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Initial impressions: IRS "GLAM" requiring holding-period segmentation when cash or property contributed to corporation without issuance of shares



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On May 22, the Office of Chief Counsel of the Internal Revenue Service ("IRS") issued a Generic Legal Advice Memorandum ("GLAM")[1] concluding that when a shareholder contributes cash or property to a wholly-owned corporation in a transaction qualifying under section 351 of the Internal Revenue Code, but no new shares are issued by the transferee corporation, the holding period of the portion of each share of the transferor's stock that is attributable to the contribution is determined by reference to the transferred money or other property. The GLAM does not constitute published guidance, and it does not have precedential effect. It does, however, stake out the IRS's position on an issue as to which there has been considerable uncertainty—whether a shareholder's holding period in its pre-existing stock remains unaffected when the shareholder contributes cash or other property to a wholly-owned corporation without the issuance of new shares, or whether instead the contribution results in segmentation of the holding period. This issue has been the subject of considerable discussion as it relates to investments made by private equity funds in their corporate portfolio companies to finance "add-on" investments in light of section 1061 of the Code, which requires a three year holding period for certain private equity fund sponsors to qualify for long-term capital gains treatment on carried interest allocations. The GLAM does not specifically address private equity add-on investments, but its reasoning appears to apply equally in that context, and the position set forth in the GLAM could also have implications for a number of other Code provisions that require compliance with stock holding period requirements to qualify for particular tax benefits.

This *TaxNewsFlash* first describes the GLAM and its reasoning. It then offers some initial impressions regarding the GLAM and the implications of its holding period segmentation conclusion.

The GLAM

The GLAM begins by stating that the IRS has become aware of transactions "that purport to result in holding periods for corporate stock that are longer than the period of economic investment." As examples of these transactions, the GLAM describes two fact patterns. In each fact pattern, on January 1, Year 1, an individual contributes property with negligible value to a newly formed corporation in exchange for all of the corporation's stock in a transaction qualifying under section 351.

In Situation 1, the shareholder transfers "a substantial amount of money" to the corporation on August 1, Year 1, and the corporation invests in property that increases in value. On February 1, Year 2, the shareholder sells all of the stock, recognizes gain, and the shareholder claims that the stock had a holding period of more than one year at the time of the sale—*i.e.,* based on the January 1, Year 1 date of the original contribution, not the August 1, Year 1 contribution of the cash that funded the corporation's property investment.

Situation 2 of the GLAM is similar but involves a property rather than a cash contribution. In that Situation, on March 1, Year 1, the shareholder invests "a substantial amount of money" in property that appreciates in value. The property is then contributed to the corporation on August 1, Year 1, and as in Situation 1, the shareholder sells the stock on February 1, Year 2. The shareholder claims a holding period of greater than one year based on the original contribution date rather than the date the shareholder acquired the property.

The GLAM's analysis starts with the proposition that a shareholder's contribution of money or property to a wholly-owned corporation is treated as qualifying under section 351 even if no stock is issued by the

[1] AM 2020-005 (May 29, 2020). A GLAM is a form of advice issued by the Office of Chief Counsel to IRS national program executives and managers to assist them in administering their programs by providing advice on specific matters, such as industry-wide issues.

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transferee corporation under the so-called "meaningless gesture" doctrine: that is, actual compliance with the statutory requirement that there be an "exchange" of stock for the contributed cash or property is not required because the issuance of additional shares to a shareholder that already owns 100% of the shares would be a meaningless gesture.

The GLAM then asserts that after the subsequent transfer to the corporation in each situation, the shareholder's stock has a split basis and split holding period, reflecting each of the two separate transfers to the corporation. The GLAM reasons that a split basis/split holding period result "reflect[s] the economics of the transactions" because after the subsequent transfer in each situation, a portion of the value of each share is attributable to the value added by the subsequent transfer. The GLAM also reasons that the basis of the shareholder's stock will include the transferred cash or the basis of the transferred property; splitting the basis of each share is consistent with the treatment of a section 351 exchange in which a transferor transfers multiple assets to a corporation and stock is actually issued; and "[i]ncluding the amount of the money or the basis of the transferred property in the stock's basis without a corresponding adjustment to the stock's holding period would be inconsistent with the principle that the holding period of property tracks the sources of the property's basis."

Based on this reasoning, the GLAM determines that in each of Situation 1 and Situation 2, the holding period of the portion of the stock that is attributable to the subsequent transfer of cash or property is less than one year at the time of the stock sale, and accordingly gain from the sale of such portion of the stock is short-term capital gain.

The GLAM recommends that the IRS challenge transactions in which a shareholder's purported holding period in the stock of a wholly-owned corporation ignores the effect of these stockless contributions. The GLAM also indicates that its reasoning is intended to extend beyond the fact patterns described in the GLAM itself. Although the situations addressed by the GLAM are described as ones that the IRS understands are being recommended to taxpayers to "artificially extend holding periods," the GLAM states that, depending on the facts and circumstances, the same analysis could apply to similar situations, including cases in which (i) the shareholder is not an individual, (ii) the shareholder acquires the corporation's stock in a taxable transaction, (iii) the corporation is not a domestic corporation, (iv) the relative values of the initial and subsequent transfers are different from those set forth in Situations 1 and 2, (v) stock is issued by the transferee corporation but the value of the stock issued is not commensurate with the cash or property transferred to it, (vi) the shareholder is not the sole shareholder of the corporation but the relationship between the shareholder and the other shareholders is such that the subsequent transfer for no consideration represents compensation, a gift, or another transfer of value from the shareholder to the other shareholders, or (vii) the shareholder does not dispose of all of the stock in a single transaction.

