DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL,

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Request for Field Service Advice

This Chief Counsel Advice responds to your memorandum dated January 10, 2001. In accordance with I.R.C. § 6110(k)(3) this Chief Counsel Advice should not be cited as precedent.

LEGEND

P =
S =
B =
A =
Year 1 =
Year 2 =
Year 7 =
Year 8 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
$a =
$b =
$c =
$d =
$e =
$f =
$g =
$h =

$i =
$j =
$k =
$l =
$m =
$n =
$o =
$p =
$q =
$r =

ISSUES

1. When a debtor defaults on a note, sells the property encumbered as security for the note, and transfers the proceeds to the creditor, is the entire transaction taxed as a sale or exchange or is the reduction of debt taxed separately as income from the discharge of indebtedness?

2. Under the facts of this case, is the underlying debt recourse or nonrecourse?

3. If the debt is nonrecourse, what are the tax consequences to the debtor?

4. If the debt is recourse, what are the tax consequences to the debtor?

5. Whether in the alternative, assuming the loan in issue is a recourse loan, the parent corporation must include in income its excess loss account in the stock of the debtor-subsidiary pursuant to Treas. Reg.§ 1.1502-19?

CONCLUSIONS

1. The entire transaction is a sale or exchange for purposes of I.R.C. §§ 61(a)(3) and 1001.

2. The debt is nonrecourse.

3. Because the debt is nonrecourse, the entire amount of the debt is considered to be the amount realized for purposes of determining gain or loss. No part of the transaction is taxed as cancellation of debt under section 61(a)(12).

4. In the alternative, if the debt is recourse, the amount of the debt that exceeds the fair market value of the underlying property is taxable under I.R.C. § 61(a)(12) as ordinary income. If the taxpayer was insolvent, the discharge of indebtedness income is excluded from gross income under section 108(a)(1)(B) and the attribute reduction rules of section 108(b) and 1017 apply. We believe that the taxpayer was insolvent.

5. In the alternative, assuming the loan in issue is a recourse loan, the parent corporation must include in income its excess loss account in the stock of the debtor-subsidiary pursuant to Treas. Reg. § 1.1502-19.

FACTS

The taxpayer is an affiliated group of corporations filing on a consolidated basis. The common parent of the consolidated group is P. At all times relevant herein, both P and S had the same President, A, the same Chief Financial Officer, and the same address.

P created S, a subsidiary, during the year ended in Year 1. P made an initial capital contribution to S of $a. P formed S with the intention of having it construct hydroelectric plants. In Year 2, B provided a loan to S to finance the project. In conjunction with the loan, the parties executed an Assignment and a Deed of Trust providing that the collateral for the loan was any interest S had in the land and hydroelectric plants (including all assets, all income, and all personal property related to the hydroelectric plants). In addition, P guaranteed the loan and executed a Pledge Agreement pursuant to which it pledged the stock of S as additional security for the loan. Upon completion of the construction, the construction loan was converted into a term loan (the “Loan Agreement”) in the amount of $b.

The title of the loan agreement was "Limited Recourse Project Funding Agreement." This funding agreement stated that S had to give an administrative agent a $c line of credit or put $c cash in a bank account as security for B in case S failed to repay the note.[1] The Deed of Trust stated that the collateral for the loan was any interest S had in the land and hydroelectric plants (including all assets, all income, and all personal property related to the hydroelectric plants). This collateral is almost everything that S owned at the time it entered into the loan agreement. The Pledge Agreement stated that P pledged the stock of S as additional security for the loan. The Pledge Agreement also stated that P guaranteed S's loan. The Assignment stated that S provided all of its rights, title, and interest in the hydroelectric projects as additional collateral for the loan. None of the documents related to the loan specifically state that S will be liable for the loan if the collateral and other security interests are insufficient to cover the amount due on the note.

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[1] S chose to provide a $c letter of credit rather than provide $c in cash. The original construction loan provided for draws up to $d. After completion of construction, the loan was to be paid down to $b. The purpose of this letter of credit was to assure that S would pay the loan down to $b when construction was complete. Because the loan balance was $b when construction was completed, B did not draw on the letter of credit.

During the period beginning in Year 2, and ending on Date 3, P made additional capital contributions to S totaling $e. Nevertheless, the operation was unsuccessful. S defaulted on its payments to B.

On Date 1, P, S, and B executed an "Amicable Resolution Agreement" ("the AR agreement"). Clause G of the opening recitals to the AR agreement states that "[b]ased upon S's payment defaults under the Loan Agreement, B has the present right to commence proceedings to foreclose the lien of the Deed of Trust [and] to assume ownership of the shares pledged pursuant to the Pledge Agreement * * *." Clause H of the opening recitals states that "S and P have informed B that they are prepared to cooperate with B to facilitate B's efforts to realize value on its interest pursuant to the Loan Documents." Clause I of the opening recitals explains that "P has requested that B consent to the transfer of certain assets to S, that such assets not be subject to any lien of B; and that B not exercise its rights pursuant to the Pledge Agreement * * *."

Pursuant to Article 2 of the AR agreement, B agreed to refrain from immediate initiation of formal proceedings to enforce its rights under the Loan Agreement, and to enter into a covenant not to sue S and P upon the successful sale of the Projects. In turn, S and P agreed to cooperate with B in its efforts to realize value on its interest pursuant to the Loan Agreement, including prompt delivery of full, complete, and exclusive possession of the Projects and/or the shares of S, to such party or parties as B might direct.

