# Tackling Taxes

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## Tackling Disappearing Debt in Nontaxable Corporate Transactions–Part II

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In our April TAXES column, we explored the current guidance and unsettled issues of debt extinguishment when debtors transfer their debts to their creditors in nontaxable corporate transactions. This column will tackle the current status of debt extinguishment when creditors transfer debts to the debtors (herein referred to as the "Creditor-to-Debtor Transfers").

In this column, we will examine the income tax consequences of three types of nontaxable corporate transactions within the separate return context:

1. Transfers to controlled corporations under Code Sec. 351
2. Subsidiary liquidations under Code Sec. 332
3. Acquisitive reorganizations under Code Sec. 368(a)

Unless stated otherwise, both the transferor and the transferee corporations are solvent for purposes of this tax column. The next column will explore the income tax consequences within the consolidated return context.

## Asset Basis Reductions

Let's begin our journey in wonderland by first exploring the asset basis reduction rules under Code Sec. 362(e). This Code section may be relevant in a debt extinguishment involving a Creditor-to-Debtor Transfer where the transferee corporation is deemed to first acquire its debt from the transferor corporation and then satisfy the debt at fair market value (FMV).

In general, the basis of property acquired by a corporation in certain nontaxable transactions is equal to the basis in the hands of the transferor (generally referred to as "carryover basis").[1] These nontaxable transactions include (1) Code Sec. 351 transfers, (2) capital contributions, (3) corporate reorganizations under Code Sec. 368(a), and (4) Code Sec. 332 liquidations.

However, as a result of the enactment of the American Jobs Creation Act of 2004,[2] the carryover basis provided by Code Sec. 362 (a) or (b) is subject to reduction under Code Sec. 362(e). This reduction generally applies only to the first three types of nontaxable transactions described above. Code Sec. 334(b)(1), which deals with the basis of assets received in a corporate liquidation, applies a similar basis reduction for the last category of nontaxable transactions above when property is transferred in a transaction described in Code Sec. 362(e)(1)(B).

As discussed below, Code Sec. 362(e) has two sets of basis reduction rules. The Code Sec. 362(e)(1) rules primarily affect transfers of assets from foreign entities to U.S. corporations. The (e)(2) rules only deal with transfers under Code Sec. 351 and capital contributions.

## Code Sec. 362(e)(1) Basis Reduction Rules

Under Code Secs. 362(e)(1) and 334(b)(1), the tax basis of property received in the four types of nontaxable transactions listed above is reduced to the property's FMV if the following three requirements are met:

1. The property would not be subject to U.S. income tax in the hands of the transferor if it were disposed of immediately before the transfer.
2. The property would be subject to U.S. income tax in the hands of the transferee (*i.e.,* acquiring corporation) if the property received in the transfer was disposed of immediately after the transfer.
3. The transferee's aggregate adjusted basis in all transferred property exceeds the aggregate FMV of all property transferred immediately after the transfer (the "net built-in loss").

If all of the three requirements are met, the basis of each property received in the transaction is adjusted to its FMV at the time of the transfer.[3] As all assets transferred in the same transaction are aggregated for this purpose, assets with built-in gains are marked up and built-in loss assets are marked down to their respective FMV. The possibility for property to be marked up without incurring an immediate U.S. tax liability is quite rare under the Code, and planning opportunities may exist as a result.

Because this basis reduction rule applies only when the property is not subject to U.S. income tax in the hands of the transferor, it primarily applies to assets transferred from a foreign person to a U.S. corporation. In essence, the purpose of this rule is to prevent perceived abuse of importation of built-in losses to U.S. corporations. For example, if a foreign person held an asset with a basis of $100 and a FMV of $25, the transfer of that asset to a U.S. corporation could allow for the asset to be sold by the U.S. corporation and generate a $75 loss even though the loss originally occurred at a time when it would not have been deductible for U.S. income tax purposes. This basis reduction rule can also apply when a nonprofit entity transfers property to a taxable subsidiary (*e.g.,* a nonprofit healthcare organization transferring property to a taxable hospital subsidiary). For purposes of this column, we assume the nontaxable transactions involve only U.S. taxable persons and this basis reduction rule is not applicable.