The GLAM further notes that depending on the facts and circumstances, the IRS may challenge these transactions on other grounds, including based on the economic substance doctrine, the substance over form doctrine, or other theories. In appropriate cases, the GLAM suggests that that the IRS may seek to impose accuracy related penalties.

Implications

The GLAM is fairly viewed as sending a strong signal to taxpayers in an area in which the law has been unsettled, a state of affairs that is due in significant part to the absence of published guidance on the

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issue.[2] The Office of Chief Counsel apparently believes, and is prepared to litigate, that taxpayers are claiming inappropriate benefits by taking the position that a contribution of cash or property to a wholly-owned corporation without the issuance of stock has no impact on holding period.

In terms of initial impressions, we have the following observations about the GLAM and its potentially far reaching implications:

- For a technical issue that has engendered considerable debate, the GLAM's reasoning is relatively sparse. There is no attempt to address contrary arguments, and there are other authorities that could be taken into account in a more fulsome analysis.

- While the specific fact patterns addressed by the GLAM are narrowly drawn and perhaps unlikely to occur very often in practice, the authors of the GLAM presumably had their sights set on a broader range of cases. Indeed, the GLAM by its terms provides that its reasoning can be extended to a wide range of "similar cases," including ones that may involve less extreme fact patterns.

- In the private equity space, where section 1061 extends the required holding period to three years for holders of applicable partnership interests ("APIs") to qualify for long-term capital gains treatment with respect to certain carried interest allocations, the GLAM has significant implications for cash contributions by funds to wholly-owned corporate portfolio companies to fund add-on investments.[3] If the IRS position is upheld, such a contribution without the issuance of new shares by the portfolio company would cause holding period segmentation of the fund's existing stock. This, in turn, would result in gain recognized in an exit transaction occurring in the succeeding three years with respect to the segment attributable to the additional contribution being treated as short-term rather than long-term to API holders. As such, the GLAM provides additional impetus for fund sponsors to consider planning measures to mitigate the potential holding period implications associated with follow-on contributions, including for example the issuance of preferred stock or debt for such contributions to limit the amount of gain that would be treated as short-term.

- The potential implications of the position taken in the GLAM extend well beyond private equity add-on investment context. There are numerous Code provisions that require compliance with holding period requirements to qualify for tax benefits in addition to the one year holding period requirement for long-term capital gain under section 1222 and the three year holding period required under section 1061 for gain with respect to APIs. Among the provisions that could potentially be impacted by holding period segmentation under the GLAM's approach are:

    - Section 1202, which requires satisfaction of a five year holding period to qualify for the benefits associated with qualified small business stock ("QSBS").

    - Sections 243 and 245A, which require satisfaction of holding period requirements for a corporation to qualify for a dividends received deduction with respect to dividends received from domestic and foreign corporations, respectively.

- The GLAM approach raises numerous practical issues, especially relating to valuation and segmentation.

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[2] Proposed regulations were published in 2009 that would have addressed this and other issues, but those proposed regulations were withdrawn. See 84 Fed. Reg. 11686 (Mar. 28, 2019).

[3] While it is unknown whether there is any connection between the two, it is noteworthy that the GLAM was issued shortly before the proposed section 1061 regulations were returned to the Office of Information and Regulatory Affairs ("OIRA") for review on June 2.

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- The GLAM's segmentation approach appears to require valuation of the existing stock in the transferee corporation and, if applicable, the contributed non-cash property to determine the portion of the stock that will be treated as attributable to the subsequent contribution for purposes of splitting the basis and holding period of the stock. Undertaking such valuations may be difficult enough in the case of "one-off" contributions, such as, for example, a private equity fund's contribution of cash to finance an add-on investment. But it becomes positively daunting if the segmentation principle were extended to cover periodic, ordinary course infusions of cash by a parent corporation to a domestic or foreign subsidiary to finance working capital needs.

- The GLAM is intended as a statement of existing law that would presumably be applied by revenue agents in audits of open years. As such, it raises the potential for taxpayers to have to revisit their approach to prior meaningless gesture contributions and determine appropriate valuations/segmentation in retrospect.

- Among the technical issues presented by the GLAM are:

  - How to apply the segmentation approach when the contributing shareholder owns multiple classes of stock in the transferee corporation.

  - Whether the basis segmentation persists once the relevant holding period requirements are satisfied.

  - Whether and when the approach might be applied to non-pro rata contributions to capital.

Conclusion

The GLAM clearly signals the IRS's position on mandatory holding period segmentation when no stock is issued in exchange for a contribution of cash or property by a shareholder to a wholly-owned corporation. It is reasonable to expect that there may be increased audit activity and eventually litigation regarding this issue, in turn resulting in a potentially extended period of uncertainty and providing additional impetus for taxpayers to consider planning measures to limit the potential for segmentation to adversely affect outcomes.

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