On Date 2, S entered into another agreement with a third party and B, whereby it agreed to sell the plants to the third party and give the proceeds to B in satisfaction of the remaining debt.

The recitals to the Purchase Agreement provide in part:

> B. B provided the financing for the Projects, and the total amount of indebtedness owed by Seller to B in connection with such financing ("the Indebtedness") exceeds the purchase price payable by Buyer for the Projects under this Agreement.
>
> C. The recourse Indebtedness is secured by the Projects and related assets.
>
> D. B has an agreement with Seller under which a portion of the Indebtedness will be forgiven and then the Projects will be sold in lieu of foreclosure.
>
> E. To facilitate the sale of the Projects and related assets for their current fair market value, B desires to discharge a portion of the Indebtedness prior to such sale so as to reduce the Indebtedness to an

amount equal to the current fair market value of the Projects and related assets.

Section 1.3 of the Purchase Agreement provides in part:.

> SECTION 1.3. Reduction of Indebtedness. (a) In order to reduce the Indebtedness to an amount equal to the current fair market value of the Projects and the Assets immediately prior to the Closing Date, B shall discharge and forgive a sufficient amount of the Indebtedness to reduce the Indebtedness, after giving effect to such discharge, to $f.
>
> * * * * *
>
> (d) The reduction of the Indebtedness shall occur prior to the sale of the Assets pursuant to Section 2.1 and prior to Buyer's payment of the Purchase Price for such Assets pursuant to Section 3.1.
>
> * * * * *

Section 2.2(b) of the Purchase Agreement provides in part:

> (b) B acknowledges that P intends to make capital contributions of certain assets to Seller both concurrently with the forgiveness of the Indebtedness and/or after the Closing Date. B agrees that it will hold no security interest in such assets and that it will have no recourse against such assets with respect to the Indebtedness.

Section 3 of the Purchase Agreement sets forth provisions regarding the purchase price. Section 3.1 of the Purchase Agreement provides:

> SECTION 3.1. Payment. The purchase price that Buyer will pay to Seller, and deliver to B on behalf of Seller, for the Assets shall be an amount equal to $f, as the same may be adjusted pursuant to section 3.2 (the "Purchase Price"). In consideration of the sale of the Assets to Buyer pursuant to Section 2.1, on the Closing Date, Buyer shall, on behalf of Seller, pay to B an amount equal to the Purchase Price by wire transfer in immediately available funds to an account designated by B.

Section 7.1 of the Purchase Agreement provides in part:

> SECTION 7.1. Conditions Precedent to the Obligations of Buyer. The obligations of Buyer to acquire and pay for the Assets and to assume the obligations and liabilities described in Section 4.3(a) at the Closing are subject to the satisfaction, or waiver in writing by Buyer, on or prior to the Closing Date of the following conditions:[2]

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[2] Section 4.3(a) of the Purchase Agreement listed only certain "obligations and liabilities arising after the Closing Date".

* * * * *

(j) B shall have released its Liens encumbering the Projects and the Assets, and the Conveyance Documents evidencing such release of Liens shall have been recorded or filed in such places and offices as the title company issuing the title insurance policy described in Section 7.1(h) or Buyer may reasonably require;

* * * * *

Section 7.2 of the Purchase Agreement provides in part:

SECTION 7.2. Conditions Precedent to the Obligations of Seller and Sumitomo. The obligations of Seller to sell the Assets, and of B to release its Liens encumbering the Assets, at the Closing are subject to the satisfaction, or waiver in writing by B (on its own behalf and on behalf of Seller), on or prior to the Closing Date of the following conditions:

(a) Buyer shall have delivered to B, on behalf of Seller, the Purchase Price in accordance with Section 3.1;

* * * * *

P decided to contribute assets to S at the same time that B discharged S's debt. On Date 3, P entered into a Contribution Agreement with S stating that concurrently with the cancellation of S's indebtedness to B, P would contribute assets to S. An undated document titled "Unanimous written consent of Directors of P Companies" states "P shall make the capital contributions to S evidenced by the attached Contribution Agreement with such contributions to occur and take effect simultaneously with the cancellation on Date 4 of certain S indebtedness to B...."[3] [Emphasis added]

Consistent with the Contribution Agreement and the Unanimous Written Consent of Directors of P, B signed a document relieving S of the debt on Date 4. However, the deeds transferring the real property from P to S were executed on Date 3 [Date 3 is one day before Date 4]. A was the President of both P and S at the time the deeds were executed and B released the debt. A executed the deeds transferring the property from P to S. In addition to the real property, P contributed to S on Date 3, P made an additional contribution to S consisting of $g of cash on Date 4.

When the debt was discharged, the principal and interest outstanding on the loan totaled $h. The proceeds from the sale of the plants totaled $f. S applied the $f to the $h of debt and B forgave the difference of $i. Except for the assets contributed

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[3] The Date 2 Purchase Agreement and the Date 1 Amicable Resolution Agreement do not discuss when the contribution of the real property from P to S will occur in relation to the cancellation of the debt. (The Amicable Resolution Agreement states that P plans to transfer assets to S and B agrees not to claim an interest in any of the contributed assets, but does not state the date such contribution will occur.)

by P, S did not have any assets on Date 4, after selling the plants and applying the proceeds to the outstanding debt.

