Debt Pushdowns in Overlapping Transactions: Part II

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Part I of this article provided a primer on Code Sec. 304 and overlapping Code Sec. 304/351 transactions. In general, when Acquirer assumes debt in an overlapping Code Sec. 304/351 transaction, Code Sec. 304 takes precedence unless the debt is acquisition debt. This Part II explores the justification for the acquisition debt exception.

As an example of the potentially harsh consequences of pushdowns of acquisition debt, consider *R.A. Maher,* 55 TC 441, Dec. 30,458 (1970).

In *Maher*, the taxpayer acquired all outstanding stock of four different corporations in exchange for cash and debt. In the same year as the acquisition, the taxpayer contributed all the stock of one of the corporations to another of the newly acquired corporations, which also assumed the acquisition debt. In Tax Court, the taxpayer did not argue in favor of Code Sec. 351 treatment, perhaps because the amount of debt assumed was greater than his basis in the contributed stock, which would have led to gain under Code Sec. 357(c).

Whatever the reason for not arguing in favor of Code Sec. 351 treatment, the taxpayer argued instead that the transaction should be treated as a sale or exchange, with the purchase price equal to basis, resulting in no gain or loss. The Tax Court sided with the IRS, holding that the assumption of the debt was a Code Sec. 304 deemed dividend.

On appeal, the Eighth Circuit mitigated this harsh result by holding that the taxpayer would only have Code Sec. 304 deemed dividend income as payments were actually made by the acquiring corporation on the debt. [*Maher,* CA-8, 72-2 USTC ¶9728, 469 F2d 225 (1972).] In limiting deemed dividend income to the amount actually paid on the notes, the Eighth Circuit applied a *Plantation Patterns* type of analysis. Because the taxpayer remained secondarily liable on the debt even after it was assumed by the acquirer, he only received a benefit as the debt was actually paid off.

One way of viewing the justification for the acquisition debt exception is that the shareholder-transferor has not actually realized any income. To be sure, the pushdown of debt relieves the shareholder of a liability. Yet the debt was only incurred to acquire the Target, and the shareholder continues to indirectly own the Target as well as to be indirectly liable for the acquisition debt. Because the shareholder continues to have economic exposure to both the Target and the debt incurred to acquire the Target, the debt pushdown has not resulted in income or any disposition of property.

In contrast, a taxpayer that borrows against appreciated stock and then causes a controlled corporation to assume the debt might be more properly viewed as having realized income.

Overlap with D Reorganizations

In addition to a Code Sec. 351/304 overlap, Code Sec. 304 can also overlap with a D reorganization.

Example 4. Shareholder P owns all T stock with basis of $70 and fair market value of $100. T has E&P of $5. P also owns all A stock with basis of $20. A has $50 in E&P. P borrows $90 and pledges T stock as collateral. P transfers T stock to A and A assumes P's $90 liability. Pursuant to a prearranged plan, T liquidates into A.

In this case, should the transaction be treated as an exchange of T stock for the $90 debt assumption that is subject to Code Sec. 304(b)(3)(A), followed by a tax-free liquidation of T into A? Or should the transaction be treated as an integrated D reorganization?

In Rev. Rul. 2004-83, 2004-2 CB 157, the IRS decided that D reorganizations trump Code Sec. 304. In that ruling, Parent sold Target stock to Acquirer for cash, and Target then liquidated into Acquirer. In holding that the transaction should be treated as a D reorganization, the IRS explained that there is no policy reason requiring Code Sec. 304 to take priority over Code Sec. 368(a)(1)(D). Based on this reasoning, Example 4 should be treated as a D reorganization.

If Code Sec. 368 trumps Code Sec. 304, and Code Sec. 304 trumps Code Sec. 351, does that mean that Code Sec. 368 prevails over Code Sec. 351? In Rev. Rul. 2007-8, 2007-1 CB 469, the IRS explained that Code Sec. 357(c)(1) would not apply to a Target's transfer of assets to Acquirer in a transaction that qualified as a D reorganization, even though it also qualified as a Code Sec. 351 transaction. Therefore, it appears that D reorganization treatment prevails.