## Code Sec. 362(e)(2) Basis Reduction Rules

Code Sec. 362(e)(2) only applies to Code Sec. 351 exchanges or capital contributions. Unlike Code Sec. 362(e)(1), this provision can apply to domestic, foreign or cross-border transfers. The purpose of this rule is to prevent the duplication of built-in loss in the basis in the stock of the transferee corporation and in the basis of transferred assets held by the transferee corporation.

This basis reduction only applies in the separate return context. Reg. §1.1502-80(h)(1) provides that Code Sec. 362(e)(2) does not apply to transfers between members of a consolidated return group. However, the anti-abuse provisions of Reg. §1.1502-80(h)(2) may still provide similar treatment to the extent that the loss duplication principles of the consolidated return regulations are not respected.

Unlike Code Sec. 362(e)(1), Code Sec. 362(e)(2) requires only the basis of the built-in loss assets to be adjusted if the following three requirements are met:

1. The property is transferred in a Code Sec. 351 exchange or a capital contribution.
2. The loss importation rule of Code Sec. 362(e)(1) does not apply.
3. The aggregate adjusted bases of all property transferred exceed the aggregate FMV of all property transferred.

The aggregate basis reduction is the net built-in loss (*i.e.,* the excess of aggregated adjusted bases over the FMV) of the assets transferred.[4] The aggregate basis reduction is allocated among the transferred property in proportion to their respective built-in losses immediately before the transfer.[5]

Under Code Sec. 358(a)(1), the basis of the stock equals the basis of the property contributed to the transferee corporation, increased by gain recognized or decreased by any loss recognized and any cash or property received by the transferor in the exchange. This asset basis adjustment rule for built-in loss assets prevents loss duplication that would occur if both the bases in the transferred assets and the basis in the stock include the built-in loss.

Instead of the transferee corporation reducing the basis of the assets received in the transfer, Code Sec. 362(e)(2)(C) provides an election in which the transferor may reduce the basis of the stock it receives. This election must be jointly made by the transferor and the transferee.[6] The total amount of the basis reduction on the stock received is the same amount that would be taken on the transferred assets if the election were not made.[7] The stock basis reduction election is valuable because it shifts the basis reductions away from potentially depreciable or amortizable assets to stock.

> Until there is substantial authority provided otherwise, Rev. Rul. 74-54 and *Gilmore Est.* appear to support the position of no income or gain recognition for the corporate shareholder.

For purposes of this tax column, we assume that the aggregate adjusted bases of the property transferred do not exceed the aggregate FMV, and therefore, an acquiring corporation's debt received from the transferor is not subject to basis reduction

In cases where there is a potential for debt basis reduction, consideration should be given as to whether an election to reduce stock basis under Code Sec. 362(e)(2)(C) is feasible and *beneficial.*

## Transfers to Controlled Corporations

In a transfer of a controlled corporation's debts to the controlled corporation, Code Sec. 351 governs the shareholder's income tax consequences on such transfer. For the controlled corporation, Code Sec. 108 provides key guidance on its income tax treatments.

### Code Sec. 351

Code Sec. 351 generally provides that no gain or loss is recognized on the transfer of "property" to a corporation in exchange for stock (other than nonqualified preferred stock described in Code Sec. 351(g)) in the corporation by a transferor or transferors that are in control of the corporation immediately after the transfer. Therefore, a shareholder will not recognize gain or loss from transferring property, including debt of the controlled corporation, to the controlled corporation under Code Sec. 351(a) as long as it is in control of the controlled corporation after the transfer.

For purposes of Code Sec. 351, not everything is considered "property." For example, according to Code Sec. 351(d), property does not include accrued interest on the controlled corporation's debt or any such debt that is not evidenced by a "security." The term security lacks a precise definition. While various factors are considered in determining whether a debt is a security, the term to maturity generally plays the most important role. Although there is no established minimum length of term, an obligation generally should have a term of five years or more before classification as a security could be entertained.[8] As a result, a shareholder is not estopped from recognizing a loss under Code Sec. 351 on the transfer of open-account debts (which generally are not evidenced by a security) if the value of stock received is less than the open-account debt. However, consideration should be given to whether the loss may be disallowed under Code Sec. 267(a)(1) or other applicable guidance.