A balance sheet for S, as of Date 3, reflected cash of $l; prepaid expenses; the Projects ("plant and land"); and accumulated depreciation. S's adjusted basis in the Projects equaled $m as of Date 4.

P maintains that the real property that P contributed to S had a fair market value of $j. Approximately $k of this was depreciable improvements. P purchased these assets from two corporations controlled by A, the controlling shareholder of P. This purchase occurred on Date 3, the same day that P contributed these assets to S. On its accounting records, P accounted for the transaction by debiting property and crediting notes payable, then debiting investment in S and crediting property. S accounted for the transaction by debiting property and crediting capital contributions. As previously stated, the S Corporations executed deeds on Date 3, transferring title to S. On the same day, S executed deeds transferring the assets to P.

Representatives of P have stated that the assets were transferred to S for the purpose of converting S into P's real property holdings entity. They stated that P intended to contribute the assets simultaneously with the debt discharge rather than before the discharge because P wanted to avoid a B claim against the contributed assets.

On its consolidated return for the fiscal year ending in Year 8, P reported S's sale of the assets. P reported a sales price of $n and a basis in the assets sold of $m, which resulted in a capital gain of $o. Because S claims that it was insolvent immediately before P contributed assets to it, S excluded the $p from income under I.R.C. § 108(a). On the return, P did not make an election to first reduce the basis of depreciable property under I.R.C. § 108(b)(5). P reduced the basis in the assets transferred to S by $p. P claims that the discharge does not require it to recognize S's excess loss account because S reduced the basis of these assets. The taxpayer claims that the B loan to S was recourse.

LAW AND ANALYSIS

Introduction

The proper treatment of a transaction in which property is disposed of in connection with the relief of a debt obligation may depend on whether the debt is recourse or nonrecourse. If the debt is nonrecourse and the debt is discharged in connection with the sale or other disposition of the property, the full amount of debt is treated as part of the amount realized and the transaction is treated as a capital gain or loss under I.R.C. §§ 61(a)(3) and 1001. Treas. Reg. § 1.1001-2(a)(1) and (4); Commissioner v. Tufts, 461 U.S. 300 (1983). Accordingly, no part of such a

transaction represents discharge of indebtedness income taxable under section 61(a)(12) and the exclusions under section 108 do not apply to the transaction. On the other hand, if the debt is recourse and, as part of the sale, the debtor is relieved from the requirement to make payments on that debt, the transaction is a bifurcated one pursuant to Treas. Reg. §§ 1.1001-2(a)(2) and 1.1001-2(c), Example 8. In such a case, gain or loss is recognized up to the fair market value of the property and the balance of any debt discharged in the transaction is covered by section 61(a)(12) and potentially subject to the rules in section 108. Thus, the amount discharged could be excludible from income under section 108(a)(1)(B) if the taxpayer were insolvent. In such a case, the taxpayer would have to reduce its tax attributes under section 108(b).

In this case, the taxpayer argues that the debt was recourse, that this is a transaction that gave rise to discharge of indebtedness income, and that it was insolvent. As a result, the taxpayer would have had to (and, in fact, did) reduce its attributes in the tax year following the discharge but not report an amount realized to the extent it exceeded the sale price/fair market value of the underlying property.[4]

Issue 1

Generally, I.R.C. § 61(a) defines gross income as "all income from whatever source derived." Included in gross income are gains derived from dealings in property, under section 61(a)(3), and income from the discharge of indebtedness, under section 61(a)(12). Section 1001(a) governs the computation of gains derived from dealings in property and provides that gain shall be the excess of the amount realized from a sale or other disposition of property over the adjusted basis in the property. Treas. Reg. § 1.1001-2(b) provides that the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. When an interest in property is transferred in exchange for an assumption or discharge of liabilities, the assumed liabilities are included in the amount realized as if the money had been paid to the seller and then paid over to the creditor. Commissioner v. Tufts, 461 U.S. 300, 306 (1983); Estate of Delman v. Commissioner, 73 T.C. 15 (1979. This is also true when a taxpayer agrees to surrender property in exchange for cancellation of debt in a foreclosure sale or in a transfer in lieu of foreclosure. 2925 Briarpark, Ltd. v. Commissioner, T.C. Memo. 1997-298, aff'd, 163 F.3d 313, 318 (5th Cir. 1999).

When a debt is forgiven, gross income includes the income from the discharge

[4] We are assuming for purposes of this advice that the sale price and fair market value were equivalent.

of the debt. Cancellation of indebtedness produces income to the debtor in an amount equal to the difference between the amount due on the obligation and the amount paid for the discharge. The determination of whether income is produced through cancellation of debt, or through the sale of property in exchange for an assumption of debt, is not always clear. However, as a general matter, courts have tended to interpret the term "sale or exchange" broadly and the term "discharge of indebtedness" narrowly. Slain v. Commissioner, T.C. Memo. 1989-221, rev'd in part on other grounds, 932 F.2d 598 (7th Cir. 1991). Further, when a debt is discharged or reduced as a result of the debtor's transfer of property to his creditor or a third party, the transaction is treated as a sale or exchange of property subject to the recognition provisions of I.R.C. § 1001. Danenberg v. Commissioner, 73 T.C. 370, 380-381 (1979), act. 1980-1 C.B. 1.

