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GLAM 2012-007

The IRS Chief Counsel advises the field in this general legal advice memorandum (GLAM) that a subsidiary does not enter a corporate group when the common parent buys the stock needed for affiliation for a note carrying below-market interest so as to compel the seller to exercise its right to take the stock back after two years.

Although the particular facts may be uncommon, the GLAM is of more general interest to taxpayers because it shows the IRS placing great reliance on the "benefits and burdens" theory of tax ownership in the context of consolidated return affiliation. Unfortunately for taxpayers, this theory of determining ownership of property carries the potential to upset a variety of common business transactions in which property ownership has been conveyed.

The Facts

Parent owns the majority—let's say 51 percent—of the vote and value of Company, which is publicly traded. Counterparty owns a substantial minority of the Company stock—let's say 29 percent. Parent buys the 29 percent of Company stock from Counterparty for a note for fair market value, but bearing interest that is less than one-third of market interest. The note term is longer than six years and is secured by the purchased stock. The security agreement prevents Parent from receiving any more than the prior average cash distribution from Company; Parent cannot sell the Company stock. At the end of two years, Counterparty can swap the note for the stock. If it does not elect the swap, the security agreement terminates. At all times, Parent can vote the stock.

The GLAM assumes the "high probability" that Counterparty will swap the note for the stock after two years because of the inadequacy of the interest on the note. Also, if Counterparty does not take the stock back after that time, it will not be entitled to any excess distributions on the stock and will not be secured because the pledge agreement will be terminated. It will have an unsecured right to be paid the original value of the stock it sold, and it will have received any abnormal dividends during the first two years after the sale.

What Is Going On?

It is hard to see how the IRS could be so certain about the unwinding of the deal after two years, particularly since the GLAM does not let the reader in on what was really going on. Obviously, either Parent, Counterparty or both wanted some benefit that they thought could be obtained by having Company in Parent's group. That would not be use of Company's net operating losses (NOLs) by the Parent group, because they would be limited to Company's income under the Separate Return Limitation Year (SRLY) regulation.

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What about the other way around? What if the Parent group has losses that it cannot use and Company has income? More specifically, perhaps Company anticipates recognizing an abnormal gain that could be sheltered by the Parent group losses. Company might then make an abnormal distribution to which Counterparty would be entitled under the terms of the pledge agreement. That distribution would be larger than it otherwise would have been, because Company will not pay tax on it. Indeed, Parent will benefit more than Counterparty if there is such a distribution because it is entitled to 51 percent of the distribution and Counterparty will receive only 29 percent.

Perhaps the low interest rate on the note is equal to or less than the normal dividends Company pays. This means that even if the abnormal sale and distribution do not occur, Parent is not harmed by the transaction.

So this is the basic rent-a-deduction scheme that is attempted in the intermediary transactions and elsewhere. However, in this case, it is more likely to work because Section 269 cannot be applied (no control is acquired) and Section 384 cannot be applied (no control is acquired). Therefore, the GLAM comes up with a different defense.

Legal Analysis

The GLAM asserts that under the "benefits and burdens" theory of ownership, Parent never acquired ownership of the 29 percent of Company stock and so it never entered the Parent group. The IRS has embraced this theory as clear law—but it is not.

The very first authority cited in the GLAM, but not discussed, is *Commissioner v. Brown*, 380 U.S. 563 (1965). This case involved a sale to/leaseback from a charity. The IRS argued that no sale occurred because the seller retained the benefits and burdens of the property through the terms of the sale and the lease. The Supreme Court disagreed, stating:

> Furthermore, risk-shifting of the kind insisted on by the Commissioner has not heretofore been considered an essential ingredient of a sale for tax purposes…. To require a sale for tax purposes to be to a financially responsible buyer who undertakes to pay the purchase price from sources other than the earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a sale. The term "sale" is used a great many times in the Internal Revenue Code and a wide variety of tax results hinge on the occurrence of a "sale." To accept the Commissioner's definition of sale would have wide ramifications which we are not prepared to visit upon taxpayers, absent congressional guidance in this direction.

Conclusion

Corporate groups with NOLs they can't use are fairly common. Marrying another taxpayer's income with those NOLs is a common plan that can be appropriately carried out. Such plans face the obvious limits aimed at them mentioned above, like Sections 269, 382 and 384, as well as the SRLY rules. Taxpayers need to be aware that the IRS will also assert the "benefits and burdens" test and need to be prepared to structure around it—and if necessary, contest it.

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