It is fairly common for a shareholder to forgive debt by contributing the debt to the capital of the debtor corporation. From the shareholder's perspective, the contribution of the debt should be nontaxable, unless the capital contribution also qualifies as a Code Sec. 351 transfer and the debt is not evidenced by a security such as an open account debt. In *P. Fink*,[9] the Supreme Court stated that "[i]t is settled that a shareholder's voluntary contribution to capital has no immediate tax consequences … Instead, the shareholder is entitled to increase the basis of his shares by the amount of his basis in the property transferred to the corporation … This rule applies not only to transfers of cash or tangible property, but also to a shareholder's forgiveness of a debt owed to him by the corporation."

## Code Sec. 108(e) Governs Debt Extinguishment

While the income tax treatment of a controlled corporation on debt extinguishment may be found in Code Secs. 118 and 1032, the guiding force is Code Sec. 108(e).

Under Reg. §1.61-12(a), a shareholder's gratuitous cancellation of debt of a corporation is generally treated as a capital contribution to the extent of the principal of the debt. Code Sec. 118(a) provides that "[i]n the case of a corporation, gross income does not include any contribution to capital of the taxpayer." Code Sec. 1032(a) provides that "[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation."

Notwithstanding the above rules, Code Sec. 108(e) governs the federal income tax treatment of a debtor corporation on the contribution of its debt to the corporation by a creditor. Specifically, Code Sec. 108(e) provides two sets of rules for determining whether a debtor corporation may have cancellation of debt (COD) income.

## Code Sec. 108(e)(6) Governs Capital Contributions

The first set of rules is provided by Code Sec. 108(e)(6) and specifically overrides Code Sec. 118 when a debtor corporation acquires its debt from a shareholder as a capital contribution. The debtor corporation is treated as if it has satisfied the indebtedness with an amount of money equal to the shareholder/creditor's adjusted basis in the debt. Neither the statute nor the regulations thereunder provide the standard of measure for the amount of indebtedness. Reg. §1.61-12(a) provides that "[a] taxpayer may realize income by the payment or purchase of his obligations at less than face value." Hence, it seems that the amount of debt should be the adjusted issue price, which should be equal to the face amount of the debt for most intercompany obligations. As explained below, typically the amount of the debt and the adjusted issue price are the same because, in most cases, there is no original issue discount (OID) on intercompany debts.

Under Code Sec. 108(e)(6), the debtor corporation recognizes COD income on a capital contribution of the debt only to the extent that the shareholder/creditor's basis in the debt is less than the adjusted issue price (typically the face amount) of the contributed debt. Thus, if the shareholder/creditor's basis in the debt equals the adjusted issue price of the contributed debt, the debtor corporation would have no COD income from the contribution.

In broad terms, adjusted issue price, as defined in Code Sec. 1272(a)(4), is the original issue price adjusted for accrued but unpaid OID and amortization of any issuance premium. In most instances, the face amount of an intercompany debt should equal the adjusted issued price since most intercompany debts are not originally issued at a discount or a premium. The adjusted basis of the debt should typically be equal to the face amount of the debt of a solvent debtor because it is unlikely that the shareholder/creditor would have claimed a partial business bad debt deduction under Code Sec. 166(a). Accordingly, the debtor typically should have no COD income if its debt is contributed to capital.

## Code Sec. 108(e)(8) Governs Stock Exchanges

The second set of rules is in Code Sec. 108(e)(8), which applies when a debtor corporation transfers its stock to a creditor in satisfaction of its debt. Under this rule, the debtor is treated as having satisfied the indebtedness in an amount equal to the fair market value (FMV) of the stock exchanged for the debt. The debtor corporation recognizes COD income to the extent that the adjusted issue price (typically the face amount) of the debt exceeds the FMV of its stock exchanged for the debt.

When a single shareholder owns 100 percent of the stock of a corporation, the courts and the IRS have held that the issuance of additional shares of stock in exchange for property transferred to the corporation would be a meaningless gesture.[10] Under this "Meaningless Gesture Doctrine," shares are deemed issued to the shareholder for purposes of satisfying the exchange requirement of Code Sec. 351. This raises the issue of whether the Meaningless Gesture Doctrine applies for Code Sec. 108(e) purposes.

