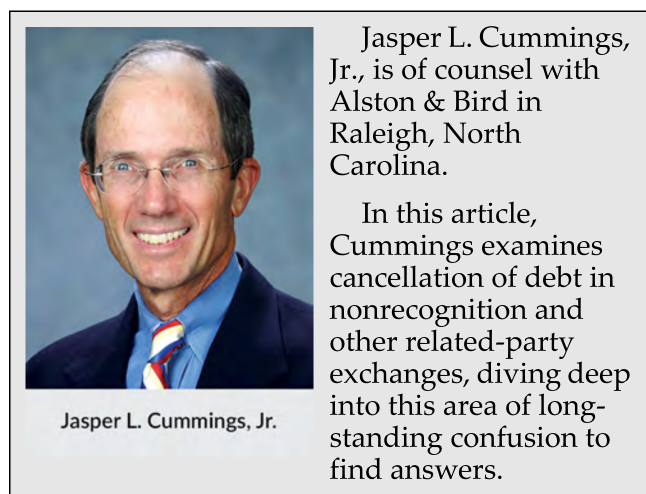
Related-Party Debt Extinguishment

by Jasper L. Cummings, Jr.



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In this article, Cummings examines cancellation of debt in nonrecognition and other related-party exchanges, diving deep into this area of long-standing confusion to find answers.

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I. A Simple Question

A. Related-Party Debt

A debtor corporation merges into its creditor corporation or vice versa; should the debtor recognize section 61(a)(11) discharge of indebtedness (COD) income? That and similar transactions happen all the time, so the answers should be clear, but some are not. Moreover, the known answers seem to be isolated solutions dictated by unique code rules or old case law. A few statutory changes have somewhat clarified the area since professor James S. Eustice's 1959 article, but not cohesively.[1] Only a few commentators have tried to corral the authorities and guess at the answers.[2] The most recent published guidance in the area is 20 years old. Before that, Treasury mused about imposing an unusual construct, but it never has, and surely it is too busy now.[3]

For the reorganization and liquidation transactions, the old ruling guidelines required this representation:

[1] *See* James S. Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 *Tax L. Rev.* 225 (1959).

[2] An excellent resource is Paul C. Lau, Mark Jolley, and Kurt Piwko, "Tackling Disappearing Debt in Nontaxable Corporate Transactions — Part I," 91 *Taxes* 15 (Apr. 2013); Lau, Jolley, and Piwko, "Tackling Disappearing Debt in Nontaxable Corporate Transactions — Part II," 91 *Taxes* 13 (Aug. 2013); Lau, Jolley, and Piwko, "Tackling Disappearing Debt in Nontaxable Corporate Transactions — Part III," 91 *Taxes* 11 (Oct. 2013). *See also* Richard M. Lipton, "The Tax Consequences to a Debtor From a Transfer of Its Indebtedness," 69 *Taxes* 939 (1991).

[3] *See* CCA 200040009; and reg. section 1.108-2(f)(3) (1992).

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> There is no intercorporate indebtedness existing between Acquiring and Target that was issued, acquired, or will be settled at a discount.[4]

Hundreds of taxpayers have made that representation. Sometimes they fibbed; sometimes they did not know what the representation meant; sometimes they zeroed out intercompany debt first, just to be safe. In fact, the IRS just wants to be informed, and it usually excepts cancellations in the nonrecognition transactions from the representation.[5]

What is going on here? How can there be so much confusion about such common transactions when much of section 108(e) deals with related-party debt extinguishments? This article collects and organizes the known answers, and recommends the rest of the answers, for the 10 or 12 common related-party debt extinguishments discussed here. The table below summarizes the results. And that's before you even get to intercompany transactions under reg. section 1.1502-13(g). Also, we do not deal with section 108(e)(4), an entirely different area of related-party debt.

It turns out that a few core authorities have driven the results, reflecting different policies and without coordination. The good news is there is little support for unexpected section 61(a)(11) income in the uncertain transactions discussed below, but the bad news is that proving it can be difficult. For readers just wanting answers, this article provides a cookbook for the known results, plus a deeper analysis of the law. The analysis tackles the tension between three competing principles that have been applied to these transactions and shows a key to reducing the confusion: Recognize that the property exchange and the debt discharge are, for tax purposes, separate events that shouldn't necessarily be decided by the same rules.

Finally, keep in mind that debt extinguishment can occur both when the debtor is the asset transferor and the asset transferee, and the debtor must consider COD income because its debt can be extinguished in both cases. (See table.) As simple as that difference is, it makes it hard to keep the few pertinent authorities straight.

B. The Three Competing Principles

1. Assumption trumps discharge.

For two nonrecognition transactions in which an acquiring corporation assumes a debtor's obligations, a code section governs the debtor-side COD treatment, according to some court decisions. Section 357(a) governs the debtor's treatment for the assumption of its liabilities in a section 351 or section 368/361 exchange. Literally, it says the assumption shall not be treated as money or other property received in the exchange; it does not directly address the fact that the debt might be discharged in the exchange because that is not typical.

Nevertheless, the Tax Court held that section 357 effectively mandates a sequencing of assumption before any discharge that would occur when the creditor acquired the debtor's assets and assumed its liabilities. The decisions are *Kniffen* (section 351 transfers to the creditor corporation)[6] and *Edwards Motor Transit Co.* (section 368 reorganizations of the debtor into the creditor).[7] So by the time the discharge occurs, the original debtor is out of the picture, and the discharge could not occur on its watch.

