Partial Debt Cancellations: Slicing Debt With Occam's Razor

By Scott M. Levine and Thomas N. Molins

Scott M. Levine is a partner with Jones Day's Washington office and an adjunct professor at the Georgetown University Law Center. Thomas N. Molins is counsel with Jones Day's Chicago office. The opinions expressed in this report are solely those of the authors and do not necessarily reflect the viewpoints of Jones Day.

In these uncertain economic times, shareholder cancellations of corporate debt are commonplace. Sometimes a shareholder only wishes to cancel a portion of that debt in an effort to protect its equity investment and improve the corporation's viability as a going concern. Until recently, the tax consequences to a debtor corporation when its shareholder partially canceled its debt were thought to be straightforward — there was no cancellation of indebtedness income provided the shareholder's basis in the debt was at least equal to the debt's adjusted issue price. A debate has emerged, however, suggesting that the tax consequences to such run-of-the-mill transactions may be more complicated. In this report, we argue that these partial debt cancellations are what they appear to be — shareholder contributions to capital subject to section 108(e)(6) provided the creditor-shareholder acts in its capacity as a shareholder. For the reasons discussed in this report, to the extent section 108(e)(10) is relevant to the analysis, we believe that section 108(e)(6) trumps section 108(e)(10) when a shareholder partially cancels its corporation's debt. We also believe that there is little, if any, support for bifurcating a partial debt cancellation in the shareholder-corporation context as part debt-for-debt exchange and part contribution to capital. In these cases, the simplest of explanations should be the correct one.

Copyright 2010 Scott M. Levine and Thomas N. Molins.
All rights reserved.

Table of Contents

I. COD Income and Contributions to Capital . . . 312
- A. COD Income . . . 312
- B. Contributions to Capital . . . 312
- C. Canceling Debt as a Contribution to Capital . . . 313
- D. Capital Contributions to Insolvent Debtors . . . 314

II. Partial Debt Cancellations . . . 315
- A. Treatment as a Contribution to Capital . . . 315
- B. Section 108(e)(10) Should Not Be Implicated . . . 315
- C. Section 108(e)(6) Trumps Section 108(e)(10) . . . 316
- D. Bifurcation Is Inappropriate . . . 318

III. Conclusion . . . 321

Entities must not be multiplied beyond necessity.[1]

In the wake of the economic downturn, many companies and their sponsors have engaged in restructurings to emerge in a stronger financial position. Before the recession, many businesses were heavily leveraged — a common situation in the heyday of private equity. In the aftermath of the downturn, these same businesses sought (and continue to seek) to extricate themselves from some of the often crippling debt owed to their creditor-shareholders. One common technique is for a creditor-shareholder to discharge some (but not all) of the debtor corporation's debt so that the corporation's debt is reduced to a more sustainable level while still preserving the creditor-shareholder's priority in bankruptcy should the corporation fail to rebound. These corporations are often owned entirely by a single shareholder (for example, a private equity fund) and at least some of their historical debt is held by creditor-shareholders in the form of a single debt instrument. Corporations that have engaged or plan to engage in this common debt reduction transaction generally do not expect to recognize cancellation of indebtedness (COD) income as a result.

When a creditor-shareholder voluntarily cancels a debtor corporation's debt, one of two provisions generally applies: section 108(e)(6) or (e)(8). Section 108(e)(6) addresses shareholder contributions to capital, while section 108(e)(8) addresses debt cancellations in exchange for debtor corporation stock. Much has been written about which provision

[1]The above quote is attributed to the 14th-century English logician, theologian, and Franciscan friar, William of Occam. Commonly referred to as "Occam's Razor," this principle provides that the simplest of explanations is more likely to be correct than any other.

applies when a creditor-shareholder contributes a debt to its debtor corporation and does not receive any additional shares in return.[2] Among the issues are whether the meaningless gesture doctrine will apply, resulting in the application of section 108(e)(8), and whether the contribution-to-capital form will be respected, resulting in the application of section 108(e)(6). The IRS appears to have concluded that form prevails and that section 108(e)(6) therefore applies when no debtor corporation stock is issued in exchange for the debt discharged.[3]

Some practitioners, however, seem unsure of the tax consequences to a debtor corporation when a creditor-shareholder cancels less than the full amount of an indebtedness previously advanced to the debtor corporation.[4] Although they suggest that these partial cancellations could trigger COD income under section 108(e)(10), for the reasons set forth in this report, the tax treatment of a partial cancellation by a shareholder for no additional stock should be determined solely by the rules of section 108(e)(6). The result is that the debtor corporation has no COD income if the creditor-shareholder's tax basis in the debt discharged is at least equal to the amount of the debt discharged. Before analyzing the tax treatment of partial cancellations, this report briefly reviews the law governing COD income, capital contributions, and shareholder contributions of debt, as well as the authorities addressing the effect of a debtor's insolvency on shareholder contributions of debt.

I. COD Income and Contributions to Capital

A. COD Income

Because a borrower is obligated to repay borrowed funds, it is not taxed on the receipt of borrowed funds.[5] However, a borrower realizes an accretion to wealth and, as a result, taxable income if that obligation to repay is canceled or repaid/acquired by the debtor at a discount.[6] The Supreme Court in *United States v. Kirby Lumber Co.*[7] established the principle that the gain or savings realized by a debtor on the reduction or cancellation of the debtor's outstanding indebtedness for less than the amount due is income for tax purposes.[8] The *Kirby Lumber* principle was codified as section 61(a)(12), which provides the general rule that gross income includes COD income.[9] However, section 108 contains several exceptions, including the exclusion of COD from income for taxpayers in bankruptcy proceedings[10] and for insolvent taxpayers (to the extent of their insolvency),[11] as well as the exemption for a cancellation of debt that constitutes a contribution to capital to the extent of the contributing shareholder's basis in the canceled debt.[12] The exclusions under section 108(a) generally come at a cost. When an insolvent or bankrupt taxpayer excludes COD income, it must reduce its tax attributes.[13]

B. Contributions to Capital

Section 118(a) generally provides that a corporation's gross income does not include a contribution to its capital. The term ''contribution to capital'' is not defined in the code or regulations. However, the regulations provide that section 118(a) does not apply to a transfer of money or property to a corporation in consideration for goods or services rendered.[14] The *motive* behind a contribution is the dominant factor in determining whether a transaction is a capital contribution or a payment for goods

---

[2]*See, e.g.*, David B. Friedel, ''New Solutions to Old Problems When Selling Member of Consolidated Group,'' 36 *J. Corp. Tax'n* 6 (2009); Carl M. Jenks et al., ''Corporate Bankruptcy,'' *Tax Mgmt*. (BNA) No. 790, at A-93 (2004); David P. Madden, ''Contribution to Capital or Contribution to Confusion?'' 25 *J. Corp. Tax'n* 367 (1999); Robert A. Rizzi, ''Contributions to Capital Under Section 108(e)(6): The Last Frontier,'' 23 *J. Corp. Tax'n* 57 (1996); *see also* Boris Bittker and Lawrence Lokken, *Federal Taxation of Income Estates and Gifts*, para. 7.4 (3d ed. with 2010 online supplements).