IRS private letter rulings supported the position that the form of the transaction should be respected in determining whether Code Sec. 108(e)(6) or 108(e)(8) applies to a transaction.[11] In particular, LTR 201016048[12] clearly showed that the form of the transaction governed which provision would apply.

In this private ruling, a U.S. corporation had outstanding debt owed to its foreign parent corporation. The foreign parent cancelled the debt in exchange for shares of stock with FMV equal to the amount of the debt. This stock exchange was later rescinded. Instead of an exchange of stock for debt, the transaction was restructured to qualify as a capital contribution under Code Sec. 108(e)(6). Under the plan, the U.S. corporation would issue a single share of stock in exchange for an amount of debt with a FMV equal to the FMV of the single share of stock and the foreign parent would cancel the remaining debt as a capital contribution. The single share of stock that was issued for debt was cancelled shortly after the capital contribution.

The IRS held that the initial rescinded stock exchange was disregarded for federal tax purposes. The single share of stock that was issued and cancelled shortly thereafter was transitory in nature and was also disregarded. Therefore, the final transaction was a capital contribution subject to Code Sec. 108(e)(6), rather than an exchange subject to Code Sec. 108(e)(8).

## Unclear Interactions Among Code Sec. 108(e) Provisions

While it seems fairly clear that the form of the transaction is important in determining which Code section applies, we have not found any specific guidance on whether a single transaction can be bifurcated into part stock exchange and part capital contribution. It is unclear whether both Code Secs. 108(e)(6) and 108(e)(8) can apply to a bifurcated transaction.

Also, there is a lack of clear guidance on how a transaction should be treated when a shareholder contributes only a portion of debt to capital. It is unsettled if a partial debt contribution should be treated as (1) a capital contribution of a partial debt governed by Code Sec. 108(e)(6), or (2) a significant modification of debt that would be treated under Reg. §1.1001-3 as an exchange of old debt for new debt governed by Code Sec. 108(e)(10).

As illustrated below, the income tax consequences can be significantly different depending on which provision is applicable to a partial debt contribution.

> **Example 1.** ***Facts.*** Parent corporation A holds a debt owed by S, a wholly owned subsidiary. The debt has a face amount and an adjusted issue price of $100. To improve the financial position of S, A contributes $50 of the debt to the capital of S and continues to hold the remaining debt of $50.
>
> ***Analysis.*** This partial debt contribution raises the issue of whether the contribution of $50 in debt is a capital contribution governed by Code Sec. 108(e)(6), or an exchange of an old debt with a face amount and adjusted issue price of $100 for a new debt with a face amount and issue price of $50 governed by Code Sec. 108(e)(10). Under Code Sec. 108(e)(6), the partial debt contribution should not trigger any COD income. However, under Code Sec. 108(e)(10), S would recognize COD income of $50.

It would be very harsh if a solvent S is required to recognize COD income on a partial debt contribution. Although the COD income is excluded from income under Code Sec. 108(a)(1)(B) to the extent that S is insolvent, it is generally not a free ride. S is still required to reduce its tax attributes under Code Sec. 108(b).

It would seem more conceptually sound that there would be no COD income. In FSA 200146013,[13] the IRS seems to accept this view. The IRS held that a U.S. subsidiary did not recognize income or gain when its foreign parent corporation contributed a promissory note of the U.S. subsidiary in exchange of a new note and the "deemed issuance" of common stock of the U.S. subsidiary.

In this FSA, the IRS stated:

> If the Service accepts that there was a deemed issuance of stock of Taxpayer with a fair market value equal to the outstanding balance of Old Note (taking into account the issuance of the New Note), the Old Note is repaid in full, and there is no cancellation of indebtedness income. If the Service does not respect the deemed issuance of stock, however, there would be cancellation of indebtedness income to the extent of the difference between the amount of the New Note … and the Old Note …

The holding in this FSA showed that the IRS accepted the view that a debt may be exchanged for a new debt and the deemed issuance of stock as a part of a single transaction. While this FSA might not be directly on point in that it seems to create a deemed issuance of stock and not a deemed contribution to capital, it does provide some support that there should be no COD income in a partial debt contribution. However, it is also possible that the deemed issuance of stock in the FSA was necessary because the IRS did not accept the position that a portion of the debt could be contributed to capital while the rest was exchanged for new debt. Additional guidance clarifying this issue would be welcome.

