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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR GLENN C. MCLOUGHLIN
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FROM: Victor L. Penico
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SUBJECT: Chief Counsel Advice

This Chief Counsel Advice responds to an oral inquiry. Chief Counsel 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

Corp. A =

Corp. B =

A =

Month M =

Year N =

B =

C =

Equipment =

D =

E =

Year O =

Month P =

ISSUES

Whether Corp. A, upon purchasing at a discount all the outstanding stock of Corp. B and liquidating Corp. B, all at a time when Corp. B held Corp. A debt earlier used by Corp. A to purchase Equipment from Corp. B, either has discharge-of-indebtedness income or other income or must adjust downward its basis in the Equipment.

CONCLUSIONS

Corp. A either has discharge-of-indebtedness income (or other income) or must adjust downward its basis in the Equipment. These are alternative theories.

FACTS

District Counsel, in a September 2, 1999, E-mail, summarized the facts of this case as follows:

"In the transaction under audit, Corp. A [a corporation] acquired the stock of an unrelated corporation, Corp. B, for $A in Month M of Year N. Corp. B held a note and a debenture issued by Corp. A with an aggregate principal balance of approximately $B in Year N. (There was also a revolving note of Corp. A held by Corp. B with a principal balance of approximately $C that does not appear to be related to the Equipment acquisition). The note and the debenture had an original aggregate principal balance of approximately $D. Corp. A issued the debenture and the note, together with $E cash, to Corp. B in Year O in exchange for some Equipment. In Month P of Year N, Corp. A used a statutory merger to effect a Sec. 332 [of the Internal Revenue Code] liquidation of Corp. B. This, of course, extinguished all the Corp. A debt. However, Corp. A did not report any DOI [discharge of indebtedness income] from the transaction, claiming that Sec. 332 and Rev. Rul. 74-54 precluded the recognition of DOI. The stock acquisition and the Sec. 332 appear be part of a single integrated transaction. Since Year N Corp. A has been selling off its assets and is in the process of liquidating and winding up its affairs."

Furthermore, we understand that Corp. B probably had recognized a loss on its sale of the Equipment to Corp. A (and hence the § 453 installment method of reporting did not apply). (If there were a gain and § 453 had applied, that might provide the Service with another avenue of attack against the transaction.) Apart from that belief on the part of the field, the field knows nothing about Corp. B's tax treatment of its sale of the rigs to Corp. A, for example whether it ever took a bad debt deduction on the aforementioned purchase-money installment consideration (the debenture and note) received from Corp. A. The field says it is unable to ascertain Corp. B's tax treatment of the sale of the Equipment.

Thus, in short, Corp. B sold Equipment to Corp. A at a loss, receiving back, among other consideration, a large amount of Corp. A installment paper. At that time, the field accepts, it was not contemplated that Corp. A would eventually buy the Corp. B stock (hence § 108(e)(4) is inapplicable). Several years later, Corp. A indeed bought the Corp. B stock (when Corp. B's only assets were the consideration got in the Equipment sale) at a price far below the face amount of the Corp. A installment paper Corp. B held. Then Corp. A liquidated Corp. B under § 332, receiving back the installment paper on which it was obligor, with such debt effectively merging out of existence in the debtor's hands under state law. Finally, the Service does not know whether Corp. B ever took a bad debt loss on the Corp. A installment paper.

LAW AND ANALYSIS

In discussions with the field, the taxpayer (Corp. A) has cited both § 332 and Rev. Rul. 74-54, 1974-1 C.B. 76, as protecting it from any discharge of indebtedness income under § 61(a)(12).

Rev. Rul. 74-54 effectively accepted the decision in Estate of Helen Gilmore, 40 B.T.A. 945 (1939). Both those authorities thus provide that a liquidating corporation's distribution of its shareholder's note to that shareholder, without an overt act of cancellation of the note by the distributing corporation, does not generate discharge-of-indebtedness income under § 61(a)(12) for the shareholder. Rev. Rul. 74-54 stated:

> [I]n the instant case, the note is property for purposes of § 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 § 61(a)(12) or § 1.301-1(m) of the regulations by reason of the cancellation of the note in connection with the liquidation.

The court in Helen Gilmore said:

> The evidence establishes that all of the corporation's assets were distributed and that the [debt of the shareholder] was treated as an asset. . . . . It was an item of the liquidation proceeds. [It was] entirely a recognition of the subsistence of the debt and the distribution of the [debt] to its shareholders. From both a practical and a theoretical standpoint, this is the proper conception of the final disposition of the indebtedness. The [shareholder] so treated the amount, for it included the [debt] as having been acquired by it in the liquidation distribution, thus serving as a factor of its liquidation gain or loss.