[3]*See, e.g.*, LTR 201016048 (Dec. 22, 2009), *Doc 2010-9078*, *2010 TNT 79-21* (concluding that section 108(e)(6) applies when no stock issued); LTR 200537026 (June 17, 2005), *Doc 2005-19076*, *2005 TNT 180-40* (concluding that section 108(e)(6) applies when no stock issued and section 108(e)(8) applies when stock actually issued); LTR 9830002 (Mar. 20, 1998), *Doc 98-23332*, *98 TNT 143-16* (concluding that section 108(e)(8) applies when stock actually issued).

[4]William Potter and Deanna Walton Harris, ''Unintended Tax Consequences from Intercompany Debt Cancellations,'' 37 *J. Corp. Tax'n* 5 (2010).

[5]*See United States v. Centennial Svgs. Bank FSB*, 499 U.S. 573, 582 (1991). (''Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates.'')

[6]Reg. section 1.61-12(c)(2)(ii).

[7]284 U.S. 1 (1931).

[8]In *Kirby Lumber*, the debtor corporation had purchased its own bonds at a discount in the open market, and the Supreme Court held that the difference between the issue price of the bonds and the price at which the bonds were acquired represented taxable income.

[9]The code was amended in 1954 to provide explicitly in section 61(a)(12) that ''income from discharge of indebtedness'' is includable in gross income.

[10]Section 108(a)(1)(A).

[11]Section 108(a)(1)(B).

[12]Section 108(e)(6).

[13]Section 108(b).

[14]Reg. section 1.118-1.

or services.[15] Thus, a voluntary contribution of money or property by a shareholder to a corporation is usually treated as a contribution to the corporation's capital under section 118(a).[16] Accordingly, a corporation generally does not include the amount of a capital contribution in income and it takes a carryover tax basis in contributed property equal to the shareholder's tax basis in that property.[17] For the contributing shareholder, the capital contribution is accounted for as a basis increase in its shares equal to the amount of money contributed and the shareholder's adjusted tax basis in the contributed property at the time of the contribution.[18]

C. Canceling Debt as a Contribution to Capital

When a creditor-shareholder of a debtor corporation transfers debt to the corporation as a contribution to capital, section 108(e)(6) provides that section 118 does not apply and the corporation is instead treated as having satisfied the debt for an amount of money equal to the shareholder's tax basis in the debt.[19] If the lender is the original holder of the debt, it will generally have a tax basis in that debt equal to the debt's adjusted issue price. Thus, a debtor corporation will usually not recognize any income on the cancellation of a shareholder loan under section 108(e)(6), which is the same result that would have applied under section 118. The contributing creditor-shareholder receives a basis increase in its historically owned debtor corporation shares. Consistent with that capital contribution treatment, the creditor-shareholder is not entitled to a bad-debt deduction for the canceled debt.

As discussed above, whether a creditor-shareholder's cancellation of a debt constitutes a contribution to capital depends on its motive and is a question of fact.[20] The legislative history to section 108(e)(6) provides that a creditor-shareholder's debt cancellation must be related to its status as a shareholder in order for the cancellation to be treated as a contribution to capital.[21] When the shareholder is acting as a creditor attempting to maximize the satisfaction of a claim (for example, when the stock and bonds are publicly held and the creditor is coincidentally also a shareholder), the cancellation of the debt is not treated as a shareholder contribution to capital for purposes of section 108(e)(6).[22] The legislative history indicates that

---

[15] *United Grocers Ltd. v. United States*, 308 F.2d 634 (9th Cir. 1962).

[16] *See* reg. section 1.118-1:

> Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company.

See also Commissioner v. Fink, 483 U.S. 89, 94 (1987):

> It is settled that a shareholder's voluntary contribution to the capital of the corporation has no immediate tax consequences. Instead, the shareholder is entitled to increase the basis of his shares by the amount of his basis in the property transferred to the corporation. When the shareholder later disposes of his shares, his contribution is reflected as a smaller taxable gain or a larger deductible loss. This rule applies not only to transfers of cash or tangible property, but also to a shareholder's forgiveness of a debt owed to him by the corporation. (Citations omitted.)

[17] *See* section 362(a)(2).

[18] *See Fink*, 483 U.S. 89.

[19] Section 108(e)(6) provides Treasury with authority to prescribe a different rule by regulations. This authority was added by the 1993 Revenue Reconciliation Act to coordinate the exception for contributions to capital with the repeal of the stock-for-debt exception under then-section 108(e)(10) (hereafter "old section 108(e)(10)"). *See* H.R. Conf. Rep. No. 103-213 at 620. No regulations have been issued to date. It should perhaps be noted that the legislative history to section 108(e)(6) demonstrates that Congress intended to leave intact the existing long-standing law that the contribution of its own debt to a corporation by its shareholders, just like the contribution of any other property, is not income to the corporation *except* when — as in the case of the cash-basis shareholders in *Putoma Corp. v. Commissioner*, 601 F.2d 734 (5th Cir. 1979) — the shareholder has no basis in the contributed debt. This carveout was accomplished by disabling the normally applicable contribution to capital provision of section 118, in the case of debts to shareholders, and replacing it with section 108(e)(6). The underlying long-standing policy regarding shareholder contributions of property, including debt, was *not* intended to be overridden or replaced except in that specific case. Thus, that same long-standing policy should continue to inform any analysis of the application of section 108(e)(6).

[20] *See, e.g.*, S. Rep. No. 96-1035 at 8 (providing that "whether a cancellation of indebtedness by a creditor-shareholder is a contribution to capital depends upon the facts of the particular case").