## Subsidiary Liquidations

Under Code Sec. 332, a subsidiary liquidation is not taxable to a corporate shareholder owning at least 80 percent (by vote and value) of the stock of the liquidating subsidiary. Code Sec. 337 provides that the liquidating subsidiary does not recognize gain or loss from the liquidation. Based on Code Sec. 337(a), no gain or loss should be recognized by the liquidating subsidiary on the distribution of the debts of its parent corporation. It is not clear whether a corporate shareholder should recognize income or loss when its own debt is extinguished in a nontaxable subsidiary liquidation. There are conflicting positions on this issue.

### Authorities for Nontaxable Treatment

In Rev. Rul. 74-54,[14] the IRS addressed a shareholder's income tax consequences of a liquidating distribution that included the shareholder's note. The IRS held that the liquidating distribution of the shareholder's note to the shareholder, without an overt act of cancelling the note by the liquidating corporation, would not generate COD income under Code Sec. 61(a)(12) for the shareholder. The ruling essentially accepted the holding in *H. Gilmore Est.,*[15] and stated:

> [I]n the instant case, the note is property for purposes of section 332(a) of the Code and, therefore, no gain or loss is recognized to P on the receipt of its note distributed in complete liquidation of S. Accordingly, P does not realize income under section 61(a)(12) or section 1.301-1(m) of the regulations by reason of the cancellation of the note in connection with the liquidation.



### Arguments for Taxable Treatment

In CCA 200040009,[16] the IRS differentiated and limited the application of Rev. Rul. 74-54 on a corporate shareholder's income tax consequences of receiving its installment note in a subsidiary liquidation. In this CCA, the Office of Chief Counsel attempted to develop tax principles and positions for recognizing gain or loss by the parent corporation on the debt extinguishment. To do so, it first restricted and limited the holding and effect of Rev. Rul. 74-54 and articulated the following assumptions and rationale:

> One may reasonably assume that, in the facts of both Rev. Rul. 74-54 and Helen Gilmore, the liquidating corporation's basis in its shareholder's debt, and hence the basis such debtor-shareholder received in the section 332 liquidation, equaled both the face amount and fair market value of such debt. (The fact that the debt may merge out of existence is addressed below.) One may so assume, because in both sets of facts the debts were originally created in return for the corporation's loan of money to the shareholder, and there are no facts suggesting the corporate creditor ever took a bad debt deduction. Thus, were the shareholder in either set of facts to redispose of the debt (had the debt not merged out of existence) by transferring it to a third party immediately after the section 332 liquidation, it would presumably recognize no gain or loss on such subsequent disposition, as its inherited basis in the debt would equal the debt's face amount and fair market value.

While the CCA did not explicitly state so, the Office of Chief Counsel seemed to opine that the distribution of the installment note to the parent corporation is protected by Code Sec. 332 and 337 and neither the parent corporation nor the subsidiary recognizes gain or loss from the distribution of the note. Advocating the tax principles set forth in Rev. Rul. 93-7, the CCA basically posited, without explicitly stating, that the parent corporation would first receive the installment note with a carryover basis from the liquidating subsidiary under Code Sec. 334(b). In effect, the CCA attempted to establish that the parent corporation was deemed to first inherit the liquidating subsidiary's basis in the note. The note was then extinguished and deemed satisfied by the shareholder for an amount equal to the note's FMV at the time of liquidation.

Relying on the statement of Rev. Rul. 93-7[17] that "there will be no opportunity for recognition at the future time," the CCA stated that loss or gain was properly reportable at the time of liquidation if the debt's carryover basis under Code Sec. 334(b)was more or less than the FMV of the extinguished debt.

