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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: D Reorganization and Cancellation of Indebtedness

This Field Service Advice responds to your memorandum dated September 3, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

S2 =
S1 =
FP =
year d =
year c =
year e =
Date a =
Date b =
Date c =
Date d =
Date e =

ISSUE 1

Whether the Service should challenge taxpayer's assertion that S1's liquidation into FP, and FP's formation of S2, qualified as a tax-free reorganization under section 368(a)(1)(D) to which section 381(a) applied.

CONCLUSION 1

We believe the Service should not challenge the taxpayer's assertion that S1's liquidation into FP, and FP's formation of S2, qualified as a tax-free reorganization under section §368(a)(1)(D) to which section 381(a) applied.

ISSUE 2

Whether on FP's cancellation of debt that S1 owed to FP, S1 recognized cancellation of indebtedness ("C.O.D.") income that was excluded from S1's gross income under section 108(a), as a result of which S1 was required to reduce tax attributes under section 108(b).

CONCLUSION 2

On FP's cancellation of debt that S1 owed to P, S1 recognized C.O.D. income to the extent S1 was insolvent at the time of the cancellation. This C.O.D. income was excluded from S1's gross income under section 108(a), as a result of which S1 was required to reduce tax attributes under section 108(b). Additionally, S1 may have also recognized some C.O.D. income under section 108(e)(6) on the remaining portion of the canceled debt, which was treated as a contribution capital from FP to S1.

ISSUE 3

Whether S1 must recognize gain by virtue of the application of: (1) section 367(a) to S1's distribution to FP of the S2 stock under section 361(c), and (2) section 367(b) to FP's contribution of debt to the capital of S1.

CONCLUSION 3

The application of section 367(a) to the distribution would cause S1 to treat FP as a non-corporate recipient, but there is no tax effect because the applicable nonrecognition provision, section 361(c), does not require the recipient to be a corporation. Additionally, the application of section 367(b) to FP's contribution of debt to the capital of S1 is not a transaction made taxable under the section 367(b) regulations.

FACTS

S1 was a wholly owned subsidiary of FP, a corporation that we assume was not a controlled foreign corporation under section 957. On Date a, S1 filed a notice of its commencement of a proceeding to wind up and dissolve. A certificate of dissolution was executed on Date c and filed on Date d. On Date b, articles of incorporation were filed for S2. In the dissolution, S1 transferred its assets to FP. Around this time, FP transferred the assets it received from S1, which were S1's historical assets, to S2.[1] The taxpayer argues that the liquidation of S1 and reincorporation of S2 qualified as a tax-free reorganization under section 368(a)(1)(D).

Both S1 and S2 were in the same line of business, selling inventory products purchased from FP. S2 generated a net operating loss during year d. Thereafter, S2 reported operating profits. S1 incurred net operating losses from year e through year c. S2 had a negative cash flow and had insufficient funds to pay its accrued debts .

At the time of the dissolution, FP discharged debt that S1 owed FP, including S1 accounts payable owed to FP. At that time, S1 was insolvent; its liabilities exceeded its assets. FP treated the entire amount of debt discharged as a contribution to the capital of S1.

LAW AND ANALYSIS

We believe the Service should not challenge the taxpayer's assertion that the series of steps in this case, which included the liquidation of S1, and FP's formation of S2, constituted a reorganization under section 368(a)(1)(D). See e.g., Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947); Rose v. United States, 640 F.2d 1030 (9th Cir. 1981).

Section 368(a)(1)(D) provides that a reorganization under that section includes the transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

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[1]The facts concerning FP's transfer of assets to S2 and S2's issuance of S2 stock to FP are unclear. In particular, the facts are unclear concerning whether S2 issued S2 stock to FP at the time of FP's transfer of assets to S2, or whether S2 had previously issued stock to FP and then issued no shares to FP at the time of FP's transfer of the assets to S2.

Section 354(a) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 354(b)(1) provides that section 354(a) shall not apply to an exchange in pursuance of a plan of reorganization with the meaning of section 368(a)(1)(D) or (G), unless --

> (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and
>
> (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Treas. Reg. § 1.368-1(b) provides, in part:

> The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms.