Returning to Example 4, as a D reorganization, the liability assumption should arguably be treated as boot. However, the treatment of the debt pushdown as boot is subject to challenge—the IRS could argue that it should be treated as a distribution from A. For example, in *H.C. Lang*, 43 TCM 874, Dec. 38,880(M), TC Memo. 1982-149 (1982), the Tax Court held that the assumption of shareholder acquisition debt in a D reorganization should be treated as a distribution.

The court in *Lang* explained that, even though the shareholder incurred the debt to acquire Target stock, the shareholder's debt did not have any connection to the Target's assets. Therefore, the assumption of the acquisition debt by the Acquirer resulted in a personal benefit to the shareholders and should be treated as a distribution. Despite the adverse result in *Lang*, the better view is arguably that the debt pushdown in Example 4 should be viewed as boot. This would lead to a better result than a Code Sec. 304 dividend because of the "boot within gain" limitation of Code Sec. 356(a), but it is not as generous as Code Sec. 357. Instead of the $55 dividend in Example 2, P would have a $30 dividend and a $60 return of basis.

Allocating Acquisition Debt

In LTR 201047023 (Aug. 6, 2010), the IRS considers yet another question raised by the Code Sec. 304(b)(3)(B) acquisition debt exception. What happens when acquisition-related debt is assumed, but at the same time, the Acquirer also acquires stock of other controlled corporations?

In a Code Sec. 351/304 overlap, if a transferor is transferring multiple assets, including stock of controlled corporations, and the acquiring corporation is assuming liabilities of the transferor as part of the consideration, the assumed liabilities will only be subject to Code Sec. 304 to the extent they are allocated to stock of the controlled corporations. How should assumed liabilities be allocated? Consider the facts in Example 5, which is based on the transaction in LTR 201047023.

Example 5. Shareholder P owns 100 percent of the stock of T with basis of $100 and fair market value of $50. P has debt of $90 that relates to the acquisition of T stock. P also owns 100 percent of the stock of Y with basis of $10 and fair market value of $100. P transfers all its stock of T and Y to Newco in exchange for Newco stock and Newco's assumption of the $90 of acquisition debt.

In Example 5, does the entire amount of acquisition debt qualify for the acquisition debt exception? Or is the debt allocated to all of the transferred assets on a *pro rata* basis? Does it make any difference that the value of the acquired stock has fallen below the amount of the acquisition debt? LTR 201047023 addresses the proper method of allocating the $90 of debt:

1) Under the Asset-by-Asset Method, the debt would be allocated *pro rata* to all assets based on their relative fair market value: 1/3 to T and 2/3 to Y.
2) Under the Aggregate Method, debt is acquired tax-free to the extent it is "acquisition debt" and does not exceed the transferor's aggregate basis in the transferred property.

Under the Asset-by-Asset method, only $30 would qualify for the acquisition debt exception, because only $30 would be allocated to the acquired stock. Under the Aggregate Method, the entire $90 of debt would qualify for the Code Sec. 304(b)(3)(B) exception. The $90 of debt represents "acquisition debt" that is being contributed along with the stock that was acquired, and therefore, under Code Sec. 357, the assumption of the $90 is tax-free because P's aggregate basis of $100 in the T stock is greater than the $90 of assumed liabilities.

If, pursuant to a plan, T and Y were to liquidate immediately after being contributed to N, Example 5 would likely be treated as a D reorganization. In that case, D reorganization treatment would prevail over Code Sec. 304, and the $90 debt pushdown would be treated as boot (or as a distribution if the IRS were to follow *Lang*).

The Asset-by-Asset Method

One way to address the choice of allocation method would be to treat the acquisition debt by analogy to boot in a Code Sec. 351 transaction. Under Code Sec. 351(b), when a transferor receives boot, the transferor recognizes gain, but not losses, but only to the extent of the value of the boot received. (This is the Code Sec. 351 version of the "boot within gain" rule.)

As discussed above, there are two principal methods of calculating the amount of gain to be recognized. The first method is the aggregate method, where the amount of gain realized is calculated on an aggregate basis and compared to the value of the boot consideration received. The second method consists of allocating the consideration to each asset received, and then calculating the amount of gain to be recognized asset-by-asset.

Under Rev. Rul. 68-55, the IRS explained that it viewed the asset-by-asset method to be proper. The aggregate method would permit the transferor to offset gain against losses, contrary to the rule preventing taxpayers from recognizing a loss under Code Sec. 351(b)(2). [Rev. Rul. 68-55, 1968-1 CB 140.] Boot consideration must be allocated to each asset transferred to a corporation in proportion to fair market value.