The *Kniffen* opinion points out that eventually the debt assumed would normally be discharged by the transferee, so it should not matter whether the discharge was immediately after the assumption rather than later. Also, it reasoned that the debtor did pay the debt by transferring assets in the nonrecognition exchange: It paid the basis of the transferred assets because the corporation assumed an amount in excess of that basis, creating a section 357(c) inclusion to which the shareholder agreed.[8] It is interesting that Judge Graydon Withey wrote both opinions that are central to this issue.

The sequencing that the court applied in *Kniffen* is second nature to practitioners of

[4] Rev. Proc. 86-42, 1986-2 C.B. 722.

[5] *E.g.*, LTR 201433007.

[6] *Kniffen v. Commissioner*, 39 T.C. 553 (1962), reviewed (with four dissents), *acq*.

[7] *Edwards Motor Transit Co. v. Commissioner*, T.C. Memo. 1964-317.

[8] When section 357(c) is not involved, it seems that the value of the property should be the payment amount.

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corporate tax law. However, today there is a lot of talk about "simultaneity" in tax events.[9] The subject attracts writers because of the minority of situations in which decision-makers purport to find truly simultaneous multistep transactions. It is fair to say that whether those decisions are right or wrong, the default approach is sequencing, as occurred in *Kniffen*.

Assumption-first was not an inevitable conclusion, but after 60-plus years, it is the law. It is a good result as far as it goes for the debtor, but it leaves two important questions unanswered. Section 357 does not apply to the third variety of carryover basis nonrecognition transactions: the section 332 liquidation. There is no clear authority that the subsidiary will not recognize COD income when its debtor position combines with the parent's creditor position. Not only does section 357 not apply, there won't even be a state law assumption unless the sub merges into the parent. That case is discussed further below.

Second, what about the creditor? If you think the discharge occurs after it assumes the debt to itself, should the creditor recognize COD income? There is published guidance on a related issue: The creditor can recognize gain on the debt it holds for the difference between its basis in the debt and what the creditor receives for the debt (probably its value), which is deemed paid by the transfer of the debtor's assets.[10] But more than 30 years ago, Treasury said it wanted to treat that gain or some other amount as COD income of the creditor. So far that has not happened; the confusion is discussed below.

2. Property transaction only.

Property transaction only is the oldest principle and probably underlies the first principle. When the combining event is turned around and the debtor receives its note (think of a liquidation of the creditor or its merger into the debtor), there is authority that the debtor only experiences a property exchange and not a debt discharge. That view is roughly equivalent to the view that section 357 occupies the field in the debt assumption cases. The historic citation is *Gilmore* (taxable liquidation),[11] which is always joined by Rev. Rul. 74-54, 1974-1 C.B. 76 (subsidiary liquidation).[12]

The property-transaction-only approach is attractive to taxpayers, like the section 357 result, because it takes COD income off the table and the property transaction will have its expected recognition (capital gain) or nonrecognition result. Therefore, there has been a tendency for property-transaction-only to be a uniform answer. But it clearly cannot fit all cases as shown by the third principle.

3. Two independent transactions.

All the transactions addressed in this article involve both a property transaction — usually an exchange or deemed exchange — and the extinguishment of a debt between the two parties to the property transaction. There is a strong set of competing authorities that treats these two tax aspects of the same property transaction as independent of each other and, more importantly, shows that nonrecognition rules for the property exchange do not necessarily control the recognition of COD income.

Section 108(e)(6), (8), and (10) requires the debtor corporation to recognize COD income in otherwise nonrecognition issuances or exchanges of stock or debt for debt, and in a capital contribution. So the corporation can issue its stock or debt tax free, and the creditor may have a nonrecognition section 354 exchange, but the debtor still can recognize COD income (or redemption premium). The absence of COD income in the other nonrecognition exchanges described above is striking by comparison and seems anomalous.

When the transaction is a recognition event like a section 301 distribution of the shareholder's

[9] Gordon Warnke et al., "Session 4: Bending Time's Arrow," Univ. of Chicago Tax Conference 2023 (Nov. 3, 2023).

[10] Rev. Rul. 72-464, 1972-2 C.B. 214 (reorganization); reg. section 1.332-7 (subsidiary liquidation).

[11] *Gilmore v. Commissioner*, 40 B.T.A. 945 (1939), *acq. Gravley v. Commissioner*, 44 B.T.A. 722 (1941), *acq.*, held the same and held the liquidating distribution was the face amount because the shareholder could pay, counting the stock of the corporation among his assets. CCA 200040009 stated, "We believe that the same rationale should apply in the case of a section 332 liquidation, and that the language just quoted from Rev. Rul. 93-7 casts institutional doubt on the Service's 1940 acquiescence in *Helen Gilmore*." But so far the acquiescence stands.

[12] The same facts and ruling appear in LTR 201123022, LTR 201010018, LTR 8418086, and LTR 8121076. In LTR 8247065 the taxpayer represented that "no debts between P and S1 and P and S2 have been issued, acquired or settled at a discount."

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note (a debt forgiveness), the law has no trouble differentiating the two tax events. The most recent published guidance in the area, Rev. Rul. 2004-79, 2004-2 C.B. 106, ruled that when a subsidiary distributed the parent's note to the parent (and section 311 applied), the parties engaged in a property transaction and also potentially a debt discharge. So the parent could recognize both dividend income based on the value of its note received and COD income based on a greater face amount less the value included as a dividend.

In contrast, in a taxable liquidation (*Gilmore*), the property transaction treatment precluded a debt discharge. Oddly, the revenue ruling did not cite *Gilmore* even though it is the closest analogous transaction — a taxable liquidation of the creditor into the debtor. Perhaps the face amount and value were the same in *Gilmore*, meaning that the liquidating distribution left no room for COD income? Or perhaps Treasury now knows *Gilmore* was wrong.