Section 361(a) provides that no gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

Section 361(c) provides that except as provided in 361(c)(2), no gain or loss shall be recognized to a corporation a party to a reorganization on the distribution to its shareholders of property in pursuance of the plan of reorganization.

We believe that P's cancellation of S1's debt had independent significance apart from the reorganization, and that S1, in substance, transferred all its assets to S2. (See Issue #2.) Since S1, in substance, transferred all its assets to S2, the transaction met the section 354(b)(1)(A) requirement that the corporation to which the assets were transferred acquired substantially all of the assets of the transferor, as well as the section 368(a)(1)(D) requirement that the transferor transfer all or a part of its assets to another corporation. Also, since P was in control (within the meaning of section 304(c)) of S2 immediately after S1's transfer of the assets to S2, the transaction also met the section 368(a)(1)(D) requirement that, immediately

after the transfer, the transferor and\or its shareholder(s) were in control of the corporation to which the assets were transferred.

FP received S2 stock upon incorporating S2, and, as a result of S1's transfer of its assets to S2, FP's S2 stock increased in value.[2] In substance, S1 can be viewed as having received S2 stock that S1, in turn, transferred to FP in pursuance of the plan. See e.g., Rose v. United States, 640 F.2d 1030, 1034 (9th Cir. 1981). Accordingly, assuming the transaction otherwise qualified for reorganization treatment, the facts indicate that the transaction met the section 354(b)(1)(B) requirement that stock received by the transferor was to be distributed in pursuance of the plan of reorganization.

In addition to meeting certain statutory requirements, a transaction must also meet certain nonstatutory requirements to qualify as a tax-free reorganization under section 368(a)(1)(D) -- e.g., namely, the business purpose requirement, the continuity of proprietary interest requirement, and the continuity of business enterprise requirement. We are aware of no facts to indicate the transaction failed to meet any of these nonstatutory requirements. Accordingly, we believe the Service should not challenge the taxpayer's assertion that the transaction is a D reorganization.[3]

Assuming the transaction qualified as a D reorganization, S1 recognized no gain or loss under sections 361(a) and 361(c) either on the transfer of property to S2 in exchange for S2 stock or on the transfer of S2 stock to FP, respectively.

ISSUE #2

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[2]As already indicated, the facts are unclear concerning whether S2 issued stock to FP upon FP's incorporation of S2 and whether S2 then issued no shares to FP at the time of FP's transfer of the assets to S2, or whether S2 issued stock to FP only at the time of FP's transfer of assets to S2. However, our conclusion does not change if S2 issued stock to FP only at the time of FP's transfer of the assets to S2.

[3]Although the taxpayer also asserts that the transaction is an "F" reorganization, we have not addressed whether the transaction is an "F" reorganization since the acquired corporation's net operating losses and general business credits carry over to the acquiring corporation under section 381(a) irrespective of whether the transaction is a "D" or an "F" reorganization.

At the time of the dissolution, FP canceled the debt [4] that S1 owed to FP. We believe FP's cancellation of S1's debt had independent economic significance apart from the reorganization. Cf. Rev. Rul. 68-602, 1968-2 C.B. 135; Rev. Rul. 78-330, 1978-2 C.B. 147. In Rev. Rul. 68-602, a parent corporation canceled the debt its subsidiary owed to it immediately before the subsidiary transferred its assets to it pursuant to a plan of complete liquidation. The parent corporation had canceled the subsidiary's debt in an attempt to qualify the transaction under section 332. If section 332 applied to the transaction, the parent corporation would have succeeded to its subsidiary's NOL carryover under section 381(a). In that ruling, the Service reasoned that the parent corporation's cancellation of the debt was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of the subsidiary's NOL carryover. As a result, the ruling concluded that the parent corporation's cancellation of the debt was transitory and was disregarded.

