Akin Gump
STRAUSS HAUER & FELD LLP

June 8, 2017

By Stuart E. Leblang, Michael J. Kliegman and Amy S. Elliott

Possible Endgames for Yahoo's Stake in Alibaba, Yahoo Japan

Stockholders of the American tech company Yahoo! Inc. (YHOO) voted June 8, 2017, to approve the taxable sale of Yahoo's core operating business to the American telecom company Verizon Communications Inc. (VZ).[1] After the transaction closes, which is expected to happen June 13, 2017, Yahoo will be renamed Altaba Inc. (AABA). Altaba will be a publicly traded closed-end investment company and will largely consist of a minority stake in the Chinese e-commerce company Alibaba Group Holdings Ltd. (BABA) and a minority stake in the Japanese internet company Yahoo! Japan Corp. (JPY).[2]

After the sale, Altaba investors will continue to face the challenge of owning stock that trades at a discount to the value of its component parts. But some are optimistic[3] that Altaba will find ways to unlock value. One obvious way is for Altaba to take a tax hit, disposing of its stake in Yahoo Japan in a taxable transaction, possibly after the corporate tax rate is reduced (assuming lawmakers are able to pass tax cuts). This would leave Altaba to trade as a pure-play indirect investment in Alibaba. Other approaches that have been considered to one degree or another, each offering potential advantages over the above strategy, include:

- **Recapitalizing Altaba to create a dual-class stock structure that would separately track the underlying Alibaba and Yahoo Japan investments;**
- **Disposing of the stake in Yahoo Japan but mitigating the tax with foreign tax credits;**
- **Arranging for Altaba (after a divestment of its Yahoo Japan stake) to be acquired by Alibaba, likely in a tax-free exchange (which requires hook stock management strategies);**
- **Disposing of Altaba's Yahoo Japan or Alibaba stake by way of a section 355(g) cash-rich split-off; or**
- **Pursuing bolder strategies, such as a leveraged buyout by individuals followed by a conversion to an S corporation or a mutual fund combination.**

---

[1] https://investor.yahoo.net/ReleaseDetail.cfm?&ReleaseID=1029619.

[2] https://www.sec.gov/Archives/edgar/data/1011006/000119312517164173/d358906d10q.htm.

[3] Krause, Reinhardt, May 24, 2017, "Yahoo Price Target Hiked On Alibaba Stake, Post-Verizon Scenario," *Investor's Business Daily* (http://www.investors.com/news/technology/yahoo-price-target-hiked-on-alibaba-stake-post-verizon-scenario/).

Akin Gump
STRAUSS HAUER & FELD LLP

Valuing the Component Parts

Altaba will own about 15 percent (384 million shares) of the outstanding ordinary shares of Alibaba, a holding worth about $48.19 billion as of June 7, 2017. Altaba will also own about 35.5 percent (2,026 million shares)[4] of Yahoo Japan common stock, a holding worth about $9.15 billion, given the current exchange rate.

Altaba's other assets will consist of about $12.23 billion in cash and marketable securities (including the proceeds from the Verizon transaction)[5] and Excalibur IP LLC, worth about $740 million,[6] which owns certain intellectual property.

The difficult question is how much of a discount to apply for U.S. taxes.

Net Asset Value (NAV) of Altaba		
Assets	Cash and marketable securities (including the proceeds from the sale of core to Verizon)	$12.23 billion
	Excalibur IP assets (nearly 4,000 patents)[7]	+ $0.74 billion
	Investment in Alibaba (384 million shares at $125.64 per share as of market close June 7)	+ $48.19 billion
	Investment in Yahoo Japan (2,026 million shares at ¥496 Yen per share as of market close June 7; ¥1,004.86 billion Yen = $9.15 billion U.S. dollars)	+ $9.15 billion
Liabilities	Liabilities other than tax	- $1.43 billion
	Estimated NAV	**$69.24 billion**
Market's Assessed Value of Altaba		
Yahoo market cap	$50.55/share (as of June 7 close)	$48.44 billion
	Market Discount	**30.04%**

[4] https://about.yahoo.co.jp/ir/en/holder/status.html.

[5] In advance of the expected June 13 sale of its core assets to Verizon, Yahoo is buying back up to $3 billion of its common shares. This means that Altaba's cash balance will be less than $12.23 billion going forward. https://www.sec.gov/Archives/edgar/data/1011006/000119312517171357/d397225d8k.htm.

[6] The $740 million figure is according to Yahoo's most recent financial statements. However, there is a wide difference of opinion as to the actual value. See Jeff John Roberts, July 12, 2016, "Yahoo's Patents Are a Pile of Junk, Report Says," *Fortune* (http://fortune.com/2016/07/12/yahoo-patents-criticized-in-report/) and Eugene Kim, April 7, 2016, "Yahoo's patents could be worth $4 billion," *Business Insider* (http://www.businessinsider.com/yahoos-patents-could-be-worth-4-billion-2016-4).

[7] Lunden, Ingrid, March 13, 2017, "Yahoo's 4K Excalibur patents in search, mobile, cloud and more valued at $740M," Tech Crunch (https://techcrunch.com/2017/03/13/yahoos-excalibur-ip-search-mobile-and-other-patents-valued-at-740m/).