<u>Additional Consequence of Applicability of § 332--Carryover Basis</u>

Thus, Rev. Rul. 74-54 stated that a debt of the shareholder distributed under § 332 "is property for purposes of § 332(a)"--and, one must assume, necessarily for all other purposes related to application of § 332. Moving beyond Rev. Rul. 74-54, one of those other purposes is the fixing of the distributee shareholder's basis in the various items of property received in the § 332 liquidation, one of which in both the facts of Rev. Rul. 74-54 and the Corp. B-Corp. A case is the shareholder's own debt. Corp. A's basis in its own installment paper received back from Corp. B in the liquidation should have been determined under § 334(b)(1), which provides that such basis shall be "the same as it would be in the hands of the transferor," the transferor being Corp. B. Thus, Corp. A inherited Corp. B's basis in the Corp. A installment paper.

So the field should first determine what basis in the Corp. A installment paper Corp. A inherited from Corp. B in the § 332 liquidation. It is urged that the field use all means at its disposal to determine that basis. Importantly, that basis would have been reduced in Corp. B's hands if Corp. B ever took a full or partial bad debt deduction respecting the Corp. A installment paper.

The important question is, how should the field proceed once it has determined the basis Corp. A got in its own installment paper? Basis determined under § 334(b)(1) is, of course, relevant to taxation of the shareholder's subsequent disposition, whenever that may occur, of such property got in the § 332 liquidation. One may reasonably assume that, in the facts of both Rev. Rul. 74-54 and <u>Helen Gilmore</u>, the liquidating corporation's basis in its shareholder's debt, and hence the basis such debtor-shareholder received in the § 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 § 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.

Are the facts in the Corp. B-Corp. A case different from the facts in those other two cases, Rev. Rul. 74-54 and Helen Gilmore? In other words, was Corp. B's tax basis in the Corp. A installment paper by any chance less than, rather than equal to, the fair market value of such paper at the time of the § 332 liquidation? If so, then that creates a distinction between the Corp. B-Corp. A case and the facts in Rev. Rul. 74-54 and Helen Gilmore.

There are at least two reasons Corp. B's basis in the Corp. A paper might have been less than the fair market value of such paper. One is if the paper bore a fixed interest rate and interest rates had fallen between the time of original issuance of the paper and the time of the § 332 liquidation: that could have driven the fair market value of the paper up. The other is if, as mentioned above, Corp. B had ever taken a full or partial bad debt deduction respecting the paper.

Assuming that the field does establish that Corp. B's basis in the paper was less than the fair market value of the paper at the time of the § 332 liquidation, then, again, what does the field do next? At this point, two more authorities become relevant: Rev. Rul. 93-7, 1993-1 C.B. 125, and Cora-Texas Mfg. Co., Inc., v. US, 222 F. Supp. 527 (E.D. La. 1963), aff'd per curiam, 341 F.2d 579 (5th Cir. 1965). These authorities dealt with distribution by a partnership of a partner's own debt or preferred stock to that partner. Section 731 provides for nonrecognition of gain or loss in the case of a distribution of property to a partner. Recognition is deferred until the partner disposes of the distributed property. The amount of the deferred gain or loss is preserved by the transferred and exchanged basis rules of § 732. Thus § 732 is, in function, analogous to § 334(b), discussed above: § 732 fixes the distributee partner's basis in property received for purposes of taxation of that partner's subsequent redisposition of the property, and § 334(b) fixes the distributee shareholder's basis in property received for purposes of taxation of that shareholder's subsequent redisposition of the property.

In Rev. Rul. 93-7, the fair market value of the distributed debt of the distributee partner differed (compare that with the circumstance in Rev. Rul. 74-54 and Helen Gilmore, supra) from the basis § 732 gave the distributee partner in that distributed property. The fair market value of the debt exceeded the distributee partner's § 732 basis in that property. In Cora-Texas, the fair market value of the distributed non-reissuable preferred stock of the distributee partner also differed from the basis § 732 gave the distributee partner in that distributed property. (Cora-Texas predated the applicability of the 1954 Code, but the then-applicable law contained a provision similar to § 732.) The fair market value of the non-reissuable preferred stock originally issued by the distributee partner was less than the distributee partner's basis in the property.

Crucially, Rev. Rul. 93-7 concluded that, because the distributed debt merged out of existence in the distributee partner's hands, and thus no occasion would ever arise subsequently to tax the partner on the excess of the debt's fair market value over the distributee partner's § 732 basis in the debt, the distributee partner must be immediately taxed on the excess. The court in Cora-Texas took a similar view: since the distributee partner could never reissue that particular preferred stock, the distributee partner was entitled to an immediate loss equal to the shortfall of fair market value below basis.

And Rev. Rul. 93-7 concluded:

> because there will be no opportunity for recognition at a future time [as the debt has merged out of existence], the partner will recognize capital gain or loss to the extent the fair market value of the indebtedness differs from the basis of the indebtedness determined under § 732.

Thus, if Corp. A's § 334(b) basis in the installment paper got back in the § 332 liquidation exceeded or was less than such paper's fair market value at the time of the § 332 liquidation, then loss or gain was at that time properly reportable, for, in the words of Rev. Rul. 93-7, "there will be no opportunity for recognition at a future time," as the debt immediately merged out of existence.