[21] S. Rep. No. 96-1035 at 19. Before the Bankruptcy Tax Act of 1980, a corporation did not realize COD income when a shareholder debt was canceled as a contribution to capital even when the contributing shareholder's basis in the contributed debt was less than the amount of the debt canceled. *See, e.g.*, reg. section 1.61-12(a). ("In general, if a shareholder in a corporation which 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.") The Bankruptcy Tax Act of 1980 narrowed this exception.

[22] S. Rep No. 96-1035 at 19. *Cf.* Rev. Rul. 98-10, 1998-1 C.B. 643, *Doc 98-7088*, *98 TNT 36-5* (when debt and stock was held disproportionately, the IRS respected stock-for-stock and debt-for-debt exchanges as separate for purposes of determining qualification of transaction as reorganization under section 368(a)(1)(B)); Rev. Rul. 99-58, 1999-2 C.B. 701, *Doc 1999-39238*,

(Footnote continued on next page.)

a principal shareholder will more likely be acting in its capacity as a shareholder when canceling a shareholder loan than a creditor that happens to be a *minority* shareholder. Thus, in most instances, a sole shareholder's cancellation of the debt of a corporation that continues in business will be treated as a contribution to capital.[23]

The principle that contributions of property to the capital of corporations, while undeniably accessions to wealth, are not taxable income to corporations has existed for at least as long as the *Kirby Lumber* principle. Thus, while *Kirby Lumber* established that a cancellation of debt represents a net increase in the corporation's assets, the principle codified under section 108(e)(6) equally establishes that such a net increase provided voluntarily by a shareholder is a nontaxable contribution to capital. The exemption from COD income of shareholder capital contributions of debt is sometimes thought of as a deviation from the *Kirby Lumber* principle. However, the practical effect of a contribution to capital of debt by a creditor-shareholder is the same as if the shareholder contributed cash equal to the amount of the debt to the corporation and the corporation used those funds to repay the debt.[24] Since shareholder capital contributions are generally not taxed to the corporation, it is appropriate that a corporation generally not recognize any COD income when an existing debt to a shareholder is canceled. This is consistent with the general principle that when a discharge of indebtedness reflects some other aspect of the debtor-creditor relationship, the transaction should be viewed as though the debtor corporation received a cash contribution from the creditor-shareholder with respect to the shareholder-corporation relationship and then used the cash to pay its debt.[25]

The lone exception to tax-free treatment for the debtor corporation in the capital contribution context is when the shareholder's basis in the forgiven debt is less than the debt's adjusted issue price. This exception is addressed in some detail below.[26]

D. Capital Contributions to Insolvent Debtors

Section 108(e)(6) should equally apply when a creditor-shareholder cancels its corporation's debt in its capacity as a shareholder when the debtor corporation is insolvent. First, section 108(e)(6) (and by analog, section 118(a)) does not contain a solvency requirement. Second, the legislative history to section 108(e)(6) strongly supports the conclusion that a debtor's insolvency should be irrelevant to the application of section 108(e)(6).[27] In an example, the legislative history concludes that section 108(e)(6) applies to a debtor corporation regardless of that corporation's solvency.[28] Third, the courts have held that if a debt cancellation conveys value to the debtor, the transaction should be treated as a contribution to capital "even on the assumption the debtors were insolvent after as well as before the cancellation [because the creditor-shareholder's] wiping out the debts was a valuable contribution to the financial structure" of the debtor corporations.[29]

1999 TNT 241-2 (issuing corporation stock received in reorganization by target shareholders surrendered under a preexisting stock repurchase program was disregarded for purposes of testing for continuity of shareholder interest); LTR 199935042 (June 4, 1999), *Doc 1999-28612*, *1999 TNT 172-28* (similar).

[23]One obvious exception is when the debtor corporation is in bankruptcy or the shareholder has otherwise exhausted all avenues for collection.

[24]Bittker and Lokken, *supra* note 2, at para. 7.4.

[25]S. Rep. No. 96-1035 at 6. ("Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules.") *See also* David Garlock, *Federal Income Taxation of Debt Instruments*, para. 1501.04 (5th ed. with 2009 online updates); Jenks et al., *supra* note 2, at Ch. X.

[26]*See* Part II.D.

[27]S. Rep. No. 96-1035.

[28]*Id*. at 56 provides:

> Assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as salary, and the cash-basis employee does not include the $1,000 in income. In a later year, the shareholder-employee forgives the debt. Under the bill, the corporation must account for a debt discharge amount of $1,000. If the corporation is *insolvent* or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a *solvent* corporation outside bankruptcy, it can elect to reduce basis of depreciable assets (or of realty held as inventory) by $1,000 in lieu of recognizing $1,000 of income in the year of discharge. On the other hand, if the shareholder-employee were on the accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required. [Emphasis added.]

See also Friedel, *supra* note 2 (concluding that insolvency is no bar to the application of section 108(e)(6) based, in part, on the above-quoted example).

[29]*Lidgerwood Mfg. Co. v. Commissioner*, 229 F.2d 241 (2d Cir. 1956) (stating that "where a parent corporation voluntarily cancels a debt owed by its subsidiary in order to improve the latter's financial position so that it may continue in business, we entertain no doubt that the cancellation should be held a capital contribution and preclude the parent from claiming it as a bad debt deduction."); *compare Mayo v. Commissioner*, T.C. Memo. 1957-9 (where corporation was "hopelessly insolvent" before and after a shareholder's debt cancellation, the Tax Court held that the discharge was not a contribution to capital thus permitting the shareholder a bad-debt deduction); *Giblin v. Commissioner*, 227 F.2d 692 (5th Cir. 1955) (bad-debt deduction allowed when corporate debtor was insolvent both before and after cancellation). We also note that in *Lidgerwood*, the amount

(Footnote continued on next page.)

The IRS, however, has taken inconsistent positions on this issue. In FSA 199915005[30] the IRS concluded that section 108(e)(6) applies only to the extent a corporation is made solvent as a result of the contribution to capital. It found that when a corporation is insolvent immediately before a shareholder's cancellation of a corporate debt, the cancellation is a contribution to capital under section 108(e)(6) only to the extent of the debtor corporation's solvency. The cancellation was governed by section 108(a) to the extent of the insolvency, with section 108(e)(6) applying only to the extent that the corporation is made solvent. In contrast, in LTR 8844032[31] the IRS concluded that a contribution of debt by a 49.9 percent shareholder to an insolvent corporation was subject to section 108(e)(6). That said, the IRS has not formally enunciated the position stated in FSA 199915005 in any other guidance. Taking into account the authorities discussed above, despite the issuance of FSA 199915005, a debtor corporation's insolvency should not affect the tax treatment to that corporation in the contribution to capital context.[32]

II. Partial Debt Cancellations

As discussed above, there are many business reasons a creditor-shareholder may want to cancel less than the entire amount of a loan made to a corporation. As discussed below, the tax consequences of a partial cancellation for no stock should be the same as a complete cancellation.