Based on the price of Yahoo as of the June 7 close, the market is implying a discount of about 30 percent. While the tax risk is not the only moving target that impacts the price of Yahoo/Altaba stock, it is the most significant, or at least, the one least responsive to what traders have in their tool kits. Despite the company's best efforts to get the market to view Altaba as merely a proxy for Alibaba[8] as opposed to a blended surrogate of two companies plus some other assets thrown in, it is not that simple. Separation of the Yahoo Japan stake, the Alibaba stake or both will require careful navigation in order to minimize tax costs.

Note that while Altaba will trade as a registered investment company under the Investment Company Act of 1940, it is still a taxable C corporation. It does not qualify as a regulated investment company (RIC) for tax purposes because it does not meet the diversification requirements. As discussed beginning on page 14, a RIC generally escapes corporate level tax, and, as a result, qualification under these rules could eliminate the tax discount in the Altaba shares.

Tax Rate and the Impact of Tax Reform

So what is the right discount for taxes? Assuming Altaba disposes of its stakes in Alibaba and Yahoo Japan in one or more fully taxable sales (which it has done before with respect to some of its Alibaba shares[9]), what will it owe? Altaba will record a $15 billion deferred tax liability (DTL) on the unrealized appreciation in the Alibaba and Yahoo Japan shares, which assumes an effective combined federal and state tax rate on the gains of 36.5 percent.

As of December 31, 2016, the cost/tax basis of Altaba's investments in Alibaba and Yahoo Japan was $5.906 billion ($3.2 billion in Yahoo Japan and $2.7 billion in Alibaba). It appears that Yahoo calculated the $15 billion DTL figure using valuations of its investments as of December 31, 2016. Since then, the share prices of Alibaba and Yahoo Japan have gone up. Using June 7 valuations (totaling $57.34 billion), there is about $51.43 billion of unrealized gains on Altaba's stakes in Alibaba and Yahoo Japan, which, if triggered, would result in a tax liability of $18.77 billion assuming a combined effective tax rate of 36.5 percent. Note that Yahoo had (as of December 31, 2016) about $0.172 billion in federal net operating loss carryforwards.[10]

[8] Yahoo reportedly came up with the name Altaba as a combination of "alternative" and "Alibaba." See Elizabeth Dwoskin, January 9, 2017, "How Yahoo came up with its new name," *The Washington Post* (https://www.washingtonpost.com/news/the-switch/wp/2017/01/09/how-yahoo-came-up-with-its-new-name-altaba/?utm_term=.9f2726379b72).

[9] September 18, 2012, "China's Alibaba buys back half of Yahoo's stake," http://www.reuters.com/article/us-alibaba-buyback-yahoo-idUSBRE88H0Y520120918.

[10] See https://www.sec.gov/Archives/edgar/data/1011006/000119312517065791/d293630d10k.htm. See also https://www.sec.gov/Archives/edgar/data/1011006/000119312517133449/d206374ddefm14a.htm.

A taxable sale of Altaba's interest in Yahoo Japan appears much more likely in the short-term than a taxable sale of its interest in Alibaba. Yahoo itself has acknowledged as much.[11] Yahoo Japan approached Yahoo with a merger-of-equals offer when Yahoo was entertaining proposals that would allow it to separate its operating business from its Alibaba shares, but Yahoo did not bite.[12] It appears from disclosures that Yahoo's tax basis in its Yahoo Japan shares is $3.2 billion,[13] meaning that an outright sale for $9.15 billion would trigger $5.95 billion of taxable gain.

Thomas J. McInerney, who was later named CEO of the investment company, described on July 25, 2016, the choices Altaba will soon face. "There are tax efficient transactions that can be done that have less than a full tax burden or we could engage in taxable transactions" to monetize the Yahoo Japan shares, McInerney said. But its Alibaba stake is a different story. "We wouldn't intend right now to . . . entertain taxable transactions on the Alibaba shares. We've obviously gone to great pains to get to this point where we wouldn't have to do that," he said.

Yahoo/Altaba is extremely sensitive to future tax expenditures associated with its appreciated investments, and when the tax hit could be as high as its estimated 36.5 percent, the company has more incentive to come up with strategies to minimize the hit.[14]

Washington is devising plans to significantly reduce corporate tax rates. Many are hoping that a Republican-controlled Congress can work with President Trump to get tax relief passed by early 2018. If that happens, there is a good chance that the top federal corporate income tax rate could be much lower than its current 35 percent.

The major tax reform proposals that have been floated include a plan by House Republicans ("A Better Way" Blueprint),[15] an April 26 outline by the Trump administration ("2017 Tax Reform for Economic Growth and American Jobs")[16] and an evolving compromise led by Senate leaders that looks more like the 2014 tax reform plan put forth by former House Ways and Means Chair Dave Camp.[17]

---

[11] "The Board currently believes that it is more likely that capital may be returned from a sale of Yahoo Japan Shares than Alibaba Shares." See https://www.sec.gov/Archives/edgar/data/1011006/000119312517133449/d206374ddefm14a.htm.