II. Recaps: The Easy Cases

A. Security for Security

1. Debtor side.

In Rev. Rul. 58-546, 1958-2 C.B. 143, the debtor corporation swapped out old bonds for new bonds with different terms but the same principal amount. Section 354 gave the holders nonrecognition treatment on the property exchange. Reg. section 1.61-12(c)(1) gave the debtor nonrecognition on issuing the new debt. But the debtor still can recognize COD income or deduct bond premium paid.[13] The new bonds in the ruling had the same face amount as the old bonds but also discharged accrued unpaid interest that the corporation had deducted against taxable income.[14] To that extent, the issuer recognized COD income. This is an extinguishment case because the debtor reacquires its own debt, thereby extinguishing it.

Reg. section 1.61-12(c)(2)(ii) explains the COD rule and does not distinguish bond swap reorganizations from taxable exchanges. It states that upon an exchange of a new bond for an old bond, the issuer can recognize discount or premium by comparing the repurchase price to the adjusted issue price of the old bond. It does not say what the repurchase price would be but refers to section 108(e)(10). It says the debtor pays the issue price of the new debt to discharge the old debt, and the comparison of the discharged principal less the issue price is the COD amount.

So it is clear that in the type E recapitalization, the nonrecognition rule applicable to the bondholder and the nonrecognition rule applicable to new debt issuance do not control the third issue: debtor discount or premium on the elimination of the old debt. That is a relatively easy case, but it shows that two nonrecognition rules could not prevent COD recognition.

2. Creditor side.

If the exchange qualifies as a reorganization, the creditor realizes and recognizes income only to the extent the principal amount of new securities received exceeds the principal amount of the old securities.[15] The amount is the fair market value of the excess.[16]

B. Old Security for New Stock

Now assume the debtor corporation issues new stock for old bonds. Section 108(e)(8) defines the COD amount as the adjusted issue price less the stock value.[17] Even though section 354 can apply to the creditor and 1032 provides nonrecognition for the debtor, they cannot prevent the COD inclusion. There is an issue, not pursued here, about whether this rule applies to a case in which the issuance of the stock was a meaningless gesture; if so, section 108(e)(6) could apply, and the COD amount would be the adjusted issue price less the shareholder's basis in the debt.[18]

[13] Reg. section 1.163-7(c).

[14] *See also* GCM 36602 (1976).

[15] Section 356(d)(2).

[16] *See* Rev. Rul. 58-397, 1958-2 C.B. 412. LTR 8815003 makes the point that obviously the FMV of the old and new bonds are the same, so a proportional analysis is required to determine the part of the value of the new bonds that reflects the increased principal amount.

[17] *See* Jasper L. Cummings, Jr., "Security Debt in Subchapter C," *Tax Notes Federal*, Feb. 12, 2024, p. 1255.

[18] *See* LTR 9830002.

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C. Old Non-Security Debt for New Stock or Debt

If the holder has a recognition exchange for new debt or stock because section 354 (and also section 351) does not apply to old non-security debt surrendered, that does not affect the debtor's COD potential, which is quantified under the rules cited above.

III. Debtor Acquires Its Note

A. Taxable Exchange

This is the normal way to discharge a note: Pay it and get it back. Reg. section 1.61-12(c)(2)(ii) defines the COD amount and calls it repurchase at a discount. It has never been thought that the discharge occurs after the debtor retrieves the note. The regulation says: "An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument."

B. Section 332 Liquidation of Creditor

1. Debtor side.

a. No COD.

Rev. Rul. 74-54 is all the law there is on this transaction and is an important ruling that has been applied in other contexts. It applies the property-transaction-only principle of *Gilmore* to the liquidation of a creditor subsidiary. It ruled that the debtor did not realize section 61(a)(11) income on the receipt of its own note from its liquidating solvent subsidiary because (1) section 332 freed it from recognition of gain or loss on property received in exchange for the sub's stock, and (2) its own note was property that it received. So the ruling collapsed the treatment of the debtor's property-for-property exchange — the sub's stock for the sub's assets — with the COD possibility and ruled that the former controlled the latter. It is probably wrong.

Rev. Rul. 74-54 claimed two grounds: (1) reg. section 1.301-1(k) (previously (m)) provides that the cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property;[19] and (2) *Gilmore*, the taxable liquidation with a debtor shareholder. To begin, the regulation is a bad cite: It is in Part I of subchapter C governing nonliquidating distributions; section 332 is in Part II, which controls a different type of distribution in liquidations. Therefore, the regulation was not controlling. The ruling might have cited it to bolster the cite to *Gilmore*, which at least involved a liquidation, albeit taxable.

The ruling also appears to have cited reg. section 1.301-1(k) to break the tie between the two opposing rules cited: section 332(a) versus section 61(a)(11). One provides for nonrecognition on the property exchange and the other provides for COD recognition, apparently without regard to any property nonrecognition rule. The ruling seems to say that the regulation resolves the conflict between the two by categorizing the whole transaction as a property exchange to which section 61(a)(11) cannot apply. That is also what *Gilmore* did. But the property transaction and COD can coexist, as the bond-for-bond case shows. *Gilmore* is discussed further below.

b. Or maybe COD?