A. Treatment as a Contribution to Capital

Just as a complete cancellation of a shareholder loan for which no stock is received is more appropriately viewed as a repayment of the loan followed by a capital contribution in the amount of the loan, a partial cancellation of a shareholder loan for which no stock is received should be treated as a repayment of the portion of the loan canceled. If the shareholder's tax basis in the portion of the loan canceled is at least equal to the portion of the loan canceled, the partial cancellation should be treated under section 108(e)(6) as though the corporation had satisfied the portion of the debt canceled with an amount of money equal to the shareholder's tax basis in the portion of the debt canceled and the debtor corporation should recognize no COD income. Some commentators have recently suggested, however, that when a shareholder partially cancels a debt of its corporation, there are two possible characterizations: (1) section 108(e)(10) applies in its entirety; or (2) the partial cancellation should be split into a debt exchange subject to section 108(e)(10) and a capital contribution subject to section 108(e)(6).[33] We believe that neither characterization is correct for the reasons discussed below.

B. Section 108(e)(10) Should Not Be Implicated

Under section 108(e)(10), for purposes of measuring the debtor's COD income, when a debtor issues a new debt instrument in satisfaction of an existing debt obligation, the debtor is ''treated as having satisfied the [existing] indebtedness with an amount of money equal to the issue price of such [new] debt instrument.'' The issue price of the new debt is determined under sections 1273 and 1274.[34] Under these rules, the issue price of nonpublicly traded new debt (issued in exchange for nonpublicly traded existing debt) is its principal amount, as long as the debt bears adequate stated interest. Thus, in the case of nonpublicly traded debt, the debtor would be treated as having COD income to the extent that the principal amount of the new debt (that is, its issue price) is less than the existing debt's adjusted issue price,[35] unless another exception (for example, the insolvency exception) applies.

If one looks only to the effect on the principal amount due, a partial cancellation of a creditor-shareholder loan results in a reduction in the principal amount owed. Under the debt modification regulations of reg. section 1.1001-3, however, a change in yield may result in a deemed exchange.[36] In fact, Example 3 of reg. section 1.1001-3(g) shows how a mere reduction of principal could result in a significant change in yield, thereby resulting in a deemed exchange of old debt for new debt. The facts of the example are as follows:

> A debt instrument issued at par has an original maturity of ten years and provides for the payment of $100,000 at maturity with interest payments at the rate of 10 percent payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the issuer and holder agree to reduce the amount payable at maturity to $80,000. The

---

of debt canceled was less than the entire amount owed to the shareholder (although it is unclear from the facts of the case whether the total amount owed was evidenced by a single note).

[30] Dec. 17, 1998, *Doc 1999-14025*, *1999 TNT 74-79*.

[31] Aug. 8, 1988.

[32] Perhaps the only time when the corporation's insolvency has relevance is when the amount of its liabilities so greatly exceeds the fair market value of its assets both before and after the cancellation that the corporation is ''hopelessly insolvent,'' as in *Mayo*, *supra* note 29.

[33] Potter and Harris, *supra* note 4.

[34] Section 108(e)(10)(B).

[35] Section 108(e)(10); reg. section 1.61-12(c)(2)(ii).

[36] Reg. section 1.1001-3(e)(2).

annual interest rate remains at 10 percent but is payable on the reduced principal.[37]

The example concludes that under reg. section 1.1001-3(e)(2), the reduction in principal causes a change in yield sufficient enough to constitute a significant modification and result in a deemed exchange of old debt for new debt. The example, however, in no way suggests or appears to contemplate that the creditor was a shareholder of the debtor. Thus, it is impossible to infer that the debt modification regulations were intended to apply to a shareholder's contribution of debt to capital — especially when, as discussed below, section 108(e)(6), related judicial authorities, and apparently the IRS provide for different treatment.

C. Section 108(e)(6) Trumps Section 108(e)(10)

We believe that section 108(e)(6) should take precedence over section 108(e)(10) (to the extent that section 108(e)(10) is even applicable) in the context of a creditor-shareholder's partial cancellation of its corporation's debt if the creditor-shareholder is acting in its shareholder capacity. First, there is no provision under section 108(e)(10) providing that section 108(e)(10) takes precedence over section 108(e)(6) in an exchange (actual or deemed) described in both.[38]

Second, a long-standing rule of legal interpretation — *lex specialis derogat legi generali* — provides that a law governing a specific subject matter (*lex specialis*) overrides a law that governs only general matters (*lex generalis*). This rule has been widely applied to the code ''without regard to priority of enactment.''[39] The IRS has consistently accepted this rule.[40] Section 108(e)(10) addresses situations in which a ''debtor issues a debt instrument in satisfaction of indebtedness.'' Section 108(e)(6) addresses situations in which a ''debtor corporation acquires its indebtedness from a shareholder as a contribution to capital.'' Section 108(e)(6), by its terms, is focused on shareholder contributions to capital. Section 108(e)(10) addresses many types of transactions, including noncorporate transactions[41] and debt restructurings in general. Thus, while section 108(e)(10) generally addresses debt-for-debt exchanges, section 108(e)(6) specifically addresses shareholder contributions of debt to capital.

Third, in general, the trigger for the application of section 108(e)(10) is section 1001, a taxable exchange[42] which results in income inclusion under section 61(a)(12).[43] In contrast, the trigger for the application of section 108(e)(6) is section 118(a) — an income exclusion provision. Section 61(a) provides that ''*except as otherwise provided* in [subtitle A of the code], gross income means all income from whatever source derived''[44] (emphasis added). As discussed above, section 118(a) excludes from a corporation's income a shareholder contribution to the capital of that corporation and therefore provides an exception to the general income inclusion rule of section 61.[45] In the context of a creditor-shareholder's cancellation of a portion of a debt owed by the corporation, because section 108(e)(6)

[37]Reg. section 1.1001-3(g), Example 3.