[12] Although the transaction was never agreed upon, it "contemplated a commitment by Alibaba to purchase approximately 50 percent of Yahoo's stake in Alibaba in six equal annual installments over a six-year period commencing one year after the closing of the transaction. The letter was not signed or acknowledged in writing by Alibaba." See https://www.sec.gov/Archives/edgar/data/1011006/000119312517133449/d206374ddefm14a.htm.

[13] https://www.sec.gov/Archives/edgar/data/1011006/000119312517133449/d206374ddefm14a.htm.

[14] Speaking on a September 7, 2016, conference call, Yahoo CFO Ken Goldman said, "We are very focused on what is perceived to be most tax-efficient way of returning cash . . . to investors." Available at https://seekingalpha.com/article/4004740-yahoo-s-yhoo-cfo-ken-goldman-2016-global-technology-conference-transcript?part=single.

[15] http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

[16] http://www.cnn.com/2017/04/26/politics/white-house-donald-trump-tax-proposal/.

[17] https://www.congress.gov/bill/113th-congress/house-bill/1.

Trump's plan is the most radical, calling for corporate income to be taxed at 15 percent. The Blueprint proposed a 20 percent corporate tax rate, while the evolving Senate compromise would likely land closer to what Camp proposed—25 percent. If you assume that the unrealized gains on the Alibaba and Yahoo Japan shares are worth an even $50 billion, then a 10 percentage point reduction in the tax rate from would save Altaba $5 billion.

Not only would a lower tax rate help Altaba going forward—as future taxable sales of all or a portion of its stake in Yahoo Japan or Alibaba would generate less tax leakage—but it could result in a sizeable accounting statement credit, given its recorded $15 billion DTL.

State Tax Considerations

In September 2016, Yahoo issued a preliminary proxy statement estimating that Altaba would face an assumed effective tax rate of 41 percent on its future income and realized and unrealized gains,[18] but Yahoo's more recent (April 2017) proxy statement estimated a rate of 36.5 percent.[19]

Although indications are that Yahoo/Altaba will retain offices in California, [20] Yahoo's 1 million-square-foot corporate headquarters on the waterfront in Sunnyvale, California, will be purchased by Verizon in the sale.[21] Yahoo/Altaba is a Delaware corporation that intends to principally just hold investments (it has set up the structure so that it can do so indefinitely).[22]

Some apparent state tax savings were figured into the estimates in the most recent proxy statement, as Yahoo assumed an estimated blended tax rate of 37.4 percent for purposes of calculating federal and composite state tax upon the sale of its core business to Verizon, but it is assuming only 36.5 percent for purposes of future taxes on Altaba.[23]

Offsetting Taxable Gain with NOLs

It appears that Altaba will begin its new life with a limited amount of net operating loss carryovers (NOLs) from its Yahoo history.[24] Beyond that, the company may consider combining

[18] https://www.sec.gov/Archives/edgar/data/1011006/000119312516706578/d206374dprem14a.htm.

[19] https://www.sec.gov/Archives/edgar/data/1011006/000119312517133449/d206374ddefm14a.htm.

[20] https://investor.yahoo.net/secfiling.cfm?filingID=1193125-17-79182&CIK=1011006.

[21] Khouri, Andrew and Tracey Lien, July 27, 2016, "By buying Yahoo, Verizon scoops up a rare prize: Silicon Valley real estate," *Los Angeles Times* (http://www.latimes.com/business/technology/la-fi-tn-yahoo-verizon-real-estate-20160725-snap-story.html).

[22] It is also assuming the investments will grow at an annual rate of 5 percent. Yahoo July 25, 2016, conference call transcript available at: https://seekingalpha.com/article/3991763-yahoo-s-yhoo-ceo-marissa-mayer-verizon-acquire-yahoos-operating-business-conference?part=single.

[23] https://www.sec.gov/Archives/edgar/data/1011006/000119312517133449/d206374ddefm14a.htm.

[24] Yahoo's annual report dated March 1, 2017, states that as of December 31, 3016, Yahoo's federal NOLs were approximately $172 million.

with a corporation with significant NOLs or capital loss carryovers with a view to using these losses to offset gain on the future disposition of Yahoo Japan or Alibaba shares.

While this avenue should be considered, it is a fairly steep uphill route. First, there is an extensive set of mechanical rules under sections 382 and 384 of the Internal Revenue Code designed to eliminate or greatly diminish incentives to do just that. To the extent these rules can be navigated, there remains a long-standing anti-abuse provision, section 269, giving the Internal Revenue Service fairly wide latitude in disallowing tax benefits where there is a corporate acquisition with the principal purpose of making use of those tax benefits. Given the high degree of visibility and "transparency" that Yahoo has and is likely to continue to enjoy, any such transaction with NOLs of a scale to be useful would be vulnerable to challenge.