There might be a COD possibility for those liquidations despite Rev. Rul. 74-54. The debt in the ruling had a face amount equal to its issue price, and the ruling likely assumed (but did not state) that the value of the note was its adjusted issue price at the time of the liquidation. If the value had been less than the adjusted issue price, the parent might recognize the difference as COD income. The theory would be that the parent "paid" the value of the note by exchanging a portion of its stock in the subsidiary of equal value; the difference might be COD income. That is the Rev. Rul. 2004-79 approach. In fact CCA 200040009, discussed below, took that approach as part of a larger two-step theory.

[19] Reg. section 1.301-1(k) goes all the way back to the original regulations adopted for the 1954 code in 1955, which means that it almost certainly stated the regulation or rules applied under the 1939 code. T.D. 6152, 1955-2 C.B. 71. The early cases involved advances or loans to shareholders that the corporation later canceled. Without any citations, the Board of Tax Appeals held that when the holding of the cash was converted into possession without obligation to repay, that was a dividend of the cash. *E.g.*, *Muller v. Commissioner*, 16 B.T.A. 1015 (1929).

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If you think such payment cannot be accomplished by a nonrecognition exchange, look at *Kniffen*. The court reasoned that the shareholder paid his assumed debt by transferring his property to the corporation in the section 351 exchange.[20]

Some early rulings found COD income on a different analysis. They said that if the face amount of the parent's note were more than the sub's basis, the difference would be COD income to the parent.[21] The method of calculation proposed seems to derive from two errors. First, the rulings cite authority that an accrual method taxpayer takes notes into income as property sale proceeds at their face amount and not their value. While true, that need have nothing to do with the section 332 case and is contrary to Rev. Rul. 2004-79, which bases the COD amount on what the shareholder pays for the debt (there, the amount it took into income as a dividend). The proper analysis would be that the parent in effect pays the FMV of its note by exchanging part of the sub's stock for it.

Second, those early rulings appear to somehow integrate the sub's basis in the parent's debt with the parent's COD calculation. The sub's basis in property does carry over generally under section 334, but there is no reason to believe that the parent takes its own note with a carryover basis and then satisfies it and recognizes the former creditor's gain, as opposed to recognizing its own COD income based on the amount it paid.

c. The reserved regulation.

At about the same time, Treasury was musing about the issue, and that likely informed the early rulings. When T.D. 8460 (1992) issued COD regulations, it said, "As stated in the preamble to the proposed regulations, 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, or the creditor assumes a debtor's obligation to the creditor." Treasury has never issued such regulations.

The proposal in 1991, 56 F.R. 12135, stated (with commentary in brackets):

> The Treasury Department intends to issue regulations designed to prevent the elimination of income from discharge of indebtedness in certain nonrecognition transactions. [That is a reasonable goal.] In general, if assets are transferred in a tax-free transaction and the transferee receives the assets with a carryover (or, in certain cases, a substituted) basis, any built-in income or gain is taxed when the transferee disposes of the asset. If, however, the debtor acquires its own indebtedness, the indebtedness is extinguished. [The same is true of hook stock; if this is an aberration, it has nothing to do with the COD issue.] In that case, the indebtedness in all cases should be treated as if it is acquired by the transferee and then satisfied. [Evidently they meant both that the sub's built-in gain could be recognized and that the parent could also recognize COD income.] Similar treatment should apply if a creditor assumes a debtor's obligation to the creditor. [This is not similar in that it does not involve basis carryover and section 357 applies.]
>
> In both cases, the debt is effectively extinguished, and current recognition of income from discharge of indebtedness is appropriate. ["Similar treatment" would mean reversing *Kniffen*, in which section 357 applied to the corporation's assumption of a debt to itself.] Thus, the regulations to be issued will provide for recognition of income from discharge of indebtedness in these cases. [They seem to have forgotten about the transferred gain problem.] Some of the nonrecognition transactions to which the regulation will apply will include transactions described in sections 332, 351, 368, 721, and 731.

[20] "To the extent of $36,379.21, petitioner *paid* in assets a pro tanto portion of the $44,625.79 liability in question (the indebtedness owing by him to the corporation) and the resulting liability excess of $8,246.58 represents gain taxable to him for the year in issue" (emphasis in original).

[21] LTR 9222059. This ruling has this strange statement: "If the issue price (as adjusted above) does exceed the adjusted basis, then FS15-J will realize income under section 61(a)(11) in an amount equal to such excess"; and LTR 8816045.

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> [Conflating subchapters C and K was a fatal error.]
>
> Current Reg. section 1.332-7 contains a similar rule. [The parent creditor recognizes gain on disposing of the sub's debt.] It is anticipated that a conforming amendment will be made to 1.332-7 to characterize the income recognized by a parent corporation that purchased its subsidiary's bonds at a discount as income from discharge of indebtedness recognized by the surviving entity (rather than as gain recognized by the parent). [There is no explanation of how gain could be transformed into COD income unless you treat the parent as both the creditor and the debtor.] The regulations to be issued will be effective for any transaction on or after March 21, 1991.

Example. Parent owes $100 to solvent Sub, which has $90 basis in the note. Sub liquidates when the note is worth $95. Parent receives the note as property without recognizing gain in its Sub stock. If Parent were deemed to pay a repurchase price equal to the value of the note, Parent would recognize $5 COD income. But that is not the approach Treasury suggested.

The Lau article points out that in 1991 the government suggested a different approach to the example, forecast in the annotated preamble above and culminating in CCA 200040009 but never repeated again.[22] It addressed facts like the example and reasoned:

- if the sub's basis in the parent's debt was less than the value, the parent should recognize the sub's gain (not COD income), as if it acquired its own note with a carryover basis and then it was retired for its value (not its face amount); and
- if the adjusted issue price is more than the value of the note, the parent also should recognize the difference as COD income; so the parent could recognize both the sub's gain and the parent's COD income on a hypothetical satisfaction at FMV.