[38]*Compare* section 368(a)(2)(A) (if a transaction is described in both section 368(a)(1)(C) and (D), the transaction shall be treated as described only in section 368(a)(1)(D)); *see generally* section 61(a) (''*Except as otherwise provided* in [subtitle A of the code], gross income means all income from whatever sources derived.'') (emphasis added); section 1001(c) (''*Except as otherwise provided* in [subtitle A of the code], the entire amount of the gain or loss, determined under [section 1001], on the sale or exchange of property shall be recognized.'') (emphasis added).

[39]*Bulova Watch Co. v. United States*, 365 U.S. 753, 757 (1961); *see also Winter v. Commissioner*, 135 T.C. 12, 33 (2010), *Doc 2010-18882*, *2010 TNT 165-10* (''where two statutes conflict, specific laws govern general ones''); *Zhang v. United States*, 89 Fed. Cl. 263, 275 (2009), *Doc 2009-21131*, *2009 TNT 183-9* (''a specific statute controls over a general one without regard to priority of enactment''); *First Nationwide Bank v. United States*, 431 F.3d 1342, 1348 (Fed. Cir. 2005), *Doc 2005-25034*, *2005 TNT 239-12* (''As a principle of statutory interpretation, a specific provision prevails against broader or more general provisions, absent clear contrary intent'').

[40]*See*, *e.g.*, ILM 200947035 (July 9, 2009), *Doc 2009-25649*, *2009 TNT 223-20* (''It is a well established rule that a specific statute controls over a general one without regard to priority of enactment.''); TAM 9538007 (Sept. 22, 1995), *95 TNT 187-20* (similar); Rev. Rul. 90-17, 1990-1 C.B. 119 (similar); GCM 39119 (Jan. 19, 1984) (similar); GCM 35,636 (Jan. 28, 1974) (similar).

[41]By its terms, section 108(e)(10) is not limited to corporate debtors, while section 108(e)(6) only addresses corporate debtors.

[42]We note that a debt-for-debt exchange could qualify as a reorganization under section 368(a)(1)(E) where both the old debt and the new debt constitute securities. That said, the determination as to whether an exchange has occurred (*i.e.*, a realization event) possibly resulting in a qualifying reorganization under section 368(a)(1)(E) is governed by section 1001 (and reg. section 1.1001-3) — section 361 provides no protection to the debtor corporation from COD income recognition under section 108(e)(10).

[43]We also note that although section 1001 is the ''trigger'' for the possible application of section 108(e)(10), reg. section 1.61-12(c)(2)(i) provides that an issuer-debtor ''does not realize gain or loss upon the repurchase of a debt instrument'' notwithstanding that such repurchase might be an ''exchange (including an exchange under section 1001) of a newly issued debt instrument for an existing debt instrument.'' Thus, reg. section 1.61-12(c)(2) acts to recharacterize what would otherwise result in a taxable gain to the debtor as COD income to the extent that the debtor repurchases its debt at a discount.

[44]Likewise, section 1001(c) has similar limiting language providing that ''*except as otherwise provided* in [subtitle A of the code], the entire amount of the gain or loss, determined under [section 1001], on the sale or exchange of property shall be recognized'' (emphasis added).

[45]Section 118(a) is in subtitle A of the code as well.

is rooted in an income exclusion provision — section 118(a), it should trump and operate as an exception to section 108(e)(10), which is triggered by an exchange resulting in income inclusion.

As also discussed above, the legislative history to section 108(e)(6) is rather clear. Congress was generally content to endorse the continued income exclusion treatment under section 118(a) when a shareholder contributed its corporation's debt to capital, and did so through the mechanism of section 108(e)(6) in order to address its sole concern with that principle: the *Putoma*-like situation[46] where there was a mismatch between the debtor's and the creditor's tax treatment. To the extent that either the debtor (under section 162) or the creditor (under section 166) claimed a deduction that had no impact on the other party's basis, Congress believed it inappropriate for the debtor corporation to avoid COD income. The *Putoma* concern does not exist in a more typical contribution to capital when the shareholder has a basis in the debtor corporation's debt equal to its face amount and both the debtor and the creditor are accrual-basis taxpayers. Thus, at least to the extent that section 108(e)(6) functions as an income exclusion provision rooted in the principle of section 118(a), section 108(e)(6) should take precedence over section 108(e)(10), a provision triggered upon a taxable exchange under section 1001(a) and requiring the inclusion of income under section 61(a)(12).

Fourth, the application of section 108(e)(10) in the context of a creditor-shareholder partial debt cancellation unnecessarily elevates form over substance. Consider the following two examples:

> **Example 1:** A owns 100 percent of the issued and outstanding X corporation stock. A transferred $100x to X in exchange for an X note treated as valid indebtedness for tax purposes. In an unrelated transaction, A agreed to reduce the principal amount of the X note to $60x.
>
> **Example 2:** A owns 100 percent of the issued and outstanding X corporation stock. A transferred $100x to X in exchange for two X notes — Note 1 with a principal amount of $60x and Note 2 with a principal amount of $40x. Both notes are treated as valid indebtedness for tax purposes. Except for the principal amounts, Note 1 and Note 2 each have identical terms to the note in Example 1. In an unrelated transaction, A agreed to cancel Note 2.

Economically, the two examples are identical — A advances $100x to X, and in an unrelated transaction, A then forgives $40x of X debt. If section 108(e)(10) trumps section 108(e)(6), X would recognize $40x of COD income in Example 1 because X would be treated as exchanging a $100x note for a $60x note. X would not recognize any COD income in Example 2, however, because there would be no debt-for-debt exchange as Note 2 was canceled — that is, nothing was received in exchange for the cancellation. Such a result would simply encourage well-advised taxpayers to issue a series of notes (rather than one single note) and prove to be a trap for the ill-advised.[47]