* * *

Tax Strategy #1: Recap Using Tracking Stock

Here we presuppose that the company would like to address the contingent tax liabilities associated with the stock holdings by not realizing that gain through a sale or other disposition of the underlying shares. One non-tax problem this presents is that by holding significant interests in both Alibaba and Yahoo Japan, Altaba cannot function as a surrogate for either investment; nor are its holdings diversified in a way that could be said to manifest a different set of investment objectives.

This problem could be addressed by undertaking a tax-free recapitalization of its single class of common stock into two classes—for example, class A (which would primarily track Altaba's interest in Alibaba) and class Y (which would primarily track Altaba's interest in Yahoo Japan)—rather than leaving its common stock to track the market prices of both on a combined basis. This represents a relatively low-risk approach, allowing investors access to a single surrogate investment as an alternative to a direct holding in either Alibaba or Yahoo Japan. On the other hand, tracking stock is an imperfect substitute for even a pure-play U.S. holding company for one or the other stock; with this and the fact that the unrealized tax liability on the underlying stock remains in place, one could expect a continued discount in the stock price.

Tax strategy #3 (described in detail below and addressing the deferred tax associated with holding the Alibaba shares) involves an acquisition of Altaba by Alibaba, either for cash or Alibaba shares. It is worth asking at this point whether such a transaction could occur in conjunction with the creation of Altaba tracking stock.

Specifically, could Alibaba acquire only the Class A stock and leave outstanding in the hands of the public the Class Y stock? From a U.S. tax standpoint, yes, with some caveats. One, doing so as a tax-free share exchange for the Class A shareholders would be unlikely, unless the Class A shareholders held at least 80 percent of the voting power in Altaba. More important, however reluctant Alibaba may be to engage in an acquisition of Altaba holding only Alibaba shares, it seems unlikely Alibaba could live with owning only a Class A tracking stock interest in Altaba while having minority interest public shareholders owning the Class Y interest.

Tax Strategy #2: Reducing Yahoo Japan Tax with Foreign Tax Credits

When a U.S. corporation owning at least 10 percent of the voting stock in a foreign corporation receives dividends from the foreign corporation, while the dividend is taxable, it may bring with it foreign tax credits based on a share of the foreign taxes paid by the foreign corporation. One possible avenue for tax mitigation on the Yahoo Japan holdings would be to try to obtain foreign tax credit relief against sale proceeds based on Japanese taxes by Yahoo Japan.

We believe that any planning to try to mitigate Altaba's U.S. tax from the disposition of its Yahoo Japan interest would require active cooperation by SoftBank Group Corp., Yahoo Japan's largest shareholder, regardless of whether SoftBank itself were the ultimate purchaser of the Yahoo Japan shares.

Ordinarily, a sale of shares in the foreign corporation does not bring foreign tax credit benefits. The exception is where the foreign corporation is a controlled foreign corporation (CFC), which generally means that U.S. shareholders holding 10 percent or more own, in the aggregate, more than 50 percent of the foreign corporation. In such a case, section 1248 of the Internal Revenue Code recharacterizes any recognized gain as a deemed dividend to the extent of the selling shareholder's share of the foreign corporation's earnings and profits (E&P).

While Altaba owns 35.5 percent of Yahoo Japan, it does not appear that there are other 10 percent U.S. shareholders in the company; SoftBank, which owns 36.4 percent, is not a U.S. shareholder.[25] Yahoo Japan could be converted to a CFC if SoftBank contributed its interest in Yahoo Japan to a U.S. (e.g., Delaware) partnership or LLC. If Altaba and SoftBank entered into a commercial arrangement that, while not involving a sale of Altaba's Yahoo Japan interest, provided SoftBank with control and other reciprocal arrangements such as conditions for purchase and sale of the other's interest, this could be done through a U.S. partnership as easily as through some other vehicle. Such an arrangement should not subject SoftBank itself to U.S. taxation, since it continues to enjoy its status as a non-U.S. corporation.

Establishing a joint venture for holding the Yahoo Japan stock via a U.S. partnership does not in itself necessarily make historical Japanese taxes paid available to Altaba, but it does open up a much greater potential to unlock those foreign tax credits than under present circumstances.[26]

[25] https://about.yahoo.co.jp/ir/en/holder/status.html.

[26] The ability to use a CFC structure to unlock foreign tax credits to shield Yahoo/Altaba from taxable gain in respect of a redemption of its Yahoo Japan stake would depend on the amount of Yahoo Japan E&P and taxes attributable to Yahoo during the time it remains a 10 percent owner of a CFC (a "U.S. Shareholder"). It is unclear whether Yahoo's share of Yahoo Japan E&P from previous years when Yahoo had control of Yahoo Japan could be taken into account. This would depend on whether

Absent making Yahoo Japan a CFC, it may be possible to structure at least a portion of Altaba's reduction in its Yahoo Japan stake as a redemption that would be treated as a dividend for U.S. tax purposes, and thereby bring foreign tax credits up for use by Altaba. This might occur under existing guidance where there is a less than 20 percent reduction in Altaba's interest in Yahoo Japan and the reduction is not otherwise found to be a meaningful one.