In this case, on Date 1, S was in default on the B note. On Date 2, S agreed to sell the assets in which B held a security interest. B released S from liability after receiving the proceeds of the sale. We believe that the entire transaction should be treated as a sale or exchange and not as a transaction in which there were two separate transactions, one being a reduction of debt under I.R.C. § 61(a)(12) and the second being a sale of the property under section 61(a)(3).[5]

Issue 2

We think that the loan from B to S was nonrecourse. The original promissary note characterized the transaction as a “Limited Recourse Project Loan Agreement.” We view this, together with the terms of the agreement, as limiting the recourse of B to the assets that were specifically encumbered by the Deed of Trust and other relevant documents.

Our review of California case law suggests that the term “limited recourse loan” is the same as the term “nonrecourse loan” within the meaning of Treas. Reg. § 1.1001-2. See e.g., Bank One Texas v. Pollack, 24 Cal. App. 4th 973 (1994); River Bank America v. Diller, 38 Cal. App. 4th 1400 (1995). In In the Matter of the Appeal of Merle R. Haggard and Leona Williams, No. 90A-1117-TL, California State Board of Equalization, 94-SBE-010 (Nov. 30, 1994), 1994 Cal. Tax LEXIS 482, the State Board of Equalization, held that a “limited recourse” loan was a nonrecourse loan for purposes of the at-risk rules under I.R.C.§ 465. Moreover,

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[5] While the tax treatment of viewing the debt discharge and the sale as two separate transactions would not affect the result if the debt were recourse, it would make a significant difference if the debt were nonrecourse. Rev. Rul. 91-31, 1991-1 C.B. 18 provides that discharge of a nonrecourse debt independent of the disposition of the underlying collateral is taxable as discharge of indebtedness income. This case is distinguishable from Rev. Rul. 91-31 because the facts in that revenue ruling did not involve the sale or exchange of the encumbered property. 2925 Briarpark, Ltd., supra.

numerous federal tax cases have treated loans denominated as "limited recourse" as being the same as "nonrecourse." See e.g., Abramson v. Commissioner, 86 T.C. 360 (1986), Peters v. Commissioner, 89 T.C. 423 (1987); Investment Research Associates v. Commissioner, T.C. memo. 1999-407; Santulli v. Commissioner, T.C. Memo. 1995-458; Wimpie v. Commissioner, T.C. Memo. 1994-41. In summary, the rights of a creditor with respect to a limited recourse loan are not as great as the rights of a creditor with respect to a recourse loan. In this case, we conclude that B could not have, for example, attached assets of S that were not specifically mentioned in the LoanAgreement. Accordingly, the loan was nonrecourse for purposes of Treas. Reg. § 1.1001-2. We recommend you take the position that the debt is nonrecourse.

Issue 3

If the debt is nonrecourse, the amount realized is the full amount of debt discharged. Treas. Reg. § 1.1001-2(a); Commissioner v. Tufts, 461 U.S. 300 (1983). The fair market value of the property is irrelevant. Treas. Reg. § 1.1001-2(b). As the regulation provides with respect to nonrecourse debt:

> The fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. Thus, if the note is nonrecourse, any income from the sale of the property would be treated as a capital gain.

Issue 4

If the debt is recourse, the amount realized is the property's fair market value. The debtor also realizes debt discharge income to the extent the debt discharged exceeds the property's fair market value. See Treas. Reg. § 1.1001-2(a)(1), (a)(2), and (c) Example 8. However, the debtor can exclude the debt discharge from income if the debtor is insolvent. I.R.C. § 108(a)(1). Thus, if the note is recourse, any income from the sale of the property is potentially part capital gain and part discharge of indebtedness income.

Here, the fair market value of the property sold was $f. When the debt was discharged, the amount outstanding on the loan totaled $h. Allan v. Commissioner, 86 T.C. 655 (1986), aff'd 856 F.2d 1169 (8th Cir. 1988). If the note was recourse, S must recognize a capital gain of $f, the amount realized, less its basis in the assets sold of $m, or which equals $r. S would also recognize discharge of indebtedness income of $h, the total debt discharged, less $f, the fair market value of the property sold, or $i.

If S were solvent, S would recognize the full amount of discharge of indebtedness as ordinary income. However, if S were insolvent, I.R.C. § 108(a)(1)(B) would exclude the discharge of indebtedness income.

I.R.C. § 108(d)(3) provides:

> For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

Taking into account the discharged debt but not the contributed assets, S was insolvent. The question here is whether the assets that were contributed by P to S "simultaneously" with the debt discharge should be taken into account for purposes of determining solvency.

With respect to basis, I.R.C. § 108(b)(2)(E) requires basis to be reduced under the rules provided in section 1017. With respect to the timing of basis reduction, section 1017(a)(1) states that the reduction in basis of property is to be made in property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. However, in determining the amount of basis that can be reduced, section 1017(b)(2) provides that in such a case the reduction in basis shall not exceed the excess of the aggregate of the basis of the property held by the taxpayer "immediately after" the discharge, over the aggregate of the liabilities of the taxpayer "immediately after" the discharge.[6]

According to the legislative history, the attribute reduction provisions in I.R.C. §§ 108 and 1018 were intended to "give flexibility to the debtor to account for a debt discharge amount in a manner most favorable to the debtor's tax situation," while at the same time carrying out "the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge." S. Rep. No. 1035, 96th Cong., 2d Sess. 10-11 (1980), 1980-2 C.B. 620, 625.