Finally, in addition to the lack of guidance suggesting that a shareholder's partial cancellation of its corporation's debt should be subject to section 108(e)(10) and not section 108(e)(6), the IRS has recently issued a private letter ruling concluding that in such a context, section 108(e)(6) applies. In LTR 201016048,[48] a foreign parent corporation (FP) advanced funds to its wholly owned U.S. subsidiary (USS) in exchange for a note treated as indebtedness for U.S. federal income tax purposes. To improve the financial position of USS, the debt was canceled by FP in exchange for USS shares, the fair market value of which was intended to be approximately equal to the fair market value of the note. However, shortly thereafter (and within the same tax year), FP and USS entered into a rescission agreement effectively unwinding the debt cancellation. Thereafter, FP and USS entered into a separate agreement pursuant to which solely for foreign country tax purposes, FP acquired a single share of USS stock in exchange for the cancellation of an amount of the note intended to be equal to the fair market value of the single share which was canceled within days of its issuance, and FP canceled another amount of the note (but not all of the note) as a capital contribution to USS. The IRS permitted the rescission, disregarded the issuance of the single share, and concluded that the partial debt cancellation was solely governed by section 108(e)(6). The IRS neither applied section 108(e)(10) to the partial debt cancellation nor did it bifurcate the transaction as part capital contribution subject to section 108(e)(6) and part debt-for-debt exchange subject to section 108(e)(10).[49]

---

[46]*Putoma*, 601 F.2d 734, is discussed in more detail below in Part II.D.

[47]Under the same line of reasoning, a taxpayer could simply issue a note explicitly allowing prepayment. A partial cancellation of such a note by a shareholder should also not result in a deemed exchange as the terms of the note would in no way be altered.

[48](Dec. 22, 2009), *Doc 2010-9078, 2010 TNT 79-21*.

[49]*But see* FSA 200146013 (June 27, 2001). In the FSA, a corporation was indebted to its sole shareholder in the form of a note. The shareholder contributed the note to the corporation in exchange for a new note that, except for a reduced principal

(Footnote continued on next page.)

In all, for the reasons stated above, section 108(e)(6) should trump section 108(e)(10) to the extent that the two provisions are treated as overlapping.

D. Bifurcation Is Inappropriate

As noted above, some commentators have recently suggested a third possible way of characterizing a partial debt cancellation by a shareholder.[50] Under their view, the partial cancellation of corporate indebtedness by a creditor-shareholder could be bifurcated — part capital contribution subject to section 108(e)(6) and part debt-for-debt exchange subject to section 108(e)(10).[51] We believe that this alternative view is incorrect. The authorities cited — *G.M. Trading Corp. v. Commissioner*,[52] the legislative history to old section 108(e)(10) (that is, the now-repealed stock-for-debt exception),[53] and Rev. Rul. 69-630[54] — do not provide adequate support for that view and we know of no other authorities that do.[55]

First, *G.M. Trading Corp.* strongly suggests that a partial cancellation of corporate indebtedness by a creditor-shareholder should *not* be bifurcated, although the commentators point to the case as analogous support for bifurcating such a transaction.[56] In *G.M. Trading Corp.*, a U.S. taxpayer wished to establish a plant in Mexico. At the time, the Mexican government had a program in place designed to ''encourage foreign investment and to decrease the outstanding balance of its foreign-currency denominated debt.'' Under this program, the taxpayer purchased U.S.-dollar-denominated Mexican debt with a face amount of $1.2 million from a third-party bank for $600,000 in a value-for-value exchange (the debt was heavily discounted in light of Mexico's then-recent debt default). The taxpayer then surrendered the debt to the Mexican government, which then transferred restricted Mexican pesos (with a fair market value of $1,044,000 if those pesos were unrestricted) to a newly formed Mexican subsidiary of the taxpayer.[57]

The taxpayer argued that the difference between the FMV of the restricted pesos and the taxpayer's basis in the U.S.-dollar-denominated Mexican debt should be treated as a nonshareholder contribution to capital under section 118(a) by the Mexican government, and, thus, that amount should be excluded from the taxpayer's gross income. The IRS treated that difference as taxable gain on an exchange governed by section 1001 and did not treat the transaction (in whole or in part) as a contribution to capital. The IRS argued that the ''dominant purpose'' for the transaction was to enable Mexico to retire its U.S.-dollar-denominated debt — a ''service,'' which rendered section 118 inapplicable. The

---

amount, had terms similar to the old note. Although not specifically stated, it appears that the corporation was solvent at the time of the exchange. After referencing sections 108(e)(8) and 108(e)(10) (but failing to reference section 108(e)(6)), the author concluded that:

> If the [IRS] accepts that there was a deemed issuance of stock of [the corporation-debtor] with a fair market value equal to the outstanding balance of the [old note] (taking into account the issuance of the [new note]), the [old note] is repaid in full, and thus there is no cancellation of indebtedness income. If the [IRS] does not respect the deemed issuance of stock, however, there would be cancellation of indebtedness income to the extent of the difference between the amount of the [new note] and the [old note].

The FSA does not contain any analysis as to why there would be no COD income to the debtor if its stock were issued. In order to reach the first conclusion, the IRS must have concluded that a portion of the old note was exchanged for the new note under section 108(e)(10) and the remaining portion of the old note was exchanged for debtor stock of an equivalent value under section 108(e)(8). If the exchange was solely governed by section 108(e)(10), presumably the exchange would have resulted in COD income in an amount equal to the difference between the adjusted issue price of the old note and the issue price of the new note. To reach the second conclusion, the IRS must have concluded that the exchange was solely governed section 108(e)(10). In essence, the IRS refused to bifurcate the transaction as part debt-for-debt exchange subject to section 108(e)(10) and part contribution to capital subject to section 108(e)(6). Query why the IRS was only willing to bifurcate the exchange if stock was deemed issued. The simplest answer is that the IRS analyzed the transaction incorrectly. First, consistent with IRS letter rulings and other recent statements, we believe that the debtor corporation should not have been deemed to issue stock. *See supra* note 3. Second, we believe that the debtor corporation should not have recognized any COD income because section 108(e)(6) applies to the entire transaction. We are not the lone critics of this FSA. *See*, *e.g.*, David Garlock, *supra* note 25, para. 1502.07 (stating that the second ''conclusion seems plainly incorrect because section 108(e)(6) could apply if the parent's basis in the old note were higher than the face amount of the new note.'').

[50]Potter and Harris, *supra* note 4.

[51]The commentators actually suggest that there could be two distinct approaches to bifurcate a partial debt cancellation by a shareholder. For a detailed discussion of each of these approaches, see Potter and Harris, *supra* note 4, at pp. 12-13.

[52]121 F.3d 977 (5th Cir. 1997), *Doc 97-25979*, *97 TNT 179-9*.

[53]S. Rep. No. 96-1035 at 17.

[54]1969-2 C.B. 112.