Reg. §1.61-12(c)(2)(ii) provides that an issuer of a debt realizes COD income upon repurchase of a debt for an amount less than its adjusted issue price (within the meaning of Reg. §1.1275-1(b)). The amount of COD income is the excess of the adjusted issue price over the repurchase price. Under Reg. §1.61-12(c)(2)(iii), an issuer is entitled to a repurchase premium deduction upon the repurchase of a debt for an amount greater than its adjusted issue price. Reg. §1.163-7(c) also provides an interest deduction for a repurchase premium, which is the amount by which the repurchase price exceeds the adjusted issue price of the debt. Without making references to these provisions, the Chief Counsel Office raised the issue of whether there should also be COD income or interest deduction to the extent of the difference between FMV and the adjusted issue price of the debt. Again, this discussion referred to the principles advocated in Rev. Rul. 93-7.

In Rev. Rul. 2004-79,[18] the IRS provided guidance on the income tax consequences of a subsidiary's current distribution of its parent corporation's debt in a tax year in which the subsidiary's earnings and profits (E&P) is greater than or equal to the FMV of the distributed debt. The IRS held that because the distribution of the parent corporation's debt extinguishes the debt, it is repurchased within the meaning of Reg. §1.61-12(c)(2). The parent corporation is treated as having repurchased its debt for an amount equal to the FMV of the debt. Accordingly, under Reg. §1.61-12(c)(2)(ii), the parent corporation realizes COD income from the debt discharge in an amount equal to the excess of the debt's adjusted issue price over the FMV (*i.e.,* the amount of taxable current distribution). If the FMV is greater than the adjusted issue price, the parent corporation is entitled to an interest deduction in an amount equal to the excess of the FMV of the debt (which is the amount of taxable distribution) over the adjusted issue price of the debt in accordance with Reg. §§1.163-7(c) and 1.61-12(c)(2)(iii).

While Rev. Rul. 2004-79 does not deal with Code Sec. 332 liquidations, the principles for debt extinguishment set forth in the ruling may be applicable to a parent corporation's debt that is extinguished in a nontaxable liquidation.

The principles advocated in the above CCA and revenue rulings were first articulated on March 22, 1991, when Reg. §1.108-2 was proposed. As quoted in our April column, the IRS asserted that if a debtor acquires its own indebtedness in a nontaxable transaction, the indebtedness is extinguished. "In that case, the indebtedness in all cases should be treated as if it is acquired by the transferee and then satisfied."[19]

> This column raised issues that remain unsettled in debt extinguishment involving nontaxable transactions of Creditor-to-Debtor Transfers.

## Observations

In summary, it is unsettled whether a corporate shareholder should recognize gain or loss when its debt is extinguished in a nontaxable Code Sec. 332 subsidiary liquidation. The IRS has been entertaining the position for many years that a corporate shareholder may have gain or loss on the difference between the FMV and the shareholder's adjusted basis (which is the carryover basis from the liquidating subsidiary) of the extinguished debt. It also indicated that the corporate shareholder may also have COD income or interest deductions on the difference between FMV and the adjusted issue price of the debt. However, these positions have not been conclusive in any guidance issued thus far.

Since the liquidating subsidiary does not recognize gain or loss from a distribution of the parent corporation's debts, it would be asymmetric that the parent corporation should recognize gain or loss on such distribution. If the parent corporation were to report income under the theory that it has satisfied its own debt by paying itself as the successor creditor of its liquidated subsidiary, it should then be allowed to claim a bad debt loss that would have been available to the liquidated subsidiary in a taxable transaction separate and independent from the liquidation.

Code Sec. 61 defines gross income as all income from whatever source derived. This generally means income recognition, unless specifically excluded for income tax purposes, on any economic gains (*i.e.,* accessions to wealth) inured to a taxpayer.[20] We struggle to appreciate how the parent corporation in a nontaxable subsidiary liquidation has any real economic gains or accessions to wealth in such a debt extinguishment.

Until there is substantial authority provided otherwise, Rev. Rul. 74-54 and *Gilmore Est.* appear to support the position of no income or gain recognition for the corporate shareholder.

## Acquisitive Reorganizations

An overview of the types of acquisitive asset reorganizations was provided in the April column. In an acquisitive asset reorganization, related-party debts are extinguished when the assets (including debts of the acquiring corporation) of the acquired corporation are transferred to the acquiring corporation. The same rules for debt extinguishment should apply to each type of acquisitive asset reorganizations. While different Code sections apply, the income tax consequences for a debt extinguishment should be the same as those of a Code Sec. 332 subsidiary liquidation.