We think that the contributed assets are not taken into account "immediately before" the discharge, for purposes of determining whether the taxpayer is insolvent, but are taken into account "immediately after" the discharge, for purposes of determining how much basis the taxpayer must reduce.

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[6] This limitation does not apply if the taxpayer elects first to reduce the basis of depreciable property under section 108(b)(5). This election was not made in this case.

Assets are routinely transferred to creditors in partial satisfaction of debt and, since the two actions are interdependent, such transfers generally occur in the "split instant" between "immediately before" and immediately after" the discharge. In this case, immediately before the discharge, S's assets included S's plants, or the proceeds from their sale; immediately after the discharge, those assets had been transferred away. While the legislative history may not specifically focus on this practice, Congress was clearly aware of it.

In this case, in addition to a transfer from the debtor, there was a transfer of assets to the debtor simultaneous with the discharge. While it could be argued that Congress anticipated the former, not the latter and that Congress only intended for transfers of assets to the creditor to be taken into account simultaneously with the discharge, it is difficult, if not impossible to reach such implicit limitations into the language of the relevant Code provisions. Accordingly, we would give the impacted Code provisions their literal meaning in this situation. Because S's liabilities "immediately before" the discharge exceeded its assets, it was insolvent.

Issue 5

Treas. Reg. § 1.1502-32

Treas. Reg. § 1.1502-32 provides rules for adjusting the basis of the stock of a subsidiary ("S") owned by another member ("P"). Treas. Reg. § 1.1502-32(a)(1).

Negative adjustments under Treas. Reg. § 1.1502-32 may exceed P's basis in S's stock. The resulting negative amount is P's excess loss account ("ELA") in S's stock. Treas. Reg. § 1.1502-32(a)(3)(ii).

Treas. Reg. § 1.1502-19

Treas. Reg. § 1.1502-19 provides rules for a member of a consolidated group ("P") to include in income its excess loss account in the stock of another member ("S"). The purpose of the excess loss account is to recapture in consolidated taxable income P's negative adjustments with respect to S's stock (e.g., under § 1.1502-32 from S's deductions, losses, and distributions), to the extent the negative adjustments exceed P's basis in the stock. Treas. Reg. § 1.1502-19(a)(1).

Treas. Reg. § 1.1502-19(b) provides:

> (b) **Excess loss account taken into account as income or gain**--(1) *General rule*. If P is treated under this section as disposing of a share of S's stock, P takes into account its excess loss account in the share as income or gain from the disposition. Except as provided in paragraph (b)(4) of this

section, the disposition is treated as a sale or exchange for purposes of determining the character of the income or gain.[7]

(2) *Nonrecognition or deferral*--(i) In general. * * *.

(ii) *Nonrecognition or deferral inapplicable*. If P's income or gain under paragraph (b)(1) of this section is from a disposition described in paragraph (c)(1)(ii) or (iii) of this section (relating to deconsolidations and worthlessness), the income or gain is taken into account notwithstanding any nonrecognition or deferral rules (even if the disposition is also described in paragraph (c)(1)(i) of this section). For example, if P transfers S's stock to a nonmember in a transaction to which section 351 applies, P's income or gain from the excess loss account is taken into account. [Emphasis added]

Treas. Reg. § 1.1502-19(c) provides in relevant part

(c) **Disposition of stock**. For purposes of this section:

(1) In general. P is treated as disposing of a share of S's stock.

* * * * *

(iii) Worthlessness. At the time–

(A) Substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes (e.g., under section 165(a) or § 1.1502-80(c), or, if S's asset is stock of a lower-tier member, the stock is treated as disposed of under this paragraph (c)). An asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration (other than relief from indebtedness); [Emphasis added]

(B) An indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under § 1.1502-32(b)(3)(ii)(C); or

(C) A member takes into account a deduction or loss for the uncollectibility of an indebtedness of S, and the deduction or loss is not matched in the same

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[7] Treas. Reg. § 1.1502-19(b)(4) provides that gain under this section is treated as ordinary income to the extent of the amount by which S is insolvent (within the meaning of section 108(d)(3)) immediately before the disposition. For this purpose S's liabilities include any amount to which preferred stock would be entitled if S were liquidated immediately before the disposition, and any former liabilities that were discharged to the extent the discharge was treated as tax-exempt income under § 1.1502-32(b)(3(ii)(C) (special rule for discharges).

tax year by S's taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.

Treas. Reg. § 1.1502-32(b)(3)(ii)(C) provides in relevant part

(C) *Discharge of indebtedness income*--(1) *In general*. Discharge of indebtedness income of S that is excluded from gross income under section 108 is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes (e.g., under section 108 or 1017). Discharge of S's indebtedness is treated as applied to reduce tax attributes only to the extent the attribute reduction is taken into account as a reduction under paragraph (b)(3)(iii) of this section.

