have? Probably the best answer is that we have an insurance policy that the Service will treat the completed transaction in the manner specified in the ruling—assuming that all the facts, statements, etc., mentioned in the ruling request are true.

It should be borne in mind, however, that a ruling, unless incorporated in a closing agreement, is not legally binding on the Commissioner, and if one is revoked, it is within his discretion to revoke it retroactively or prospectively. However, it can be said that if a ruling is revoked it will be done only prospectively if:

1) There is no misstatement or omission of a material fact in the request;
2) The facts as subsequently developed are substantially the same as those on which the ruling was based;
3) There is no change in the applicable law;
4) The taxpayer acted in good faith on the basis of the ruling; and
5) The ruling was originally issued with respect to a prospective transaction.

Accordingly, it would be a rare situation when the ruling was revoked retroactively.

If a ruling is revoked, it would be by direct communication with the taxpayer or by publication in the *Internal Revenue Bulletin.*

It should also be remembered that only the taxpayer receiving the ruling may rely on it. Thus, if you have two taxpayers, with identical issues, only the one receiving the ruling may proceed accordingly—the other one proceeds at his own peril or advantage as the case may be.

Change of Accounting Practice

That concludes my remarks with respect to rulings. However, I should like to take a few moments with respect to a subject mentioned briefly before—that is, changes of accounting practice. The details of this procedure are set out in Rev. Proc. 64-16, which you can read at your leisure. What I do want to point out is that, in my opinion, this is a very useful tool—both to us practitioners and to the Internal Revenue Service. What it says, in effect, is that—other than the five listed areas —no change of accounting "method," if that is what you want to call it, is a change of accounting method but is, rather, a change of accounting "practice." The precise rules with regard to change of accounting method therefore do not have to be followed. I honestly believe that most changes of accounting that our clients would like to make will fall within the purview of this Revenue Procedure. The pros and cons of filing an application under this approach are really the subject of another discussion, but I believe that serious consideration should be given to it when a change of accounting "practice" is contemplated. Worthy of note is the time period within which such an application may be filed—which is any time up to the due date of the return (including extensions).

REQUESTS FOR TECHNICAL ADVICE

Let us turn now to the subject of "technical advice." I have mentioned heretofore the definition, that is, the communication between the National Office and the District Director. But it might be well to get into the details somewhat because there seems to be some misunderstanding about what it is exactly—especially from the standpoint of what the taxpayer's rights are.

The usual way in which a technical-advice case arises is through the agent's seeking National Office assistance with respect to a particular issue or issues during his examination of a taxpayer's return.

The form in which technical advice is sought is found in Rev. Proc. 62-29. The District Director may request technical advice on any issue found in a taxpayer's return or claim for refund. When the District Director requests technical advice, the taxpayer will be so informed, and he will have 10 days (or longer) to submit his statement of facts, if they don't agree with the agent's (which usually they do not), and brief in support of his contention. After this is done, the file is forwarded to the National Office.

While normally the request for technical advice originates with the District Director, it can be originated by the taxpayer with the approval of the Chief of Audit. This is discretionary with the Chief. In other words, during the course of an examination the taxpayer may request technical advice because the particular agent is not applying uniformly what the taxpayer considers to be the applicable rule, or because the taxpayer may consider the issue to be novel and wants National Office consideration, or for both reasons. If the agent doesn't agree with the taxpayer's desires, the taxpayer may submit to the Chief of Audit a brief in which are described the facts, law, and arguments with respect to the issue, and the reasons why it should be submitted to the National Office. The decision is then with the Chief of Audit to forward the file, and if he decides not to do so the taxpayer has no right of appeal. However, if the Chief of Audit decides not to act on the matter he must prepare an internal memorandum in which will be described his reasons for not complying with the taxpayer's request. As a consequence, he must have valid reasons for denying the taxpayer's request.

Once the file is submitted to the National Office the taxpayer has the same rights as he would with a ruling request. That is, he may check the status of it, and if an adverse reply is contemplated he is entitled to the one conference.

The question arises about whether the taxpayer gets a copy of the National Office communication in a technical-advice case. The answer is no, yes, or maybe. The National Office reply is in two parts, viz., a covering letter and a technical memorandum. The covering letter is confidential and the taxpayer will never get a copy. It is discretionary with the District Director whether the taxpayer will get a copy of the technical memorandum, but generally the taxpayer will be given a copy if so requested. In situations where the taxpayer is not given a copy, this will be as a result of instructions from the National Office to the District Director, and the taxpayer will be so informed if he had requested a copy.