[55]We note that we are not the first commentators to conclude that creditor-shareholder capital contributions of debt to the debtor corporation should *not* be bifurcated. *See*, *e.g.*, Bittker and Lokken, *supra* note 2, at para. 7.4 (providing that ''section 108(e)(6) is not consistent with a bifurcation approach'').

[56]Potter and Harris, *supra* note 4, at pp. 9-10.

[57]Under Mexico's program, the use of the pesos was restricted in several ways. First, the pesos could only be used for the purchase of land and for the construction of an industrial plant in Acuna, Mexico. Also, the Mexican government controlled the pesos and paid them to vendors directly. Further, the vendors had to be Mexican companies that used Mexican goods and services in constructing the plant.

Fifth Circuit held that the transaction should be treated as two transactions — part exchange of Mexican debt for pesos and part nonshareholder contribution to capital by the Mexican government to the taxpayer's Mexican subsidiary under section 118(a).[58] In arriving at this holding, the Fifth Circuit stated:

> Part of the payment by the Mexican government was in exchange for extinguishing a portion of Mexico's debt. This portion was compensation for a specific, quantifiable service and does not qualify as a nontaxable contribution to capital. Another part of the payment was intended to induce [the taxpayer] to invest in the Mexican economy. This is not a specific, quantifiable service. A payment to induce investment is the quintessential nontaxable contribution to capital.[59] [Citations omitted.]

The commentators seek to analogize the Fifth Circuit's conclusion that section 118(a) permits bifurcation to another provision involving a contribution to capital — section 108(e)(6).[60] *G.M. Trading Corp.*, however, leaves no room for an analogy to section 108(e)(6). The Fifth Circuit explicitly provides that in *Putoma*[61] it ''faced a single-part payment, none of which was a specific service, and thus we had no opportunity to consider the merits of bifurcation.''[62] In *Putoma*, the taxpayer was a corporation that was indebted to a cash basis shareholder. The taxpayer had been accruing (and deducting) interest on the debt but had failed to make any interest payments. After several years of accruing such interest, the creditor-shareholder forgave the accrued interest. The Fifth Circuit held that the forgiveness of interest was a nontaxable contribution to capital under section 118(a). Although the *result* in *Putoma* was later overridden with the enactment of section 108(e)(6), Congress never indicated any intent to alter the *characterization* of the transaction in *Putoma* — to the contrary, every indication was that it did not so intend. Thus, under section 108(e)(6), the transaction in *Putoma* would still be entirely treated as a capital contribution. The taxpayer, however, would be forced to recognize COD income in an amount equal to the forgiven interest because the creditor-shareholder, as a cash basis taxpayer, had no adjusted tax basis in the forgiven interest. Thus, consistent with the reasoning of *G.M. Trading Corp.* and *Putoma*, when a creditor-shareholder discharges part of the debt of a debtor corporation, that discharge should not be bifurcated.[63]

Second, reliance on the legislative history to old section 108(e)(10) is misplaced. The commentators argue that, ''although not directly on point, some support for a bifurcated approach can be found in the legislative history accompanying the enactment of the Bankruptcy Tax Act of 1980,'' which codified the stock-for-debt exception as old section 108(e)(10).[64] More specifically, they would rely on the following language:

> If a corporate debtor issued a package of stock and other property (including cash) in cancellation of debt, the cash and other property were treated as satisfying an amount of debt equal to the amount of cash and value of the property, and the stock was treated as satisfying the remainder of the debt.[65]

The above-quoted language is consistent with Rev. Rul. 92-52,[66] which provides that when an insolvent corporation that is not in bankruptcy issues stock and cash or other property to a creditor, the cash and other property is first applied in partial satisfaction of the debt, and the remaining debt is

---

[58]For a contribution to be treated as a nonshareholder contribution to capital under section 118(a), ''the contribution (1) must become a part of the recipient's capital structure; (2) may not be compensation for a 'specific, quantifiable service'; (3) must be bargained for; (4) must result in a benefit to the recipient; and (5) ordinarily will contribute to the production of additional income.'' *G.M. Trading Corp.*, 121 F.3d at 980-981 (quoting *United States v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401, 413 (1973)).

[59]*G.M. Trading Corp.*, 121 F.3d at 981.

[60]It should be noted that the Fifth Circuit's conclusion that section 118(a) permits bifurcation has not been followed in at least one other case dealing with a similar debt-equity swap. In *Kohler Co. v. United States*, 468 F.3d 1032 (7th Cir. 2006), *Doc 2006-23543*, *2006 TNT 224-10*, the Seventh Circuit stated that it was ''dubious'' about the approach taken by the Fifth Circuit ''in the nearly identical case of'' *G.M. Trading Corp.* In *Kohler*, the Seventh Circuit concluded that the swap was not a contribution to capital, but a taxable exchange because the Mexican government was buying a service — the retirement of a part of Mexico's foreign debt.

[61]601 F.2d 734.

[62]*G.M. Trading Corp.*, 121 F.3d at 982. As discussed below, the Fifth Circuit's reference to a ''single-part payment'' in *Putoma* addresses a creditor-shareholder's *partial* cancellation of the debt of a debtor corporation.

[63]We understand that when certain qualifying prepayments of principal are made on a debt instrument, reg. section 1.1275-2(f) assumes that ''the original debt instrument consists of two instruments, one that is retired and one that remains outstanding.'' Treated as such, there would not in general be a change in yield under reg. section 1.1001-3(e)(2) for the debt outstanding. Without a change in yield, there would not be a deemed exchange under reg. section 1.1001-3, and thus section 108(e)(10) would not apply because there would not be a debt-for-debt exchange.

[64]Potter and Harris, *supra* note 4, at p. 14.

[65]S. Rep. No. 1035 at 17.

