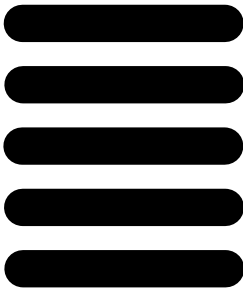




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Don't Sweat the Assumed Debt?

By Stan D. Blyth • Wood & Porter • San Francisco

Historically, when planning an acquisitive reorganization to which Code Sec. 351 applies (and that's common), you worry whether the assumed debt of the transferor will be greater than the adjusted basis of the transferred property. There's good reason for concern given the potential for gain recognition under Code Sec. 357(c). After all, Code Sec. 351 is omnipresent. However, it's a new day after the American Jobs Creation Act of 2004 (P.L. 108-357, 188 Stat. 1418) ("Jobs Act") amended Code Sec. 357(c).

In Rev. Rul. 2007-8 [IRB 2007-7, 469], the IRS examined the effect of this amendment on two transactions qualifying both as acquisitive reorganizations and as transfers to controlled corporations under Code Sec. 351. In the first transaction, A, an individual, owned all of the stock of corporation X and corporation Y. Y acquired all of the assets of X (and assumed the liabilities of X) in exchange for a controlling block of Y's stock. Pursuant to the plan, X then liquidated and distributed the Y stock to A.

At the time of the transaction, the sum of X's liabilities assumed by Y exceeded X's total adjusted basis in the property transferred to Y. Additionally, the value of X's assets transferred to Y exceeded X's liabilities assumed by Y. Immediately after the exchange, the value of Y's assets exceeded Y's liabilities. The transaction qualified as a D reorganization and as a Code Sec. 351 exchange.

The second transaction presented a more complex structure. Here, A, an individual, owned all of the stock of corporation X. B, an individual unrelated to A, owned all of the stock of corporation Y. Y acquired all of the assets of X in exchange for Y voting stock and the assumption of X's liabilities. Pursuant to the plan of reorganization, X liquidated and

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distributed the Y voting stock to A. At the time of the acquisition, the sum of the X liabilities assumed by Y exceeded X's total adjusted basis in the property transferred to Y.

Furthermore, the value of X's assets transferred to Y exceeded the amount of X's liabilities assumed by Y. Immediately after the exchange, the value of Y's assets also exceeded the amount of Y's liabilities. Simultaneously, and as part of the overall plan of reorganization, B contributed property to Y in exchange for additional Y stock. Thus, immediately after the transaction, B held more than 50 percent of the vote and of the value of all Y stock.

The Y stock issued to X, along with the Y stock issued to and held by B immediately after the transaction, constituted control of Y. The transfer by X of all of its assets to Y in exchange for Y voting stock and assumption of liabilities, followed by the liquidation of X, qualified as a C reorganization. Plus, X's transfer of assets to Y in exchange for Y voting stock (along with

B's transfer of property to Y in exchange for additional Y stock) was a Code Sec. 351 transfer.

Following Legislative Intent

The IRS began its analysis in Rev. Rul. 2007-8 with a brief discussion of Code Sec. 357(a). It is nearly an axiom that where a liability of the taxpayer is assumed by another party to the exchange, that assumption is not treated as money or other property. The IRS then turned to Code Sec. 357(c)(A)(1), which requires a transferor to recognize gain if the sum of liabilities assumed exceeds the total adjusted basis of the property transferred.


Prior to the enactment of the Jobs Act, Code Sec. 357(c)(1) applied to any Code Sec. 351 transfer or exchange to which Code Sec. 361 applied by reason of a plan of reorganization within the meaning of Code Sec. 368(a)(1)(D). The Jobs Act amended Code Sec. 357(c)(1)(B), limiting the application of Code Sec. 357(c)(1) to exchanges to which Code Sec. 351 applies, or to which Code Sec. 361 applies by reason of a plan of reorganization within the meaning of Code Sec. 368(a)(1)(D) with respect to which stock or securities of the corporation to which the assets are transferred are distributed in a transaction qualifying under Code Sec. 355.

Put simply, Code Sec. 357(c) no longer applies to an acquisitive D reorganization satisfying the requirements of Code Sec. 354(b)(1) (which requires that substantially all of the assets of the transferor, and the stock and other properties received by such transferor, are distributed pursuant to a plan of reorganization).

As a basis for its decision, the IRS looked to the legislative history underlying the Jobs Act amendment:

The Committee believes that ... the [transferee] should be permitted to assume liabilities of the [transferor] without application of the rule of section 357(c). This is because in an acquisitive reorganization under section 368(a)(1)(D), the transferor must generally transfer substantially all of its assets to the acquiring corporation and then go out of existence

In light of the legislature's intent, the IRS determined that the amendment was intended to conform the treatment of D reorganizations to the treatment of other acquisitive reorganizations. Plus, it was designed to exclude reorganizations from the application of Code Sec. 357(c)(1), unless



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they are described in Code Sec. 357(c)(1)(B), regardless of whether these reorganizations are also Code Sec. 351 exchanges.

Transferor Not Enriched

Because the transferor corporation ceased to exist in both situations before it, the IRS reasoned that the transferor could not be enriched as a result of the assumption of liabilities. Accordingly, the

IRS found that Code Sec. 357(c)(1) did not apply to either transaction, even though the transfers involved in each were also 351 exchanges. The IRS further concluded because Code Sec. 357(c)(1) is no longer applicable to an A, C or D reorganization, it no longer applies to a G reorganization either (that satisfies the requirements of Code Sec. 354(b)(1)), regardless of whether the transaction is also a Code Sec. 351 exchange.