'Meaningless Gesture' Guidance Not Limited to Abusive Situations

by Emily L. Foster

The potential broad applicability of recent guidance addressing situations in which a shareholder's stock has split holding periods and split basis continues to alarm practitioners, in part because of anomalies in the cross-border context.

The IRS has cautioned practitioners against thinking that a May 2020 generic legal advice memorandum (AM 2020-005) applies narrowly or applies too broadly, leaving some pondering the meaning of specific language.

The memorandum, commonly referred to as a GLAM, states that the two situations described represent common forms of transactions that the IRS understands "are being recommended to taxpayers as a means of artificially extending holding periods."

During a January 15 webinar hosted by the International Tax Institute, Gordon Warnke of KPMG LLP asked the government panelist — John Lovelace, branch 3 senior counsel, IRS Office of Associate Chief Counsel (Corporate) — whether the GLAM only applies to abusive transactions.

Lovelace said the facts in the GLAM involve a transaction that the IRS thinks is abusive, but he suggested that the analysis isn't limited to those types of situations. He pointed out that the memo relies heavily on, and in some ways extends, Rev. Rul. 85-164, 1985-2 C.B. 117, which "didn't involve an abusive transaction, and yet the holding period was split."

The IRS determined in the GLAM that if a shareholder owns all the stock of a corporation and later transfers money or other property to the corporation for no consideration — that is, in a meaningless gesture transaction — that transaction is subject to section 351(a).

The IRS concluded that the holding period of the portion of each share of the shareholder's stock attributable to that transaction is determined by referring to the transferred money or other property.

In the two situations discussed in the GLAM, a shareholder sells all its stock for a price that reflects unrealized appreciation in property more than a year after the initial transfer acquiring all of a corporation's stock, but less than a year after a subsequent transfer. The IRS said the shareholder's stock — to the extent attributable to the later transfer — has a holding period of less than one year at the time of the sale of the stock, and the gain attributable to the sale is short-term capital gain.

Kevin M. Jacobs of Alvarez & Marsal Taxand LLC asked how common the facts presented are. Is it the meaningless gesture contribution that's common, or is it having a negligible contribution upfront followed later by a sizable contribution?

According to Warnke, the facts in the GLAM are extreme and don't represent situations he has seen much of in practice — that is, shareholders making contributions of money or assets with the expectation of significant appreciation within one year.

Lovelace emphasized that a GLAM is intended to provide legal advice to an internal IRS organization on a type of transaction that the agency has seen. The generic advice is distinguished from a technical advice memorandum, which addresses a taxpayer-specific situation, he added.

In a GLAM, the IRS tries to consider a range of facts that might occur within the confines of the type of transaction it's addressing, Lovelace said.

"All we're saying is this is what we have seen," and it doesn't necessarily mean the transaction occurs all the time, Lovelace explained. "It's something that we may have seen at least once."

Beyond One-Year Holding Periods

Warnke asked whether the IRS's concern is the one-year holding period or whether the GLAM applies to provisions like section 1061 for carried interest, which has a three-year period and "would seem to be a more likely fact pattern."

The GLAM doesn't mention other code provisions that have longer holding periods, but it could apply in those contexts, Lovelace said, noting that the IRS was thinking more generally about holding periods. But he said, "There may be special situations to which [the advice] . . . wouldn't apply for whatever reason."

The GLAM states that "depending on the facts and circumstance, the same analysis could apply to similar situations, in which (i) Shareholder is not an individual; (ii) Shareholder initially

acquires Corporation's stock in a taxable transaction; [and] (iii) Corporation is not a domestic corporation," among other specified situations.

That statement is what is raising questions, Jacobs said, adding that the IRS could have issued the GLAM without it by just providing the fact pattern and the guidance and remaining silent on the myriad situations to which it could apply. He analogized that suggested approach to a revenue ruling in which the IRS provides a specific fact pattern and explains how the rules apply to it.

The challenge in setting the scope of GLAMs is that the IRS isn't responding to a specific set of facts, Lovelace said. He said taxpayers reading them always ask what facts the analysis applies to, and what facts it doesn't apply to. The GLAM is providing some indication of the scope, but it's always difficult to "come up with a very specific rule that applies to a broad range of facts," he added.

Lovelace cautioned practitioners against leaning toward a broad application of the GLAM analysis and instead suggested that they think about the factual variations to which the analysis could apply for a particular taxpayer's situation. He noted that in writing the GLAM, the Office of Chief Counsel didn't want the Large Business and International Division — to which the advice was provided — to think that the analysis only applies narrowly to the specific set of facts.

Only When Holding Period Matters?

Warnke pointed out that in Rev. Rul. 85-164, which the GLAM cites, the initial transaction doesn't involve a capital contribution because stock and securities are issued in exchange for property.

In that ruling, the aggregate basis of different assets transferred to a controlled corporation in a section 351 exchange is allocated among the stock and securities received in proportion to their fair market values. The stock and securities have a split holding period determined by reference to the assets deemed exchanged for purposes of determining gain or loss.