Similarly, Rev. Rul. 85-164 held that the basis and holding period of stock and securities that a transferor received tax-free in a Code Sec. 351 transaction should be determined based on a *pro rata* allocation of the basis and holding period of the transferred assets. [Rev. Rul. 85-164, 1985-2 CB 117.]

In proposed regulations issued in 2009, the IRS adopted the asset-by-asset approach of Rev. Rul. 68-55. [REG-143686-07 (Jan. 21, 2009); Proposed Reg. §1.351-2(b).] Under Proposed Reg. §1.351-2(b), for purposes of determining the amount of gain recognized under Code Sec. 351(b), "each category of consideration" should be allocated to the transferred assets based on their relative fair market value. In the context of distributions, the IRS also favors a *pro rata* allocation.

For example, the Fourth Circuit sided with the IRS in holding that, for purposes of the basis recovery rules under Code Sec. 301(c)(3), the amount of a distribution should be allocated *pro rata* to all shares. [*W.T. Johnson*, CA-4, 71-1 USTC ¶9148, 435 F2d 1257 (1971).] The Fourth Circuit rejected the taxpayer's argument that aggregate basis should be recovered, holding instead that the distribution should be allocated to individual shares *pro rata.*

The IRS has adopted a slightly different allocation method in the context of reorganizations. Under the "tracing" approach for reorganizations, taxpayers have flexibility to allocate boot according to the terms of the exchange as long as the terms are "economically reasonable." [*See* Reg. §1.358-2(a)(2)(ii).]

Even if the IRS decided to borrow the more flexible allocation rules for boot in reorganizations, instead of the general rule of *pro rata* allocation under Code Sec. 351, it would not make any difference in Example 5. The allocation of all of the acquisition debt to the T stock cannot be said to be "economically reasonable."

Considered from the economic point of view, the acquiring corporation is not assuming the $90 of acquisition debt in consideration for the T stock. Under the facts of LTR 201047023, on the date of the debt pushdown, the amount of the acquisition debt exceeded the fair market value of the stock that had been acquired. If a purely economic interpretation of the allocation rule prevailed, and the IRS looked to allocate the acquisition debt by analogy to boot, the IRS would not rule that the entire amount of acquisition debt qualified for the exception. Based on the analogy to boot, the Asset-by-Asset Method should arguably prevail, and only $30 of the acquisition debt would qualify for the exception.

Aggregate Method

In LTR 201047023, the IRS adopted the Aggregate Method. The IRS apparently believed that the acquisition debt exception should apply *before* acquisition debt is allocated to any assets.

In deciding in favor of the Aggregate Method, the IRS may have considered the policy justification behind the acquisition debt exception. After all, the transferor could have structured the transaction differently. The acquiring company could have directly borrowed and acquired Target stock without generating any deemed dividend income.

Another justification? A deemed Code Sec. 304 dividend is not appropriate in a pushdown of acquisition debt because the transferor does not realize any income. This policy justification should be even stronger when the transferor is transferring stock that has depreciated in value, as appeared to be the case in LTR 201047023.

Under either rationale, there is no reason to limit the acquisition debt exception in Example 5. There is nothing to suggest that Congress intended the Code Sec. 304(b)(3)(B) exception to be unavailable merely because the value of the acquired stock has fallen below the amount of the acquisition debt due to fluctuations in market price between the time of acquisition and the time of the Code Sec. 351 transaction. The acquisition debt exception should not be turned off just because the acquiring corporation is receiving stock of other controlled corporations at the same time that it is assuming the acquisition debt.

In LTR 201047023, the IRS ruled in favor of the aggregate approach to liabilities. The application of the aggregate approach led to a very different result than the asset-by-asset approach for the allocation of boot in reorganizations and Code Sec. 351 transactions. The aggregate approach to dealing with debt pushdowns in a Code Sec. 351 transaction is far more favorable to taxpayers than when debt pushdowns are treated as deemed dividends or boot in a reorganization.

The IRS seems to have acknowledged that this favorable treatment should be extended to acquisition debt in a Code Sec. 351/304 overlap transaction, even when the acquisition debt cannot, as an economic matter, be allocated to the acquired stock.

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