Treas. Reg. § 1.1502-32(b)(3)(iii) provides in relevant part:

(iii) Noncapital, nondeductible expenses--(A) *In general*. S's noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss, and that decrease, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses. Similarly, if a loss carryover (e.g., under section 172 or 1212) attributable to S expires or is reduced under section 108(b), it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried. However, if S sells and repurchases a security subject to section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustments under section 1091(d) prevent the disallowance from being permanent.

(B) *Nondeductible basis recovery*. Any other decrease in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) may be a noncapital, nondeductible expense to the extent that the decrease is not otherwise taken into account in determining stock basis and is permanently eliminated for purposes of determining S's taxable income or loss. Whether a decrease is so treated is determined by taking into account both the purposes of the Code or regulatory provision resulting in the decrease and the purposes of this section. For example, S's noncapital, nondeductible expenses include any basis reduction under section 50(c)(1), section 1017, section 1059, § 1.1502-20(b), or § 1.1502-20(g). * * *. [Emphasis added]

Treas. Reg. § 1.1502-19(e), the anti-avoidance rule, provides that if any person acts with a principal purpose contrary to the purposes of the section, to avoid the effect of the rules of the section or apply the rules of the section to avoid the effect

of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of the section.

Examples illustrating the principles of Treas. Reg. § 1.1502-19 are provided for in paragraph (g) of the section. Examples 5 and 6 of Treas. Reg. § 1.1502-19(g), pertaining to worthlessness, provide:

> (g) *Examples*. For purposes of the examples in this section, unless otherwise stated, P owns all 100 shares of the only class of S's stock and S owns all 100 shares of the only class of T's stock, the stock is owned for the entire year, T owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this section are illustrated by the following examples.
>
> *Example 5*. *Worthlessness*. (a) *Facts*. P forms S with a $150 contribution, and S borrows $150. For Year 1, S has a $50 ordinary loss that is carried over as part of the group's consolidated net operating loss. For Year 2, P has $160 of ordinary income, and S has a $160 ordinary loss. Under § 1.1502-32(b), S's loss results in P having a $10 excess loss account in S's stock. During Year 3, the value of S's assets (without taking S's liabilities into account) continues to decline and S's stock becomes worthless within the meaning of section 165(g) (without taking into account § 1.1502-80(c)). For Year 4, S has $10 of ordinary income.
>
> (b) *Analysis*. Under paragraph (c)(1)(iii)(A) of this section, P is not treated as disposing of S's stock in Year 3 solely because S's stock becomes worthless within the meaning of section 165(g) (taking S's liabilities into account). In addition, because S's stock is not treated as worthless, section 382(g)(4)(D) does not prevent the Year 1 consolidated net operating loss carryover from offsetting S's $10 of income in Year 4.
>
> (c) *Discharge of indebtedness*. The facts are the same as in paragraph (a) of this Example 5, except that, instead of S's stock becoming worthless within the meaning of section 165(g), S's creditor discharges $40 of S's indebtedness during Year 3, S is insolvent by more than $40 before the discharge, the discharge is excluded from the P group's gross income under section 108(a), and $40 of the $50 consolidated net operating loss carryover attributable to S is eliminated under section 108(b). Under § 1.1502-32(b)(3)(ii)(C), S's $40 of discharge income is treated as tax-exempt income because there is a corresponding decrease under § 1.1502-32(b)(3)(iii) for elimination of the loss carryover. Under paragraph (c)(1)(iii)(B) of this section, P is treated as disposing of S's stock if the amount discharged is not included in gross income and is not treated as

tax-exempt income under § 1.1502-32(b)(3)(ii)(C). Because the discharge is treated as tax-exempt income, P is not treated as disposing of S's stock by reason of the discharge.

Example 6. *Avoiding worthlessness*. (a) *Facts*. P forms S with a $100 contribution and S borrows $150. For Years 1 through 5, S has a $210 ordinary loss that is absorbed by the group. Under § 1.1502-32(b), S's loss results in P having a $110 excess loss account in S's stock. S defaults on the indebtedness, but the creditor does not discharge the debt (or initiate collection procedures). At the beginning of Year 6, S ceases any substantial operations with respect to the assets, but maintains their ownership with a principal purpose to avoid P's taking into account its excess loss account in S's stock.

(b) *Analysis*. Under paragraph (c)(1)(iii)(A) of this section, P's excess loss account on each of its shares of S's stock ordinarily is taken into account at the time substantially all of S's assets are treated as disposed of, abandoned, or destroyed for Federal income tax purposes. Under paragraph (e) of this section, however, S's assets are not taken into account at the beginning of Year 6 for purposes of applying paragraph (c)(1)(iii)(A) of this section. Consequently, S is treated as worthless at the beginning of Year 6, and P's $110 excess loss account is taken into account.

II Analysis.

The first two of the three tests for worthlessness under Treas. Reg. § 1.1502-19(c)(1)(iii) are implicated in the instant case. The third test, under Treas. Reg. § 1.1502-19(c)(1)(iii)(C), is not implicated because a nonmember issued and held the debt.

Overview

The facts indicate that the debt was forgiven well before the contribution of assets, and, therefore, the test for worthlessness under Treas. Reg. § 1.1502-19(c)(1)(iii)(B) has been satisfied outright. Even assuming otherwise, the anti-avoidance rule of Treas. Reg. § 1.1502-19(e) may be asserted in the alternative under the theory that the principal purpose for the contributions of property by P was to avoid having to take the ELA into income due to worthlessness under Treas. Reg. § 1.1502-19(c)(1)(iii)(B) and, therefore, the contributions are not taken into account for purposes of applying that section.