"If part or all of the stock or securities received in the exchange is disposed of at a time when the split holding period is relevant in determining tax liability, the same fractions will be applied to apportion the amount realized among the [two] components of the stock or security," the ruling says. One component relates to a receivable, and the other to real estate and machinery.

The ruling only requires that the amount realized be bifurcated between the segments for as long as the holding periods are relevant, Warnke observed, asking whether it was intentional that the GLAM doesn't include that language.

Lovelace suggested that practitioners not infer anything by the absence of that language. He explained that the generic advice was intended to address the holding period, which is a two-step process — to split the holding period you have to split basis. Lovelace pointed out that the memo doesn't address whether basis is split for other purposes, but that that might be the case in some situations.

Lovelace agreed that Rev. Rul. 85-64 could be read as limiting basis splitting to situations involving holding periods for purposes of determining short- and long-term capital gain. "That's a fair reading, although I don't think it's necessarily the only reading," he added.

The GLAM could apply to other provisions of the tax code, but if taxpayers have questions about applying it to sections 245A, 1059, or 1061, the IRS might consider addressing them, Lovelace said.

'Mind-Numbing Complexity'

The advice memo suggests that LB&I consider whether to apply the GLAM analysis if the subsidiary isn't a domestic corporation, which raises the question of how to apply it in the international context, Jacobs said.

Jacobs turned to section 367(c)(2), which provides for a deemed issuance of shares in the context of a contribution of capital to a foreign corporation, and asked what happens after the deemed issuance of shares and whether the GLAM would apply. He cited two revenue rulings (Rev. Rul. 82-112, 1982-1 C.B. 59; and Rev. Rul. 70-291, 1970-1 C.B. 168) that he said suggest that the shares wouldn't be segmented, but rather that the shareholder's basis in the shares would increase.

Lovelace emphasized that the IRS isn't saying whether the GLAM applies in that context, but rather is identifying a situation that should be considered. He suggested that if the advice memo

didn't reference a situation involving a foreign corporation, people would likely have inquired about it.

According to Warnke, the GLAM could create "mind-numbing complexity" if it actually applies in the foreign context. For example, he asked whether the stock of a subsidiary would have to be valued each time there is an actual or deemed contribution, such as any transfer of property to a subsidiary, tax sharing payments, or payments of a liability by a parent on behalf of a subsidiary.

Jacobs posited a situation in which a shareholder of a U.S. subsidiary has one share with two segments under the GLAM, but rather than sell the stock, the shareholder contributes property for additional stock, making it an actual section 351 exchange.

Jacobs asked whether, if the corporation later makes a distribution to the shareholder, there would be three segments — two for the initial share, and one for the later stock received — for purposes of the distribution rules under section 301(c)(2), the section 245A dividends received deduction, and the section 1059 stock basis reduction rules.

Jacobs also inquired whether it's possible for the GLAM approach to apply for one part of a provision and not for another.

That's a possibility, Lovelace said, but he noted that the GLAM didn't specifically address those code sections, so people "shouldn't infer whether the same analysis, if done in those contexts, would produce the same result or not."

Jacobs pointed out that the IRS has "historically said that the fundamental unit of property is a share of stock," and asked whether the GLAM is rejecting or pivoting from that approach by saying that taxpayers must take into account smaller pieces.

"The view is that a share of stock is the fundamental unit of priority unless it isn't, and that was already the rule under Rev. Rul. 85-164, and nothing has changed," Lovelace said.

Teeing Up Issues

Warnke described a situation in which a U.S. shareholder's basis in the stock of a foreign subsidiary is $100. In year 2, the foreign subsidiary earns $10 in cash, which is an inclusion in income under section 951(a), and therefore results in a corresponding $10 increase in the shareholder's basis in the stock under section 961(a).

Warnke asked whether the shareholder would need to bifurcate its basis between the $10 and $100 segments. He noted that a government official has suggested that the answer is no, saying that the section 951(a) income is merely added to the shareholder's basis in the stock.

That seems like the right answer, Warnke said, but it appears that whether the basis is segmented could depend on whether the earnings are at the foreign corporation level or the U.S. shareholder earns the income elsewhere and contributes the cash to the corporation.

Other complexities and anomalies could arise if segmentation applies in the foreign context when considering the previously taxed earnings and profit rules and the interplay between the section 1248 gain recognition rules and basis reduction under section 1059, Warnke said. He said the latter would be a nightmare and a reason why segmentation shouldn't apply in cross-border situations.

Jacobs wondered whether the underlying policy to determine the application of the GLAM is based "on the section or subsection to which the segments would then be relevant, or is it . . . the artificial expansion of the holding period, and as a result of that, [the] policy is at the time of the contribution?"

Lovelace emphasized that the GLAM was developed as an extension of Rev. Rul. 85-164 to cover situations in which shares weren't issued. "That's really all we thought we were doing," he said. ■