Actually, the memorandum more suggested than asserted that should be the result. Since it was unlikely that the liquidating sub had built-in gain or loss in the parent's note, the memo likely had no practical significance. Its approach has some similarity to Rev. Rul. 2004-79, discussed below, involving a taxable distribution of the parent's note. But there the parent first recognized the value of the note as a dividend and then recognized its own COD income; it did not recognize the sub's gain in the note (although section 311 would have caused the sub to recognize any gain).

d. Does that make any sense?

The memo is the only time the IRS has ever tried to explain what Treasury had in mind in its 1991 preamble. And pity the poor district counsel who had to interpret and try to apply that novel advice. Very likely the complexity and lack of law support for the proposal explains why Treasury has never returned to the subject.

The memo's theory makes no sense and is unnecessary to reach the desired result. There is no basis in the tax law for finding an issuer's stock or debt to have independent existence as property once reacquired, much less with a carryover basis. A hundred years ago, taxpayers claimed that treasury stock had basis, and in 1954 Congress enacted section 1032 to end that view. The Supreme Court has addressed a case in which the debtor that acquired its note and held it "intact" claimed no income, and the Court held that discharge occurred upon receipt of the note.[23]

It is far more straightforward to say that in the liquidation of the subsidiary, the parent exchanges the sub stock on a value-for-value basis for the property received, so if the amount deemed paid by the parent to retire its debt was less than the adjusted issue price, the parent recognized COD income for the difference. That is consistent with Rev. Rul. 2004-79, without trying to fix the problem of the sub's disappearing gain. Gain disappears all the time when corporations combine: Think of the parent basis in stock of a sub that liquidates under section 332.

The chief counsel advice purported to derive its theory from Rev. Rul. 93-7, 1993-1 C.B. 125. The

[22] Lau, Jolley, and Piwko, "Part II," *supra* note 2.

[23] *Commissioner v. Jacobson*, 336 U.S. 28 (1949).

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partnership distributed the partner's note to it in redemption. The ruling treated the partner as having received cash equal to the value of its note and then possibly COD income if that face amount exceeded the value. That is entirely consistent with the two-independent-transactions principle: The parent receives its note tax free under section 332 and is deemed to discharge it for a portion of the sub's stock. Rev. Rul. 2004-79 agreed that the 1993 ruling stood for the proposition that the shareholder satisfied its debt for its FMV, which was the same as the amount realized on the distribution of its own note to it; but neither one required that the holder's basis in the note carry over to the maker.

e. The amount issue.

In both the creditor transferee cases and the debtor transferee cases, the amount deemed paid for the discharge must be determined if you decide the debtor should recognize COD income. Some authorities suggest that the amount is the face amount. For example, Rev. Rul. 72-464, 1972-2 C.B. 214, applied the assumption-only analysis to a merger of the debtor into the creditor. But it required the creditor/survivor to include the difference between its adjusted basis of the notes and the face amount of the notes, which was the FMV. That was based on reg. section 1.332-7, which said:

> For example, if the parent corporation purchased its subsidiary's bonds at a discount and upon liquidation of the subsidiary the parent corporation receives payment for the face amount of such bonds, gain shall be recognized to the parent corporation. Such gain shall be measured by the difference between the cost or other basis of the bonds to the parent and the amount received in payment of the bonds.

Those two sentences are confusing. The first sentence suggests that the amount received is the face amount. The second sentence refers to "amount received." GCM 34902 stated that chief counsel believed the correct amount was the value of the notes. That is confirmed by Rev. Rul. 2004-79, which ruled that the debtor received its notes in a section 301 distribution as a dividend at their value and then discharged the face amount for the price of that income inclusion (as if it were the amount paid to repurchase the notes).

2. Creditor side.

Section 337(a) provides nonrecognition treatment for the subsidiary.

C. Taxable Liquidation of Creditor

1. Debtor side.

Gilmore is a debtor-side case. The issue in *Gilmore* was whether the individual shareholder recognized gain or COD income on the receipt of his own note in a taxable liquidation of the corporation. The answer could affect both the amount and character of his income. Actually, he was dead and his estate held the stock at the time of liquidation (Mrs. Helen Gilmore was the legatee, also deceased). Also, the estate reincorporated the assets, which today might be treated as an F reorganization with a boot dividend, but the opinion did not consider that. It also did not question the continued status of the debt as a debt up to the liquidation. The court reasoned: (1) the corporation did not forgive the debt; (2) the shareholder did in fact receive the debt as property; and (3) the shareholder could have paid the debt and received the cash back, with the result of a capital gain.

Reason (1) was factual; reason (3) is novel in the authorities; reason (2) is similar to reg. section 1.301-1(k) and is probably where it came from. It dates from 1955, as does reg. section 1.317-1, which says a shareholder's debt can be part of the property distributed in a nonliquidating distribution. But again, both of those regulations relate to part 1 of subchapter C, not liquidations.

Gilmore involved an open account receivable from the shareholder and treated that as the amount of the liquidating distribution. Some early letter rulings have said the face amount was the amount of the distribution.[24] That precludes the possibility of COD income and is inconsistent with the treatment of nonliquidating distributions discussed below and should not be correct today. In the case of the nonliquidating distribution of the shareholder's note, the shareholder receives a section 301 distribution in the amount of the value

[24] *E.g.*, LTR 8616056.

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of the note and also can recognize COD income to the extent the adjusted issue price exceeds that value.[25] The same should be true of section 331 liquidations.