Under Code Sec. 361(a), no gain or loss should be recognized by the acquired corporation from the transfer of the acquiring corporation's debt. No gain or loss should be recognized by the acquiring corporation for stock issued pursuant to the plan of reorganization.[21] The acquiring corporation should have a carryover basis (*i.e.,* basis in the hands of the acquired corporation) of its debt under Code Sec. 362(b).

Issues and uncertainties of debt extinguishment addressed in nontaxable subsidiary liquidations also apply to acquisitive reorganizations. In the April column, we cited the preamble to Reg. §1.108-2, issued on December 29, 1992[22]:

> …. The Treasury department intends to issue regulations clarifying the measurement and treatment of income from discharge of indebtedness in certain nonrecognition transactions in which the debtor acquires its own indebtedness…

We are not aware of any recent substantive development on this issue. Rev. Rul.74-54, which deals with subsidiary liquidation, was cited in private rulings as the relevant authority supporting no COD income for debt extinguishment in nontaxable reorganizations.

In LTR 201252002,[23] the IRS cited Rev. Rul. 74-54 as the basis for holding that the acquiring corporation recognizes no gain or loss under Code Sec. 61(a)(12) or Reg. §1.301-1(m) with respect to the extinguishment of debts owed to various acquired corporations in nontaxable reorganizations. This LTR involved multiple integrated steps in an internal restructuring of various foreign corporations owned by a U.S. consolidated group.

For U.S. income tax purposes, the multiple interrelated steps were treated as if certain foreign corporations transferred their assets and liabilities (including intercompany debts) to an affiliated foreign corporation in either a nontaxable Code Sec. 368(a)(1)(A) or (D) reorganization. Some of these foreign corporate transferors were either the creditors or the debtors of intercompany obligations that were extinguished when transferred to the affiliated acquiring foreign corporation. In each case, it was represented that these intercompany debts were not issued, acquired, or to be settled at a discount. In each case, the IRS cited Rev. Rul. 74-54 and held that the affiliated acquiring foreign corporation did not recognize gain or loss as a result of the debt extinguishment.

In LTR 201127004,[24] the IRS also cited Rev. Rul. 74-54 and held that the extinguishment of a debt owed by the acquiring parent corporation ("Parent") in a nontaxable Code Sec. 308(a)(1)(C) did not result in COD income. In this LTR, the Parent was the common parent of a consolidated group and owned all of the stock of a domestic subsidiary ("Sub"), which conducted two businesses. Parent had outstanding debt owed to Sub ("Intercompany Debt").

Prior to the reorganization, Sub contributed a business to an LLC ("LLC 1") in exchange for an interest in LLC 1. LLC 1 is treated as a partnership for federal income tax purposes. The reorganization involved the following steps:

- Sub converted to a single-member LLC ("Sub LLC") that is disregarded for federal income tax purposes.
- Sub LLC assigned and transferred its LLC 1 interest to Parent, which then assigned and transferred the LLC 1 interest to a newly formed single member LLC ("LLC 2") that was treated as a disregarded entity.
- Sub LLC distributed the Intercompany Debt to Parent.
- Sub LLC then converted to a corporation under state law (the "Reincorporation").

It was represented that no intercompany debt between Parent and Sub was issued, acquired or to be settled at a discount. These series of steps were treated as a Code Sec. 368(a)(1)(C) reorganization. Based on Code Sec. 368(a)(2)(C) and Reg. §1.368-2(k), this nontaxable reorganization was not disqualified as a result of the Reincorporation. In effect, the series of steps were treated as a "C" reorganization, followed by a drop-down of assets to a subsidiary within the meaning of Code Sec. 368(a)(2)(C).

The LTR also made reference to Rev. Rul. 74-54 when stating that Parent would not realize income under Code Sec. 61(a)(12) or Reg. §1.301-1(m) with respect to the extinguishment of the Intercompany Debt.

**Example 2—D Reorganization. *Facts.*** P is the parent corporation of B and C, two wholly owned subsidiaries. Each corporation files returns on a separate company basis. On January 1, year 1, B borrowed $100 from C in exchange for B's note with adequately stated interest. The note is a capital asset in the hands of C. On January 1, year 3, C transferred all of its assets and liabilities, including B's note, to B pursuant to a nontaxable Code Sec. 368(a)(1)(D) reorganization. Due to an increase in prevailing market interest rates, the note's FMV was $90 at the time of the reorganization.