As another alternative, Treas. Reg. § 1.1502-19(c)(1)(iii)(A) may also be implicated under the theory that all of S's assets were disposed of, in substance, in exchange for relief from indebtedness. This test is complicated somewhat by the contribution of assets and the subsequent operation of the entity. However, the anti-avoidance

rule may likewise be asserted under the theory that the principal purpose for the contributions of property by P was to avoid having to take the ELA into income due to worthlessness under Treas. Reg. § 1.1502-19(c)(1)(iii)(A).

Finally, for purposes of applying the anti-avoidance rule of Treas. Reg. § 1.1502-19(e) in this case (under either of the above alternatives), S should not be required to reduce basis in the contributed property under sections 108 or 1017.

Application of Treas. Reg. § 1.1502-19(c)(1)(iii)(B) and the Anti-avoidance Rule

Under the test provided by Treas. Reg. § 1.1502-19(c)(1)(iii)(B), stock of a member is deemed worthless if an indebtedness of the member is discharged, and (1) any part of the amount discharged is not included in gross income (e.g., pursuant to section 108(a)(1)(B)) and (2) is not treated as tax-exempt income under Treas. Reg. § 1.1502-32(b)(3)(ii)(C) (i.e., is not applied to reduce tax attributes of the member).

Discharge of indebtedness income of a member that is excluded from gross income under section 108 is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes (e.g., under section 108 or 1017). Treas. Reg. § 1.1502-32(b)(3)(ii)(C)(1). Discharge of a member's indebtedness is treated as applied to reduce tax attributes only to the extent the attribute reduction is taken into account as a reduction under Treas. Reg. § 1.1502-32(b)(3)(iii). Id. Pursuant to Treas. Reg. § 1.1502-32(b)(3)(iii)(B), S's noncapital, nondeductible expenses include any basis reduction under section 1017.

With respect to the first prong of the test, the taxpayer excluded the total amount discharged from gross income pursuant to section 108(a)(1)(B). Therefore, the first prong of the test for worthlessness under Treas. Reg. § 1.1502-19(c)(1)(iii)(B) is satisfied.

With respect to the second prong of the test, the taxpayer applied the total amount discharged to reduce tax attributes of S. Specifically, pursuant to sections 108(b)(2)(E) and 1017, S reduced its basis in the nondepreciable and depreciable property contributed by P prior to the end of the taxable fiscal year in which the debt was discharged. However, we believe the facts support a finding that part, if not all, of the amount discharged and not included in gross income should not have been applied to reduce basis in the real and depreciable property contributed, as follows.

(1) Because the taxpayer excluded its discharge of indebtedness income pursuant to section 108(a)(1)(B), and did not make an election under section 108(b)(5), the limitation under section 1017(b)(2) applies to the depreciable as well as nondepreciable property contributed in this case. Consequently, the reduction in basis under section 1017(a) cannot exceed the excess of the

aggregate of the bases of the property held by the taxpayer immediately after the discharge, over the aggregate of the liabilities of the taxpayer immediately after the discharge.

(2) Arguably the discharge was effected as early as Date 1 (the date of the AR agreement), if not sooner, and no later than Date 2 (the date of the Purchase Agreement). Both of these dates are more than one month before the contribution of the real and depreciable property by P (no earlier than Date 3). Therefore, S did not hold the nondepreciable and depreciable property contributed by P immediately after the discharge, and such property is not included in calculating the section 1017(b)(2) limitation.

(3) The facts presented to us indicate that the aggregate basis in all of the property held by S immediately after the discharge (which occurred, in substance, no later than Date 2) was much less than its aggregate liabilities immediately after the discharge.[8] Therefore the amount of the section 1017(b)(2) limitation is zero.

(4) Without the bases in the contributed property, S had insufficient tax attributes to offset all, if any, of the COD income excluded from gross income.[9] Any discharged amount that does not result in a corresponding tax attribute reduction does not result in a noncapital, nondeductible expense and, therefore, is not treated as tax-exempt income.

Consequently, both prongs of the test for worthlessness under Treas. Reg. § 1.1502-19(c)(1)(iii)(B) are satisfied, and P will have to include in income its ELA in the S stock. Treas. Reg. § 1.1502-19(b)(1).

Even assuming the discharge occurred immediately before (or simultaneously with) the contribution of the real and depreciable property, the anti-avoidance rule of Treas. Reg. § 1.1502-19(e) may be asserted in the alternative as grounds for

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[8] S's adjusted basis in the Projects equaled $m as of Date 4. B discharged all but $f of the indebtedness. It is our understanding that S had no basis in property other than that in the Projects (or at least an insufficient amount such that the aggregate did not exceed $f). Consequently, immediately after the discharge, which occurred no later than Date 2, S's tax attributes available for offset totaled no more than $m, while its liabilities totaled no less than $f. If this is incorrect, we ask that this issue be submitted for reconsideration.