2. Creditor side.

The liquidating corporation will recognize gain or loss on the distribution of the shareholder's note like any other asset under section 336. But that was not the law when the *Gilmore* case occurred, under the *General Utilities* doctrine.

D. Nonliquidating Distribution

1. Debtor side.

Rev. Rul. 2004-79 ruled that when a subsidiary distributed the parent's note to the parent, the parties engaged in a property transaction and potentially a debt discharge.

The value of the debt did not exceed the sub's earnings and profits. Therefore, the sub distributed property of that value and the parent received a dividend of that value. The ruling did not cite reg. section 1.301-1(k), probably because it treats a cancellation as a property distribution as opposed to treating distribution of the shareholder's note as a property distribution. Rather, it cited reg. section 1.317-1, which classifies the distribution as property.

Then the ruling made this breathtaking analysis of the COD possibility:

> Additionally, because the distribution of the P indebtedness to P extinguishes the indebtedness, it is repurchased within the meaning of section 1.61-12(c)(2), and P is treated as having repurchased its indebtedness for an amount equal to the fair market value of the indebtedness, $9,250,000. . . . Accordingly, under section 1.61-12(c)(2)(ii), P realizes income from the discharge of indebtedness in an amount equal to $397,868, the excess of the adjusted issue price of the P indebtedness ($9,647,868) over the amount of the distribution ($9,250,000).

So the ruling clearly did not treat P as first acquiring its debt and then extinguishing it; rather, the distribution accomplished the extinguishment. The upshot is that the ruling split the tax treatment into two parts: (1) It treated the property distribution as a property distribution — which is unremarkable — producing a dividend, and (2) it supplied the amount of the repurchase price when the debtor actually pays nothing as the amount realized in the dividend, the value of the note.

Perhaps the ruling is not literally in conflict with CCA 200040009 because the sub would have recognized its gain in the parent's note and there was no carryover basis issue. But the ruling supports COD income for the parent in a section 332 liquidation if the adjusted issue price exceeds the value of the parent's note.

We can find one opinion that said that if the value of the debt were its dividend amount and that was less than the face amount, the shareholder could recognize COD income for the difference.[26]

2. Creditor side.

The creditor will recognize gain but not loss under section 311.

E. Asset Reorganization Into Debtor

1. Debtor side.

Asset reorganization into the debtor is the hard one. In form, the debtor exchanges its stock for its debt. Section 1032 provides nonrecognition on the stock issuance (the property side of the transaction). But what about the debt discharge? Pretty clearly Congress addressed this case in section 108(e)(8):

> For purposes of determining income of a debtor from discharge of indebtedness, if —
>
> > (A) a debtor corporation transfers stock, or
> >
> > (B) a debtor partnership transfers a capital or profits interest in such partnership,

[25] Rev. Rul. 2004-79.

[26] *Exchange Security Bank v. United States*, 345 F. Supp. 486, n.7 (N.D. Ala. 1972), *rev'd on other grounds*, 492 F.2d 1096 (5th Cir. 1974).

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> to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

LTR 200403019 applied section 108(e)(8) to a D/355 reorganization exchange of Controlled's note for Controlled stock. The value of the Controlled stock was equal to the adjusted issue price of the Controlled debt, and the debtor did not realize COD income. But in a D/354 reorganization, the IRS ruled that the survivor did not realize COD income on receipt of its own note, without a citation to section 108(e)(8). Rather, it said, "See Rev. Rul. 74-54, 1974-1 C.B. 76."[27] It had to be a "see" cite because that ruling addressed a subsidiary liquidation into the debtor. And Rev. Rul. 74-54 did not consider the possibility of the section 61(a)(11) issue being separated from the property exchange issue. The Rev. Rul. 74-54 citation shows that chief counsel really does not want to tax COD income in otherwise nonrecognition transactions — but can't quite explain why.

Rev. Rul. 2004-79 separated the property exchange from the debt discharge with no trouble in a taxable distribution of the shareholder's note. There is nothing about a nonrecognition exchange that makes it harder to do or less appropriate. The bond-for-bond authorities prove that nonrecognition of the property exchange is a whole different thing from COD consequences, although they may interact. The chief counsel advice floated the idea of an odd interaction, but at least it recognized that the debt should be considered retired for its value. As argued above, there is no reason for Treasury to think it can "fix" the disappearance of the basis of the merging corporation in the successor's note by taxing that gain to the survivor.

To apply section 108(e)(8) you must know the stock value. Rev. Rul. 92-52, 1992-2 C.B. 34, shows that the debtor's stock is valued post discharge, when it necessarily will be more valuable.

2. Creditor side.

Section 361 protects the creditor from gain or loss recognition.

F. Upstream Reorganization Into Debtor

1. Debtor side.

An upstream reorganization into the debtor is really the same as the other reorganizations above, but there are more letter rulings. An upstream merger or asset transfer can be a liquidation unless the parent reincorporates enough assets to prevent a "complete" liquidation, in which case it can be an upstream C reorganization.[28]

The IRS thinks these reorganizations look like subsidiary liquidations because the acquiring corporation owns some stock, but the amount seems not to matter. And recall that the IRS thought subsidiary liquidations looked like taxable liquidations. A handful of letter rulings state that the surviving debtor does not recognize COD income, citing reg. section 1.301-1(k) (nonliquidating distribution) and Rev. Rul. 74-54 (subsidiary liquidation), neither of which apply.[29] The target corporation is not making a distribution related to stock. The theory of the upstream C is that the survivor exchanges its own stock for the target's assets.[30]

Obviously, the fact that the surviving corporation owned some amount of subsidiary stock does not turn the receipt of its own note into a section 301 distribution. But perhaps by making the analogy to the upstream liquidations, the IRS

---

[27] LTR 201252002. A U.S. corporation owned FS3, FS4, and FS6. An upstream corporation owned FS1 and FS2. FS3 and FS4 were lenders, but it is not clear who were the borrowers. Evidently, FS6 was a borrower of both, either initially or as a result of acquisitive reorganizations. First, FS3 merged into FS6, then FS4 merged into FS6, and then FS1 and FS2 made D reorganizations into FS6. The ruling assumes that FS6, the acquirer, was a debtor to the target in all 4 reorganizations. It ruled there would be no COD income: "see Rev. Rul. 74-54." Each of the asset reorganizations involved transitory ownership of the target by FS6.