Alternatively, it may be possible to couple a greater redemption of shares with the granting of a call option by Yahoo Japan or by Softbank, with the result that even a redemption of all of Altaba's interest in Yahoo Japan could be treated as a dividend. This technique relies on statutory rules that attribute ownership of stock over which the redeeming shareholder has an option to purchase. The use of this technique in a different context has received attention from the IRS and can be controversial. A related approach that is likely to offer a stronger position than a naked call option would be for Yahoo Japan to redeem the shares in full or partial exchange for a convertible promissory note.

Tax Strategy #3: Acquisition by Alibaba

Assuming that Altaba were to first divest its position in Yahoo Japan, Altaba would seem to be a reasonably pure surrogate investment in Alibaba. This leaves in place an ongoing source of potential tax inefficiency—the deferred tax liability. From a balance sheet standpoint, Altaba will still have to account for the prospective tax cost of eventually disposing of its Alibaba shares.

The most direct and comprehensive transaction to present itself is an acquisition of Altaba by Alibaba itself. This could be done for cash, of course, but it could likely be done solely in exchange for Alibaba stock in a tax-free reorganization. If Alibaba were a U.S. company, such a "downstream reorganization" would be a fairly clean winner. A similar transaction that comes to mind is the 1995 merger of Petrie Stores Corp. into Toys "R" Us Inc., of which Petrie held approximately 14 percent, after Petrie sold off its core (and much less valuable) retail business.[27] In such a transaction with a domestic company, the Alibaba stock owned by Altaba could truly be eliminated.

However, with Alibaba as a foreign company, the 15 percent holding in Alibaba cannot actually be eliminated without triggering U.S. tax.[28] Immediately following the reorganization, former Altaba shareholders would directly own shares in Alibaba, and Alibaba would own 100 percent of the Altaba stock. The fly in the ointment—a rather substantial one—is the Alibaba stock

---

Yahoo could take the position it was a U.S. Shareholder of a CFC in those previous years and whether E&P and taxes from such prior period could be taken into account in connection with a current deemed dividend from Yahoo Japan.

[27] See Geraldine Fabrikant, December 6, 1994, "Market Place; At Petrie Stores, estate planning drove a final swap of stock," *The New York Times* (http://www.nytimes.com/1994/12/06/business/market-place-at-petrie-stores-estate-planning-drove-a-final-swap-of-stock.html) and LTR 9506036, dated November 15, 1994.

[28] Achieving shareholder level tax deferral on an exchange of Altaba stock for Alibaba stock depends on satisfying requirements under Section 367(a) and detailed regulations thereunder. In general, satisfying those requirements seems reasonably likely.

previously owned by Altaba, now continuing to be held by Altaba in its parent company, Alibaba. Such an arrangement is referred to, at least in tax circles, as hook stock.

This scenario was addressed on Yahoo's July 25, 2016, earnings call. McInerney explained: "If, down the line, there were an interest in Alibaba buying [Altaba], then [Alibaba] would own a company that would own [its] own shares. So, there's a bit of circularity there. . . . My understanding is there are potential resolutions to that; it's a complicated topic. And it's only an issue if they were and we were subsequently interested in doing a transaction and it gets technical and complex."[29]

The tax law has historically respected the form of transactions that create or involve the use of hook stock; indeed, the IRS in 1994 issued guidance intended to ensure that when such circular stock arrangements were involved, proper respect was paid to the value of such shares in relation to shares held by third parties or issued in a restructuring transaction.[30] Although from an accounting standpoint, these shares held in the parent company are ordinarily treated as treasury shares, it is extremely important to keep in mind that, for U.S. tax purposes, Altaba remains a corporation fully subject to U.S. tax law and retains ownership of shares with all the built-in taxable gain that they had before it was acquired by Alibaba.

Lawmakers and the IRS have had their eyes on the use of hook stock for some time, and have put the tax bar on notice that they are concerned some transactions involving hook stock may be too complex to address in rulings. In January 2014, the IRS decided that it would ordinarily no longer issue private letter rulings addressing the treatment or effects of hook stock "including as a result of its issuance, ownership, or redemption."[31] Hook stock remains on the no-rule list today.[32]

The hook stock conundrum has not been lost on Alibaba. A recent article quotes Alibaba executive vice chairman Joseph Tsai, who used to work as a tax attorney at Sullivan & Cromwell LLP, explaining that even if Alibaba bought Altaba, its Alibaba shares could not be retired without triggering tax.[33] With outstanding shares, dividends and spin-offs would be much more difficult.

Ostensibly, the hook stock can be managed by not disposing of it, which it would seem should be commercially unnecessary. Where tax people, presumably including Mr. Tsai, tend to focus on is what happens when Alibaba eventually wishes to start paying dividends. Let's say, for

[29] https://seekingalpha.com/article/3991763-yahoo-s-yhoo-ceo-marissa-mayer-verizon-acquire-yahoos-operating-business-conference?part=single.

[30] Notice 94-93, 1994-2 C.B. 563.

[31] See Rev. Proc. 2014-3, https://www.irs.gov/irb/2014-1_IRB/ar07.html.

[32] See Rev. Proc. 2017–3, https://www.irs.gov/irb/2017-01_IRB/ar09.html.