In contrast, in Rev. Rul. 78-330, a parent corporation canceled the debt its subsidiary owed to it immediately before that first subsidiary merged into a second subsidiary of the parent corporation in a transaction described under section 368(a)(1)(A) and section 368(a)(1)(D). The parent corporation canceled the subsidiary's debt to avoid section 357(c) gain; if the parent had not canceled the debt, the amount of the subsidiary's liabilities would have exceeded the basis of the subsidiary's assets. In that ruling, the Service concluded that the parent corporation's cancellation of the subsidiary's debt had independent economic significance and had substance for tax purposes –i.e., under the facts of that case, as a capital contribution by the parent corporation to the subsidiary.[5]

We believe that, analogous to Rev. Rul. 78-330, the cancellation of the debt in the instant case that S1 owed to FP had independent economic significance and substance for tax purposes. Unlike the situation in Rev. Rul. 68-602, the parent's cancellation of the subsidiary's debt was not transitory, but had independent significance apart from the reorganization and apart from securing any tax benefits.

Additionally, because we believe FP's cancellation of S1's debt had independent economic significance and substance for tax purposes, we believe neither Rev. Rul. 59-296, 1959-2 C.B. 87, nor Rev. Rul. 68-359, 1968-2 C.B. 161, applies in this case. In both Rev. Rul. 59-296 and Rev. Rul. 68-359, the liabilities of the liquidating subsidiary exceeded the fair market value of the assets of the liquidating

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[4]We express no opinion on whether the debt is equity for tax purposes.

[5]In that ruling, we believe the entire amount of the canceled debt was treated as a capital contribution because the ruling appears to assume the subsidiary was not insolvent.

subsidiary so that section 332 did not apply to the transactions at issue. However, in the instant case, by respecting FP's cancellation of the S1 debt, S1 was solvent at the time of the reorganization. The amount of S1's liabilities no longer exceeded the fair market value of S1's assets. At the time of the reorganization, none of S1's assets went to P; instead, all of S1's assets were transferred directly to S2 in the reorganization transaction.

However, although we believe FP's cancellation of the debt had independent significance and substance for tax purposes, we believe FP did not make a capital contribution to S1 of the entire amount of the debt that was canceled. Instead, as discussed below, we believe FP made a capital contribution to S1 of the debt only to the extent S1 became solvent as a result of the cancellation.

Canceled Debt That Is Capital Contribution

A shareholder generally makes a capital contribution to a debtor corporation to the extent that the shareholder's cancellation of the corporation's debt enhances the value of the shareholder's stock. Cf. Mayo v. Commissioner, T.C. Memo. 1957-9, acq., AOD-OM 11,813 (May 27, 1957). In the case of debt that is canceled, the value of a debtor corporation increases by the amount by which the corporation becomes solvent as a result of the debt that is canceled.

In the instant case, the value of S1 only increased by the amount by which S1 became solvent as a result of FP's cancellation of S1's indebtedness owed to FP. As a result, we believe FP made a capital contribution of debt to S1 only to the extent S1 became solvent as a result of FP's cancellation of the debt.[6] Depending on FP's basis in this debt, S1 may have recognized COD income under section 108(e)(6) on FP's capital contribution to S1 of this portion of the debt.

A corporate shareholder that gratuitously forgives a debt the corporation owes the shareholder generally makes a capital contribution to the corporation to the extent of the debt forgiven. Treas. Reg. §1.61-12(a). Gross income generally does not include contributions to capital. I.R.C. § §118. However, under I.R.C. § 108(e)(6), a debtor corporation is treated as having satisfied debt contributed by a shareholder with an amount of cash equal to the shareholder's adjusted basis in the debt contributed.

Canceled Debt That Is Not Capital Contribution

[6]Or, viewed from a different perspective, the amount of canceled debt that results in COD income (rather than a capital contribution), should be the amount of debt, less the amount of debt that the debtor can pay off -- i.e., with its assets.

S1 recognized C.O.D. income on the amount of debt that was canceled that was not a capital contribution. S1 excluded this C.O.D. income from gross income under section 108(a); however, S1 was then required to reduce tax attributes under section 108(b) by the amount of this excluded income.