One of the reasons for discussing requests for technical advice in a talk about rulings is the tie-in between the two. Suppose, for example, my client has requested and obtained a favorable ruling, completed the transaction, and reported it on his return. Now the agent either doesn't agree with the ruling or doesn't think it was carried out on the basis of the facts submitted in the ruling request. What may the agent do? This

is a situation in which technical advice might be requested. If it is, it takes the form of any other technical-advice case.

I should like to make a couple of other observations about requests for technical advice. For one thing, they cannot be requested once a case gets to Appellate, although it is possible to bring a case back to the District level from Appellate. Another is that technical advise has the same effect as a ruling, although it is not binding for subsequent years. Moreover, if the same issue appears in a return for a later year the District Director can again request technical advice.

DETERMINATION LETTERS

Now for a short discussion about determination letters.

The principal difference between a determination letter and a ruling is that the former is issued only with respect to completed transactions other than requests for exemption under sections 501 and 521 of the Code and qualified employee-retirement plans under section 401. Moreover, a District Director is allowed to issue determination letters only in those situations where a clear-cut precedent has been established by the National Office. Except for exemption requests and retirement-plan determinations, it is probably only in rare instances that a taxpayer will ask for a determination letter.

A District Director may not issue a determination letter if:

1) The same issue is in a return already filed;
2) The same question is submitted in a ruling request to the National Office; and
3) The issue applies to an estate-tax question relating to a living person.

It should be noted that when an organization seeks exemption from income tax the application must be filed with the District Director in the district where the organization files its tax returns. If the application is filed with the National Office the application will be sent to the appropriate District Director's office without any action having been taken on it. The District Director does not always act on the application, however. If he believes that there is no clear-cut precedent for issuing the determination letter, or if he believes the issues to be novel or complicated, the file will be sent to the National Office and the organization will then deal with the National Office in the same way as with a request for ruling. And in situations including prohibited transactions, feeder or-

ganizations, accumulation of income, and sections 511 to 515 the file must be referred to the National Office by the District Director.

If an organization is denied exemption it may appeal the case by filing a protest with the District Director within 30 days of such notice. If the District Director does not agree with the protest, the file will be sent to the National Office for its opinion, and the case will be treated as a request for technical advice.

With respect to employee-retirement plans, the taxpayer has the option of requesting a determination letter under sections 401 and 501 of the Code, either before or after the plan becomes operational. However, I should think that we would want to advise our clients to get approval in almost all cases because of the dire tax consequences that might result.

If during the course of an examination of a taxpayer's return a question arises with respect to the qualification, amendment, or any other matter pertaining to the retirement plan, and if the taxpayer and the District Director cannot agree on the issues, with the result that the District Director sends the file to the National Office, the case will be treated as a request for technical advice. The taxpayer's rights in such a situation are the same as in any other technical-advice case. If the District Director refuses to request technical advice, the taxpayer must notify him that he himself intends to request National Office assistance. Such notification must include a copy of the request the taxpayer intends to send to the National Office. If the District Director still does not agree with the taxpayer or if the District Director does nothing within 30 days, the taxpayer can appeal directly to the National Office. The taxpayer cannot always appeal directly to the National Office. In order to do so, one of the following criteria must be met:

1) The position of the District Director is contrary to law or regulations on the issue
2) The position of the District Director is contrary to a published ruling still in effect or contrary to an acquiesced Tax Court decision
3) The contemplated position of the District Director is contrary to a determination made on the same issue in the same or another district
4) The question is novel and has not been made the subject of a published ruling

CONCLUSION

The rulings program of the Internal Revenue Service can be of great help to us in planning or completing transactions for our clients, and I hope my presentation has been of some help toward realizing that result. As mentioned in the beginning, the program should definitely be included in the services we render to our clients. On the other hand, although the Service spends a great deal of time, effort, and money in connection with the program, the Service believes it also derives advantages from it, such as uniformity in the administration of the tax laws and the ability to glean what new types of transactions taxpayers are contemplating. Let us hope the rulings program continues and that more areas will be opened in which rulings can be issued.