[33] Wieczner, Jen, September 13, 2016, "Here's Why Alibaba Will Never Buy Back Yahoo Stake," Fortune (http://fortune.com/2016/09/13/alibaba-yahoo-stock/).

example, that the company wished to pay a dividend of $100 million to its common shareholders, and that Altaba (wholly owned by Alibaba) held 15 percent of the nominally outstanding shares. Chinese corporate law might well allow Alibaba to ignore the shares held by Altaba and only distribute to its public shareholders. If it did, in fact, distribute $85 million directly to the public shareholders, and circulate $15 million through Altaba, back to Alibaba and out to the shareholders, there would be considerable tax leakage. First, there could be Chinese withholding tax on the dividend paid to Altaba, then full U.S. corporate tax to Altaba on the $15 million dividend and U.S. withholding tax on the distribution of cash as a dividend out of Altaba to Alibaba.

It is possible from a legal standpoint for Alibaba to waive its right to dividends on the Alibaba shares it holds, and it is possible that such a waiver would be respected for U.S. tax purposes such that the above-described tax leakage could be avoided. The IRS is wary of dividend waivers, but has allowed them to be respected in circumstances where a non-U.S. corporate tax business purpose has been demonstrated. In the event that dividends are waived and such a waiver is not respected for U.S. tax purposes, there would be deemed circular distributions with associated U.S. income and withholding taxes as described above.

Alibaba could consider recapitalizing the shares held by Altaba to legally permit dividends to be paid on the public shares without having to declare them on the shares owned by Altaba. We think this would present a risk that the resulting diminution of the value of the shares held by Altaba could give rise to a deemed taxable disposition by Altaba.

An alternative recapitalization approach would be to freeze the value of the hook stock. This would involve exchanging Altaba's ordinary shares in Alibaba for a non-growth preferred stock. This would be beneficial in that it could substantially prevent growth of the contingent U.S. tax liability as the value of Alibaba increases. The important downside is that such a value freezing preferred stock typically carries a higher, preferred right to dividends, and therefore, the problem of tax leakage when Alibaba wishes to start paying dividends would be exacerbated.

At the same time, Alibaba could potentially make use of this wholly-owned U.S. subsidiary for acquisitions in the United States. Also, if and when Alibaba may wish to distribute cash out to shareholders, it could do so by way of share repurchases rather than dividends.

Ultimately, these tax risks and burdens are likely to work their way into a negotiated exchange ratio between Alibaba and Altaba. Some believe that the concerns are exaggerated by Alibaba. Mike Winston of Sutton View Capital has said of Alibaba's stance: "Jack Ma (founder of Alibaba) . . . doesn't want the Wal-Marts and Amazons of the world to be able to take a 15 [percent] stake in his company without so much as placing a phone call to Alibaba headquarters . . .

Alibaba [would] like us to believe they only care to buy [Yahoo's stake] at a discount, but its very existence troubles them deeply."[34]

Tax Strategy #4: Cash-Rich Split-Off

If Altaba ultimately decides to monetize its interest in either Alibaba or Yahoo Japan by way of a cash-rich split-off, then we really will have come full circle. That is because a split-off under section 355(g) is exactly what Yahoo was contemplating as far back as 2011.[35]

Reportedly, the plan fell through when "Alibaba backed off, fearing that it wouldn't look good for a Chinese company to help an American one avoid paying taxes."[36]

A cash-rich split-off would allow Alibaba to acquire its shares held by Altaba in what amounts to a kind of redemption transaction (because Altaba is a shareholder of Alibaba). The split-off is a historically conventional transaction most often used to enable owners of a closely held company to go their separate ways on a tax-free basis. Arguably less benign, the cash-rich version envisions a mix of assets in the Splitco weighted in favor of cash and other investment assets, and is relatively light on active business assets.

Alibaba would first create a new U.S. subsidiary (Splitco) in which it would place enough value to effectively purchase Altaba's stake in Alibaba. Then Alibaba would engage in a tax-free exchange whereby it would distribute all of the Splitco stock to Altaba and in return would receive all of Altaba's shares in Alibaba.

In response to more extreme asset mixes, Congress enacted rules restricting the asset mix in Splitco. If two-thirds or more of the fair market value of the assets of Splitco are investment assets (cash, stock, etc.), then it is a disqualified investment company and cannot engage in a tax-free split.[37] If Altaba's stake in Alibaba is worth $47.55 billion, then Splitco would need to contain at least $16.2 billion of non-investment assets.

Alibaba would also need to contribute to Splitco one or more active trades or businesses (ATBs) that have been actively conducted for the preceding 5 years (in a size that likely satisfies

---

[34] See SumZero, "Hedge Fund: Here's what's going to happen at Yahoo," *Business Insider* (http://www.businessinsider.com/a-hedge-fund-manager-explains-how-to-bet-on-yahoos-coming-spin-off-2016-1).