[9] We are assuming that in any event S's total basis in the Projects and any other assets (excluding the contributed property) was much less than the amount of COD income excluded under section 108(a).

applying Treas. Reg. §§ 1.1502-19(b) and (c)(1)(iii)(B), and requiring P to include in income its ELA in the S stock.

The application of 108(a) is not contingent upon having tax attributes to reduce under section 108(b). This raises a strong inference that the only reason P forfeited the bases in the contributed property was to avoid triggering its ELA in the S common stock under Treas. Reg. §§ 1.1502-19(b) and (c)(1)(iii)(B). Therefore, pursuant to Treas. Reg. § 1.1502-19(e), the "simultaneous" contribution of property is not taken into account for purposes of applying Treas. Reg. §§ 1.1502-19(b) and (c)(1)(iii)(B). S would thus have no tax attributes (as previously discussed) to reduce and P would be required to include in income its ELA in the S stock.

Application of Treas. Reg. § 1.1502-19(c)(1)(iii)(A) and the Anti-avoidance Rule

As another alternative, it can be argued that the worthlessness test under Treas. Reg. § 1.1502-19(c)(1)(iii)(A) is satisfied under the theory that all of S's assets were disposed of, in substance, in exchange for relief from indebtedness.

Pursuant to Treas. Reg. § 1.1502-19(c)(1)(iii)(A), an asset of S is not considered to be disposed of or abandoned to the extent the disposition is in complete liquidation of S or is in exchange for consideration (other than relief from indebtedness). Therefore, an asset of S is considered disposed of or abandoned to the extent the disposition is in exchange for relief from indebtedness.

It is clear from the AR agreement and the Purchase Agreement that B forgave the indebtedness in excess of the fair market value of the Projects to facilitate their sale, and realize the proceeds, in lieu of foreclosing on the Projects and selling them itself. Indeed, section 3.1 of the Purchase Agreement required the buyer of the Projects to pay the purchase price by wire transfer directly to B on behalf of S. Clearly the disposition of the Projects and related assets was in exchange for relief from indebtedness.

Of course, the contribution of real property provided S with additional assets that were not disposed of during the taxable year. However, the anti-avoidance rule is clearly implicated. P formed S with the intention of having it construct hydroelectric plants that would convert rainfall into electricity, which S was planning to sell to electric utility companies. Representatives of P have stated that they transferred the real property to S for the purpose of *converting* S into P's real property holdings entity (as opposed to furthering S's business of constructing hydroelectric plants and selling electricity to utility companies).

Absent the contribution of the real property, S would be deemed worthless under Treas. Reg. § 1.1502-19(c)(1)(iii)(A). Because the contributed property was wholly unrelated to the business S was created to pursue, and in which it generated only

losses and became insolvent, there is a strong inference that the principal purpose for contributing the property to S was to avoid being deemed worthless under Treas. Reg. § 1.1502-19(c)(1)(iii)(A), and having to include in income the ELA. Accordingly, under Treas. Reg. § 1.1502-19(e), the "simultaneous" contribution of property would not be taken into account for purposes of applying Treas. Reg. §§ 1.1502-19(b) and (c)(1)(iii)(A). S would thus have disposed of substantially all of its assets, and P would be required to include in income its ELA in the S stock.

Application of the Anti-avoidance Rule Precludes Attribute Reduction

In the context of applying Treas. Reg. § 1.1502-19(e), S should not be required to reduce basis in the contributed property under sections 108 or 1017.

Treas. Reg. § 1.1502-80(a) provides in general that the Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application. Here, in applying Treas. Reg. § 1.1502-19(e), the "simultaneous" contribution of property is not to be taken into account for purposes of applying Treas. Reg. §§ 1.1502-19(b) and either (c)(1)(iii)(A) or (c)(1)(iii)(B). In so doing, Treas. Reg. § 1.1502-19(e) precludes the reduction of basis under sections 108 and 1017.

Accordingly, pursuant to Treas. Reg. § 1.1502-80(a), for purposes of applying Treas. Reg. § 1.1502-19(e) in this case, S should not be required to reduce basis in the contributed property under sections 108 or 1017.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

1. Our response on Issue 2 takes that position that the loan is nonrecourse. Accordingly, the entire transaction is taxed as a gain under I.R.C. § 61(a)(3) and no part of the taxpayer's income is from discharge of indebtedness. As a result, no amount is includible on account of the taxpayer's insolvency under section 108(a)(1)(B). This conclusion is driven as much by the parties' characterization of the loan as "limited recourse" as by any specific term of the agreement. [redacted]

[redacted]

2. P maintains that the real property P contributed to S had a fair market value of $j. [redacted]

3. P reported a sales price of $n. [redacted]

4. S sold the assets to the third party for $f. [redacted]

5. Our analysis touches on the question whether accrued but unpaid interest is considered to be part of the amount realized for purposes of determining gain or loss and cites Allan,86 T.C. 655 (1986), aff'd 856 F.2d 1169 (8th Cir. 1988), on this point. [redacted]

6. Because the contributed property was wholly unrelated to the business S was created to pursue, and in which it generated only losses and became insolvent, there is a strong inference that the principal purpose for contributing the property to S was to avoid being deemed worthless under Treas. Reg. § 1.1502-19(c)(1)(iii)(A), and having to include in income the ELA. Should the taxpayer raise a plausible reason otherwise, we are available to discuss it further.

Please call if you have any further questions.

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