[28] *See* Cummings, "The Demise of the Liquidation-Reincorporation Doctrine," *Tax Notes*, Nov. 12, 2012, p. 797; Cummings, "The Worthless Stock Deduction," *Tax Notes Federal*, June 20, 2022, p. 1875.

[29] *See* LTR 201418046; LTR 201228030; LTR 201127004; and LTR 201418039.

[30] Reg. section 1.368-2(d).

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was able to cross-fertilize the no-COD idea into reorganizations generally. Who will complain? But there is no directly relevant published guidance.

2. Creditor side.

Again, section 361 prevents creditor recognition.

G. Corporate Debt and Section 351

1. Debtor side.

A person can exchange security debt with the issuing corporation for its stock in a section 351 exchange.[31] Section 1032 provides nonrecognition to the corporation on the property transaction. Section 108(e)(8) defines how much COD income the corporation may recognize. There is no confusion in this case about making a two-part analysis: property exchange and COD inclusion. But there is no guidance describing this specific transaction.

In general, if a shareholder in a corporation that is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.[32] Section 108(e)(6) defines the COD amount as the principal amount less the shareholder's adjusted basis in the indebtedness. There are uncertainties about the interaction of this subsection with subsections (6) and (8) that we don't pursue here.[33]

2. Creditor side.

The shareholder will obtain new basis or increased basis in the stock of the debtor corporation without recognition but derived from the basis of the note.

IV. When Creditor Acquires Debtor

Here the combinations run the other way and the creditor acquires the assets of the debtor corporation and assumes the debt to itself, either by operation of section 381 or state law. The tax rules are clearer. But observe that the creditor effectively receives payment for the note.

A. Debtor Subsidiary Liquidation

1. Debtor side.

Unlike section 351 and 361 exchanges, section 357 cannot apply to a debtor subsidiary liquidation. The reason is that it was not needed; until repeal of the *General Utilities* doctrine, a corporation could not recognize gain on a distribution. So instead, the statute and regulations address the issue. Section 337(b)(1) states:

> If a corporation is liquidated in a liquidation to which section 332 applies, and on the date of the adoption of the plan of liquidation, such corporation was indebted to the 80-percent distributee, for purposes of this section and section 336, any transfer of property to the 80-percent distributee in satisfaction of such indebtedness shall be treated as a distribution to such distributee in such liquidation.

That means the subsidiary did not pay assets to discharge debt, which could cause subsidiary to recognize gain or loss in the assets. Also, reg. section 1.332-7 states:

> If section 332(a) is applicable to the receipt of the subsidiary's property in complete liquidation, then no gain or loss shall be recognized to the subsidiary upon the transfer of such properties even though some of the properties are transferred in satisfaction of the subsidiary's indebtedness to its parent.

And reg. section 1.337-1 states:

> If sections 332(a) and 337 are applicable with respect to the receipt of a subsidiary's property in complete liquidation, no gain or loss is recognized to the liquidating subsidiary with respect to such property (including property distributed with respect to indebtedness, see section 337(b)(1) and section 1.332-7).

So unlike the other cases discussed above, someone really thought about this case in writing the rules, and the fact that that someone was Congress impelled Treasury to get the regulations right. What this rule does is avoid the possibility

[31] Section 351(d)(2).

[32] Reg. section 1.61-12(a).

[33] *See* LTR 200146013; Lau, Jolley, and Piwko, "Part II," *supra* note 2, at 17.

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that the debtor would be deemed to have exchanged the depreciated truck for the cancellation of its debt to the parent. But again, that says nothing about COD income. Presumably, the property exchanged for the debt is worth the debt's FMV. If that is less than the adjusted issue price, the sub should recognize COD income. But there is no authority to that effect. Best guess is that the conversion of a debt payment into a stock redemption solely for purposes of sections 332 and 337 is extended to pretend that the sub did not discharge the debt for COD purposes, akin to the property-transaction-only principle.

This rule has another oddity. It applies only to debt to the 80-percent distributee that existed on the date of the adoption of the plan of liquidation. There can be confusion when the board formally adopts the plan substantially in advance of the actual liquidation or the liquidation occurs over time.

Finally, note that the regulation says the parent can recognize loss too. Because the sub will be solvent, presumably the loss might only reflect purchase price discount. But if the same rule applies to a reorganization, according to Rev. Rul. 72-464, the surviving corporation might recognize a loss on the merger of an insolvent target.

2. Creditor side.

Reg. section 1.332-7 (2016) states that:

> Any gain or loss realized by the parent corporation on such satisfaction of indebtedness, shall be recognized to the parent corporation at the time of the liquidation. For example, if the parent corporation purchased its subsidiary's bonds at a discount and upon liquidation of the subsidiary the parent corporation receives payment for the face amount of such bonds, gain shall be recognized to the parent corporation. Such gain shall be measured by the difference between the cost or other basis of the bonds to the parent and the amount received in payment of the bonds.