[66]1992-2 C.B. 34.

deemed satisfied by stock. Reliance on the legislative history to old section 108(e)(10) is misplaced for the following reasons. First, the bifurcation language in the legislative history and Rev. Rul. 92-52 applied only to old section 108(e)(10). The legislative history to current section 108(e)(8) did not mention the consequences of a transaction in which a creditor receives both stock and other property in exchange for a discharge of indebtedness. Second, even if the bifurcation analysis in the legislative history to old section 108(e)(10) and Rev. Rul. 92-52 is still relevant in analyzing current section 108(e)(8), there is no suggestion in either authority that a similar analysis should apply to section 108(e)(6). Section 108(e)(6) and old section 108(e)(10) were enacted under the same legislation — the 1980 Bankruptcy Tax Act. Within five paragraphs of the old section 108(e)(10) bifurcation discussion, the legislative history addresses the treatment of capital contributions under section 108(e)(6). The legislative history to section 108(e)(6) in no way suggests that a transaction could be bifurcated into a part-contribution to capital and part-something else. In fact, the legislative history to section 108(e)(6), as discussed above, strongly suggests that the judicially created contribution to capital exception to COD income recognition is to remain intact with a narrow exception to address *Putoma*-like concerns. In addition, the courts have consistently excluded from a corporation's income the contribution to capital made by a shareholder, including when a shareholder does not receive equivalent value in return for the property contributed.[67] The legislative history to the 1980 Bankruptcy Tax Act in no way suggests that Congress intended to alter that treatment.[68]

Third, we also believe that reliance on Rev. Rul. 69-630 is misplaced. Contributions to capital are the quintessential exception to the general tax principle that transactions between related parties must be arm's-length, ''value-for-value'' exchanges.[69] In Rev. Rul. 69-630, A, an individual, owned all the stock of two corporations, X and Y. A caused X to sell some of its property to Y for less than an arm's-length price. The IRS concluded that one of the principal purposes of the sale was the avoidance of federal income tax, resulting in a significant understatement of X's taxable income. The IRS therefore increased X's income to reflect an arm's-length price of the property and treated the amount of the increase as a distribution by X to A followed by a capital contribution of the same amount by A to Y. As the commentators admit, Rev. Rul. 69-630 ''is not directly on point in situations involving parent-subsidiary intercompany debt cancellations because the ruling occurred between two corporations owned by the same shareholder.''[70] In fact, we do not know of any guidance in which the IRS was successful in applying section 482 principles to override an otherwise qualifying shareholder capital contribution under either section 118(a) or section 108(e)(6) — at least when the contributing shareholder wholly owns the contributee-corporation.

Section 482 provides in general that the IRS may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among commonly controlled organizations if it determines the allocation is necessary to prevent the evasion of taxes or to clearly reflect the income of the organizations. Regulations thereunder contemplate that the IRS may apply section 482 in circumstances involving nonrecognition transactions ''when necessary to prevent the avoidance of taxes or to clearly reflect income.''[71] The cases in which section 482 has been invoked to prevent avoidance of tax or to clearly reflect income in nonrecognition transactions demonstrate that section 482 must exist in harmony with the code's nonrecognition provisions.[72] Congress has specifically authorized some tax-free transactions, one of which is the transfer of assets to a controlled subsidiary under section 118(a). By their very nature, all tax-free transactions will result to some extent in a distortion of income. Carryover of tax basis in a tax-free transfer of assets to a controlled subsidiary, for instance, allows the appreciation (or depreciation) associated with assets owned by the transferor to transfer, free of

---

[67]*See*, *e.g.*, *Fink*, 483 U.S. 89; *Sackstein v. Commissioner*, 14 T.C. 566 (1950).

[68]We note that even if the bifurcation approach of Rev. Rul. 92-52 were to apply to a partial debt cancellation situation, the results would likely be the same. *See* Potter and Harris, *supra* note 4, at pp. 15-16 (example 6, adjusted issue price-for-value exchange scenario).

[69]*See supra* note 67.

[70]Potter and Harris, *supra* note 4, at p. 11. The commentators also discuss two field service advice memoranda (FSA 724 (Mar. 3, 1993) and FSA 750 (June 2, 1993)) as additional support for a bifurcation approach consistent with Rev. Rul. 69-630. We note that the author of both field service advice memoranda also authored FSA 199915005, discussed above, concluding that on a shareholder contribution of its debtor corporation's debt to capital, section 108(e)(6) applied only to the extent of the debtor corporation's postcontribution solvency.

[71]Reg. section 1.482-1(f)(1)(iii) (citing *National Securities Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943), *cert. denied*, 320 U.S. 794 (1943)).

[72]*Ruddick Corp. v. United States*, 226 Ct. Cl. 426, 433 (1981). (Reg. section 1.482-1(f)(iii) ''cannot be read as allowing [section] 482 to override all nonrecognition provisions, . . . the regulation is simply a general, over-all indication that the presence of a nonrecognition provision is not an automatic bar to use of [section] 482.'')

current tax, to the transferee corporation, so that the appreciation (or depreciation) is thereafter recognized by the transferee on the ultimate disposition of the assets. This same distortion occurs in virtually all nonrecognition transactions, and it, together with the tax-free transactions themselves, has been approved by Congress.

The broad powers granted by Congress to the IRS under section 482 are tempered by this preexisting policy of endorsing tax-free transactions and their consequences. In balancing the policies underlying the nonrecognition provisions with those underlying section 482, the courts have applied section 482 to reallocate income, gain, deduction, or loss, not from a nonrecognition transaction itself, but rather from *subsequent* sales, exchanges, or other dispositions of property transferred in the nonrecognition transaction. In these cases, the nonrecognition transaction provides the mechanism for transferring the property tax free and with a carryover basis to the related party. The cases do not construct a taxable event to supplant the tax-free transaction that has met the requirements for such treatment. Thus, when a creditor-shareholder makes a capital contribution of a portion of a debt to a debtor corporation, section 482 (and, as a result, Rev. Rul. 69-630) should not apply to bifurcate the contribution. This is consistent with the principle that section 482 is not intended to render transactions taxable that qualify for tax-free treatment (such as sections 118(a) and 108(e)(6) in most instances), but merely to reallocate some items from subsequent sales, exchanges, or other dispositions of property transferred in such a transaction.

III. Conclusion

A partial cancellation by a creditor-shareholder of debt for no stock should be subject solely to section 108(e)(6). Consistent with the courts and congressional intent, there is little reason to treat partial debt cancellations by shareholders as anything other than what they are in both form and substance: contributions to capital.

Experts don't have all the answers.

They just always know where to find them.

Whether you're looking for the latest tax news headline or an in-depth analysis of a recent treaty, you can always turn to the leading tax policy and news source. You'll discover Tax Analysts has the timely, accurate and comprehensive information you need. To see why experts rely on us, please visit taxanalysts.com.

Tax Notes Today® ▲ State Tax Today® ▲ Worldwide Tax Daily®

taxanalysts®

The experts' experts.℠