[35] Rusli, Evelyn M. and Michael J. De La Merced, December 21, 2011, "Yahoo to Consider Sale of Asian Assets," *The New York Times* (https://dealbook.nytimes.com/2011/12/21/yahoo-to-consider-sale-of-asian-assets/). Yahoo came back to the idea. On an October 21, 2014, earnings call, Yahoo CFO Ken Goldman referred to a cash-rich split as a CRS when he said, "The various approaches we're looking at includes the various ways of spinning, includes CRS and some other structures that I am not at liberty [to] talk to." (See https://seekingalpha.com/article/2581415-yahoo-s-yhoo-ceo-marissa-mayer-on-q3-2014-results-earnings-call-transcript?part=single.)

[36] Carlson, Nicholas, September 26, 2014, "Activist Shareholders Go After Yahoo, Tell Marissa Mayer To Buy AOL," *Business Insider* (http://www.businessinsider.com/yahoo-exploring-deal-with-aol-2014-9).

[37] See section 355(g)(2)(A).

proposed regulations[38] requiring that the combined ATBs comprise at least 5 percent of the total assets of each of Alibaba and Splitco).

If all of the many rules for tax-free spinoffs under section 355 are satisfied—including control, business purpose, ATB and device—then the gain in Altaba's Alibaba shares is not triggered in the transaction.

A similar cash-rich split-off could be utilized to effect the monetization of Altaba's Yahoo Japan shares. But both come with the same problems.

One of those is that one-third of the consideration cannot be in the form of cash or stock and securities, other than in 20 percent owned companies, and would likely take the form of an operating business. When Yahoo was contemplating a cash-rich split in early 2012, the word on the street was that Yahoo might have been given the opportunity to select the operating business, which Alibaba or Yahoo Japan would have then gone out and purchased before contributing to Splitco (assuming the selection comported with the ATB restrictions).[39]

But now that Altaba is merely a registered investment company, it may not care as much what it gets in return as long as it can be resold for as much or more value. Note that to ensure that it does not run afoul of the rules under section 355, Altaba would likely hold onto the Splitco's operating business for at least two years.

Another problem was highlighted in a January 8, 2015, letter to Yahoo, in which activist investor Starboard Value LP wrote that it did not think a cash-rich split-off was advisable because the total consideration package (the value of Splitco) Yahoo would receive in exchange for its stake in either Alibaba or Yahoo Japan "would likely be lower than the value that those assets would garner if they were traded as separate public entities."[40] As we note elsewhere, we expect any transaction to involve a discount imposed by the other participating party, no less in such an exchange with Alibaba.

In a cash-rich split-off scenario, it seems likely that Alibaba would require a considerably heavier lift than Yahoo Japan. In the case of Alibaba, it is unclear that such cooperation would be forthcoming. Yahoo Japan, on the other hand, might be an easier sell. Japanese holding company SoftBank controls 36.4 percent of the voting rights of Yahoo Japan,[41] and expressed interest in buying Yahoo when the American tech company was soliciting offers.[42] Back in 2015, one activist investor estimated that if Yahoo Japan were able to purchase and retire its shares

[38] REG-134016-15

[39] Dalton, Matthew, January 9, 2012, "Yahoo Cash-Rich Split-Offs Would Be Largest Ever," *Tax Notes*, Jan. 16, 2012, p. 281.

[40] http://www.prnewswire.com/news-releases/starboard-delivers-letter-to-ceo-and-board-of-directors-of-yahoo-inc-300017820.html.

[41] https://about.yahoo.co.jp/ir/en/holder/status.html.

[42] Swisher, Kara, September 9, 2016, "Yahoo sale proxy: A $145 million termination fee, 51 possible bidders and a scotched offer from Yahoo Japan," *recode* (https://www.recode.net/2016/9/9/12867842/yahoo-proxy-verizon-acquisition-japan).

held by Yahoo, Yahoo Japan shares "would go from ¥500 to ¥770 overnight," increasing the value of SoftBank's stake in Yahoo Japan by $5.5 billion U.S. dollars.[43]

* * *

Each of the above-described approaches to addressing Altaba's potential tax liability on its unrealized Yahoo Japan or Alibaba gain raises challenges and complexities. With that in mind, we present below two potential approaches that might be described as unconventional; we leave to the reader to gauge their viability from a practical perspective.

Tax Strategy #5: Conversion to an S Corporation

Subchapter S of the Internal Revenue Code provides a flow-through tax regime similar to that of partnerships for "small business corporations" meeting certain requirements and electing to be taxed under the S corporation rules. Despite the small business nomenclature, there is, in fact, no size limit on S corporations, and it is at least technically possible for Altaba to convert to an S corporation and ultimately escape corporate-level tax on its Alibaba and Yahoo Japan holdings.

The central requirement for S corporation status is that it can have no more than 100 shareholders, and the only permissible shareholders are U.S. citizens or resident individuals, certain trusts, section 501(c)(3) organizations and qualified pension plans. As a result, the central transaction must be a (presumably leveraged) buyout of Altaba by an investor group consisting of no more than 100 of these qualifying shareholders. After consummating this challenging transaction, Altaba may be converted to an S corporation.