In contrast with the subsidiary's treatment, this regulation basically bifurcates the transaction for purposes of taxing the shareholder on disposition of the subsidiary's note. It does not say the creditor is paid the value; it implies creditor is paid the face amount. But GCM 34902 interpreted the regulation to mean the creditor received the value of the note in the liquidation.

Reg. section 1.334-1 (2016) addresses the same case and says carryover basis applies to the creditor. T.D. 9759 last updated both of them. So the combination of regulations seems to be saying that the liquidation really should be bifurcated, but we don't want the subsidiary maybe choosing which assets were exchanged for the debt, so we won't cause the subsidiary to recognize gain or loss; thus, all of the asset basis carries over; but the liquidation will be bifurcated for the shareholder, which will recognize gain or loss on the sub's debt.

B. Taxable Liquidation

1. Debtor side.

In a state law liquidation, the debtor would have to apply its assets first to its debts. That should establish the amount paid to discharge the debt to the parent, and the difference, if any, would be COD income, which might be excluded by section 108(a). The debtor will recognize gain or loss on exchanging its assets.

2. Creditor side.

In a check-the-box liquidation, Rev. Rul. 2003-125, 2003-2 C.B. 1243, did not quantify the amount of the worthless debt deduction on the creditor side. Presumably it would be the difference between the FMV of the sub's assets (for a sole shareholder parent) and the basis in the debt.[34]

C. Debtor Asset Reorganization

1. Debtor side.

Section 357 treats the debt relief as an assumption, and *Edwards Motor Transit* (downstream reorganization) held that was exclusive and precluded COD income for the target debtor. Rev. Rul. 72-464 confirms the result. The same result should apply to an upstream reorganization of the debtor. *Edwards Motor Transit* also reasoned that the debtor paid the debt by the transfer of its assets in the nonrecognition exchange for assumption and stock of the

[34] *See* CCA 200706011.

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surviving corporation. The IRS has ruled that the acquirer's "interim financing" of the target is boot and did not create a liability to be assumed.[35]

2. Creditor side.

The creditor survivor will recognize gain or loss on the target's note and take a transferred basis in all its assets, again according to Rev. Rul. 72-464. The ruling simply applied the section 332 law, without explaining how it could do that.

D. Section 351

1. Debtor side.

If the debtor transfers assets to a corporation that takes it subject to or assumes a debt to itself, section 357 applies and *Kniffen* treats the shareholder debtor as only having its debt assumed and not discharged.

2. Creditor side.

The creditor should recognize gain or loss in the note by analogy to the preceding authorities, but there is no law to that effect.[36]

V. Consolidated Groups

Reg. section 1.1502-13(g) governs extinguishment of intercompany debt among other intercompany transactions.[37] Extinguishment is a triggering transaction that could cause intercompany debt to be deemed satisfied and reissued. That is the regime that applies when an intercompany obligation enters or leaves the group or is exchanged but remains outstanding.

But reg. section 1.1502-13(g)(3)(i)(B) states exceptions for extinguishments from debt to be deemed satisfied and reissued when there is section 361, 332, or 337 nonrecognition. Also, section 351 exchanges can avoid any net income or deduction if the debt's adjusted issue price equals the creditor's adjusted basis (the usual case). For such transactions, sections 108, 351, and 354 are turned off.

While enormously complex and hard to understand, the regulation generally winds up either (1) applying a nonrecognition rule to the debt extinguishment, or (2) triggering offsetting recognized items that would not otherwise exist, to produce no net income and no debt to be deemed satisfied and reissued. The regulation sort of had to work that way because the debt will be extinguished and could not be deemed reissued. The consolidated return regulation does not change the rules discussed above.

VI. Chart of Consequences

The table summarizes the COD and other consequences of the transactions discussed in more detail above. The last six columns identify six types of transactions in which the debtor can either be the transferee (of assets, including its note) or the transferor of assets (in which its obligation is assumed by the transferee creditor). Although there are some question marks (see text above for discussion), in general the cites for "no COD" can be relied upon.

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[35] Rev. Rul. 72-343, 1972-2 C.B. 213.

[36] See LTR 8042022, which cited Rev. Rul. 72-464 but said the creditor did not recognize gain or loss.

[37] *See* Lau, Jolley, and Piwko, "Part III," *supra* note 2; Cummings, "Consolidated Returns Primer: Part 1," *Tax Notes Federal*, Aug. 1, 2022, p. 667.

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Summary of Consequences

Party Affected	Section 301 Distribution	Section 331-336 Liquidation	Section 332-337 Liquidation	Asset Reorganization	Section 351	Recap; Contribution to Capital
Debtor transferee	COD Reg. section 1.301-1(k) Rev. Rul. 2004-79	No COD? *Gilmore*	No COD? Rev. Rul. 74-54	No COD? Rev. Rul. 74-54	COD Section 108(e)(6) Section 108(e)(8)	COD Section 108(e)(10) Section 108(e)(8) Section 118 Reg. section 1.61-12(c)(2)
Creditor transferor	Section 311	Section 336	Section 337	Section 361(a)	Section 351	Section 1271 Section 354
Debtor transferor		COD and section 108	No COD? Reg. section 1.332-7 Reg. section 1.337-1 Section 337(b)(1)	No COD Section 357 Rev. Rul. 72-464; *Edwards Motor Transit*	No COD Section 357 *Kniffen*	
Creditor transferee		Rev. Rul. 2003-125	Reg. section 1.332-7 Section 334(b)(1)	Rev. Rul. 72-464	Gain or loss?	

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