Note that this outcome does not contravene § 332. Section 332(a) and § 731(a) (relevant in Rev. Rul. 93-7 and Cora-Texas) are analogous. Section 332(a) provides:

> No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

And § 731(a) provides, in relevant part:

> In the case of a distribution by a partnership to a partner, (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and (2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of (A) any money distributed, and (B) the basis to the distributee, as determined under § 732, of any unrealized receivables (as defined in § 751(c)) and inventory (as defined in § 751(d)).

Thus, in the case of both § 332(a) and § 731(a) taxpayers could perhaps make the same facile argument that their receipt of their own debt cannot in any way or shape result in current taxation to them, but in the partnership situation, Cora-Texas and Rev. Rul. 93-7 clearly establish otherwise. Neither the § 332 nor § 731 regimes block taxation on the shareholder's or partner's subsequent redisposition of distributed property. Cora-Texas and Rev. Rul. 93-7 merely consider that redisposition to have occurred immediately, since, in the words of Rev. Rul. 93-7, "there will be no opportunity for recognition at a future time," since the instrument immediately merges out of existence. Thus, §§ 332(a) and 731(a) are respected; Cora-Texas and Rev. Rul. 93-7 instead apply immediately after the §§ 332(a) and 731(a) events. So, the field should determine whether the Corp. B-Corp. A case is factually distinguishable from Rev. Rul. 74-54 and Helen Gilmore on the crucial basis-versus-fair-market-value issue.

Treatment of Any Excess of the Adjusted Issue Price of the Paper Over Its Fair Market Value

This memorandum has so far addressed taxation of any spread between Corp. A's inherited basis under § 332 in its own installment paper and the fair market value of such paper. The remaining question is whether any theory exists for taxing any excess of the adjusted issue price of the installment paper over fair market value. In other words, there are three dollar amounts involved: (1) Corp. A's inherited basis under § 332 in its installment paper, (2) the fair market value of such paper, and (3) the adjusted issue price of such paper. Assuming that amount (2) exceeds amount (1) and also that amount (3) exceeds amount (2), this memorandum has thus far posited only a theory for taxing the difference between amounts (2) and (1). The question is whether there is also a theory for taxing the difference between amounts (3) and (2). (Depending on the nature of such a theory, it might also provide a back-up argument for taxing the difference between amounts (2) and (1).) Indeed, two such theories exist.

The first theory is discharge-of-indebtedness income under § 61(a)(12), which provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . . income from discharge of indebtedness . . . ." As noted, Helen Gilmore and Rev. Rul. 74-54 indicate that, to have discharge-of-indebtedness income, an overt act of cancellation by the creditor is required.

To explain, § 332(a) and § 731(a) are, as noted above, functionally analogous. The former section limits taxation in the case of a § 332 liquidation; the latter limits taxation to specific amounts in the case of a distribution from a partnership. Notwithstanding that § 731(a) specifically limits taxation on such an event, Rev. Rul. 93-7, discussed above, besides considering the partner immediately to have redisposed of the debt instrument received (as this memorandum previously discussed), also addressed the discharge-of-indebtedness issue. After saying that "the partner will recognize capital gain or loss to the extent the fair market value of the indebtedness differs from the basis of the indebtedness determined under § 732," the ruling said:

> In addition, the receipt of the indebtedness by a partner may require the partner to include in gross income discharge of indebtedness income under § 61(a)(12). The partner is treated as having satisfied the debt for its fair market value, and the amount of discharge of indebtedness income is equal to the amount by which the issue price (adjusted for any premium or discount) of the indebtedness exceeds the fair market value of the indebtedness.

We believe that the same rationale should apply in the case of a § 332 liquidation, and that the language just quoted from Rev. Rul. 93-7 casts institutional doubt on the Service's 1940 acquiesence in Helen Gilmore.

The second theory takes a considerably different approach. Instead of forcing the taxpayer to recognize discharge-of-indebtedness income, forcing the Service to circumnavigate § 332 and Helen Gilmore, this theory would force Corp. A, on the peculiar facts of the Corp. B case, to reduce its basis in the assets originally bought with the installment paper. Section 1016 seems like an appropriate vehicle.

Specifically, § 1016(a)(1) provides that "[p]roper adjustment in respect of the property shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account . . . ." We believe that "properly chargeable to capital account" includes any realized event (as opposed to, say, as-yet unrealized gain in an unsold asset) that increases the taxpayer's net worth while not increasing its corporate-tax earnings and profits. The argument is that Corp. A's reducing its purchase price for the Equipment by purchasing, at a discount, the holder of the purchase money debt falls within that phrase. "Proper adjustment in respect of the property" would refer to the purchased Equipment. Corp. A's basis in the Equipment should thus have been adjusted down by the amount of the bargain purchase of the debt (in other words, the discount obtained), thus reducing Corp. A's subsequent depreciation deductions on the Equipment and increasing any gain on sale of such Equipment.

Should the field desire any additional assistance in applying the second theory, it might contact CC:DOM:IT&A.

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Please call if you have any further questions.

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