Like a partnership, an S corporation generally passes through all of its taxable income, ordinary or capital, to shareholders who report it on their tax return and obtain a corresponding adjustment to their stock basis; this basis adjustment reduces taxable gain upon an eventual disposition of the shares. For a corporation that converts from C to S status, there is a five-year waiting period with respect to the recognition of built-in gains before the corporate level tax can be avoided. As a result, privately held Altaba would have to wait at least five years before disposing of its Alibaba and Yahoo Japan shares.

Of course, there are details to be managed. If an S corporation has E&P from C-corporation years, corporate-level tax is imposed on passive investment income; and excess passive investment income for three consecutive tax years can terminate S-corporation status.

---

[43] See SpringOwl Asset Management LLC's December 2015 Yahoo investor presentation at https://www.wsj.com/public/resources/documents/yahoopresentation.pdf.

Tax Strategy #6: Regulated Investment Company

As mentioned earlier, while Altaba will be a registered investment company under the securities laws, it will not be a RIC for tax purposes. The tax treatment of RICs is similar to that of real estate investment trusts in that RICs (essentially mutual funds) are taxable corporations, but enjoy the benefit of a dividends paid deduction that effectively wipes out the corporate-level tax.

Altaba will be taxed as a regular C corporation rather than as a RIC as a result of its failure to meet diversification rules specified in the tax law. Without going through the specifics of those rules here, it is possible for Altaba to become diversified by combining with one or more existing RICs and/or through contributions of cash or investment assets by investors, and thereafter becoming subject to taxation under the RIC regime.

Based on assumed market values of $48 billion and $9 billion for Altaba's holdings in Alibaba and Yahoo Japan, respectively, we estimate Altaba would need at least an additional $126 billion in adequately diversified investment assets in order to meet the diversification requirements.[44] Such diversified investment assets may include cash, government securities and holdings in other RICs.

As with the S corporation idea, conversion to a RIC would require a five-year waiting period before shares in Alibaba and Yahoo Japan could be sold without a corporate-level tax on the gain.

Structuring the business combination or contribution transactions in a tax-efficient manner will depend on the particular details. The tax-free reorganization rules and tax-free contribution rules each have provisions designed to penalize tax-free diversifying transactions, but we do not think these should in themselves block an otherwise viable plan. For example, a taxable acquisition by an existing RIC of the stock of Altaba, followed by a merger or liquidation of Altaba into the acquiring RIC, while resulting in taxable gain to the Altaba shareholders, would not trigger gain to Altaba itself.

[44] There are two main parts to the section 851 diversification requirements under the RIC tax rules—a 50-percent test (section 851(b)(3)(A)) and a 25-percent test (section 851(b)(3)(B)). The 50-percent test requires, in general, that at least 50 percent (by value) of a RIC's assets be made up of cash, cash items, government or other RIC securities, and/or other securities (except if the securities of one issuer represent more than 5 percent of the total assets of the RIC or if the securities of one issuer represent more than 10 percent of the issuer's outstanding voting securities, then those securities cannot count for the 50-percent test). The 25-percent test provides, in general, that no more than 25 percent (by value) of the RIC's assets can be invested in the securities of any one issuer (except if the issuer is a government or another RIC) or in two or more issuers (of which the RIC owns 20 percent or more and which are engaged in the same or related trades or businesses).

Akin Gump
STRAUSS HAUER & FELD LLP

Final Alibaba Strategy—Stay the Course

After a thorough examination of the above approaches to disposing of the underlying interest in Alibaba or converting the Altaba stock into a direct Alibaba stake, it is worth pausing to reconsider the approach actually articulated by management—dispose of the Yahoo Japan interest and hunker down as a pure-play indirect investment in Alibaba. It is worth asking what amount of discount the market would apply to the Altaba stock if it believed that this was the long-term strategy, as compared with the discount applied based on a belief that aggressive tax planning would be applied to eliminate Altaba as an Alibaba proxy.

Finally, we would like to bring up an issue that may present itself after (in theory, at least) all of the tax challenges have been met. If a non-controlling investor sought to sell a 15 percent block of stock in Alibaba, conventional valuation wisdom would attribute a "liquidity discount" to that block, which could be perhaps 15 percent to20 percent of the per share trading price. Arguably, even filtering out any discount attributable to taxes, the stock of Altaba should trade at such a discount to the aggregate per share pricing on the underlying Alibaba shares. Indeed, the more the market believes that it is management's intention to dispose of the Alibaba interest as a block (again, taxes aside), the more justified it would be in attributing a liquidity discount to the Alibaba block, and therefore, the Altaba shares.

If, instead, the market believed that the company's intention was to retain the Alibaba shares indefinitely and had no plan to dispose of them in either a taxable or tax-advantaged manner, it might more fully value the company's Alibaba holdings, and the absence of a liquidity discount would be reflected in the trading price of the Altaba stock.

Akin Gump Strauss Hauer & Feld LLP has a full tax team closely following developments in this area. Please feel free to contact any of them with any questions.

Stuart E. Leblang
Partner
sleblang@akingump.com
212.872.1017

Michael J. Kliegman
Senior Counsel
mkliegman@akingump.com
212.872.8124

Amy S. Elliott
Senior Attorney
aelliott@akingump.com
202.887.4039