Gross income includes income from the discharge of indebtedness. I.R.C. §61(a)(12). Gross income does not include discharge of indebtedness income when the taxpayer is insolvent. I.R.C. § 108(a)(1)(B). The amount of indebtedness excluded from gross income is applied to reduce the taxpayer's tax attributes as follows:

> (A) NOL - any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year
>
> (B) General business credit - any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

I.R.C. §108(b)(2).

In summary, we believe S1 recognized "C.O.D." income to the extent S1 was insolvent at the time of the cancellation. This C.O.D. income was excluded from S1's gross income under section 108(a), as a result of which S1 was required to reduce tax attributes under section 108(b). Furthermore, S1 may have also recognized some C.O.D. income under section 108(e)(6) on the remaining portion of the canceled debt, which was treated as a contribution capital from FP to S1.

ISSUE 3

S1's distribution of S2 stock to FP

If a U.S. person transfers property to a foreign corporation in connection with any exchange described in section... 361, then such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. I.R.C. § 367(a). The effect of section 367(a) is that gain will be recognized on certain transfers to foreign recipients. Gain or income is recognized under section 367(a) only when the applicable nonrecognition provision requires that the recipient be a corporation (*e.g.*, section 361(a)).

S1's transfer of the S2 stock to FP is a distribution under section 361(c). Section 361(c) provides "that no gain or loss shall be recognized to a corporation a party to

the reorganization on the distribution to its shareholders of property in pursuance of a plan of reorganization." Section 361(c) does not require that the recipient shareholders be corporations.

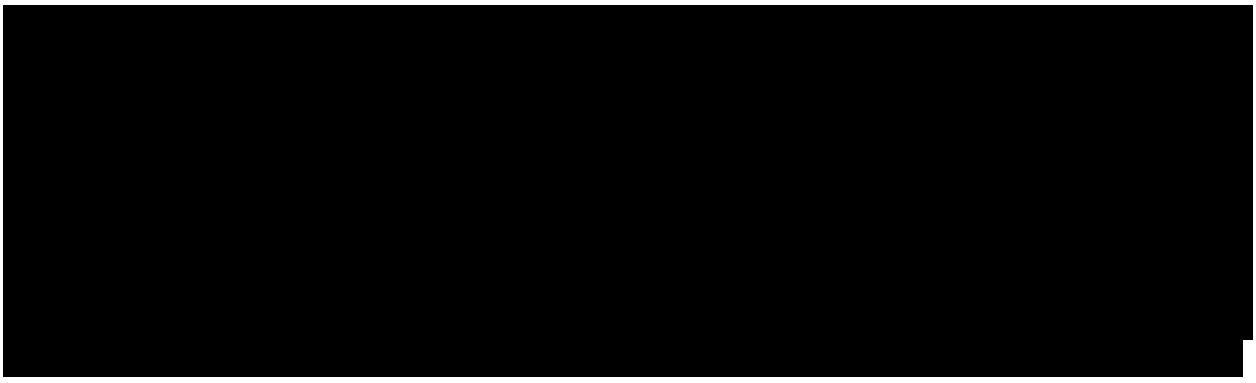
The application of section 367(a) to the distribution of the S2 stock, however, would not have any tax effect on this transaction because the applicable nonrecognition provision, section 361(c), does not require that the recipient be a corporation. We also note that section 367(e)(2) does not apply to S1's distribution of stock followed by its dissolution because that transaction is not subject to section 332.

FP's contribution to the capital of S1

In the case of any exchange described in section ... 351, in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation, except to the extent provided in regulations. I.R.C. § 367(b). Thus, the rule for transactions described in section 367(b) is that a foreign corporation will be considered to be a corporation for purposes of the applicable nonrecognition provisions, unless regulations provide otherwise.

FP canceled S1's debt in a transaction separate from the reorganization. This cancellation of the debt resulted, in part, in a capital contribution to S1. The regulations under section 367(b) do not address transfers by foreign corporations that are not controlled foreign corporations. Therefore, assuming FP's contribution to the capital of S1 is an exchange described in section 367(b), there would be no tax effect under section 367(b) by virtue of FP's capital contribution to S1.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



If you have any further questions, please call (202) 622-7930.

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