***Analysis.*** C should have no gain or loss on the transfer of B's note under Code Sec. 361(a). B should have no gain or loss for the issuance of its stock in exchange of property of the acquired corporation under Code Sec. 1032.

If extinguishment of B's note is deemed as first received by B and then repaid, B would have a carryover basis of $100 from C under Code Sec. 362(b). B may then be treated as having satisfied the note with an adjusted issue price of $100 for $90, resulting in COD income. However, in the absence of clear guidance provided otherwise, B should not be required to recognize COD income pursuant to Rev. Rul. 74-54.

## Conclusion

This column raised issues that remain unsettled in debt extinguishment involving nontaxable transactions of Creditor-to-Debtor Transfers. We are uncertain and not convinced that a transferee corporation is economically enriched in every debt extinguishment resulting from a nontaxable transaction.

If a transferee corporation were to recognize income or gain on an extinguishment of its debt, there would be asymmetry in tax treatment when the transferor corporation is not allowed to claim a loss or deduction in a nontaxable Creditor-to-Debtor Transfer. Additionally, it is not a simple task to properly determine the FMV of a nontraded debt. Unless the codified economic substance doctrine under Code Sec. 7701(o) is applicable, it seems that the potential COD income (or tax asymmetry) from the deemed receipt and satisfaction of the debt by the transferee can be avoided if the intercompany debt were repaid before the nontaxable transaction. Therefore, it may be a trap for the unwary for the simple failure of following form even when there is no difference in substance.

In the next column, we will explore the consolidated return rules on debt extinguishment involving nontaxable transactions.

### Endnotes

* This column represents the views of the authors only, and does not necessarily represent the views or professional advice of Plante Moran.

1 *See* Code Sec. 362 (a) and (b).

2 P.L. 108-357.

3 Code Sec. 362(e)(1)(A).

4 Code Sec. 362(e)(2)(A)(ii).

5 Code Sec. 362(e)(2)(B).

6 Code Sec. 363 (e)(2)(C)(i).

7 Proposed Reg. §1.362-4(c)(3) and (4).

8 *See* FSA 200146013 (Nov. 19, 2001) and Bittker & Lokken, Federal Taxation of Income, Estates and Gifts ¶91.2.4 (3d ed., 1999-date).

9 *P. Fink,* SCt, 483 US 89 (1987).

10 *See e.g., S. Lessinger,* 85 TC 824, Dec. 42,489 (1985) and Rev. Rul. 64-155, 1964-1 CB 138.

11 *See, e.g.,* TAM 9830002 (Mar. 20, 1998) and LTR 200537026 (Sept. 16, 2005).

12 LTR 201016048 (Apr. 23, 2010).

13 FSA 200146013 (Nov. 19, 2001).

14 Rev. Rul. 74-54, 1974-1 CB 76.

15 *H. Gilmore Est.,* 40 BTA 945, Dec. 10,873 (1939).

16 CCA 200040009 (Oct. 6, 2000).

17 Rev. Rul. 93-7, 1993-1 CB 125, addressed the distribution of a partner's note to the partner in liquidation of such partner's interest in the partnership. The IRS held that the redeemed partner recognizes (1) capital gain to the extent that the FMV of the note exceeds the partner's basis in the note determined under Code Sec. 732, and (2) COD income to the extent that the adjusted issue price exceeds the FMV of the note. In most cases, adjusted issue price should equal to the adjusted basis of the debt in intercompany debt, unless the creditor has claimed a partial bad debt deduction or made a basis reduction under Code Sec. 108(b).

18 Rev. Rul. 2004-79, 2004-2 CB 106.

19 Preamble , 56 FR 12135.

20 *See Glenshaw Glass Co.*, SCt, 55-1 USTC ¶9308, 348 US 426, 75 SCt 473.

21 Code Sec. 1032.

22 T.D. 8460.

23 LTR 201252002 (Dec. 28, 2012).

24 LTR 201127004 (July 8, 2011).